

IMPAC MORTGAGE HOLDINGS INC

Form 10-Q

November 09, 2006

## **UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

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Washington, D.C. 20549

## **FORM 10-Q**

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

For the quarterly period ended September 30, 2006 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: 1-14100

## **IMPAC MORTGAGE HOLDINGS, INC.**

(Exact name of registrant as specified in its charter)

**Maryland**

(State or other jurisdiction of  
incorporation or organization)

**33-0675505**

(I.R.S. Employer  
Identification No.)

**19500 Jamboree Road, Irvine, CA 92612**

(Address of principal executive offices)

**(949) 475-3600**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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.

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

There were 76,143,144 shares of common stock outstanding as of November 6, 2006.

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**IMPAC MORTGAGE HOLDINGS, INC.**

**FORM 10-Q QUARTERLY REPORT**

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**PART I. FINANCIAL INFORMATION****ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS****IMPAC MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(dollar amounts in thousands, except share data)**

|  | <b>September 30,<br/>2006<br/>(Unaudited)</b> | <b>December 31,<br/>2005</b> |
|--|---|------------------------------|
| <b>ASSETS</b>  |   |                              |
| Cash and cash equivalents  | \$ 161,901                                    | \$ 146,621                   |
| Restricted cash  | 498   | 698                          |
| Securitized mortgage collateral  | 20,232,463                                    | 24,494,290                   |
| Finance receivables  | 297,657                                       | 350,217                      |
| Mortgages held-for-investment  | 3,134   | 160,070                      |
| Allowance for loan losses  | (65,715)                                      | (78,514)                     |
| Mortgages held-for-sale  | 1,293,085                                     | 2,052,694                    |
| Accrued interest receivable  | 103,807                                       | 123,565                      |
| Derivatives  | 176,797                                       | 250,368                      |
| Other assets   | 286,757                                       | 220,370                      |
| Total assets   | \$ 22,490,384                                 | \$ 27,720,379                |
| <b>LIABILITIES</b>   |   |                              |
| Securitized mortgage borrowings  | \$ 19,697,798                                 | \$ 23,990,430                |
| Reverse repurchase agreements  | 1,542,441                                     | 2,430,075                    |
| Trust preferred securities   | 97,448  | 96,750                       |
| Other liabilities  | 85,036  | 36,177                       |
| Total liabilities  | 21,422,723                                    | 26,553,432                   |
| Commitments and contingencies  |   |                              |
| <b>STOCKHOLDERS EQUITY</b>   |   |                              |
| Series-A junior participating preferred stock, \$0.01 par value; 2,500,000 shares authorized; none issued and outstanding as of September 30, 2006 and December 31, 2005, respectively   |   |                              |
| Series-B 9.375% cumulative redeemable preferred stock, \$0.01 par value; liquidation value \$50,000; 2,000,000 shares authorized, 2,000,000 shares issued and outstanding as of September 30, 2006 and December 31, 2005, respectively                       | 20  | 20                           |
| Series-C 9.125% cumulative redeemable preferred stock, \$0.01 par value; liquidation value \$109,280; 5,500,000 shares authorized; 4,383,900 shares and 4,371,200 shares issued and outstanding as of September 30, 2006 and December 31, 2005, respectively | 44  | 44                           |
| Common stock, \$0.01 par value; 200,000,000 shares authorized; 76,083,865 and 76,112,963 shares issued and outstanding as of September 30, 2006 and December 31, 2005, respectively  | 761   | 761                          |
| Additional paid-in capital   | 1,168,729                                     | 1,167,059                    |
| Accumulated other comprehensive (loss) income  | (567)   | 1,305                        |
| Net accumulated deficit:   |   |                              |
| Cumulative dividends declared  | (758,689)                                     | (675,373)                    |
| Retained earnings  | 657,363                                       | 673,131                      |
| Net accumulated deficit  | (101,326)                                     | (2,242)                      |
| Total stockholders equity  | 1,067,661                                     | 1,166,947                    |

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|  |    |            |    |            |
|--|----|------------|----|------------|
| Total liabilities and stockholders' equity | \$ | 22,490,384 | \$ | 27,720,379 |
|--|----|------------|----|------------|

See accompanying notes to consolidated financial statements.

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## IMPAC MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS  
AND COMPREHENSIVE EARNINGS (LOSS)

(in thousands, except per share data)

(unaudited)

|   | For the Three Months<br>Ended September 30, |            | For the Nine Months<br>Ended September 30, |            |
|---|---|------------|--|------------|
|   | 2006  | 2005       | 2006                                       | 2005       |
| <b>INTEREST INCOME:</b>                                       |   |            |  |            |
| Mortgage assets   | \$ 298,139                                  | \$ 322,705 | \$ 942,778                                 | \$ 907,065 |
| Other   | 2,127                                       | 1,345      | 6,451                                      | 4,149      |
| Total interest income   | 300,266                                     | 324,050    | 949,229                                    | 911,214    |
| <b>INTEREST EXPENSE:</b>                                      |   |            |  |            |
| Securitized mortgage borrowings                               | 289,925                                     | 243,945    | 888,144                                    | 639,667    |
| Reverse repurchase agreements                                 | 32,552                                      | 35,448     | 81,881                                     | 78,192     |
| Other borrowings  | 2,299                                       | 1,761      | 6,986                                      | 3,200      |
| Total interest expense  | 324,776                                     | 281,154    | 977,011                                    | 721,059    |
| Net interest (expense) income                                 | (24,510 )                                   | 42,896     | (27,782 )                                  | 190,155    |
| Provision for loan losses                                     | 3,183                                       | 13,434     | 3,288                                      | 25,219     |
| Net interest (expense) income after provision for loan losses | (27,693 )                                   | 29,462     | (31,070 )                                  | 164,936    |
| <b>NON-INTEREST INCOME:</b>                                   |   |            |  |            |
| Realized gain (loss) from derivative instruments              | 60,630                                      | 10,975     | 156,633                                    | (4,209 )   |
| Change in fair value of derivative instruments                | (155,534 )                                  | 107,881    | (92,602 )                                  | 141,521    |
| Gain on sale of loans   | 4,906                                       | 12,118     | 35,647                                     | 44,063     |
| Recovery of (provision for) repurchases                       | 15,876                                      | (3,242 )   | (7,233 )                                   | (8,606 )   |
| Loss on lower of cost or market writedown                     |   |            | (15,284 )                                  |            |
| Other income  | 8,724                                       | 1,280      | 27,128                                     | 8,664      |
| Total non-interest (loss) income                              | (65,398 )                                   | 129,012    | 104,289                                    | 181,433    |
| <b>NON-INTEREST EXPENSE:</b>                                  |   |            |  |            |
| Personnel expense   | 16,643                                      | 19,592     | 51,973                                     | 59,282     |
| General and administrative and other expense                  | 4,591                                       | 7,111      | 14,190                                     | 18,584     |
| Amortization of deferred charge                               | 4,861                                       | 6,908      | 15,872                                     | 19,503     |
| Professional services   | 1,692                                       | 1,730      | 6,201                                      | 7,170      |
| Equipment expense   | 1,543                                       | 1,414      | 4,862                                      | 3,797      |
| Occupancy expense   | 1,248                                       | 1,284      | 3,860                                      | 3,599      |
| Data processing expense                                       | 1,709                                       | 1,296      | 3,819                                      | 3,075      |
| Amortization and impairment of mortgage servicing rights      | 380   | 551        | 1,112                                      | 1,577      |
| Gain on sale of other real estate owned                       | (302 )                                      | (432 )     | (1,277 )                                   | (1,261 )   |
| Total non-interest expense                                    | 32,365                                      | 39,454     | 100,612                                    | 115,326    |
| Net (loss) earnings before income taxes                       | (125,456 )                                  | 119,020    | (27,393 )                                  | 231,043    |
| Income tax expense (benefit)                                  | 2,234                                       | (7,337 )   | (11,625 )                                  | (13,924 )  |
| Net (loss) earnings   | (127,690 )                                  | 126,357    | (15,768 )                                  | 244,967    |
| Cash dividends on cumulative redeemable preferred stock       | (3,672 )                                    | (3,624 )   | (11,016 )                                  | (10,872 )  |
| Net (loss) earnings available to common stockholders          | \$ (131,362 )                               | \$ 122,733 | \$ (26,784 )                               | \$ 234,095 |



See accompanying notes to consolidated financial statements

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|  | For the Three Months<br>Ended September 30, |            | For the Nine Months<br>Ended September 30, |            |
|--|---|------------|--|------------|
|  | 2006  | 2005       | 2006                                       | 2005       |
| Net (loss) earnings                                | \$ (127,690 )                               | \$ 126,357 | \$ (15,768 )                               | \$ 244,967 |
| Net unrealized (losses) gains on securities:       |   |            |  |            |
| Unrealized holding losses arising during period    | (237 )                                      | (803 )     | (2,015 )                                   | (363 )     |
| Reclassification of gains included in net earnings |   |            | 143  |            |
| Net unrealized losses                              | (237 )                                      | (803 )     | (1,872 )                                   | (363 )     |
| Comprehensive (loss) earnings                      | \$ (127,927 )                               | \$ 125,554 | \$ (17,640 )                               | \$ 244,604 |
| Net (loss) earnings per share:                     |   |            |  |            |
| Basic  | \$ (1.73 )                                  | \$ 1.62    | \$ (0.35 )                                 | \$ 3.10    |
| Diluted  | \$ (1.73 )                                  | \$ 1.61    | \$ (0.35 )                                 | \$ 3.07    |
| Dividends declared per common share                | \$ 0.25                                     | \$ 0.45    | \$ 0.75                                    | \$ 1.95    |

See accompanying notes to consolidated financial statements

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## IMPAC MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

|   | For the Nine Months<br>Ended September 30, |               |
|---|--|---------------|
|   | 2006                                       | 2005          |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>  |  |               |
| Net (loss) earnings   | \$ (15,768 )                               | \$ 244,967    |
| Adjustments to reconcile net earnings to net cash provided by (used in) operating activities: |  |               |
| Provision for loan losses   | 3,288                                      | 25,219        |
| Amortization of deferred charge   | 15,872                                     | 19,503        |
| Amortization of premiums, securitization costs and debt issuance costs                        | 181,769                                    | 216,284       |
| Gain on sale of other real estate owned   | (1,277 )                                   | (1,261 )      |
| Gain on sale of loans   | (35,647 )                                  | (44,063 )     |
| Provision for repurchases   | 7,233                                      | 8,606         |
| Lower of cost or market writedown   | 15,284                                     |               |
| Change in fair value of derivative instruments  | 92,602                                     | (141,521 )    |
| Purchase of mortgages held-for-sale   | (7,594,574 )                               | (16,300,056 ) |
| Sale and principal reductions on mortgages held-for-sale                                      | 8,369,598                                  | 14,700,238    |
| Net change in deferred taxes  | 83   | (2,077 )      |
| Share-based compensation  | 1,628                                      |               |
| Depreciation and amortization   | 4,422                                      | 3,427         |
| Amortization and impairment of mortgage servicing rights                                      | 1,112                                      | 1,577         |
| Net change in accrued interest receivable   | 19,758                                     | (18,712 )     |
| Net change in restricted cash   | 200  | 252,964       |
| Net change in other assets and liabilities  | (16,890 )                                  | (35,365 )     |
| Net cash provided by (used in) operating activities   | 1,048,693                                  | (1,070,270 )  |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |  |               |
| Net change in securitized mortgage collateral   | 3,974,163                                  | (3,467,578 )  |
| Net change in finance receivables   | 52,560                                     | 166,677       |
| Purchase of premises and equipment  | (8,162 )                                   | (5,880 )      |
| Net change in mortgages held-for-investment   | 154,130                                    | 388,105       |
| Purchase (disposition) of investment securities available-for-sale                            | 36,781                                     | (36,413 )     |
| Net change in mortgage servicing rights   | (495 )                                     | (736 )        |
| Purchase of investments for deferred compensation plan  |  | (3,201 )      |
| Net principal reductions on investment securities available-for-sale                          | (29,035 )                                  | 1,501         |
| Proceeds from the sale of other real estate owned   | 62,588                                     | 38,960        |
| Net cash provided by (used in) investing activities   | 4,242,530                                  | (2,918,565 )  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>  |  |               |
| Net change in reverse repurchase agreements   | (887,634 )                                 | 1,026,328     |
| Proceeds from securitized mortgage borrowings   | 2,973,399                                  | 10,564,127    |
| Repayment of securitized mortgage borrowings  | (7,297,487 )                               | (7,754,514 )  |
| Issuance of trust preferred   |  | 76,202        |
| Common stock dividends paid   | (53,281 )                                  | (113,194 )    |
| Preferred stock dividends paid  | (11,016 )                                  | (10,872 )     |
| Proceeds from sale of cumulative redeemable preferred stock                                   | 203  |               |
| Purchases of common stock   | (951 )                                     |               |

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|   |              |            |
|---|--------------|------------|
| Proceeds from exercise of stock options             | 824          | 6,311      |
| Net cash provided by (used in) financing activities | (5,275,943 ) | 3,794,388  |
| Net change in cash and cash equivalents             | 15,280       | (194,447 ) |
| Cash and cash equivalents at beginning of period    | 146,621      | 324,351    |
| Cash and cash equivalents at end of period          | \$ 161,901   | \$ 129,904 |

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|  | <b>For the Nine Months<br/>Ended September 30,</b> |             |
|--|--|-------------|
|  | <b>2006</b>  | <b>2005</b> |
| <b>SUPPLEMENTARY INFORMATION:</b>                |  |             |
| Interest paid                                    | \$ 862,033   | \$ 656,422  |
| Taxes paid                                       | 45   | 17,821      |
| <b>NON-CASH TRANSACTIONS:</b>                    |  |             |
| Accumulated other comprehensive loss             | \$ (1,872 )  | \$ (363 )   |
| Transfer of mortgages to other real estate owned | 129,785  | 58,169      |
| Dividends declared and accrued but unpaid        | 19,021   | 34,194      |

See accompanying notes to consolidated financial statements.

**IMPAC MORTGAGE HOLDINGS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(in thousands, except per share data or as otherwise indicated)**  
(unaudited)

**Note A Summary of Business and Significant Accounting Policies**

**1. Business Summary and Financial Statement Presentation**

*Business Summary*

Impac Mortgage Holdings, Inc. (the Company or IMH), is a Maryland corporation incorporated in August 1995, and has the following subsidiaries, IMH Assets Corp. (IMH Assets), Impac Warehouse Lending Group, Inc. (IWLG), and Impac Funding Corporation (IFC), together with its wholly-owned subsidiaries Impac Secured Assets Corp. (ISAC), and Impac Commercial Capital Corporation (ICCC).

The Company is a mortgage real estate investment trust, or REIT, that is a nationwide acquirer, originator, seller and investor of non-conforming Alt-A residential mortgages or Alt-A mortgages and to a lesser extent, small-balance commercial mortgages or commercial mortgages. The Company also provides warehouse financing to originators of mortgages.

The Company operates four core businesses:

- the Long-Term Investment Operations that is conducted by IMH and IMH Assets;
- the Mortgage Operations that is conducted by IFC and ISAC;
- the Warehouse Lending Operations that is conducted by IWLG; and
- the Commercial Operations that is conducted by ICCC.

The REIT (IMH) is comprised of the long-term investment operations and the warehouse lending operations. The Taxable REIT Subsidiaries (TRS) include the Mortgage Operations and Commercial Operations and are subsidiaries of the REIT.

The long-term investment operations generate earnings primarily from net interest income earned on mortgages held as securitized mortgage collateral and mortgages held-for-investment (long-term mortgage portfolio) and associated derivative cash flows. The long-term mortgage portfolio as reported on our consolidated balance sheets consists of mortgages held as securitized mortgage collateral and mortgages held-for-investment. Investments in Alt-A mortgages and commercial mortgages are initially financed with short-term borrowings under reverse repurchase agreements, which are subsequently converted to long-term financing in the form of securitized mortgage borrowings. Cash flows from the long-term mortgage portfolio and proceeds from the sale of capital stock finance the acquisition of new Alt-A and commercial mortgages.

The mortgage operations acquire, originate, sell and securitize primarily Alt-A adjustable rate mortgages (ARMs) and fixed rate mortgages (FRMs) from correspondents, mortgage brokers and retail customers. Correspondents originate and close mortgages under their mortgage programs and then sell the closed loans to the mortgage operations on a flow (loan-by-loan) basis or through bulk sale commitments. Correspondents include; savings and loan associations, commercial banks and mortgage bankers. The mortgage operations generate income by securitizing and selling mortgages to permanent investors, including the long-term investment operations. This business also earns revenue from fees associated with mortgage servicing rights, master servicing agreements and interest income earned on mortgages held-for-sale. The mortgage operations use facilities provided by the warehouse lending operations to finance the acquisition and origination of mortgages.

The warehouse lending operations provide repurchase financing to mortgage loan originators, including the mortgage and commercial operations, by funding mortgages from their closing date until sale to pre-approved investors. This business earns fees from each transaction as well as net interest income from the difference between its cost of borrowings and the interest earned on repurchase advances.

The commercial operations originate commercial mortgages, that are primarily adjustable rate mortgages with initial fixed interest rate periods of two-, three-, five-, seven- and ten-years that subsequently convert to adjustable rate mortgages, or hybrid ARMs, with balances that generally range from \$500,000 to \$5.0 million. Commercial mortgages have interest rate floors, which is the initial start rate; in some circumstances have lock out periods, and prepayment penalty periods of three-, five-, seven- and ten-years. These mortgages provide greater asset diversification on our balance sheet as commercial mortgage borrowers typically have higher credit scores and typically have lower loan-to-value ratios, or LTV ratios, and the mortgages have longer average lives than residential mortgages.

The Company securitizes mortgages in the form of collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs). The typical CMO securitization is designed so that the transferee (securitization trust) is not a qualifying special purpose entity (QSPE) and thus as the sole residual interest holder, the Company consolidates securitization. Amounts consolidated are classified as securitized mortgage collateral and securitized mortgage borrowings in the consolidated balance sheets. In some cases, the REMIC securitization qualifies for sale accounting treatment and the securitization trust is a QSPE and thus not consolidated by the Company. Generally, a REMIC securitization trust does not meet sale accounting and QSPE criteria, and thus the securitization is treated as a secured borrowing and consolidation is assessed pursuant to FIN 46R, Consolidation of Variable Interest Entities.

In 2005 and 2006, the Company completed ISAC REMIC 2005-2, ISAC REMIC 2006-1, and ISAC REMIC 2006-3 securitizations which were treated as sales for tax purposes but treated as secured borrowings for generally accepted accounting principles (GAAP) and consolidated in the financial statements. The associated collateral and borrowings are included in securitized mortgage collateral and borrowings, respectively, for reporting purposes. Hence, reference to Securitized mortgage collateral or Securitized mortgage borrowings includes the REMIC 2005-2, 2006-1, and 2006-3 securitized collateral and borrowings.

In the second quarter of 2006, the Company completed ISAC REMIC 2006-2 securitization in the amount of \$834.0 million which was treated as a sale for both tax and GAAP purposes. The residual interest, calculated as the present value of estimated future cash flows, was retained as a result of the ISAC REMIC 2006-2 securitization, and is recorded in other assets on the balance sheet as investment securities available-for-sale. Investments in residual interest and subordinated securities represent higher risk than investments in senior mortgage-backed securities because these subordinated securities bear all credit losses prior to the related senior securities. The risk associated with holding residual interests and subordinated securities is greater than holding the underlying mortgage loans directly due to the concentration of losses attributed to the subordinated securities. The value of residual interests represents the present value of future cash flows expected to be received by us from excess cash flows created in the securitization transaction. In general, future cash flows are estimated by taking the coupon rate of the loans underlying the transaction less the interest rate paid to the investors, less contractually specified servicing and trustee fees, and after giving effect to estimated prepayments and credit losses. The Company estimates future cash flows from these securities utilizing assumptions based in part on projected discount rates, delinquency rates, mortgage loan prepayment speeds and credit losses.

In January 2006, the Company combined our Alt-A wholesale and sub-prime residential mortgage product offerings under one platform. Our sub-prime residential mortgage products previously marketed under Novelle Financial Services, Inc., are now offered by our Alt-A wholesale operations, Impac Lending Group (ILG), a division of IFC.

On January 1, 2006, the Company elected to convert Impac Commercial Capital Corporation (ICCC) from a qualified REIT subsidiary to a taxable REIT subsidiary. On June 30, 2006, the Company approved the transfer of ICCC to be a wholly-owned subsidiary of IFC effective January 1, 2006.

### ***Financial Statement Presentation***

The accompanying unaudited consolidated financial statements of the Company and our subsidiaries (as defined above) have been prepared in accordance with GAAP 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 GAAP for audited financial statements. In the opinion of management, all adjustments, consisting of normal recurring adjustments considered necessary for a fair presentation, have been included. Operating results for the three-month and nine-month period ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

The Company's consolidated financial statements should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements of the Company and the notes thereto, included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

All significant inter-company balances and transactions have been eliminated in consolidation. In addition, certain amounts in the prior periods consolidated financial statements have been reclassified to conform to the current period presentation.

Management has made a number of estimates and assumptions relating to the reporting of assets and liabilities, including the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period to prepare these financial statements in conformity with GAAP. The items effected by management's estimates and assumptions include allowance for loan losses, valuation of derivative financial instruments, repurchase liabilities related to sold loans, the amortization of various loan premiums and discounts due to prepayment estimates, and lower of cost or market - LOCOM. Actual results could differ from those estimates.

Premiums, discounts and securitization costs associated with the securitized mortgage collateral and securitized mortgage borrowing are amortized or accreted into interest income/expense over the projected lives of the securitized mortgage collateral and securitized mortgage borrowings using the interest method. The Company policy for estimating prepayment speeds for calculating the effective yield is to evaluate historical performance, market prepayment speeds, and current conditions. If the estimate of prepayments is incorrect, the Company may be required to make an adjustment to the amortization or accretion of premiums and discounts that would have an effect on future income.

## **2. Stock Options**

The Company maintains a stock based incentive compensation plan the terms of which are governed by the Impac Mortgage Holdings, Inc. 2001 Stock Option, Deferred Stock and Restricted Stock Plan, as amended (the 2001 Stock Plan). Officers, key employees, directors, consultants and advisors are eligible to receive awards pursuant to the 2001 Stock Plan. The aggregate number of shares reserved under the 2001 Stock Plan is 10,222,765 shares (including increases pursuant to the plan's evergreen provision), and as of September 30, 2006 there were 2,225,699 shares available for grant as stock options, restricted stock and deferred stock awards.

Effective January 1, 2006, the Company adopted the Statement of Financial Accounting Standards (SFAS) No. 123R, Share-Based Payment, using the modified prospective method, which requires recognition of compensation expense for all awards granted after the date of adoption, and for the unvested portion of previously granted awards that remain outstanding at the date of adoption. Accordingly, prior period amounts presented herein have not been restated to reflect the adoption of SFAS 123R. As required, the pro forma effect from recognition of the estimated fair value of stock options granted to employees has been disclosed for previous periods.

As a result of adopting SFAS 123R on January 1, 2006, the Company's net earnings before income taxes and net earnings for the nine months ended September 30, 2006 are \$1.6 million and \$1.3 million lower, respectively, than if it had continued to account for share-based compensation under Accounting Principles Board Opinion No. 25 Accounting for Stock Issued to Employees, (APB 25). Basic and diluted earnings per share for the nine months ended September 30, 2006 are \$0.02 and \$0.02 lower, respectively, than if the Company had continued to account for share-based compensation under APB 25.



The fair value of each stock option granted under the Company's stock based compensation plan is estimated on the date of grant using the Black-Scholes option-pricing model and the assumptions noted below. The expected volatility is based on both the implied and historical volatility of the Company's stock. The expected option term of options granted represents the period of time that the options granted are expected to be outstanding and is based on historical experience giving consideration for the contractual terms, vesting periods and expectations of future employee behavior. The risk-free interest rate is based on the U.S. Treasury rate with a term equal to the expected term of the option grants on the date of grant.

SFAS 123R requires forfeitures to be estimated at the time of grant and prospectively revised, if necessary, in subsequent periods if actual forfeitures differ from initial estimates. Share-based compensation expense was recorded net of estimated forfeitures for the nine months ended September 30, 2006 such that expense was recorded only for those stock-based awards that were expected to vest. Previously under APB 25 to the extent awards were forfeited prior to vesting, the corresponding previously recognized expense was reversed in the period of forfeiture.

On August 18, 2006, the Compensation Committee of the Board of Directors approved performance criteria for the 225,000 performance based options granted to each of the following, Messrs. Joseph R. Tomkinson, our Chairman and Chief Executive Officer, William S. Ashmore, our President, and Richard J. Johnson our Executive Vice President and Chief Operating Officer. The awards vest in one-third increments if the Company meets specified estimated taxable income targets over each of the three 12-month periods ending June 30, 2009. The options expire four years from the date of grant. If a portion of an award does not vest, the failure of that portion to vest will not affect the vesting of earlier or subsequent portions. These options were granted in the third quarter of 2006, and are included in the option grants below. The fair value of each performance based option was measured on the date of grant using the same assumptions used to value the service based options, and assumed that performance goals would be achieved. If such goals are not met, no compensation cost is recognized and any recognized compensation cost is reversed.

The following table illustrates the effect as if the Company had elected to use the fair value approach to account for its employee stock-based compensation plan at September 30, 2005:

|   | <b>For the Three Months<br/>Ended September 30, 2005</b> | <b>For the Nine Months<br/>Ended September 30, 2005</b> |
|---|--|---|
| Net earnings available to common stockholders                                     | \$ 122,733   | \$ 234,095  |
| Less: Total stock-based employee compensation expense using the fair value method | (686   | ) (1,764  |
| Pro forma net earnings  | \$ 122,047   | \$ 232,331  |
| <b>Net earnings per share as reported:</b>  |  |   |
| Basic   | \$ 1.62  | \$ 3.10   |
| Diluted   | \$ 1.61  | \$ 3.07   |
| <b>Pro forma net earnings per share:</b>  |  |   |
| Basic   | \$ 1.61  | \$ 3.08   |
| Diluted   | \$ 1.59  | \$ 3.01   |

The fair value of options granted, which is amortized to expense over the option vesting period, is estimated on the date of grant using the Black-Scholes-Merton option pricing model with the following weighted average assumptions:

|  | <b>For the Nine Months<br/>Ended September 30,</b> |                |
|--|--|----------------|
|  | <b>2006</b>  | <b>2005</b>    |
| Risk-free interest rate                | 3.90% to 4.26%                                     | 2.16% to 4.50% |
| Expected lives (in years)              | 3  | 3 - 4          |
| Expected volatility (1)                | 34.75%   | 42.26%         |
| Expected dividend yield                | 11.00%   | 10.00%         |
| Grant date fair value of share options | \$1.41   | \$3.71         |

(1) Expected volatilities are based on the historical volatility of the Company's stock over the expected option life.

The following table summarizes activity, pricing and other information for the Company's stock options for the nine-month period ended September 30, 2006:

|  | <b>Number of<br/>Shares</b> | <b>Weighted-<br/>Average<br/>Exercise<br/>Price \$</b> | <b>Weighted-<br/>Average<br/>Remaining Life<br/>(Years)</b> | <b>Aggregate<br/>Intrinsic<br/>Value (1)<br/>(in thousands)</b> |
|--|-----------------------------|--|---|---|
| Options outstanding at beginning of year | 5,266,544                   | \$ 14.55   |   |   |
| Options granted                          | 2,774,000                   | 9.94   |   |   |
| Options exercised                        | (75,202 )                   | 10.95  |   |   |
| Options forfeited / cancelled            | (853,087 )                  | 13.64  |   |   |
| Options outstanding at end of period     | 7,112,255                   | \$ 12.90   | 3.00  | \$ 3,753.9  |
| Options exercisable at end of period     | 3,116,390                   | \$ 13.98   | 2.41  | \$ 3,753.9  |

(1) The intrinsic value of a stock option is the amount by which the fair value of the underlying stock exceeds the exercise price of the option.

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on the Company's closing stock price of \$9.37 per share as of September 30, 2006, which would have been received by the option holders had all option holders exercised their options as of that date. As of September 30, 2006, there was approximately \$4.9 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the plan. That cost is expected to be recognized over a weighted average period of 1.19 years.

In addition to the options granted, the Company has granted nonvested shares, which vest over a three year period. The fair value of each nonvested share was measured on the date of grant using the grant date price of the Company's stock. A summary of the option activity of the Company's nonvested shares during the nine month period ended September 30, 2006, is presented below:

|  | <b>Shares</b> | <b>Weighted-Average<br/>Grant-Date<br/>Fair Value</b> |
|--|---------------|---|
| Nonvested outstanding at beginning of period | 5,000         | \$ 13.76  |
| Shares Granted                               | 42,577        | 9.94  |
| Shares Vested                                |               |   |
| Shares Forfeited                             |               |   |
| Nonvested outstanding at end of period       | 47,577        | \$ 10.34  |

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As of September 30, 2006, there was approximately \$450,000 of total unrecognized compensation cost related to nonvested stock compensation arrangements granted under the plan. That cost is expected to be recognized over a weighted average period of 1.52 years.

Additional information regarding stock options outstanding as of September 30, 2006, is as follows:

| Exercise Price Range (\$) | Stock Options Outstanding |  |                                      | Options Exercisable |                                      |  |
|---------------------------|---------------------------|--|--------------------------------------|---------------------|--------------------------------------|--|
|                           | Number Outstanding        | Weighted-Average Remaining Contractual Life in Years | Weighted-Average Exercise Price (\$) | Number Exercisable  | Weighted-Average Exercise Price (\$) |  |
| 3.85 - 9.42               | 796,250                   | 4.55   | 4.65                                 | 796,250             | 4.66                                 |  |
| 9.94                      | 2,708,500                 | 3.88   | 9.94                                 |                     |                                      |  |
| 13.76 - 14.27             | 2,410,505                 | 1.98   | 13.98                                | 1,508,825           | 14.12                                |  |
| 21.77 - 22.83             | 692,000                   | 2.17   | 22.77                                | 474,654             | 22.74                                |  |
| 23.10                     | 505,000                   | 1.84   | 23.10                                | 336,661             | 23.10                                |  |
| 3.85 - 23.10              | 7,112,255                 | 3.00   | 12.90                                | 3,116,390           | 13.98                                |  |

### 3. Recent Accounting Pronouncements

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments*, an amendment of FASB Statements No. 133 and SFAS No. 140 ( SFAS 155 ). This statement permits fair value re-measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. It also clarifies which interest-only strips and principal-only strips are not subject to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* ( SFAS 133 ). The statement also establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or hybrid financial instruments that contain an embedded derivative requiring bifurcation. The statement also clarifies that concentration of credit risks in the form of subordination are not embedded derivatives, and it also amends SFAS 140 to eliminate the prohibition on a QSPE from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The adoption of this statement by the Company will not have a significant effect on the consolidated financial statements.

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets- an amendment of FASB Statement No. 140* ( SFAS 156 ). This statement requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in any of the following situations; whenever a transfer of the servicer's financial assets that meets the requirements for sale accounting, a transfer of the servicer's financial assets to a qualifying special-purpose entity in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities and classifies them as either available-for-sale securities or trading securities in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, an acquisition or assumption of an obligation to service a financial asset that does not relate to financial assets of the servicer or its consolidated affiliates. This statement requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable. This statement permits an entity to choose either the amortization method or the fair value measurement method for each class of separately recognized servicing assets and servicing liabilities. This statement at its initial adoption, permits a one-time reclassification of available-for-sale securities to trading securities by entities with recognized servicing rights, without calling into question the treatment of other available-for-sale securities under Statement 115, provided that the available-for-sale securities are identified in some manner as offsetting the entity's exposure to changes in fair value of servicing assets or servicing liabilities that a servicer elects to subsequently measure at fair value. This statement also requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities. An entity should adopt this statement as of the beginning of its first fiscal year that begins after September 15, 2006. The adoption of this statement by the Company is not expected to have a significant effect on the consolidated financial statements.

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, ( FIN 48 ) which expands on the accounting guidance of FASB Statement No. 109, *Accounting for Income Taxes*. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The adoption of this interpretation by the Company is not expected to have a significant effect on the consolidated financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Qualifying Misstatements in Current Year Financial Statements* ( SAB 108 ), which provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB 108 was issued to address diversity in practice in quantifying financial statement misstatements. SAB 108 requires that we quantify misstatements based on their effect on each of our financial statements and related disclosures. SAB 108 is effective as of the end of the Company's 2006 fiscal year.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurement* ( SFAS 157 ), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently assessing the effect, if any, from the adoption of SFAS No. 157 on the consolidated financial statements.

#### **4. Legal Proceedings**

The Company's Form 10-K for the year ended December 31, 2005 and Forms 10-Q for the periods ended March 31, 2006 and June 30, 2006, reported shareholder derivative actions filed against the Company and its senior officers and directors in the U.S. District Court, Central District of California and Orange County Superior Court. On September 14, 2006, the Orange County Superior Court stayed the consolidated state shareholder derivative action pending resolution of the federal securities class actions and federal shareholder derivative actions.

Management believes that they have meritorious defenses to the above claims and intend to defend these claims vigorously. Nevertheless, litigation is uncertain and the Company may not prevail in the lawsuits and can express no opinion as to their ultimate resolution. An adverse judgment in any of these matters could have a material adverse effect on the consolidated financial statements.

#### **Note B Reconciliation of Earnings Per Share**

The following table presents the computation of basic and diluted net earnings per common share including the dilutive effect of stock options outstanding for the periods indicated:

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|  | For the Three Months<br>Ended September 30, |            | For the Nine Months<br>Ended September 30, |            |
|--|---|------------|--|------------|
|  | 2006  | 2005       | 2006                                       | 2005       |
| <b>Numerator for basic earnings per share:</b>                               |   |            |  |            |
| Net (loss) earnings  | \$ (127,690 )                               | \$ 126,357 | \$ (15,768 )                               | \$ 244,967 |
| Less: Cash dividends on cumulative redeemable preferred stock                | (3,672 )                                    | (3,624 )   | (11,016 )                                  | (10,872 )  |
| Net (loss) earnings available to common stockholders                         | \$ (131,362 )                               | \$ 122,733 | \$ (26,784 )                               | \$ 234,095 |
| <b>Denominator for basic earnings per share:</b>                             |   |            |  |            |
| Basic weighted average number of common shares outstanding during the period | 76,132                                      | 75,720     | 76,119                                     | 75,440     |
| <b>Denominator for diluted earnings per share:</b>                           |   |            |  |            |
| Basic weighted average number of common shares outstanding during the period | 76,132                                      | 75,720     | 76,119                                     | 75,440     |
| Net effect of dilutive stock options   |   | 598        |  | 871        |
| Diluted weighted average common shares                                       | 76,132                                      | 76,318     | 76,119                                     | 76,311     |
| Net (loss) earnings per share:   |   |            |  |            |
| Basic  | \$ (1.73 )                                  | \$ 1.62    | \$ (0.35 )                                 | \$ 3.10    |
| Diluted  | \$ (1.73 )                                  | \$ 1.61    | \$ (0.35 )                                 | \$ 3.07    |

For the three and nine month periods ended September 30, 2006, stock options to purchase 7.1 million shares were outstanding but not included in the above weighted average calculations because they were anti-dilutive. For the three and nine month periods ended September 30, 2005, stock options to purchase 1.4 million shares, were outstanding but not included in the above weighted average calculations because they were anti-dilutive.

#### Note C Segment Reporting

The following tables present reporting segments as of and for the nine and three months ended September 30, 2006 and 2005:

|  | Reporting Segments as of and for the Nine Months<br>Ended September 30, 2006 |                                    |                                 |                          |                       |               |
|--|--|------------------------------------|---------------------------------|--------------------------|-----------------------|---------------|
|  | Long-Term<br>Investment<br>Operations  | Warehouse<br>Lending<br>Operations | Mortgage<br>Operations<br>(IFC) | Commercial<br>Operations | Inter-<br>Company (1) | Consolidated  |
| <b>Balance Sheet Items:</b>  |  |                                    |                                 |                          |                       |               |
| Securitized mortgage collateral and<br>Mortgages held-for-investment | \$ 20,203,367  | \$                                 | \$ 136,004                      | \$                       | \$ (103,774 )         | \$ 20,235,597 |
| Mortgages held-for-sale  |  |                                    | 932,419                         | 360,666                  |                       | 1,293,085     |
| Finance receivables  |  | 1,614,544                          |                                 |                          | (1,316,887 )          | 297,657       |
| Total assets   | 20,638,699   | 1,683,810                          | 1,235,179                       | 355,578                  | (1,422,882 )          | 22,490,384    |
| Total stockholders equity (deficit)                                  | 873,154  | 239,887                            | 91,540                          | (6,453 )                 | (130,467 )            | 1,067,661     |
| <b>Income Statement Items:</b>                                       |  |                                    |                                 |                          |                       |               |
| Net interest (expense) income  | \$ (91,393 )   | \$ 24,229                          | \$ (4,621 )                     | \$ 251                   | \$ 43,752             | \$ (27,782 )  |
| Provision for (recovery of) loan<br>losses                           | 3,638  | (350 )                             |                                 |                          |                       | 3,288         |
| Realized gain from derivatives                                       | 156,582  |                                    | 21                              | 30                       |                       | 156,633       |
| Change in fair value of derivatives                                  | (95,186 )  |                                    | 4,877                           | (6,324 )                 | 4,031                 | (92,602 )     |
| Other non-interest (loss) income                                     | (852 )   | 2,426                              | 57,971                          | 3,387                    | (22,674 )             | 40,258        |
| Non-interest expense and income<br>taxes                             | 12,916   | 5,578                              | 60,476                          | 6,113                    | 3,904                 | 88,987        |
| Net (loss) earnings  | \$ (47,403 )   | \$ 21,427                          | \$ (2,228 )                     | \$ (8,769 )              | \$ 21,205             | \$ (15,768 )  |

|   | Reporting Segments as of and for the Three Months<br>Ended September 30, 2006 |                                    |                                 |                          |                      |               |
|---|---|------------------------------------|---------------------------------|--------------------------|----------------------|---------------|
|   | Long-Term<br>Investment<br>Operations   | Warehouse<br>Lending<br>Operations | Mortgage<br>Operations<br>(IFC) | Commercial<br>Operations | Inter-<br>Company(1) | Consolidated  |
| <b>Income Statement Items:</b>          |   |                                    |                                 |                          |                      |               |
| Net interest (expense) income           | \$ (44,079 )  | \$ 9,659                           | \$ (3,234 )                     | \$ 61                    | \$ 13,083            | \$ (24,510 )  |
| Provision for (recovery of) loan losses | 3,533   | (350 )                             |                                 |                          |                      | 3,183         |
| Realized gain from derivatives          | 60,595  |                                    | 18                              | 17                       |                      | 60,630        |
| Change in fair value of derivatives     | (150,051 )  |                                    | 623                             | (6,106 )                 |                      | (155,534 )    |
| Other non-interest (loss) income        | (70 )   | 878                                | 40,092                          | 286                      | (11,680 )            | 29,506        |
| Non-interest expense and income taxes   | 5,198   | 2,077                              | 25,896                          | 1,008                    | 420                  | 34,599        |
| Net (loss) earnings                     | \$ (142,336 )   | \$ 8,810                           | \$ 11,603                       | \$ (6,750 )              | \$ 983               | \$ (127,690 ) |

(1) Income statement items include inter-company loan sale transactions and the elimination of related gains. Corporate overhead expenses are generally allocated to the segments based on percentage of time devoted to the segment.

|  | Reporting Segments as of and for the Nine Months<br>Ended September 30, 2005 |                                    |                                 |                       |               |
|--|--|------------------------------------|---------------------------------|-----------------------|---------------|
|  | Long-Term<br>Investment<br>Operations (1)                                    | Warehouse<br>Lending<br>Operations | Mortgage<br>Operations<br>(IFC) | Inter-<br>Company (2) | Consolidated  |
| <b>Balance Sheet Items:</b>  |  |                                    |                                 |                       |               |
| Securitized mortgage collateral and<br>Mortgages held-for-investment | \$ 24,859,044  | \$                                 | \$                              | \$ (129,355 )         | \$ 24,729,689 |
| Mortgages held-for-sale  |  |                                    | 2,214,215                       |                       | 2,214,215     |
| Finance receivables  |  | 2,619,075                          |                                 | (2,313,932 )          | 305,143       |
| Total assets   | 25,109,976   | 2,757,884                          | 2,267,415                       | (2,246,326 )          | 27,888,949    |
| Total stockholders equity  | 981,721  | 203,324                            | 19,469                          | (67,810 )             | 1,136,704     |
| <b>Income Statement Items:</b>                                       |  |                                    |                                 |                       |               |
| Net interest income  | \$ 89,967  | \$ 40,455                          | \$ 6,559                        | \$ 53,174             | \$ 190,155    |
| Provision for (recovery of) loan losses                              | 25,484   | (265 )                             |                                 |                       | 25,219        |
| Realized loss from derivatives                                       | (4,209 )   |                                    |                                 |                       | (4,209 )      |
| Change in fair value of derivatives                                  | 146,913  |                                    | (5,392 )                        |                       | 141,521       |
| Other non-interest income (loss)                                     | 451  | 6,268                              | 105,959                         | (68,557 )             | 44,121        |
| Non-interest expense and income taxes                                | 10,256   | 5,833                              | 90,872                          | (5,559 )              | 101,402       |
| Net earnings   | \$ 197,382   | \$ 41,155                          | \$ 16,254                       | \$ (9,824 )           | \$ 244,967    |

|   | Reporting Segments as of and for the Three Months<br>Ended September 30, 2005 |                                    |                                 |                       |              |
|---|---|------------------------------------|---------------------------------|-----------------------|--------------|
|   | Long-Term<br>Investment<br>Operations (1)                                     | Warehouse<br>Lending<br>Operations | Mortgage<br>Operations<br>(IFC) | Inter-<br>Company (2) | Consolidated |
| <b>Income Statement Items:</b>          |   |                                    |                                 |                       |              |
| Net interest income (expense)           | \$ 8,941  | \$ 15,475                          | \$ (101 )                       | \$ 18,581             | \$ 42,896    |
| Provision for (recovery of) loan losses | 13,699  | (265 )                             |                                 |                       | 13,434       |
| Realized gain from derivatives          | 10,975  |                                    |                                 |                       | 10,975       |
| Change in fair value of derivatives     | 108,905   |                                    | (1,024 )                        |                       | 107,881      |
| Other non-interest (loss) income        | (530 )  | 2,011                              | 31,559                          | (22,884 )             | 10,156       |
| Non-interest expense and income taxes   | 3,257   | 1,978                              | 29,604                          | (2,722 )              | 32,117       |
| Net earnings                            | \$ 111,335  | \$ 15,773                          | \$ 830                          | \$ (1,581 )           | \$ 126,357   |

(1) For the three and nine month periods ended September 30, 2005, the commercial operations were included in the Long Term Investment Operations. On January 1, 2006, we elected to convert Impac Commercial Capital Corporation ICCC from a qualified REIT subsidiary to a taxable REIT subsidiary. Therefore, there is no corresponding three or nine month comparison.

(2) Income statement items include inter-company loan sale transactions and the elimination of related gains. Corporate overhead expenses are generally allocated to the segments based on percentage of time devoted to the segment.

#### Note D Mortgages Held-for-Sale

Mortgages held-for-sale for the periods indicated consisted of the following:

|   | At September 30,<br>2006 | At December 31,<br>2005 |
|---|--------------------------|-------------------------|
| Mortgages held-for-sale - residential                 | \$ 921,189               | \$ 2,027,194            |
| Mortgages held-for-sale - commercial                  | 356,520                  |                         |
| Change in fair value of mortgages held-for-sale       |                          | (4,465 )                |
| Net premiums on mortgages held-for-sale - residential | 13,241                   | 29,965                  |
| Net premiums on mortgages held-for-sale - commercial  | 2,135                    |                         |
| Total mortgages held-for-sale                         | \$ 1,293,085             | \$ 2,052,694            |

Mortgages held-for-sale consist primarily of Alt-A mortgages, which are secured by residential and commercial properties, located throughout the United States. Mortgages held-for-sale are carried at the lower of cost net of purchase discounts or premiums and deferred fees, or market value. We determine the fair value of mortgages held-for-sale using current secondary market prices for loans with similar coupons, maturities and credit quality.

#### Note E Securitized Mortgage Collateral

Securitized mortgage collateral consisted of the following:

|  | At September 30,<br>2006 | At December 31,<br>2005 |
|--|--------------------------|-------------------------|
| Mortgages secured by single-family residential real estate | \$ 18,676,687            | \$ 22,986,632           |
| Mortgages secured by commercial real estate                | 1,347,646                | 1,195,541               |
| Net unamortized premiums on mortgages - residential        | 195,845                  | 301,709                 |
| Net unamortized premiums on mortgages - commercial         | 12,285                   | 10,408                  |
| Total securitized mortgage collateral                      | \$ 20,232,463            | \$ 24,494,290           |

#### Note F Allowance for Loan Losses

The allowance for loan losses is comprised of the following:

|   | At September 30,<br>2006 | At December 31,<br>2005 |
|---|--------------------------|-------------------------|
| Securitized mortgage collateral and mortgages held-for-investment | \$ 48,791                | \$ 55,007               |
| Specific reserve for finance receivables                          | 10,334                   | 10,683                  |
| Specific reserve for estimated hurricane losses                   | 6,590                    | 12,824                  |
| Total allowance for loan losses                                   | \$ 65,715                | \$ 78,514               |

Activity for allowance for loan losses for the periods indicated was as follows:



|                                 | For the Three Months<br>Ended September 30, |           | For the Nine Months<br>Ended September 30, |           |
|---------------------------------|---|-----------|--|-----------|
|                                 | 2006  | 2005      | 2006                                       | 2005      |
| Beginning balance               | \$ 68,072                                   | \$ 69,826 | \$ 78,514                                  | \$ 63,955 |
| Provision for loan losses       | 3,183                                       | 13,434    | 3,288                                      | 25,219    |
| Charge-offs, net of recoveries  | (5,540 )                                    | (4,690 )  | (16,087 )                                  | (10,604 ) |
| Total allowance for loan losses | \$ 65,715                                   | \$ 78,570 | \$ 65,715                                  | \$ 78,570 |

**Note G Other Assets**

Other assets consisted of the following:

|  | At September 30,<br>2006 | At December 31,<br>2005 |
|--|--------------------------|-------------------------|
| Real estate owned                          | \$ 114,825               | \$ 46,351               |
| Cash collateral balances                   | 47,828                   | 16,567                  |
| Deferred charge                            | 39,335                   | 47,406                  |
| Investment securities available-for-sale   | 30,579                   | 40,227                  |
| Prepaid and other assets                   | 23,315                   | 34,422                  |
| Premises and equipment, net                | 16,082                   | 12,312                  |
| Deferred income taxes                      | 12,077                   | 12,160                  |
| Investment in Impac Capital Trusts         | 2,716                    | 2,884                   |
| Investments for deferred compensation plan |                          | 8,041                   |
| Total other assets                         | \$ 286,757               | \$ 220,370              |

**Note H Investment Securities Available-for-Sale**

Investment securities are classified as available-for-sale and are included in other assets on our consolidated balance sheets. Available-for-sale securities are reported at fair value with unrealized gains and losses as other comprehensive earnings. Securities available for sale include the residual interest from the ISAC REMIC 2006-2 securitization of approximately \$27.5 million, calculated as the present value of estimated future cash flows. Gains and losses realized on the sale of available-for-sale investment securities and declines in value judged to be other-than-temporary are based on the specific identification method and reported in current earnings.

**Note I Securitized Mortgage Borrowings**

Selected information on securitized mortgage borrowings for the periods indicated consisted of the following (dollars in millions):

| Year of Issuance                         | Original Issuance Amount | Securitized mortgage borrowings outstanding as of |                   | Range of Percentages: |  |   |
|--|--------------------------|---|-------------------|-----------------------|--|---|
|  |                          | September 30, 2006                                | December 31, 2005 | Fixed Interest Rates  | Interest Rate Margins over One-Month LIBOR (1) | Interest Rate Margins after Adjustment Date (2) |
| 2002                                     | \$ 3,876.1               | \$ 53.8   | \$ 219.8          | 5.25 - 12.00          | 0.27 - 2.75                                    | 0.54 - 3.68                                     |
| 2003                                     | 5,966.1                  | 1,063.9   | 1,723.0           | 4.34 - 12.75          | 0.27 - 3.00                                    | 0.54 - 4.50                                     |
| 2004                                     | 17,710.7                 | 6,447.4   | 10,191.9          | 3.58 - 5.56           | 0.25 - 2.50                                    | 0.50 - 3.75                                     |
| 2005                                     | 13,387.7                 | 9,345.5   | 11,902.9          |                       | 0.24 - 2.90                                    | 0.48 - 4.35                                     |
| 2006                                     | 3,004.7                  | 2,820.6   |                   | 6.25                  | 0.10 - 2.50                                    | 0.20 - 3.75                                     |
| Subtotal securitized mortgage borrowings |                          | 19,731.2  | 24,037.6          |                       |  |   |
| Accrued interest expense                 |                          | 19.5  | 18.1              |                       |  |   |
| Unamortized securitization costs         |                          | (52.9 )   | (65.3 )           |                       |  |   |
| Total securitized mortgage borrowings    |                          | \$ 19,697.8                                       | \$ 23,990.4       |                       |  |   |

(1) One-month LIBOR was 5.32% as of September 30, 2006.

(2) Interest rate margins over one-month LIBOR are generally adjusted when the unpaid principal balance is reduced to less than 10% to 20% of the original issuance amount, or if certain other triggers are met.

#### Note J Reverse Repurchase Agreements

Reverse repurchase agreements are entered into to finance our warehouse lending operations and to fund the closing and purchase of mortgages by the mortgage and commercial operations. These facilities consist of committed and uncommitted lines. At September 30, 2006, the Company was in compliance with all of the financial covenants associated with the reverse repurchase agreements. During the third quarter of 2006, these facilities amounted to \$5.5 billion, of which \$1.5 billion was outstanding at September 30, 2006.

#### Note K Repurchase Reserve

The liability for mortgage repurchases is maintained for the purpose of purchasing previously sold mortgages for various reasons, including early payment defaults or breach of representations or warranties, which may be subsequently sold at a loss. Actual gains and losses on repurchases are recorded against the gain on sale of loans in the consolidated financial statements. In determining the adequacy of the liability for mortgage repurchases, management considers such factors as specific requests for repurchase, known problem loans, underlying collateral values, recent sales activity of similar loans and other appropriate information. During the third quarter of 2006 a recovery of repurchases of \$15.9 million was recorded compared to a provision of \$3.2 million for the same period in 2005. The provision for repurchases decreased as a result of \$114.4 million in outstanding requests which were rescinded by investors during the third quarter of 2006.

In the ordinary course of business, the Company sells whole pools of loans with standard representations and warranties including borrower defaults. When whole pools are sold, as opposed to securitized, the Company makes an estimate of the ultimate losses to be realized on the repurchased loans. Because the loans are no longer on the Company's balance sheet, the implied warranty component is considered a guarantee, under FIN 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. During the nine months ended September 30, 2006, the Company sold \$5.3 billion in whole loan sales. The Company maintains a \$15.2 million reserve related to these guarantees as of September 30, 2006 compared to \$10.4 million at December 31, 2005, included in other liabilities.

#### Note L Income Taxes

During the three and nine months ended September 30, 2006, income tax expense (benefit) was \$2.2 million and (\$11.6) million, respectively. During the three and nine months ended September 30, 2005, income tax benefit was \$7.3 million and \$13.9 million, respectively. The income tax provision for three months ended September 30, 2006 was primarily due to reduced net losses at the taxable REIT subsidiaries. The Company makes an estimate of the effective tax rate expected to be applicable for the fiscal year when providing for income tax expense (benefit).



**ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Unless the context otherwise requires, the terms Company, we, us, and our refer to Impac Mortgage Holdings, Inc. (the Company or IMH), a Maryland corporation incorporated in August 1995, and its subsidiaries, IMH Assets Corp. (IMH Assets), Impac Warehouse Lending Group, Inc. (IWLG), and Impac Funding Corporation (IFC), together with its wholly-owned subsidiaries Impac Secured Assets Corp. (ISAC), and Impac Commercial Capital Corporation (ICCC).

**Forward-Looking Statements**

This report on Form 10-Q contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements, some of which are based on various assumptions and events that are beyond our control may be identified by reference to a future period or periods or by the use of forward-looking terminology, such as may, will, believe, expect, likely, should, could, anticipate, or similar terms or variations on those terms or the negative of those terms. Forward-looking statements are based on management expectations. Actual results may differ materially as a result of several factors, including, but not limited to, failure to achieve projected earnings levels; unexpected or greater than anticipated increases in credit and bond spreads; the ability to generate sufficient liquidity; the ability to access the equity markets; increased operating expenses and mortgage origination or purchase expenses that reduce current liquidity position more than anticipated; continued increase in price competition; risks of delays in raising, or the inability to raise on acceptable terms, additional capital, either through equity offerings, lines of credit or otherwise; the ability to generate taxable income and to pay dividends; interest rate fluctuations on our assets that unexpectedly differ from those on our liabilities; unanticipated interest rate fluctuations; changes in expectations of future interest rates; unexpected increase in prepayment rates on our mortgages; changes in assumptions regarding estimated loan losses or an increase in loan losses; continued ability to access the securitization markets or other funding sources, the availability of financing and, if available, the terms of any financing; changes in markets which the Company serves, such as mortgage refinancing activity and housing price appreciation; changes in laws that affect our products and our business; and other general market and economic conditions.

For a discussion of these and other risks and uncertainties that could cause actual results to differ from those contained in the forward-looking statements, see Risk Factors and Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's Annual Report on Form 10-K for the period ended December 31, 2005, and the other reports we file under the Securities and Exchange Act of 1934. This document speaks only as of its date and we do not undertake, and specifically disclaim any obligation, to publicly release the results of any revisions that may be made to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

***The Mortgage Banking Industry and Discussion of Relevant Fiscal Periods***

The mortgage banking industry is continually subject to current events that occur in the financial services industry. Such events include changes in economic indicators, interest rates, price competition, housing prices, geographic shifts, disposable income, market anticipation and customer perception as well as others. The factors that affect the industry change rapidly.

In this environment, mortgage banking companies generally attempt to anticipate the future marketplace, engage in hedging activities and continuously reassess business plans and strategies to effectively position themselves in the marketplace.

As a result, current events can diminish the relevance of quarter over quarter and year-to-date over year-to-date comparisons of financial information. In such instances, the Company intends to present financial information in its Management Discussion and Analysis that is the most relevant to its financial information.

**General Overview**

We are a mortgage real estate investment trust, or REIT, that is a nationwide acquirer, originator, seller and investor of non-conforming Alt-A residential mortgages, or Alt-A mortgages, and to a lesser extent, small-balance, commercial mortgages, or commercial mortgages. We also provide warehouse financing to originators of mortgages.

We operate four core businesses:

- the Long-Term Investment Operations that is conducted by IMH and IMH Assets;

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- the Mortgage Operations that is conducted by IFC and ISAC;
- the Warehouse Lending Operations that is conducted by IWLG; and
- the Commercial Operations that is conducted by ICC.

The long-term investment operations primarily invest in adjustable rate and, to a lesser extent, fixed rate Alt-A mortgages and commercial mortgages that are acquired and originated by our mortgage and commercial operations. Alt-A mortgages are primarily first lien mortgages made to borrowers whose credit is generally within typical Fannie Mae and Freddie Mac guidelines, but have loan characteristics that make them non-conforming under those guidelines. Some of the principal differences between mortgages purchased by Fannie Mae and Freddie Mac and Alt-A mortgages are as follows:

- credit and income histories of the mortgagor;
- underwriting guidelines for debt and income ratios;
- documentation required for approval of the mortgagor; and
- loan balances in excess of maximum Fannie Mae and Freddie Mac lending limits.

For instance, Alt-A mortgages may not have certain documentation or verifications that are required by Fannie Mae and Freddie Mac and, therefore, in making our credit decisions, we are more reliant upon the borrower's credit score and the adequacy of the underlying collateral. We believe that Alt-A mortgages provide an attractive net earnings profile by producing higher yields without commensurately higher credit losses than other types of mortgages.

The long-term investment operations also invest in commercial mortgages that are primarily adjustable rate mortgages with initial fixed interest rate periods of two-, three-, five-, seven- and ten-years that subsequently convert to adjustable rate mortgages, or hybrid ARMs. Commercial mortgages have interest rate floors, which are the initial start rate, in some circumstances lock out periods and prepayment penalty periods of three-, five-, seven- and ten-years. Commercial mortgages provide greater asset diversification on our balance sheet as borrowers of commercial mortgages typically have higher credit scores and commercial mortgages typically have lower loan-to-value ratios, or LTV ratios, and longer average life to payoff than Alt-A mortgages.

The long-term investment operations generate earnings primarily from net interest income earned on mortgages held for long-term investment, or (long-term mortgage portfolio). The long-term mortgage portfolio as reported on our consolidated balance sheet consists of mortgages held as securitized mortgage collateral and mortgages held-for-investment. Investments in Alt-A mortgages and commercial mortgages are initially financed with short-term borrowings under reverse repurchase agreements that are subsequently converted to long-term financing in the form of securitized mortgage borrowings. Cash flows from the long-term mortgage portfolio, proceeds from the sale of capital stock and issuance of trust preferred securities also finance new Alt-A and commercial mortgages.

In 2005 and 2006, the Company completed ISAC REMIC 2005-2, ISAC REMIC 2006-1, and ISAC REMIC 2006-3 securitizations which were treated as sales for tax purposes but treated as secured borrowings for generally accepted accounting principles (GAAP) and consolidated in the financial statements. The associated collateral and borrowings are included in securitized mortgage collateral and borrowings, respectively, for reporting purposes. Hence, reference to Securitized mortgage collateral or Securitized mortgage borrowings includes the REMIC 2005-2, 2006-1, and 2006-3 securitized collateral and borrowings.

In the second quarter of 2006, the Company completed ISAC REMIC 2006-2 securitization in the amount of \$834.0 million which was treated as a sale for both tax and GAAP purposes. The residual interest, calculated as present value of estimated future cash flows, was retained as a result of the ISAC REMIC 2006-2 securitization, and is recorded in other assets on the balance sheet as investment securities available for sale. Investments in residual interest and subordinated securities represent higher risk than investments in senior mortgage-backed securities because these subordinated securities bear all credit losses prior to the related senior securities. The risk associated with holding residual interest and subordinated securities is greater than holding the underlying mortgage loans directly due to the concentration of losses attributed to the subordinated securities. The value of residual interests represents the present value of future cash flows expected to be received by us from excess cash flows created in the securitization transaction. In general, future cash flows are estimated by taking the coupon rate of the loans underlying the transaction less the interest rate paid to the investors, less contractually specified servicing and trustee fees,



and after giving effect to estimated prepayments and credit losses. The Company estimates future cash flows from these securities utilizing assumptions based in part on projected discount rates, delinquency rates, mortgage loan prepayment speeds and credit losses.

The mortgage operations acquire, originate, sell and securitize primarily adjustable rate and fixed rate Alt-A mortgages and, to a lesser extent, sub-prime residential mortgages. The mortgage operations generate income by securitizing and selling mortgages to permanent investors, including the long-term investment operations. This business also earns revenue from fees associated with mortgage servicing rights, master servicing agreements and interest income earned on mortgages held-for-sale. The mortgage operations use warehouse facilities provided by the warehouse lending operations to finance the acquisition and origination of mortgages.

The warehouse lending operations provide short-term financing to mortgage loan originators, including our mortgage operations, by funding mortgages from their closing date until sale to pre-approved investors. This business earns fees from warehouse transactions as well as net interest income from the difference between its cost of borrowings and the interest earned on warehouse advances.

The commercial operations originate commercial mortgages that are primarily adjustable rate mortgages with initial fixed interest rate periods of two-, three-, five-, seven- and ten-years that subsequently convert to adjustable rate mortgages, or hybrid ARMs, with balances that generally range from \$500,000 to \$5.0 million. Commercial mortgages have interest rate floors, which is the initial start rate; in some circumstances have lockouts and prepayment penalty periods of three-, five-, seven- and ten-years. These mortgages provide greater asset diversification on our balance sheet as commercial mortgage borrowers typically have higher credit scores and typically have lower loan-to-value ratios, or LTV ratios, and the mortgages have longer average lives than residential mortgages.

#### **Critical Accounting Policies**

We define critical accounting policies as those that are important to the portrayal of our financial condition and results of operations and may require estimates and assumptions based on our judgment of changing market conditions and the performance of our assets and liabilities at any given time. In determining which accounting policies meet this definition, we considered our policies with respect to the valuation of our assets and liabilities and estimates and assumptions used in determining those valuations. We believe the most critical accounting issues that require the most complex and difficult judgments and that are particularly susceptible to significant change to our financial condition and results of operations include allowance for loan losses, derivative financial instruments and securitization of financial assets as financing versus sale, amortization of loan premium and securitization costs, compliance with Regulation AB and taxable income.

#### **Selected Financial Results for the Third Quarter of 2006**

- Estimated taxable income per diluted share was \$0.23 compared to \$0.27 for the second quarter of 2006 and \$0.36 for the first quarter of 2006;
- Cash dividends declared per common share was \$0.25 compared to \$0.25 for the second quarter of 2006 and \$0.25 for the first quarter of 2006;
- Book value per common share was \$11.94 as of September 30, 2006 compared to \$13.24 as of December 31, 2005 and \$12.93 as of September 30, 2005; the reduction in the net book value per common share from June 30, 2006 is primarily the result of a non-cash \$155.5 million loss on the change in fair value of derivative instruments, as more fully described in the Results of Operations discussion;
- Total assets were \$22.5 billion as of September 30, 2006 compared to \$27.7 billion as of December 31, 2005 and \$27.9 billion as of September 30, 2005;
- The mortgage operations acquired and originated \$3.1 billion of primarily Alt-A mortgages compared to \$2.2 billion for the second quarter of 2006 and \$6.2 billion for the third quarter of 2005;



- The commercial mortgage operations originated \$233.9 million of commercial mortgages compared to \$277.9 million for the second quarter of 2006 and \$211.9 million for the third quarter of 2005.
- The Company completed the \$2.0 billion REMIC 2006-3 securitization which was treated as financing for GAAP purposes and consolidated onto the balance sheet as compared to the \$834.0 million REMIC 2006-2 securitization during the second quarter of 2006 which was treated as a sale for GAAP purposes. During the third quarter of 2005, the Company did not complete a REMIC securitization.

**Selected Financial Results for the First Nine Months of 2006**

- Estimated taxable income per diluted share decreased to \$0.86 compared to \$1.68 for the first nine months of 2005;
- Cash dividends declared per share decreased to \$0.75 compared to \$1.95 for the first nine months of 2005;
- The mortgage operations acquired and originated \$7.4 billion of primarily Alt-A mortgages compared to \$16.3 billion for the first nine months of 2005;
- The long-term investment operations, retained for investment \$2.8 billion of primarily Alt-A mortgages compared to \$9.7 billion for the first nine months of 2005; and
- The commercial mortgage operations originated \$713.8 million of commercial mortgages compared to \$591.8 million for the first nine months of 2005.

**Third Quarter and Year to Date 2006 Taxable Income**

Because dividend payments are based on estimated taxable income, dividends may be more or less than net earnings. As such, we believe that the disclosure of estimated taxable income available to common stockholders, which is a non-generally accepted accounting principle, or non-GAAP, financial measurement, is useful information for our investors.

The following table presents a reconciliation of net (loss) earnings (GAAP) to estimated taxable income available to common stockholders for the periods indicated (in thousands, except per share amounts):

|   | For the Three Months<br>Ended September 30, (1) |            | For the Nine Months<br>Ended September 30, (1) |            |
|---|---|------------|--|------------|
|   | 2006  | 2005       | 2006   | 2005       |
| Net (loss) earnings GAAP                                      | \$ (127,690 )                                   | \$ 126,357 | \$ (15,768 )                                   | \$ 244,967 |
| Adjustments to net (loss) earnings: (2)                       |   |            |  |            |
| Loan loss provision (3)                                       | 3,183   | 13,434     | 3,288  | 25,219     |
| REMIC income (4)  | 2,838   |            | 11,933   |            |
| Tax deduction for actual loan losses (3)                      | (5,540 )  | (4,690 )   | (16,087 )                                      | (10,604 )  |
| Change in fair value of derivatives (5)                       | 150,051   | (108,905 ) | 95,186   | (146,913 ) |
| Dividends on preferred stock                                  | (3,672 )  | (3,624 )   | (11,016 )                                      | (10,872 )  |
| Net (earnings) loss of taxable REIT subsidiaries (6)          | (4,853 )  | (830 )     | 10,997   | (16,254 )  |
| Dividend from taxable REIT subsidiaries (7)                   | 3,900   | 7,000      | 7,400  | 32,850     |
| Elimination of inter-company loan sales transactions (8)      | (983 )  | 1,581      | (21,205 )                                      | 9,824      |
| Miscellaneous adjustments                                     | 96  |            | 335  |            |
| Estimated taxable income available to common stockholders (9) | \$ 17,330                                       | \$ 30,323  | \$ 65,063                                      | \$ 128,217 |
| Estimated taxable income per diluted common share (9)         | \$ 0.23   | \$ 0.40    | \$ 0.86  | \$ 1.68    |
| Diluted weighted average common shares outstanding            | 76,132  | 76,318     | 76,119   | 76,311     |

(1) Estimated taxable income includes estimates of book to tax adjustments and can differ from actual taxable income as calculated when we file our annual corporate tax return. Since estimated taxable income is a

non-GAAP financial measurement, the reconciliation of estimated taxable income available to common stockholders to net (loss) earnings is intended to meet the requirements of Regulation G as promulgated by the SEC for the presentation of non-GAAP financial measurements. To maintain our REIT status, we are required to distribute a minimum of 90% of our annual taxable income to our stockholders.

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- (2) Certain adjustments are made to net (loss) earnings in order to calculate taxable income due to differences in the way revenues and expenses are recognized under the two methods.
- (3) To calculate estimated taxable income, actual loan losses are deducted. For the calculation of net earnings, GAAP requires a deduction for estimated losses inherent in our mortgage portfolios in the form of a provision for loan losses, which are not deductible for tax purposes. Therefore, as the estimated losses provided for under GAAP are actually realized, the losses will negatively and may materially effect future taxable income.
- (4) Includes GAAP to Tax Differences related to the ISAC REMIC 2005-2, ISAC REMIC 2006-1, and ISAC REMIC 2006-3 securitizations, which were treated as secured borrowings for GAAP purposes and sales for tax purposes.
- (5) The mark-to-market change for the valuation of derivatives at IMH is income or expense for GAAP financial reporting purposes but is not included as an addition or deduction for taxable income calculations until realized.
- (6) Represents net earnings of IFC and ICCG, our taxable REIT subsidiaries (TRSs), which may not necessarily equal taxable income. Starting January 1, 2006, the Company elected to convert ICCG from a qualified REIT subsidiary to a TRS. Therefore, the three and nine months ended September 30, 2005 does not include any net earnings or losses of ICCG.
- (7) Any dividends paid to IMH by the TRSs in excess of their cumulative undistributed taxable income would be recognized as return of capital by IMH to the extent of IMH's capital investment in the TRSs. Distributions from the TRSs to IMH may not equal the TRSs' net earnings, however, IMH can only recognize dividend distributions received from the TRSs as taxable income to the extent that the TRSs' distributions are from current or prior period undistributed taxable income. Any distributions by the TRSs in excess of IMH's capital investment in the TRSs would be taxed as capital gains.
- (8) Includes the effects to taxable income associated with the elimination of gains from inter-company loan sales and other inter-company transactions between IFC, ICCG, and IMH, net of tax and the related amortization of the deferred charge.
- (9) Excludes the deduction for common stock dividends paid and the availability of a deduction attributable to net operating loss carry-forwards. As of December 31, 2005, the Company has estimated federal net operating loss carry-forwards of \$18.1 million that are expected to be utilized prior to their expiration in the year 2020.

***Third Quarter 2006 vs. Second Quarter 2006 Net GAAP Earnings***

The results of operations for the third quarter of 2006 resulted in a net loss of \$127.7 million or \$1.73 per share as compared to net earnings \$26.4 million or \$0.30 per share, for the second quarter of 2006. The decrease is primarily due to the decrease in the fair value of the derivative instruments and a decrease in net interest income partially offset by an increase in realized gains from derivative instruments.

Included in net earnings was a primarily mark-to-market loss in the fair value of derivative instruments whereby the Company records a change in fair value of its derivative instruments as a gain or loss in the current period, which during the third quarter of 2006 decreased to a loss of \$155.5 million as compared to a gain of \$11.5 million during the second quarter 2006. The change in the fair value of the derivative instruments was the result of a partial inversion in the forward yield curve as of September 30, 2006. The third quarter of 2006 resulted in a net interest expense of \$24.5 million as compared to a net interest expense of \$14.7 million for the second quarter of 2006. The increase in net interest expense of \$9.8 million was primarily due to a decrease in interest income on mortgage assets of \$13.1 million partially offset by a reduction in interest expense mortgage borrowings of \$3.7 million. Realized gains on derivative instruments increased to \$60.6 million during the third quarter of 2006 as compared to \$55.9 million during the second quarter of 2006.

*Third Quarter 2006 vs. Second Quarter 2006 Estimated Taxable Income*

Estimated taxable income decreased by \$3.3 million to \$17.3 million, or \$0.23 per diluted common share during the third quarter of 2006, compared to \$20.6 million or \$0.27 per diluted common share for the second quarter 2006 primarily attributable to a decrease in adjusted net interest income at the REIT of \$3.9 million, partially offset by a decrease in actual loan losses of \$600,000, and a \$400,000 increase in dividend income from the taxable REIT subsidiary, Impac Funding Corporation.

The decrease in adjusted net interest income at the REIT of \$3.9 million was primarily the result of a decrease in interest income of \$10.3 million, partially offset by a decrease in interest expense of \$3.7 million and an increase in realized gain from derivative instruments of \$2.7 million. Although interest income and interest expense decreased primarily due to a decline in the average balances of the securitized mortgage collateral and the related securitized mortgage borrowings, the adjusted net interest margin as a percentage of total average mortgage assets improved to 39 basis points as compared to 38 basis points during the second quarter 2006.

**Financial Condition and Results of Operations***Financial Condition*

## Condensed Balance Sheet Data

(dollars in thousands)

|  | September 30,<br>2006 | December 31,<br>2005 | Increase<br>(Decrease) | %        | Change      |           |
|--|-----------------------|----------------------|------------------------|----------|-------------|-----------|
| Cash and cash equivalents                        | \$ 161,901            | \$ 146,621           | \$ 15,280              | 10       | %           |           |
| Restricted Cash                                  | 498                   | 698                  | (200)                  | )        | (29)        | )         |
| Securitized mortgage collateral                  | 20,232,463            | 24,494,290           | (4,261,827)            | )        | (17)        | )         |
| Finance receivables                              | 297,657               | 350,217              | (52,560)               | )        | (15)        | )         |
| Mortgages held-for-investment                    | 3,134                 | 160,070              | (156,936)              | )        | (98)        | )         |
| Allowance for loan losses                        | (65,715)              | (78,514)             | (12,799)               | )        | (16)        | )         |
| Mortgages held-for-sale                          | 1,293,085             | 2,052,694            | (759,609)              | )        | (37)        | )         |
| Accrued interest receivable                      | 103,807               | 123,565              | (19,758)               | )        | (16)        | )         |
| Derivatives                                      | 176,797               | 250,368              | (73,571)               | )        | (29)        | )         |
| Other assets                                     | 286,757               | 220,370              | 66,387                 | )        | 30          | )         |
| <b>Total assets</b>                              | <b>\$ 22,490,384</b>  | <b>\$ 27,720,379</b> | <b>\$ (5,229,995)</b>  | <b>)</b> | <b>(19)</b> | <b>)%</b> |
| Securitized mortgage borrowings                  | \$ 19,697,798         | \$ 23,990,430        | \$ (4,292,632)         | )        | (18)        | )%        |
| Reverse repurchase agreements                    | 1,542,441             | 2,430,075            | (887,634)              | )        | (37)        | )         |
| Other liabilities                                | 182,484               | 132,927              | 49,557                 | )        | 37          | )         |
| Total liabilities                                | 21,422,723            | 26,553,432           | (5,130,709)            | )        | (19)        | )         |
| Total stockholders equity                        | 1,067,661             | 1,166,947            | (99,286)               | )        | (9)         | )         |
| <b>Total liabilities and stockholders equity</b> | <b>\$ 22,490,384</b>  | <b>\$ 27,720,379</b> | <b>\$ (5,229,995)</b>  | <b>)</b> | <b>(19)</b> | <b>)%</b> |

Total assets were \$22.5 billion as of September 30, 2006 as compared to \$27.7 billion as of December 31, 2005. The reduction in total assets of \$5.2 billion was mainly attributable to \$5.3 billion in whole loan sales, REMIC securitizations for \$834.0 million, and \$6.7 billion in total principal pay downs, which was partially offset by total year-to-date acquisitions and originations of \$8.2 billion.

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The following table presents selected information about mortgages held as securitized mortgage collateral as of the dates indicated:

|  | Residential                    |                      |                       | Commercial                     |                      |                       |
|--|--------------------------------|----------------------|-----------------------|--------------------------------|----------------------|-----------------------|
|  | As of<br>September 30,<br>2006 | December 31,<br>2005 | September 30,<br>2005 | As of<br>September 30,<br>2006 | December 31,<br>2005 | September 30,<br>2005 |
| Percent of Alt-A mortgages                   | 99                             | 99                   | 99                    | N/A                            | N/A                  | N/A                   |
| Percent of non-hybrid ARMs                   | 10                             | 14                   | 15                    | 2                              | 4                    | 5                     |
| Percent of hybrid ARMs                       | 75                             | 75                   | 75                    | 98                             | 96                   | 95                    |
| Percent of FRMs                              | 15                             | 11                   | 10                    | 0                              | 0                    | 0                     |
| Percent of interest-only                     | 73                             | 71                   | 69                    | 13                             | 11                   | 8                     |
| Weighted average coupon                      | 6.52                           | 6.10                 | 5.97                  | 5.84                           | 5.62                 | 5.51                  |
| Weighted average margin                      | 3.73                           | 3.79                 | 3.77                  | 2.69                           | 2.69                 | 2.71                  |
| Weighted average original LTV                | 75                             | 76                   | 76                    | 67                             | 67                   | 67                    |
| Weighted average original credit score       | 696                            | 695                  | 695                   | 730                            | 728                  | 728                   |
| Percent with active prepayment penalty       | 73                             | 75                   | 76                    | 100                            | 100                  | 100                   |
| Prior 3-month constant prepayment rate       | 40                             | 38                   | 40                    | 8                              | 9                    | 11                    |
| Prior 12-month prepayment rate               | 38                             | 37                   | 37                    | 9                              | 9                    | 8                     |
| Lifetime prepayment rate                     | 30                             | 25                   | 25                    | 6                              | 5                    | 5                     |
| Weighted average debt service coverage ratio | N/A                            | N/A                  | N/A                   | 1.29                           | 1.22                 | 1.32                  |
| Percent of mortgages in California           | 53                             | 55                   | 56                    | 66                             | 71                   | 73                    |
| Percent of purchase transactions             | 59                             | 60                   | 59                    | 51                             | 52                   | 52                    |
| Percent of owner occupied                    | 79                             | 81                   | 81                    | N/A                            | N/A                  | N/A                   |
| Percent of first lien                        | 99                             | 99                   | 99                    | 100                            | 100                  | 100                   |

\* N/A = Not Applicable

The following table presents selected financial data as of the dates indicated (dollars in thousands, except share data):

|  | As of and Year-to-Date Ended, |                      |                       |
|--|-------------------------------|----------------------|-----------------------|
|  | September 30,<br>2006         | December 31,<br>2005 | September 30,<br>2005 |
| Book value per share                   | \$ 11.94                      | \$ 13.24             | \$ 12.93              |
| Return on average assets               | (0.09)%                       | 1.01%                | 1.25%                 |
| Return on average equity               | (1.73)%                       | 24.13%               | 29.74%                |
| Assets to equity ratio                 | 20.97:1                       | 23.75:1              | 24.53:1               |
| Debt to equity ratio                   | 19.99:1                       | 22.72:1              | 23.46:1               |
| Mortgages owned 60+ days delinquent    | \$ 1,035,601                  | \$ 733,348           | \$ 512,382            |
| 60+ day delinquency of mortgages owned | 5.01%                         | 3.12%                | 2.18%                 |

We believe that in order for us to generate positive cash flows and earnings we must successfully manage the following primary operational and market risks:

- credit risk;
- prepayment risk;

- liquidity risk; and
- interest rate risk.

*Credit Risk.* We manage credit risk by acquiring for long-term investment high credit quality Alt-A and commercial mortgages from our customers, adequately providing for loan losses and actively managing delinquencies and defaults. Alt-A mortgages are primarily first lien mortgages made to borrowers whose credit is generally within typical Fannie Mae and Freddie Mac guidelines, but that have loan characteristics that make them non-conforming under those guidelines.

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As of September 30, 2006, the original weighted average credit score of mortgages held as residential and commercial securitized mortgage collateral was 696 and 730 respectively, and the original weighted average LTV ratio was 75% and 67%, respectively. During the third quarter of 2006, the mortgage operations acquired or originated \$3.1 billion of residential mortgages with an original weighted average credit score of 695 and an original weighted average LTV ratio of 73%. ICCG also originated \$233.9 million of commercial mortgages with a weighted average credit score of 724, a weighted average debt service cover ratio of 1.22 and an original weighted average LTV ratio of 65%.

We monitor our sub-servicers to make sure that they perform loss mitigation, foreclosure and collection functions according to our servicing guide. This includes an effective and aggressive collection effort in order to minimize the number of mortgages becoming seriously delinquent. When resolving delinquent mortgages, sub-servicers are required to take timely and aggressive action. The sub-servicer is required to determine payment collection under various circumstances, which will result in maximum financial benefit. We accomplish this by either working with the borrower to bring the mortgage current or by foreclosing and liquidating the property. We perform ongoing reviews of mortgages that display weaknesses and believe that we maintain an adequate loss allowance on the mortgages. When a borrower fails to make required payments on a mortgage and does not cure the delinquency within 60 days, we generally record a notice of default and commence foreclosure proceedings. If the mortgage is not reinstated within the time period permitted by law for reinstatement, the property may then be sold at a foreclosure sale. At foreclosure sales, we generally acquire title to the property. As of September 30, 2006, our long-term mortgage portfolio included 5.01% of mortgages that were 60 days or more delinquent compared to 3.12% as of December 31, 2005.

The following table summarizes mortgages that we own, including securitized mortgage collateral, mortgages held for long-term investment and mortgages held-for-sale, that were 60 or more days delinquent for the periods indicated (in thousands):

|                                  | At September 30,<br>2006 | At December 31,<br>2005 |
|----------------------------------|--------------------------|-------------------------|
| 60 - 89 days delinquent          | \$ 319,346               | \$ 300,039              |
| 90 or more days delinquent       | 322,809                  | 221,581                 |
| Foreclosures                     | 334,415                  | 161,414                 |
| Delinquent bankruptcies          | 59,031                   | 50,314                  |
| Total 60 or more days delinquent | \$ 1,035,601             | \$ 733,348              |

Non-performing assets consist of mortgages that are 90 days or more delinquent, including loans in foreclosure and delinquent bankruptcies. It is our policy to place a mortgage on non-accrual status when it becomes 90 days delinquent and to reverse from revenue any accrued interest. When real estate is acquired in settlement of loans, or other real estate owned, the mortgage is written-down to a percentage of the property's appraised value or broker's price opinion less anticipated selling costs. As of September 30, 2006, non-performing assets as a percentage of total assets was 3.70% compared to 1.73% as of December 31, 2005.

The following table summarizes mortgages that we own, including securitized mortgage collateral, mortgages held for long-term investment and mortgages held-for-sale, that were non-performing for the periods indicated (in thousands):

|  | At September 30,<br>2006 | At December 31,<br>2005 |
|--|--------------------------|-------------------------|
| 90 or more days delinquent, foreclosures and delinquent bankruptcies | \$ 716,255               | \$ 433,309              |
| Other real estate owned  | 114,825                  | 46,351                  |
| Total non-performing assets  | \$ 831,080               | \$ 479,660              |

Real estate owned, which consists of residential real estate acquired in satisfaction of loans, is carried at the lower of cost or estimated fair value less estimated selling costs. Adjustments to the loan carrying value required at the time of foreclosure are charged against the allowance for loan losses. Losses or gains from the ultimate disposition of real estate owned are recorded as (gain) loss on sale of other real estate owned in the consolidated statement of operations. Real estate owned increased from \$46.4 million to \$114.8 million as a result of an increase in delinquencies. We have realized a gain on



disposition of real estate owned in the amount of \$1.3 million for each of the nine month periods ended September 30, 2006 and 2005.

In evaluating the adequacy of the allowance for loan losses, a detailed analysis of historical loan performance data is accumulated and reviewed, including the delinquency rates. This data is analyzed for loss performance and prepayment performance by product type, and vintage. The results of that analysis are then applied to the current mortgage portfolio and an estimate is calculated. We believe that pooling of mortgages with similar characteristics is an appropriate methodology in which to evaluate the allowance for loan losses. Management also recognizes that there are qualitative factors that must be taken into consideration when evaluating and measuring inherent loss in our loan portfolios. These items include, but are not limited to, economic indicators that may affect the borrower's ability to pay, changes in value of collateral, political factors and industry statistics. While our delinquency rates have increased they have not increased at a rate in excess of our expectations. We believe our total allowance for loan losses is adequate to absorb losses inherent in our mortgage portfolio as of September 30, 2006.

*Prepayment Risk.* The Company uses prepayment penalties as a method of partially mitigating prepayment risk. Mortgage industry evidence suggests that the increase in home appreciation rates and lower payment option mortgage products over the last three years was a significant factor affecting borrowers refinancing decisions through 2005. The three-month constant prepayment rate (CPR) increased to 40% at September 30, 2006 from 38% as of December 31, 2005, which is related to prepayments on hybrid ARMs at their reset.

During the nine months ended September 30, 2006, 82% of Alt-A mortgages acquired by the long-term investment operations from the mortgage operations had prepayment penalty features ranging from six-months to five years. As of September 30, 2006, 73% and 100% of mortgages held as residential and commercial securitized mortgage collateral had prepayment penalties, respectively. As of September 30, 2006, the twelve-month CPR of mortgages held as securitized mortgage collateral was 38% as compared to a 37% twelve-month CPR as of September 30, 2005. Prepayment penalties are charged to borrowers for mortgages that are paid early and recorded as interest income on our consolidated financial statements. Interest income from prepayment penalties helps offset amortization of loan premiums and securitization costs. During the first nine months of 2006, prepayment penalties received from borrowers were recorded as interest income and increased 7 basis points to 21 basis points of mortgage assets as compared to 14 basis points of mortgage assets in the first nine months of 2005.

*Liquidity Risk.* We employ a leverage strategy to increase assets by financing our long-term mortgage portfolio primarily with securitized mortgage borrowings, reverse repurchase agreements and capital, then using cash proceeds to acquire additional mortgage assets. We retain ARMs and FRMs that are acquired and originated from the mortgage and commercial operations and finance the acquisition of those mortgages, during this accumulation period, with reverse repurchase agreements. After accumulating a pool of mortgages we sell the mortgages in the form of securitized mortgage collateral, whole loan sales or REMICs. Our strategy is to sell or securitize our mortgages within 90 days in order to reduce the accumulation period that mortgages are outstanding on short-term reverse repurchase facilities, which reduces our exposure to margin calls and reduces spread risk on these facilities. Securitized mortgage borrowings are classes of bonds that are sold to investors of mortgage-backed securities and as such are not subject to margin calls. In addition, the securitized mortgage borrowings generally require a smaller initial cash investment as a percentage of mortgages financed than does interim reverse repurchase financing. We continually monitor our leverage ratio and liquidity levels to insure that we are adequately protected against adverse changes in market conditions. Additionally, as interest rates decline our requirement to maintain certain cash collateral balances increases, which reduces our cash and cash equivalents available for use in operations. As of September 30, 2006 our cash collateral balance totaled \$47.8 million, as compared to \$16.6 million as of December 31, 2005. For additional information regarding liquidity refer to Liquidity and Capital Resources.

*Interest Rate Risk.* Refer to Item 3. Quantitative and Qualitative Disclosures About Market Risk.

*Results of Operations*

*For the Three Months Ended September 30, 2006 compared to the Three Months Ended September 30, 2005*

Condensed Statements of Operations Data

(dollars in thousands, except share data)

|   | For the Three Months Ended September 30, |            | Increase      | %       |
|---|--|------------|---------------|---------|
|   | 2006                                     | 2005       | (Decrease)    | Change  |
| Total Interest income   | \$ 300,266                               | \$ 324,050 | \$ (23,784 )  | (7 )%   |
| Total Interest expense  | 324,776                                  | 281,154    | 43,622        | 16      |
| Net interest (expense) income                                 | (24,510 )                                | 42,896     | (67,406 )     | (157 )  |
| Provision for loan losses                                     | 3,183                                    | 13,434     | (10,251 )     | (76 )   |
| Net interest (expense) income after provision for loan losses | (27,693 )                                | 29,462     | (57,155 )     | (194 )  |
| Total non-interest (loss) income                              | (65,398 )                                | 129,012    | (194,410 )    | (151 )  |
| Total non-interest expense                                    | 32,365                                   | 39,454     | (7,089 )      | (18 )   |
| Income tax expense (benefit)                                  | 2,234                                    | (7,337 )   | (9,571 )      | (130 )  |
| Net (loss) earnings   | \$ (127,690 )                            | \$ 126,357 | \$ (254,047 ) | (201 )% |
| Net (loss) earnings per share - diluted                       | \$ (1.73 )                               | \$ 1.61    | \$ (3.34 )    | (207 )% |
| Dividends declared per common share                           | \$ 0.25                                  | \$ 0.45    | \$ (0.20 )    | (44 )%  |

*For the Nine Months Ended September 30, 2006 compared to the Nine Months Ended September 30, 2005*

Condensed Statements of Operations Data

(dollars in thousands, except share data)

|   | For the Nine Months Ended September 30, |            | Increase      | %       |
|---|---|------------|---------------|---------|
|   | 2006                                    | 2005       | (Decrease)    | Change  |
| Total Interest income   | \$ 949,229                              | \$ 911,214 | \$ 38,015     | 4 %     |
| Total Interest expense  | 977,011                                 | 721,059    | 255,952       | 35      |
| Net interest (expense) income                                 | (27,782 )                               | 190,155    | (217,937 )    | (115 )  |
| Provision for loan losses                                     | 3,288                                   | 25,219     | (21,931 )     | (87 )   |
| Net interest (expense) income after provision for loan losses | (31,070 )                               | 164,936    | (196,006 )    | (119 )  |
| Total non-interest income                                     | 104,289                                 | 181,433    | (77,144 )     | (43 )   |
| Total non-interest expense                                    | 100,612                                 | 115,326    | (14,714 )     | (13 )   |
| Income tax benefit  | (11,625 )                               | (13,924 )  | (2,299 )      | (17 )   |
| Net (loss) earnings   | \$ (15,768 )                            | \$ 244,967 | \$ (260,735 ) | (106 )% |
| Net (loss) earnings per share - diluted                       | \$ (0.35 )                              | \$ 3.07    | \$ (3.42 )    | (111 )% |
| Dividends declared per common share                           | \$ 0.75                                 | \$ 1.95    | \$ (1.20 )    | (62 )%  |

*Net Interest Income*

We earn interest income primarily on mortgage assets which include securitized mortgage collateral, mortgages held-for-investment, mortgages held-for-sale, finance receivables and investment securities available-for-sale, or collectively, mortgage assets, and, to a lesser extent, interest income earned on cash and cash equivalents. Interest expense is primarily interest paid on borrowings on mortgage assets, which include securitized mortgage borrowings and reverse repurchase agreements.



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The following table summarizes average balance, interest and weighted average yield on investments in mortgage assets and borrowings on mortgage assets for the periods indicated (dollars in thousands):

|  | For the Three Months Ended September 30,<br>2006 |              |         | 2005               |            |         |
|--|--|--------------|---------|--------------------|------------|---------|
|  | Average<br>Balance                               | Interest     | Yield   | Average<br>Balance | Interest   | Yield   |
| <b><u>MORTGAGE ASSETS</u></b>  |  |              |         |                    |            |         |
| Subordinated securities collateralized by mortgages                  | \$ 31,503  | \$ 1,509     | 19.16 % | \$ 58,227          | \$ 442     | 3.04 %  |
| Securitized mortgage collateral (1)                                  | 19,581,945                                       | 257,995      | 5.27 %  | 23,294,226         | 271,661    | 4.66 %  |
| Mortgages held-for-investment and held-for-sale                      | 2,073,935  | 33,405       | 6.44 %  | 2,956,712          | 45,768     | 6.19 %  |
| Finance receivables  | 263,106  | 5,230        | 7.95 %  | 304,593            | 4,834      | 6.35 %  |
| Total mortgage assets\ interest income                               | \$ 21,950,489                                    | \$ 298,139   | 5.43 %  | \$ 26,613,758      | \$ 322,705 | 4.85 %  |
| <b><u>BORROWINGS</u></b>   |  |              |         |                    |            |         |
| Securitized mortgage borrowings                                      | \$ 19,190,482                                    | \$ 289,925   | 6.04 %  | \$ 22,849,177      | \$ 243,945 | 4.27 %  |
| Reverse repurchase agreements  | 2,098,722  | 32,552       | 6.20 %  | 3,070,767          | 35,448     | 4.62 %  |
| Total borrowings on mortgage assets\ interest expense                | \$ 21,289,204                                    | \$ 322,477   | 6.06 %  | \$ 25,919,944      | \$ 279,393 | 4.31 %  |
| <b>Net Interest Spread (2)</b>                                       |  |              | (0.63 ) |                    |            | 0.54 %  |
| <b>Net Interest Margin (3)</b>                                       |  |              | (0.44 ) |                    |            | 0.65 %  |
| Net interest (expense) income on mortgage assets                     |  | \$ (24,338 ) | (0.44 ) |                    | \$ 43,312  | 0.65 %  |
| Less: accretion of loan discounts (4)                                |  | (14,837 )    | (0.27 ) |                    | (20,355 )  | (0.31 ) |
| Adjusted by net cash receipts on derivatives (5)                     |  | 60,630       | 1.10    |                    | 10,975     | 0.17    |
| <b>Adjusted Net Interest Margin (6)</b>                              |  | \$ 21,455    | 0.39 %  |                    | \$ 33,932  | 0.51 %  |
| Effect of amortization of loan premiums and securitization costs (7) |  | \$ 54,594    | (0.99 ) |                    | \$ 77,571  | (1.17 ) |

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|  | For the Nine Months Ended September 30, |              |         | 2005          |            |         |
|--|---|--------------|---------|---------------|------------|---------|
|  | 2006                                    |              |         | Average       |            |         |
|  | Average                                 | Interest     | Yield   | Balance       | Interest   | Yield   |
|  | Balance                                 |              |         |               |            |         |
| <b>MORTGAGE ASSETS</b>   |   |              |         |               |            |         |
| Subordinated securities collateralized by mortgages                  | \$ 29,722                               | \$ 2,686     | 12.05 % | \$ 36,343     | \$ 1,094   | 4.01 %  |
| Securitized mortgage collateral (1)                                  | 21,667,571                              | 838,452      | 5.16 %  | 22,931,073    | 780,395    | 4.54 %  |
| Mortgages held-for-investment and held-for-sale                      | 1,782,364                               | 86,603       | 6.48 %  | 2,350,281     | 110,902    | 6.29 %  |
| Finance receivables  | 284,295                                 | 15,037       | 7.05 %  | 342,728       | 14,674     | 5.71 %  |
| Total mortgage assets\ interest income                               | \$ 23,763,952                           | \$ 942,778   | 5.29 %  | \$ 25,660,425 | \$ 907,065 | 4.71 %  |
| <b>BORROWINGS</b>  |   |              |         |               |            |         |
| Securitized mortgage borrowings                                      | \$ 21,233,648                           | \$ 888,144   | 5.58 %  | \$ 22,542,836 | \$ 639,667 | 3.78 %  |
| Reverse repurchase agreements  | 1,870,276                               | 81,881       | 5.84 %  | 2,499,525     | 78,192     | 4.17 %  |
| Total borrowings on mortgage assets\ interest expense                | \$ 23,103,924                           | \$ 970,025   | 5.60 %  | \$ 25,042,361 | \$ 717,859 | 3.82 %  |
| <b>Net Interest Spread (2)</b>                                       |   |              | (0.31 ) |               |            | 0.89 %  |
| <b>Net Interest Margin (3)</b>                                       |   |              | (0.15 ) |               |            | 0.98 %  |
| Net interest (expense) income on mortgage assets                     |   | \$ (27,247 ) | (0.15 ) |               | \$ 189,206 | 0.98 %  |
| Less: accretion of loan discounts (4)                                |   | (48,910 )    | (0.27 ) |               | (57,940 )  | (0.30 ) |
| Adjusted by net cash receipts (payments) on derivatives (5)          |   | 156,633      | 0.88    |               | (4,209 )   | (0.02 ) |
| <b>Adjusted Net Interest Margin (6)</b>                              |   | \$ 80,476    | 0.45 %  |               | \$ 127,057 | 0.66 %  |
| Effect of amortization of loan premiums and securitization costs (7) |   | \$ 181,071   | (1.02 ) |               | \$ 216,168 | (1.12 ) |

- (1) Interest on Securitized mortgage collateral includes amortization of acquisition cost on mortgages acquired from the mortgage operations and accretion of loan discounts.
- (2) Net interest spread on mortgage assets is calculated by subtracting the weighted average yield on total borrowings on mortgage assets from the weighted average yield on total mortgage assets.
- (3) Net interest margin on mortgage assets is calculated by subtracting interest expense on total borrowings on mortgage assets from interest income on total mortgage assets and then dividing by total average mortgage assets and annualized for the quarter margin.
- (4) Yield represents income from the accretion of loan discounts, included in (1) above, divided by total average mortgage assets.
- (5) Yield represents net cash (payments) receipts on derivatives divided by total average mortgage assets.
- (6) Adjusted net interest margin on mortgage assets is calculated by subtracting interest expense on total borrowings on mortgage assets, accretion of loan discounts and net cash receipts on derivatives from interest income on total mortgage assets divided by total average mortgage assets. Net cash receipts on derivatives are a component of realized gain on derivative instruments on the consolidated statements of operations. Adjusted net interest margins on mortgage assets is a non-GAAP financial measurement, however, the reconciliation provided in this table is intended to meet the requirements of Regulation G as promulgated by the SEC for the presentation of non-GAAP financial measurements. We believe that the presentation of adjusted net interest margin on mortgage assets is useful information for our investors as it more closely reflects the true economics of net interest margins on mortgage assets.
- (7) The amortization of loan premiums and securitization costs are components of interest income and interest expense, respectively. Yield represents the cost of amortization of net loan premiums and securitization costs divided by total average mortgage assets.

Decreases in net interest income were primarily due to a decline in net interest margins on mortgage assets primarily caused by the following:

- increase in one-month LIBOR rate underlying borrowings only partially offset by realized gain (loss) from derivative instruments;



- differences in interest rate adjustment periods;
- prepayments of higher yielding mortgages;
- a more challenging competitive environment; and
- partially offset by cash receipts from derivative instruments.

*Third Quarter 2006 vs. Third Quarter 2005*

The operations for the third quarter of 2006 resulted in net interest expense of \$24.5 million as compared to net interest income of \$42.9 million for 2005. The decrease in net interest income of \$67.4 million was primarily due to net interest margins on mortgage assets declining by 109 basis points to (0.44)% for 2006 as compared to 0.65% for 2005. Net interest margin on mortgage assets declined as one-month LIBOR, which is the interest rate index used to price borrowing costs on securitized mortgage and reverse repurchase borrowings, rose approximately 146 basis points since the third quarter of 2005 while mortgage assets over the same period did not re-price upward as quickly. The increase in borrowings resulted in an increase in interest expense of 16% to \$324.8 million during the quarter ended September 30, 2006 as compared to \$281.2 million during the quarter ended September 30, 2005. Adjusted net interest margins on mortgage assets, as defined in the yield table above, declined by 12 basis points to 0.39% during the third quarter of 2006 as compared to 0.51% during the third quarter of 2005. The decrease in adjusted net interest margins on mortgage assets was primarily due to a negative variance of 175 basis points in borrowing costs partially offset by a favorable variance of 93 basis points on realized gains from derivative assets and a favorable variance of 58 basis points on mortgage assets as coupons have adjusted.

Since the third quarter of 2005, the Federal Reserve raised short-term interest rates, which increased the one-month LIBOR, approximately 146 basis points. This caused borrowing costs on adjustable rate securitized mortgage borrowings, which are tied to the one-month LIBOR to re-price monthly without limitation, to rise at a faster pace than coupons on LIBOR ARMs securing securitized mortgage borrowings, which generally re-price every six months with limitation. LIBOR ARMs held in our long-term investment portfolio are subject to the following interest rate risks:

- interest rate adjustment limitations on mortgages held for long-term investment due to periodic and lifetime interest rate cap features as compared to borrowings which are not subject to adjustment limitations;
- mismatched interest rate re-pricing periods between mortgages held for long-term investment, which generally re-price every six months, and borrowings, which re-price every month in regards to securitized mortgage borrowings and daily in regards to reverse repurchase agreements; and
- uneven and unequal movements in the interest rate indices used to re-price mortgages held for long-term investment, which are generally indexed to one-, three- and six-month LIBOR and one-year LIBOR, and borrowings, which are generally indexed to one-month LIBOR.

Along with an increase in short-term interest rates, our expectation, based on past experience, was that we would see a corresponding decline in mortgage prepayment speeds. However, mortgage prepayment speeds have continued at heightened levels during 2006. There is mortgage industry evidence that documents a substantial increase in home appreciation rates over the last three years which has been a significant factor affecting prepayment patterns of residential borrowers. The three-month constant prepayment rate (CPR) increased to 40% at September 30, 2006 from 38% as of December 31, 2005, which is related to prepayments on hybrid ARMs at their reset.

Amortization of loan premiums and securitization expenses decreased by 18 basis points to 0.99% of average mortgage assets during the third quarter of 2006 as compared to 1.17% of average mortgage assets during the same period in 2005. A substantial portion of our long-term mortgage investment portfolio consists of mortgages with prepayment penalty features that are primarily designed to help minimize the rate of early mortgage prepayments. However, if borrowers do prepay on mortgages, a prepayment penalty is charged which helps partially offset additional amortization of loan premiums and securitization costs related to the prepaid mortgages. During the third quarter of 2006, prepayment penalties received from borrowers was recorded as interest income and remained flat at 20 basis points of mortgage assets as compared to the third quarter of 2005.

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Additionally, the net interest margin continues to be affected by the difficult competitive environment facing mortgage portfolio lenders. As a result, net interest margins continue to tighten on newly originated loans. Furthermore, a

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rise in short-term rates and a decline in long-term rates has resulted in a partial inversion of the yield curve, adding pressure to mortgage lending profitability.

During the third quarter of 2006, adjusted net interest margins on mortgage assets, which is a non-GAAP financial measurement as indicated in the yield table above, decreased by 12 basis points as compared to a decline of 109 basis points on net interest margin on mortgage assets. Adjusted net interest margin on mortgage assets did not decline as much as net interest margin on mortgage assets primarily due to a 93 basis point increase in realized cash receipts from derivative instruments relative to total average mortgage assets. Realized cash receipts from derivative instruments partially offset the decline in adjusted net interest margins on mortgage assets which was caused by the factors described above.

Our interest rate risk management policies are formulated with the intent to offset the potential adverse effects of changing interest rates primarily associated with cash flows on adjustable rate securitized mortgage borrowings. However, as a result of the combination of the factors listed above, the interest rate spread differential between ARMs and adjustable rate securitized mortgage borrowings compressed, which decreased net interest margins on mortgage assets. By design, our current interest rate risk management program provides 20% to 25% coverage of the outstanding principal balance of our six month LIBOR ARMs and 85% to 98% coverage of the outstanding principal balance of intermediate, or hybrid, ARMs at the point in time that we securitize the mortgages.

*First Nine Months of 2006 vs. First Nine Months of 2005*

The operations for the first nine months of 2006 resulted in net interest expense of \$27.8 million as compared to net interest income of \$190.2 million for the same period of 2005. The decrease in net interest income of \$217.9 million was primarily due to net interest margins on mortgage assets declining by 113 basis points to (0.15)% for 2006 as compared to 0.98% for 2005. Net interest margin on mortgage assets declined as the one-month LIBOR, which is the interest rate index used to price borrowing costs on securitized mortgage and reverse repurchase borrowings, rose approximately 146 basis points since the third quarter of 2005 while mortgage assets over the same period did not re-price upward as quickly. This resulted in an increase in interest expense of 35% to \$977.0 million for the nine months ended September 30, 2006 as compared to \$721.1 million for the nine months ended September 30, 2005. Adjusted net interest margins on mortgage assets, as defined in the yield table above, declined by 21 basis points to 0.45% during the first nine months of 2006 as compared to 0.66% during the first nine months of 2005. The decrease in adjusted net interest margins on mortgage assets was primarily due to a negative variance of 178 basis points in borrowing costs partially offset by a favorable variance of 90 basis points on realized gains from derivative assets and a favorable variance of 58 basis points on mortgage assets as coupons adjust.

Since the third quarter of 2005, the Federal Reserve raised short-term interest rates, which increased the one-month LIBOR, approximately 146 basis points. This caused borrowing costs on adjustable rate securitized mortgage borrowings, which are tied to the one-month LIBOR and re-price monthly without limitation, to rise at a faster pace than coupons on LIBOR ARMs securing securitized mortgage borrowings, which generally re-price every six months with limitation. LIBOR ARMs held in our long-term investment portfolio are subject to the following interest rate risks:

- interest rate adjustment limitations on mortgages held for long-term investment due to periodic and lifetime interest rate cap features as compared to borrowings which are not subject to adjustment limitations;
- mismatched interest rate re-pricing periods between mortgages held for long-term investment, which generally re-price every six months, and borrowings, which re-price every month in regards to securitized mortgage borrowings and daily in regards to reverse repurchase agreements; and
- uneven and unequal movements in the interest rate indices used to re-price mortgages held for long-term investment, which are generally indexed to one-, three- and six-month LIBOR and one-year LIBOR, and borrowings, which are generally indexed to one-month LIBOR.

Along with an increase in short-term interest rates, our expectation, based on past experience, was that we would see a corresponding decline in mortgage prepayment speeds. However, mortgage prepayment speeds have continued at heightened levels during 2006. There is mortgage industry evidence that documents a substantial increase in home appreciation rates over the last three years which has been a significant factor affecting prepayment patterns of residential borrowers. The three-month constant prepayment rate (CPR) increased to 40% at September 30, 2006 from 38% as of December 31, 2005 which is related to prepayments on hybrid ARMs at their reset.

Amortization of loan premiums and securitization expenses decreased by 10 basis points to 1.02% of average mortgage assets during the first nine months of 2006 as compared to 1.12% of average mortgage assets during the same period in 2005.



A substantial portion of our long-term mortgage investment portfolio consists of mortgages with prepayment penalty features that are primarily designed to help minimize the rate of early mortgage prepayments. However, if borrowers do prepay on mortgages, a prepayment penalty is charged which helps partially offset additional amortization of loan premiums and securitization costs related to the prepaid mortgages. During the first nine months of 2006, prepayment penalties received from borrowers was recorded as interest income and increased 7 basis points to 21 basis points of mortgage assets as compared to 14 basis points of mortgage assets in the first nine months of 2005.

Additionally, the net interest margin continues to be affected by the difficult competitive environment facing mortgage portfolio lenders. As a result, net interest margins continue to tighten on newly originated loans. Furthermore, a rise in short-term rates and a decline in long-term rates has resulted in a partial inversion of the yield curve, adding pressure to mortgage lending profitability.

During the first nine months of 2006, adjusted net interest margins on mortgage assets, which is a non-GAAP financial measurement as indicated in the yield table above, decreased by 21 basis points as compared to a decline of 113 basis points on net interest margin on mortgage assets. Adjusted net interest margin on mortgage assets did not decline as much as net interest margin on mortgage assets primarily due to a 90 basis point increase in realized cash receipts from derivative instruments relative to total average mortgage assets. Realized cash receipts from derivative instruments partially offset the decline in adjusted net interest margins on mortgage assets which was caused by the factors described above.

Our interest rate risk management policies are formulated with the intent to offset the potential adverse effects of changing interest rates primarily associated with cash flows on adjustable rate securitized mortgage borrowings. However, as a result of the combination of the factors listed above, the interest rate spread differential between ARMs and adjustable rate securitized mortgage borrowings compressed, which compressed net interest margins on mortgage assets. By design, our current interest rate risk management program provides 20% to 25% coverage of the outstanding principal balance of our six month LIBOR ARMs and 85% to 98% coverage of the outstanding principal balance of intermediate, or hybrid, ARMs at the point in time that we securitize the mortgages.

For further information on our interest rate risk management policies refer to Item 3. Quantitative and Qualitative Disclosures About Market Risk.

#### *Provision for Loan Losses*

The Company provides for loan losses in accordance with its policies that include a detailed analysis of historical loan performance data which is analyzed for loss performance and prepayment performance by product type, origination year and securitization issuance. The results of that analysis are then applied to the current mortgage portfolio and an estimate is derived. The Company's general allowance for loan losses reflects the expectation that losses inherent in the portfolio will exceed the level of annualized losses we are currently experiencing.

The allowance for loan losses of \$65.7 million at September 30, 2006 was comprised of specific reserves for estimated hurricane losses of \$6.6 million, for finance receivables of \$10.3 million and a loan portfolio reserve of \$48.8 million. During the nine months ended September 30, 2006, specific reserves on hurricane losses and the loan portfolio reserve both decreased by \$6.2 million. The decrease in the specific reserve for estimated hurricane losses was due to updated property inspection information and principal reductions of loans. The decrease in the loan portfolio reserve was due to a decrease in the portfolio of securitized mortgage collateral and mortgages held for investment. However, exclusive of specific reserves, the Company maintained an allowance for securitized mortgage collateral and mortgage loan held-for-sale for loan losses of 24 basis points at September 30, 2006 compared to 22 basis points at December 31, 2005. The ratio of loan portfolio reserve to annualized loan losses was 2.27 at September 30, 2006. The Company believes the total allowance for loan losses is adequate to absorb losses inherent in the loan portfolio at September 30, 2006.

For further information on delinquencies in our long-term investment portfolio and non-performing assets refer to Financial Condition and Results of Operations Credit Risk.

## Non-Interest Income

## Changes in Non-Interest Income

(dollars in thousands)

|  | For the Three Months Ended September 30, |            | Increase<br>(Decrease) | %<br>Change |    |
|--|--|------------|------------------------|-------------|----|
|  | 2006                                     | 2005       |                        |             |    |
| Realized gain from derivative instruments      | \$ 60,630                                | \$ 10,975  | \$ 49,655              | 452         | %  |
| Change in fair value of derivative instruments | (155,534 )                               | 107,881    | (263,415 )             | (244        | )  |
| Gain on sale of loans                          | 4,906                                    | 12,118     | (7,212 )               | (60         | )  |
| Recovery of (provision for) repurchases        | 15,876                                   | (3,242 )   | 19,118                 | 590         |    |
| Other income                                   | 8,724                                    | 1,280      | 7,444                  | 582         |    |
| Total non-interest (expense) income            | \$ (65,398 )                             | \$ 129,012 | \$ (194,410 )          | (151        | )% |

*Realized Gain from Derivative Instruments.* Realized gain from derivative instruments increased to \$60.6 million during the third quarter of 2006 as compared to \$11.0 million during the third quarter of 2005, or 110 basis points of total average mortgage assets during the third quarter of 2006 as compared to 17 basis points of total average mortgage assets during the third quarter of 2005. The increase in realized gain from derivative instruments is due to the approximately 146 basis point increase in the one-month LIBOR from the end of the third quarter 2005, which has caused the floating rate payments received on swaps to increase above the fixed payments made. Realized gains from derivative instruments are recorded as current period expense or income in our consolidated financial statements and are included in the calculation of taxable income in the Taxable Income table.

*Change in Fair Value of Derivative Instruments.* The change in fair value of derivative instruments decreased to a loss of \$155.5 million during the third quarter of 2006 as compared to a gain of \$107.9 million during the third quarter of 2005. The amount of market valuation adjustment is the result of changes in the market's expectation of future interest rates, and resulted in a partial inversion in the forward yield curve as of September 30, 2006. The fair value of the derivative instruments represented the present value of estimated future net cash flows. As the forward yield curve inverted the floating rate cash receipts declined resulting in a reduced fair value of the derivative instruments. We primarily enter into derivative contracts to offset changes in cash flows associated with securitized mortgage borrowings. In our consolidated financial statements, we record a market valuation adjustment for these derivatives, as well as other derivatives used by the mortgage operations to hedge our loan pipeline and mortgage loans held-for-sale, as current period expense or income. The change in fair value of derivatives at the qualified REIT entities is excluded for purposes of calculating taxable income as shown in the reconciliation table of net earnings to estimated taxable income in the Taxable Income table.

*Gain on Sale of Loans.* The quarter-over-quarter decrease in gain on sale of loans was primarily due to a decrease in the associated net gains related to the subsequent sale of whole loans to 43 basis points per loan during the third quarter of 2006 as compared to 63 basis points per loan for the same period in 2005. Additionally, we use derivatives to protect the market value of mortgages when we have established a rate-lock commitment on a particular mortgage prior to its close and eventual sale or securitization. Any changes in interest rates on mortgages that we have committed to acquire at a particular rate until we sell or securitize the mortgage generally results in an increase or decrease in the market value of that mortgage. During the third quarter of 2006, the value of these derivatives resulted in a loss of \$3.8 million as compared to a gain of \$6.8 million during the third quarter of 2005.

*Recovery of (Provision for) Repurchases.* A recovery of \$15.9 million during the third quarter of 2006 was recorded compared to a provision of \$3.2 million for the same period in 2005. The change was primarily due to a decrease in

the outstanding repurchase requests at the end of the third quarter of 2006 and expected future repurchases. Additionally, there was \$114.4 million in outstanding repurchase requests from the second quarter that were rescinded by investors during the third quarter of 2006. Repurchases were \$16.0 million for the third quarter of 2006 compared to \$100.0 million for the second quarter of 2006. Additionally, whole loan sales volume decreased to \$1.1 billion during the third quarter of 2006 as compared to \$1.9 billion for the same period last year.

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## Changes in Non-Interest Income

(dollars in thousands)

|  | For the Nine Months Ended September 30, |             | Increase<br>(Decrease) | %<br>Change |   |
|--|---|-------------|------------------------|-------------|---|
|  | 2006                                    | 2005        |                        |             |   |
| Realized gain (loss) from derivative instruments | \$ 156,633                              | \$ (4,209 ) | \$ 160,842             | 3,821       | % |
| Change in fair value of derivative instruments   | (92,602 )                               | 141,521     | (234,123 )             | (165 )      |   |
| Gain on sale of loans                            | 35,647                                  | 44,063      | (8,416 )               | (19 )       |   |
| Provision for repurchases                        | (7,233 )                                | (8,606 )    | (1,373 )               | (16 )       |   |
| Loss on lower of cost or market writedown        | (15,284 )                               |             | 15,284                 | 100         |   |
| Other income                                     | 27,128                                  | 8,664       | 18,464                 | 213         |   |
| Total non-interest income                        | \$ 104,289                              | \$ 181,433  | \$ (77,144 )           | (43 )       | % |

*Realized Gain (Loss) from Derivative Instruments.* Realized gain (loss) from derivative instruments increased to \$156.6 million gain during the first nine months of 2006 as compared to a \$4.2 million loss during the first nine months of 2005, or 88 basis points of total average mortgage assets during the first nine months of 2006 as compared to (2) basis points of total average mortgage assets during the first nine months of 2005. The increase in realized gain (loss) from derivative instruments is due to the approximately 146 basis point increase in the one-month LIBOR from the end of the third quarter of 2005, which has caused the floating rate payments received on swaps to increase above the fixed payments made. Realized gain (loss) from derivative instruments is recorded as current period expense or income on our consolidated financial statements and is included in the calculation of taxable income in the Taxable Income table.

*Change in Fair Value of Derivative Instruments.* The change in fair value of derivative instruments decreased to a loss of \$92.6 million during the first nine months of 2006 as compared to income of \$141.5 million during the first nine months of 2005. The amount of market valuation adjustment is the result of changes in the market's expectation of future interest rates and resulted in a partial inversion in the forward yield curve as of September 30, 2006. The fair value of the derivative instruments represented the present value of estimated future net cash flows. As the forward yield curve inverted the floating rate cash receipts declined resulting in a reduced fair value of the derivative instruments. We primarily enter into derivative contracts to offset changes in cash flows associated with securitized mortgage borrowings. In our consolidated financial statements, we record a market valuation adjustment for these derivatives, as well as other derivatives used by the mortgage operations to hedge our loan pipeline and mortgage loans held-for-sale, as current period expense or income. The change in fair value of derivatives at IMH is excluded for purposes of calculating taxable income as shown in the reconciliation table of net earnings to estimated taxable income in the Taxable Income table.

*Gain on Sale of Loans.* The decrease in gain on sale of loans for the nine months ended September 30, 2006 was primarily due to a decrease in the associated net gains related to the subsequent sale of whole loans. During the first nine months of 2006, net gains on whole loans decreased to 67 basis points per loan as compared to 99 basis points for the same period in 2005. Additionally, we use derivatives to protect the market value of mortgages when we have established an interest rate-lock commitment on a particular mortgage prior to its close and eventual sale or securitization. Any changes in interest rates on mortgages that we have committed to acquire at a particular rate until we sell or securitize the mortgage generally results in an increase or decrease in the market value of that mortgage. During the nine months ended September 30, 2006, the value of these derivatives resulted in a loss of \$3.9 million as compared to a gain of \$3.9 million during the same period in 2005.

*Provision for Repurchases.* Provision for repurchases decreased to \$7.2 million during the nine months ended September 30, 2006 as compared to \$8.6 million for the same period in 2005. The decrease in provision for repurchases was primarily due to a decrease in outstanding repurchase requests at the end of the third quarter of 2006 and \$114.4 million of outstanding repurchase requests that were rescinded by investors.

*Loss on Lower of Cost or Market Writedown.* The loss on lower of cost or market ( LOCOM ) writedown, for the nine months ended September 30, 2006, was primarily due to the writedown on loans repurchased in the second quarter related to loans sold on a whole loan basis rather than securitized. The Company repurchased approximately \$100.0 million in loans in the second quarter of 2006 for reasons that primarily included early payment default compared to \$16.0 million for the third quarter of 2006.

During September 2006 the Company transferred collateral with a net book value of \$135.7 million, after including the associated lower of cost or market valuation allowance of \$28.6 million, which consisted of primarily non-performing collateral from mortgages held-for-sale to securitized mortgage collateral at the lower of aggregate cost or market. Subsequent to the transfer the Company obtained financing in the amount of \$80.5 million.

*Non-Interest Expense*

Changes in Non-Interest Expense

(dollars in thousands)

For the Three Months Ended September 30,

|  | 2006      | 2005      | Increase<br>(Decrease) | %<br>Change |
|--|-----------|-----------|------------------------|-------------|
| Personnel expense  | \$ 16,643 | \$ 19,592 | \$ (2,949 )            | (15 )%      |
| General and administrative and other expense             | 4,591     | 7,111     | (2,520 )               | (35 )       |
| Professional services                                    | 1,692     | 1,730     | (38 )                  | (2 )        |
| Equipment expense  | 1,543     | 1,414     | 129                    | 9           |
| Occupancy expense  | 1,248     | 1,284     | (36 )                  | (3 )        |
| Data processing expense                                  | 1,709     | 1,296     | 413                    | 32          |
| Total operating expense (1)                              | 27,426    | 32,427    | (5,001 )               | (15 )       |
| Amortization of deferred charge                          | 4,861     | 6,908     | (2,047 )               | (30 )       |
| Amortization and impairment of mortgage servicing rights | 380       | 551       | (171 )                 | (31 )       |
| Gain on sale of other real estate owned                  | (302 )    | (432 )    | (130 )                 | (30 )       |
| Total non-operating expense (2)                          | 4,939     | 7,027     | (2,088 )               | (30 )       |
| Total non-interest expense                               | \$ 32,365 | \$ 39,454 | \$ (7,089 )            | (18 )%      |

Changes in Non-Interest Expense

(dollars in thousands)

For the Nine Months Ended September 30,

|  | 2006       | 2005       | Increase<br>(Decrease) | %<br>Change |
|--|------------|------------|------------------------|-------------|
| Personnel expense  | \$ 51,973  | \$ 59,282  | \$ (7,309 )            | (12 )%      |
| General and administrative and other expense             | 14,190     | 18,584     | (4,394 )               | (24 )       |
| Professional services                                    | 6,201      | 7,170      | (969 )                 | (14 )       |
| Equipment expense  | 4,862      | 3,797      | 1,065                  | 28          |
| Occupancy expense  | 3,860      | 3,599      | 261                    | 7           |
| Data processing expense                                  | 3,819      | 3,075      | 744                    | 24          |
| Total operating expense (1)                              | 84,905     | 95,507     | (10,602 )              | (11 )       |
| Amortization of deferred charge                          | 15,872     | 19,503     | (3,631 )               | (19 )       |
| Amortization and impairment of mortgage servicing rights | 1,112      | 1,577      | (465 )                 | (29 )       |
| Gain on sale of other real estate owned                  | (1,277 )   | (1,261 )   | 16                     | 1           |
| Total non-operating expense (2)                          | 15,707     | 19,819     | (4,112 )               | (21 )       |
| Total non-interest expense                               | \$ 100,612 | \$ 115,326 | \$ (14,714 )           | (13 )%      |

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- (1) Operating expenses are primarily related to the mortgage operations personnel, which generally fluctuate in conjunction with increases or decreases in mortgage acquisition and origination volumes.
- (2) Non-operating expenses generally relate to existing assets and liabilities and are generally not a function of increases or decreases in mortgage acquisition or origination volumes.

*Operating Expense.* The decrease in operating expense was primarily due to the following:

- decrease in personnel expenses; and
- decrease in general and administrative expenses.

*2006 to 2005 Quarterly Comparative*

Total operating expenses decreased 15% on a quarter-over-quarter basis as personnel expense decreased 15% to \$16.6 million during the third quarter of 2006 as compared to \$19.6 million for the same period in 2005. The quarter over quarter decrease is mainly attributable to a 58% decrease in bonus and incentives to \$1.6 million for the third quarter of 2006 as compared to \$3.8 million for the third quarter of 2005. General and administrative and other expense decreased 35% on a quarter-over-quarter basis as business promotion decreased 53% to approximately \$950,000 as compared to \$2.0 million for the third quarter of 2005.

*2006 to 2005 Nine Month Comparative*

Total operating expenses decreased 11% for the nine months ended September 30, 2006 as personnel expense decreased 12% to \$52.0 million during the first nine months of 2006 as compared to \$59.3 million for the same period in 2005. The decrease is mainly attributable to a 57% decrease in bonus and incentives to \$6.6 million for the nine months ended September 30, 2006 as compared to \$15.5 million for the same period in 2005. General and administrative and other expense decreased 24% for the nine months ended September 30, 2006 as business promotion expense decreased 48% to \$3.2 million as compared to \$6.2 million for the same period in 2005.

*Mortgage Acquisitions and Originations by Channel*

The following table summarizes the principal balance of mortgage acquisitions and originations for the periods indicated (in thousands):

|   | For the Three Months Ended September 30,<br>2006 |            | 2005                 |            |
|---|--|------------|----------------------|------------|
|   | Principal<br>Balance                             | %          | Principal<br>Balance | %          |
| <b>By Production Channel:</b>                 |  |            |                      |            |
| <b>Correspondent acquisitions:</b>            |  |            |                      |            |
| Flow  | \$ 1,104,017                                     | 33         | \$ 1,692,926         | 27         |
| Bulk  | 1,191,686  | 35         | 3,523,484            | 55         |
| <b>Total correspondent acquisitions</b>       | <b>2,295,703</b>                                 | <b>68</b>  | <b>5,216,410</b>     | <b>82</b>  |
| Wholesale and retail originations             | 846,803  | 25         | 940,202              | 15         |
| <b>Total mortgage operations acquisitions</b> | <b>3,142,506</b>                                 | <b>93</b>  | <b>6,156,612</b>     | <b>97</b>  |
| Commercial Mortgage Operations                | 233,894  | 7          | 211,891              | 3          |
| <b>Total acquisitions and originations</b>    | <b>\$ 3,376,400</b>                              | <b>100</b> | <b>\$ 6,368,503</b>  | <b>100</b> |

*2006 to 2005 Quarterly Comparative*

As a result of the Company's pricing strategies and a more competitive market, total residential acquisitions and originations for the third quarter of 2006 decreased to \$3.1 billion as compared to \$6.2 billion for the same period in 2005. Pricing strategies and an increasingly competitive market are the primary drivers behind the reduction in bulk acquisitions, which decreased to 35% of our total acquisitions and originations during the third quarter of 2006 as compared to 55% for the same period in 2005. Commercial originations have increased to \$233.9 million for the third quarter of 2006 as compared to

