

NOVASTAR FINANCIAL INC
Form 10-Q
November 07, 2006
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x 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 001-13533

NOVASTAR FINANCIAL, INC.

(Exact Name of Registrant as Specified in its Charter)

Maryland
(State or Other Jurisdiction of

Incorporation or Organization)

8140 Ward Parkway, Suite 300, Kansas City, MO
(Address of Principal Executive Office)

74-2830661
(I.R.S. Employer

Identification No.)

64114
(Zip Code)

Edgar Filing: NOVASTAR FINANCIAL INC - Form 10-Q

Registrant's Telephone Number, Including Area Code: (816) 237-7000

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. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

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

The number of shares of the Registrant's Common Stock outstanding on October 31, 2006 was 36,995,202.

Table of Contents

NOVASTAR FINANCIAL, INC.

FORM 10-Q

For the Quarterly Period Ended September 30, 2006

TABLE OF CONTENTS

Part I Financial Information

Item 1.	<u>Financial Statements</u>	1
	<u>Condensed Consolidated Balance Sheets</u>	1
	<u>Condensed Consolidated Statements of Income</u>	2
	<u>Condensed Consolidated Statement of Shareholders' Equity</u>	4
	<u>Condensed Consolidated Statements of Cash Flows</u>	5
	<u>Notes to Condensed Consolidated Financial Statements</u>	7
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	27
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	65
Item 4.	<u>Controls and Procedures</u>	67
Part II <u>Other Information</u>		
Item 1.	<u>Legal Proceedings</u>	67
Item 1A.	<u>Risk Factors</u>	69
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	86
Item 3.	<u>Defaults Upon Senior Securities</u>	86
Item 4.	<u>Submission of Matters to a Vote of Security Holders</u>	86
Item 5.	<u>Other Information</u>	86
Item 6.	<u>Exhibits</u>	87

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****NOVASTAR FINANCIAL, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(unaudited; dollars in thousands, except share amounts)**

	September 30, 2006	December 31, 2005
Assets		
Cash and cash equivalents	\$ 182,157	\$ 264,694
Mortgage loans held-for-sale	1,532,755	1,291,556
Mortgage loans held-in-portfolio, net of allowance of \$17,654 and \$699, respectively	2,391,914	28,840
Mortgage securities - available-for-sale	428,787	505,645
Mortgage securities - trading	270,925	43,738
Warehouse notes receivable	59,756	25,390
Mortgage servicing rights	60,483	57,122
Deferred income tax asset, net	41,642	30,780
Servicing related advances	33,030	26,873
Derivative instruments, net	14,201	12,765
Accrued interest receivable	37,296	4,866
Property and equipment, net	8,978	13,132
Other assets	74,212	30,333
Total assets	\$ 5,136,136	\$ 2,335,734
Liabilities and Shareholders' Equity		
Liabilities:		
Short-term borrowings secured by mortgage loans	\$ 1,500,117	\$ 1,238,122
Short-term borrowings secured by mortgage securities	404,809	180,447
Other short-term borrowings	15,045	
Asset-backed bonds secured by mortgage loans	2,323,160	26,949
Asset-backed bonds secured by mortgage securities	19,554	125,630
Junior subordinated debentures	82,908	48,664
Dividends payable	105,008	45,070
Due to securitization trusts	73,795	44,382
Accounts payable and other liabilities	69,092	62,250
Total liabilities	4,593,488	1,771,514
Commitments and contingencies (Note 9)		
Shareholders' equity:		
Capital stock, \$0.01 par value, 50,000,000 shares authorized:		
Redeemable preferred stock, \$25 liquidating preference per share; 2,990,000 shares issued and outstanding	30	30
Common stock, 36,314,691 and 32,193,101 shares issued and outstanding, respectively	363	322
Additional paid-in capital	714,760	581,580
Accumulated deficit	(247,031)	(128,554)
Accumulated other comprehensive income	75,118	111,538
Other	(592)	(696)
Total shareholders' equity	542,648	564,220

Edgar Filing: NOVASTAR FINANCIAL INC - Form 10-Q

Total liabilities and shareholders' equity	\$ 5,136,136	\$ 2,335,734
--	--------------	--------------

See notes to condensed consolidated financial statements.

Table of Contents**NOVASTAR FINANCIAL, INC.****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****(unaudited; dollars in thousands, except share amounts)**

	For the Nine Months Ended September 30,		For the Three Months Ended September 30,	
	2006	2005	2006	2005
Interest income:				
Mortgage securities	\$ 125,875	\$ 139,655	\$ 41,887	\$ 50,619
Mortgage loans held-for-sale	121,062	77,680	50,272	36,169
Mortgage loans held-in-portfolio	94,294	3,531	45,885	1,090
Total interest income	341,231	220,866	138,044	87,878
Interest expense:				
Short-term borrowings secured by mortgage loans	97,049	40,781	31,248	19,471
Short-term borrowings secured by mortgage securities	7,411	1,649	4,609	92
Other short-term borrowings	242		221	
Asset-backed bonds secured by mortgage loans	54,305	1,439	36,633	414
Asset-backed bonds secured by mortgage securities	3,598	12,682	575	4,059
Junior subordinated debentures	4,952	2,046	2,080	1,000
Total interest expense	167,557	58,597	75,366	25,036
Net interest income before provision for credit losses	173,674	162,269	62,678	62,842
Provision for credit losses	19,876	1,050	10,286	331
Net interest income	153,798	161,219	52,392	62,511
Gains on sales of mortgage assets	51,027	60,462	27,709	9,691
Gains (losses) on derivative instruments	7,854	13,275	(6,877)	6,522
Impairment on mortgage securities available-for-sale	(13,249)	(10,066)	(6,796)	(8,328)
Fee income	22,129	24,845	7,671	7,448
Premiums for mortgage loan insurance	(9,295)	(4,008)	(3,145)	(2,026)
Other income, net	27,143	14,168	8,396	5,543
General and administrative expenses:				
Compensation and benefits	94,025	76,572	32,872	24,320
Office administration	19,970	21,363	6,592	7,076
Professional and outside services	15,076	12,767	4,798	4,054
Loan expense	4,239	10,438	1,055	3,449
Other	14,361	19,526	3,735	5,510
Total general and administrative expenses	147,671	140,666	49,052	44,409
Income from continuing operations before income tax expense	91,736	119,229	30,298	36,952
Income tax expense (benefit)	2,677	(693)	1,813	(1,708)
Income from continuing operations	89,059	119,922	28,485	38,660
(Loss) income from discontinued operations, net of income tax	(1,717)	(8,907)	94	(2,367)
Net income	87,342	111,015	28,579	36,293
Dividends on preferred shares	(6,653)	(4,989)	(3,327)	(1,663)

Edgar Filing: NOVASTAR FINANCIAL INC - Form 10-Q

Net income available to common shareholders	\$ 80,689	\$ 106,026	\$ 25,252	\$ 34,630
---	-----------	------------	-----------	-----------

Continued

Table of Contents

	For the Nine Months Ended September 30,		For the Three Months Ended September 30,	
	2006	2005	2006	2005
Basic earnings per share:				
Income from continuing operations available to common shareholders	\$ 2.47	\$ 3.95	\$ 0.73	\$ 1.21
(Loss) income from discontinued operations, net of income tax	(0.05)	(0.31)		(0.08)
Net income available to common shareholders	\$ 2.42	\$ 3.64	\$ 0.73	\$ 1.13
Diluted earnings per share:				
Income from continuing operations available to common shareholders	\$ 2.45	\$ 3.90	\$ 0.73	\$ 1.20
(Loss) income from discontinued operations, net of income tax	(0.05)	(0.30)		(0.08)
Net income available to common shareholders	\$ 2.40	\$ 3.60	\$ 0.73	\$ 1.12
Weighted average basic shares outstanding	33,303	29,121	34,427	30,617
Weighted average diluted shares outstanding	33,559	29,468	34,694	30,962
Dividends declared per common share	\$ 5.60	\$ 4.20	\$ 2.80	\$ 1.40

Concluded

See notes to condensed consolidated financial statements

Table of Contents

NOVASTAR FINANCIAL, INC.

CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY

(unaudited; dollars in thousands, except share amounts)

	Preferred Stock	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income	Other	Total Shareholders Equity
Balance, January 1, 2006	\$ 30	\$ 322	\$ 581,580	\$ (128,554)	\$ 111,538	\$ (696)	\$ 564,220
Forgiveness of founders' notes receivable						104	104
Issuance of common stock, 4,024,453 shares		40	122,027				122,067
Issuance of stock under stock compensation plans, 97,630 shares		1	560				561
Compensation recognized under stock compensation plans			1,972				1,972
Dividend equivalent rights (DERs) on vested options			818	(3,079)			(2,261)
Dividends on common stock (\$5.60 per share)				(196,087)			(196,087)
Dividends on preferred stock (\$2.23 per share)				(6,653)			(6,653)
Common stock repurchased, 493 shares			(17)				(17)
Tax benefit derived from capitalization of affiliate			7,858				7,858
Write-off of deferred tax asset related to stock compensation plans			(38)				(38)
Comprehensive income:							
Net income				87,342			87,342
Other comprehensive income					(36,420)		(36,420)
Total comprehensive income							50,922
Balance, September 30, 2006	\$ 30	\$ 363	\$ 714,760	\$ (247,031)	\$ 75,118	\$ (592)	\$ 542,648

See notes to condensed consolidated financial statements.

Table of Contents**NOVASTAR FINANCIAL, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(unaudited; dollars in thousands)

	For the Nine Months Ended September 30,	
	2006	2005
Cash flows from operating activities:		
Net Income	\$ 87,342	\$ 111,015
Loss from discontinued operations	1,717	8,907
Income from continuing operations	89,059	119,922
Adjustments to reconcile income from continuing operations to net cash used in operating activities:		
Amortization of mortgage servicing rights	23,469	19,663
Retention of mortgage servicing rights	(26,957)	(33,102)
Impairment on mortgage securities available-for-sale	13,249	10,066
Gains on derivative instruments	(7,854)	(13,275)
Depreciation expense	5,661	5,464
Amortization of deferred debt issuance costs	2,141	4,525
Compensation recognized under stock compensation plans	1,972	1,574
Provision for credit losses	19,876	1,050
Amortization of premiums on mortgage loans	5,101	324
Forgiveness of founders promissory notes	104	105
Provision for deferred income taxes	(5,625)	424
Accretion on available-for-sale and trading securities	(121,570)	(129,462)
Gains on sales of mortgage assets	(51,027)	(60,462)
Gains on trading securities	(2,862)	
Originations and purchases of mortgage loans held-for-sale	(8,683,608)	(7,163,120)
Proceeds from repayments of mortgage loans held-for-sale	79,214	5,413
Repurchase of mortgage loans due from securitization trust	(114,260)	(6,784)
Proceeds from sales of mortgage loans held-for-sale to third parties	1,524,432	747,434
Proceeds from sales of mortgage loans held-for-sale in securitizations	4,176,943	5,797,615
Purchase of mortgage securities - trading	(163,661)	
Proceeds from paydowns of mortgage securities - trading	4,301	
Proceeds from sale of mortgage securities - trading	11,223	143,153
Changes in:		
Servicing related advances	(7,000)	(979)
Accrued interest receivable	(58,050)	(29,704)
Derivative instruments, net	780	(16)
Other assets	(47,367)	(20,782)
Accounts payable and other liabilities	6,943	22,090
Net cash used in operating activities from continuing operations	(3,325,373)	(578,864)
Net cash used in operating activities from discontinued operations	(444)	(2,870)
Net cash used in operating activities	(3,325,817)	(581,734)
Cash flows from investing activities:		
Proceeds from paydowns on mortgage securities available-for-sale	252,329	352,000
Purchase of mortgage securities available-for-sale	(1,922)	
Proceeds from repayments of mortgage loans held-in-portfolio	290,992	14,263
Proceeds from sales of assets acquired through foreclosure	1,277	1,665
Purchases of property and equipment	(1,538)	(4,701)

Edgar Filing: NOVASTAR FINANCIAL INC - Form 10-Q

Net cash provided by investing activities	541,138	363,227
Cash flows from financing activities:		
Proceeds from issuance of asset-backed bonds	2,505,457	128,921
Payments on asset-backed bonds	(317,137)	(290,933)
Proceeds from issuance of capital stock and exercise of equity instruments, net of offering costs	119,098	94,753
Net change in short-term borrowings	508,845	333,426
Proceeds from issuance of junior subordinated debentures	33,917	48,428
Repurchase of common stock	(17)	
Dividends paid on vested options	(1,021)	
Dividends paid on preferred stock	(3,326)	(4,989)
Dividends paid on common stock	(136,231)	(147,320)
Net cash provided by financing activities from continuing operations	2,709,585	162,286
Net cash (used in) provided by financing activities from discontinued operations	(7,443)	10,551
Net cash (used in) provided by financing activities	2,702,142	172,837
Net decrease in cash and cash equivalents	(82,537)	(45,670)
Cash and cash equivalents, beginning of period	264,694	268,563
Cash and cash equivalents, end of period	\$ 182,157	\$ 222,893

Continued

Table of Contents**SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION****(unaudited; dollars in thousands)**

	For the Nine Months Ended September 30,	
	2006	2005
Cash paid for interest	\$ 173,617	\$ 56,021
Cash paid for income taxes	9,902	297
Cash received on mortgage securities available-for-sale with no cost basis	4,305	10,923
Cash received for dividend reinvestment plan	3,246	3,042
Non-cash operating, investing and financing activities:		
Cost basis of securities retained in securitizations	121,025	246,057
Change in loans under removal of accounts provision	29,414	12,605
Transfer of cost basis of residual securities and mortgage servicing rights to mortgage loans held-for-sale due to securitization calls	2,450	7,423
Transfer of loans to held-in-portfolio from held-for-sale	2,684,515	
Assets acquired through foreclosure	14,969	2,782
Dividends payable	105,008	43,053
Tax benefit derived from capitalization of affiliate	7,858	
Restricted stock issued in satisfaction of prior year accrued bonus	283	262

Concluded

See notes to condensed consolidated financial statements.

Table of Contents

NOVASTAR FINANCIAL, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2006 (Unaudited)

Note 1. Financial Statement Presentation

NovaStar Financial, Inc. and subsidiaries (the Company) operate as a specialty finance company that originates, purchases, sells, invests in and services residential nonconforming loans. The Company offers a wide range of mortgage loan products to borrowers, commonly referred to as nonconforming borrowers, who generally do not satisfy the credit, collateral, documentation or other underwriting standards prescribed by conventional mortgage lenders and loan buyers, including United States of America government-sponsored entities such as Fannie Mae or Freddie Mac. The Company retains significant interests in the nonconforming loans originated and purchased through its mortgage securities investment portfolio. Historically, the Company has serviced all of the loans in which it retains interests through its servicing platform.

The Company's condensed consolidated financial statements as of September 30, 2006 and for the nine and three months ended September 30, 2006 and 2005 are unaudited. In the opinion of management, all necessary adjustments have been made, which were of a normal and recurring nature, for a fair presentation of the condensed consolidated financial statements. Reclassifications to prior year amounts have been made to conform to current year presentation. In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the Company has reclassified the operating results of NovaStar Home Mortgage, Inc (NHMI) and its branches through September 30, 2006, as discontinued operations in the Condensed Consolidated Statements of Income for the nine and three months ended September 30, 2006 and 2005.

The Company's condensed 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.

The condensed consolidated financial statements of the Company include the accounts of all wholly-owned subsidiaries. Intercompany accounts and transactions have been eliminated in consolidation. Interim results are not necessarily indicative of results for a full year.

The Financial Accounting Standards Board (FASB) has been deliberating on a technical interpretation of GAAP with respect to the accounting for transactions where assets are purchased and simultaneously financed through a repurchase agreement with the same party and whether these transactions create derivatives requiring a net presentation instead of the acquisition of assets and related financing obligation. The Company's current accounting for these transactions is to record the transactions as an acquisition of assets and related financing obligation. The alternative accounting treatment would be to record any net cash representing the haircut amount as a deposit and the forward leg of the repurchase agreement (that is, the obligation to purchase the financial asset(s) at the end of the repo term) as a derivative. Because the FASB has not issued any guidance on this matter as of the filing date of this report, the Company has not changed its accounting treatment for this item. During the three months ended March 31, 2006, the Company had purchased approximately \$1.0 billion of mortgage loans from counterparties which were subsequently financed through repurchase agreements with that same counterparty. As of March 31, 2006, the entire \$1.0 billion of mortgage loans purchased during the first quarter remained on the Company's condensed consolidated balance sheet. The \$1.0 billion of mortgage loans purchased in the first quarter of 2006 also remained on the Company's balance sheet as of September 30, 2006, but they were no longer financed with repurchase agreements as they had been securitized in transactions structured as financings and the short-term repurchase agreements were replaced with asset backed bond financing. Additionally, during the nine months ended September 30, 2006 the Company purchased \$39.2 million of securities from counterparties which were subsequently financed through repurchase agreements with the same counterparties. As of September 30, 2006 the market value of these securities which remained on the Company's condensed consolidated balance sheet was \$39.7 million. If the Company would be required to change its current accounting based on this interpretation the Company does not believe that there would be a material impact on its condensed consolidated statements of income, however, total assets and total liabilities would be reduced by approximately \$31.0 million, \$20.5 million and \$1 billion at September 30, 2006, June 30, 2006 and March 31, 2006, respectively. In addition, cash flows from operating and financing activities would be reduced by approximately \$31.0 million and \$20.5 million and \$1.0 billion for the three months ended September 30, 2006, June 30, 2006 and March 31, 2006, respectively. The Company believes its liquidity, and ability to pay a dividend would be unchanged, and it does not believe the economics of the transactions or its taxable income or status as a REIT would be affected.

Table of Contents**Note 2. New Accounting Pronouncements**

At September 30, 2006, the Company had one stock-based employee compensation plan, which is described more fully in Note 15. From January 1, 2004 through December 31, 2005, the Company accounted for the plan under the recognition and measurement provisions of FASB Statement No. 123 (SFAS 123), Accounting for Stock-Based Compensation. Effective January 1, 2006, the Company adopted the fair value recognition provisions of FASB Statement No. 123(R) (SFAS 123(R)), Share-Based Payment, using the modified-prospective-transition method. Because the Company was applying the provisions of SFAS 123 prior to January 1, 2006, the adoption of SFAS 123(R) had no material impact on the condensed consolidated financial statements.

Prior to adoption of SFAS 123(R), the Company presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the Statement of Cash Flows. SFAS 123(R) requires the cash flows resulting from the tax benefits of tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. Additionally, the write-off of deferred tax assets relating to the excess of recognized compensation cost over the tax deduction resulting from the award will continue to be reflected within operating cash flows. Any excess tax benefits the Company recorded during the nine and three months ended September 30, 2006 are considered to have no material impact on the condensed consolidated financial statements.

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 remeasurement 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 Qualifying Special Purpose Entity (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. Early adoption of this statement is allowed. The Company is still evaluating the impact the adoption of this statement will have on its condensed consolidated financial statements.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets , an amendment of SFAS No. 140 (SFAS 156). This statement requires that an entity separately recognize a servicing asset or a servicing liability when it undertakes an obligation to service a financial asset under a servicing contract in certain situations. Such servicing assets or servicing liabilities are required to be initially measured at fair value, if practicable. SFAS 156 also allows an entity to choose one of two methods when subsequently measuring its servicing assets and servicing liabilities: (1) *the amortization method* or (2) *the fair value measurement method*. The amortization method existed under SFAS 140 and remains unchanged in (1) allowing entities to amortize their servicing assets or servicing liabilities in proportion to and over the period of estimated net servicing income or net servicing loss and (2) requiring the assessment of those servicing assets or servicing liabilities for impairment or increased obligation based on fair value at each reporting date. The fair value measurement method allows entities to measure their servicing assets or servicing liabilities at fair value each reporting date and report changes in fair value in earnings in the period the change occurs. SFAS 156 introduces the notion of *classes* and allows companies to make a separate subsequent measurement election for each class of its servicing rights. In addition, SFAS 156 requires certain comprehensive roll-forward disclosures that must be presented for each class. The Statement is effective as of the beginning of an entity 's first fiscal year that begins after September 15, 2006. Earlier adoption is permitted as of the beginning of an entity 's fiscal year, so long as the entity has not yet issued financial statements, including financial statements for any interim period, for that fiscal year. The Company is still evaluating the impact the adoption of this statement will have on its condensed consolidated financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 . FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or to be taken on a tax return. This interpretation also provides additional guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. This interpretation is effective for fiscal years after December 15, 2006. The Company is currently evaluating the potential impact of this interpretation on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No. 157). SFAS No. 157 establishes a framework for measuring fair value and requires expanded disclosures regarding fair value measurements. This accounting standard is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is still evaluating the impact the adoption of this statement will have on its condensed consolidated financial statements.

In September 2006, the Securities and Exchange Commission SEC issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial

Table of Contents

Statements (SAB No. 108). SAB No. 108 provides guidance regarding the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of materiality assessments. The method established by SAB No. 108 requires each of the Company's financial statements and the related financial statement disclosures to be considered when quantifying and assessing the materiality of the misstatement. The provisions of SAB 108 are effective for financial statements issued for fiscal years beginning after December 31, 2006. The Company is still evaluating the impact the adoption of this statement will have on its condensed consolidated financial statements.

Note 3. Mortgage Loans

Mortgage loans, all of which are secured by residential properties, consisted of the following as of September 30, 2006 and December 31, 2005 (dollars in thousands):

	September 30, 2006	December 31, 2005
Mortgage loans held-for-sale:		
Outstanding principal	\$ 1,459,870	\$ 1,238,689
Loans under removal of accounts provision	73,795	44,382
Net premium	6,072	