NEW CENTURY FINANCIAL CORP
Form 10-Q
November 09, 2004

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, 2004

OR

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

For the transition period from to

Commission file number 001-32314

NEW CENTURY FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

MARYLAND	**56-2451736**
(State or other jurisdiction of	**(I.R.S. Employer Identification No.)**

incorporation or organization)

18400 VON KARMAN, SUITE 1000,

IRVINE, CALIFORNIA	**92612**
(Address of principal executive offices)	**(Zip code)**

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

Not Applicable

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

Indicate by check ¨ whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding twelve months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES x NO ¨

Indicate by check ¨ whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

YES x NO ¨

As of October 31, 2004, the registrant had 48,385,959 shares of common stock outstanding.

EXPLANATORY NOTE

This Quarterly Report on Form 10-Q is filed by New Century Financial Corporation, a Maryland corporation (the Company). The Company s principal subsidiary is New Century TRS Holdings, Inc., a Delaware corporation (New Century TRS), which became a wholly-owned subsidiary of the Company through the merger of a wholly-owned subsidiary of the Company with and into New Century TRS on October 1, 2004. Pursuant to the merger, each then-outstanding share of New Century TRS common stock was converted into one share of common stock of the Company. New Century TRS is separately filing a Quarterly Report on Form 10-Q with the Securities and Exchange Commission in connection with the $210,000,000 principal amount of its 3.50% convertible senior notes which have been registered for resale with the Securities and Exchange Commission and remain outstanding.

As used in this Quarterly Report on Form 10-Q, New Century Financial, Company, we, our, and us refer to New Century Financial Corporat except where the context otherwise requires. Any discussion regarding our business before October 1, 2004 refers to New Century TRS Holdings, Inc. and its consolidated subsidiaries, including New Century Financial Corporation. The financial statements presented herein are the condensed consolidated financial statements of New Century Financial and its consolidated subsidiaries, including New Century TRS, after giving effect to the merger on an as if pooling basis.

NEW CENTURY FINANCIAL CORPORATION AND SUBSIDIARIES

FORM 10-Q

QUARTER ENDED SEPTEMBER 30, 2004

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Certain information included in this Quarterly Report on Form 10-Q may include forward-looking statements under federal securities laws, and we intend that such forward-looking statements be subject to the safe-harbor created thereby. Such statements include, without limitation, (i) the assumptions and estimates underlying our projections of our residual asset value and cash flow, (ii) our projections of our residual asset value and cash flow, (iii) the estimates underlying our allowance for losses on mortgage loans held for investment, (iv) our allowance for repurchase losses, (v) the estimates underlying our allowance for repurchase losses, (vi) our goal of matching the timing of cash flows with the recognition of earnings on our loans, (vii) our goal to continue to add mortgage loans held for investment to our balance sheet to reduce the reliance on the origination and sale of loans for earnings and cash flows, (viii) our expectation that we will continue to grow our balance sheet, (ix) our goal of reducing our loan acquisition costs so that we can maintain a strong operating margin in periods when the secondary market for our loans is not as favorable, (x) our expectation that our loan acquisition costs will be approximately 2.25% for the fourth quarter of 2004, (xi) our goal to generate primarily cash-based earnings rather than non-cash gain on sale revenue, (xii) our expectation that the recognition of income as interest payments are received on the mortgage loans held for investment underlying an on-balance sheet securitization will result in higher income recognition in future periods than would an off-balance sheet securitization, (xiii) our beliefs regarding our critical accounting policies, (xiv) our belief that our allowance for losses on mortgage loans held for investment is adequate for known and inherent losses in the portfolio of mortgage loans that we hold for investment, (xv) our estimates regarding tax rates and future taxable income, (xvi) our goal of securitizing approximately 20% of our loan production through sales structured as financings and recorded on-balance sheet, (xvii) our expectation that our net execution will be between 3.50% and 3.75% for all of 2004, (xviii) our belief that the receipt of a rating of RPS3, or average, from Fitch Ratings and a rating of average from Standard & Poor s will enable us to grow our servicing portfolio in the future through increased sales of loans on a servicing retained basis, (xix) our expectation that we will service loans owned by third parties to take advantage of our technical capabilities, capitalization and economies of scale, (xx) our expectations regarding the renewal or non-renewal of certain of our credit facilities, (xxi) the expectation that we will continue to concentrate on maintaining our targeted liquidity and leverage levels, (xxii) our plan to effectively manage the percentage of loans sold through whole loan sales versus on-balance sheet securitizations, giving consideration to whole loan prices, the amount of cash required to finance on-balance sheet securitizations and REIT qualification requirements, (xxiii) our belief that our liquidity, credit facilities and capital resources will be sufficient to fund our operations for the foreseeable future while enabling us to maintain our qualification as a REIT under the requirements of the Internal Revenue Code, (xxiv) our beliefs with respect to our legal proceedings, (xxv) our expectation that approximately 50% of our loan commitments with interest rate locks as of September 30, 2004 will ultimately fund, (xxvi) our belief that Carrington Mortgage Credit Fund I, LP will raise additional capital over the next two quarters, (xxvii) our expectation that we will qualify as a real estate investment trust, or REIT, for U.S. federal income tax purposes and our expectation that the tax advantages related to our REIT status will result in a lower effective tax rate, (xxviii) our plan to use the net proceeds we received from our public offering and the concurrent private placement for general working capital purposes, substantially all of which will be used to build a portfolio of self-originated mortgage loans and, if necessary to maintain our REIT status, to purchase mortgage-related assets from third parties, (xxix) our belief that any interest-bearing, short-term, investment grade securities that we invest in on a temporary basis with the net proceeds from our public offering and the concurrent private placement will provide a lower net return than we hope to achieve from our long-term intended use such proceeds, (xxx) our expectation that we will pay quarterly distributions during January, April, July and October of each year for the preceding quarter, (xxxi) our expectation that such quarterly distributions will generally be paid from cash available for distribution or, to the extent that cash available for distribution is insufficient to make such distributions, from funds borrowed from one of our subsidiaries or a third party, (xxxii) our belief that our current rate of business is sustainable and that our origination strategies and initiatives are consistent with that belief, (xxxiii) our belief that our exposure to interest rate cyclicality will be reduced if we are successful in maintaining our mix between home purchase and cash-out refinancings, and (xxxiv) our expectation that we will be able to commence or consummate the planned offer to convert the convertible senior notes of our wholly-owned subsidiary, New Century TRS Holdings, Inc., or New Century TRS.

We caution that these statements are qualified by important factors that could cause our actual results to differ materially from expected results in the forward-looking statements. Such factors include, but are not limited to, (i) the condition of the U.S. economy and financial system, (ii) the interest rate environment, (iii) the condition of the markets for whole loans and mortgage-backed securities, (iv) the stability of residential property values, (v) our ability to continue to maintain low loan acquisition costs, (vi) the potential effect of new state or federal laws and regulations, (vii) the effect of increasing competition in our sector, (viii) our ability to accurately predict target levels of liquidity and capital, (ix) our ability to maintain adequate credit facilities to finance our business, (x) our ability to adequately hedge our residual assets and mortgage loans held for investment, (xi) the accuracy of our assumptions regarding our allowance for losses on mortgage loans held for investment, (xii) the accuracy of our assumptions regarding our allowance for repurchase losses and residual valuations, (xiii) the ability of our servicing platform to maintain high performance standards, (xiv) our ability to continue to designate our derivative financial instruments as accounting hedges under SFAS 133, as amended, (xv) the performance of our mortgage loans underlying our securitization transactions, (xvi) the initiation of a margin call under any of our credit facilities, (xvii) our ability to comply with the requirements applicable to REITs, (xviii) the assumptions underlying our risk management practices, and (xix) the ability of New Century TRS to commence or consummate the tender offer to convert its convertible senior notes due 2008. Refer to the section titled Risk Factors in this Quarterly Report on Form 10-Q for additional discussion regarding these and other risk factors which affect our business. We assume no obligation to update the forward-looking statements contained in this Form 10-Q.

On November 4, 2004, the Company and New Century TRS filed a joint registration statement on Form S-4 (333-120209) with the Securities and Exchange Commission relating to the planned offer to convert the convertible senior notes of New Century TRS. In addition to the joint registration statement, the Company and New Century TRS intend to file other documents relating to the offer, including a tender offer statement and related offer materials. Investors are urged to read the joint registration statement, as well as the tender offer statement and other related offer materials when they are filed with the Securities and Exchange Commission, because these documents will contain important information. You will be able to obtain these documents free of charge at the website maintained by the Securities and Exchange Commission at www.sec.gov. In addition, you may obtain documents filed by the Company and New Century TRS with the Securities and Exchange Commission free of charge by requesting them in writing from New Century Financial Corporation, 18400 Von Karman Avenue, Suite 1000, Irvine, California, 92612, Attention: Carrie Marrelli, or by telephone at (949) 224-5745.

NEW CENTURY FINANCIAL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except share amounts)

(Unaudited)

	September 30, 2004	December 31, 2003
ASSETS:		
Cash and cash equivalents (note 1)	$ 166,098	$ 278,598
Restricted cash (note 1)	359,351	116,883
Mortgage loans held for sale, net (notes 2 and 10)	3,937,062	3,422,211
Mortgage loans held for investment, net (notes 3 and 10)	10,890,455	4,745,937
Residual interests in securitizations (note 4)	207,300	179,498
Mortgage servicing assets (note 5)	5,295	1,900
Accrued interest receivable	59,896	35,824
Income taxes, net	141,216	52,377
Office property and equipment	42,504	32,258
Prepaid expenses and other assets (note 6)	79,670	36,901
TOTAL ASSETS	$ 15,888,847	$ 8,902,387
LIABILITIES AND STOCKHOLDERS EQUITY:		
Credit facilities (notes 7 and 11)	$ 3,822,208	$ 3,311,837
Financing on mortgage loans held for investment, net (notes 8 and 11)	10,788,213	4,686,323
Convertible notes, net (note 9)	205,638	204,858
Notes payable	31,261	18,977
Accounts payable and accrued liabilities	223,829	138,381
Total liabilities	15,071,149	8,360,376
Stockholders equity:		
Preferred stock, $0.01 par value. Authorized 10,000,000 shares; no shares outstanding at September 30, 2004 and December 31, 2003		
Common stock, $0.01 par value. Authorized 300,000,000 shares; issued and outstanding 34,094,751 shares at September 30, 2004 and 33,759,695 shares at December 31, 2003	341	338
Additional paid-in capital	52,749	52,988
Accumulated other comprehensive loss (note 12)	(13,181)	(1,742)
Retained earnings, restricted (note 7)	785,502	509,998
	825,411	561,582
Treasury stock, 2,500 shares at September 30, 2004 and 377,500 shares at December 31, 2003, respectively, at cost	(70)	(14,163)
Deferred compensation costs	(7,643)	(5,408)
Total stockholders equity	817,698	542,011
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 15,888,847	$ 8,902,387

See accompanying notes to unaudited condensed consolidated financial statements.

NEW CENTURY FINANCIAL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

(Dollars in thousands, except per share amounts)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	**2003**	**2004**	**2003**
Revenues:				
Gain on sale of loans	$ 203,390	$ 163,630	$ 620,417	$ 435,714
Interest income (note 10)	260,730	84,988	595,635	190,851
Residual interest income (note 4)	9,271	5,898	18,629	18,582
Servicing and other income	6,739	2,398	21,217	8,219
Total revenues	480,130	256,914	1,255,898	653,366
Expenses:				
Personnel	99,038	72,546	289,004	172,174
Interest (note 11)	107,442	27,934	230,712	65,234
General and administrative	46,275	23,370	119,251	73,473
Provision for loan losses on mortgage loans held for investment (note 3)	25,769	8,113	62,750	15,799
Advertising and promotion	12,127	6,562	32,783	19,137
Professional services	7,367	6,838	20,433	13,807
Total expenses	298,018	145,363	754,933	359,624
Earnings before income taxes	182,112	111,551	500,965	293,742
Income taxes	74,833	46,673	204,064	122,310
Net earnings	$ 107,279	$ 64,878	$ 296,901	$ 171,432
Basic earnings per share (note 13)	$ 3.21	$ 1.92	$ 8.93	$ 5.03
Diluted earnings per share (note 13)	$ 2.49	$ 1.75	$ 6.96	$ 4.58

See accompanying notes to unaudited condensed consolidated financial statements.

NEW CENTURY FINANCIAL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE EARNINGS

(Dollars in thousands)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	**2003**	**2004**	**2003**
Net earnings	$ 107,279	$ 64,878	$ 296,901	$ 171,432
Other comprehensive loss:				
Net unrealized loss on derivative instruments designated as hedges, net of tax of $20,977 and $7,891 for the three months and nine months ended September 30, 2004, respectively, and $2,915 for the three and nine months ended September 30, 2003, net of reclassification adjustments	(29,772)	(4,091)	(11,439)	(4,091)
Comprehensive earnings	$ 77,507	$ 60,787	$ 285,462	$ 167,341

See accompanying notes to unaudited condensed consolidated financial statements.

NEW CENTURY FINANCIAL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

Nine Months Ended September 30, 2004 and 2003

(Dollars in thousands)

(Unaudited)

	September 30, 2004	September 30, 2003
Cash flows from operating activities:		
Net earnings	$ 296,901	$ 171,432
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	17,433	11,806
Cash flows received from residual interests, net	43,391	58,331
Accretion of NIRs	(18,629)	(18,582)
NIR gains	(35,375)	
Initial deposits to over-collateralization accounts	(20,040)	
Retained bonds on residual interests, net	(3,510)	
Servicing gains	(4,508)	(7,777)
Fair value adjustment of residual securities	6,361	1,494
Provision for losses on mortgage loans held for investment	62,750	15,799
Provision for repurchase losses	3,722	4,946
Mortgage loans originated or acquired for sale	(23,072,756)	(15,319,412)
Mortgage loan sales, net	22,464,159	13,974,283
Principal payments on mortgage loans held for sale	93,553	91,947
Increase in credit facilities on mortgage loans held for sale	510,371	1,222,262
Net change in other assets and liabilities	(74,708)	(54,730)
Net cash provided by operating activities	269,115	151,799
Cash flows from investing activities:		
Mortgage loans originated or acquired for investment, net	(7,622,891)	(2,754,898)
Principal payments on mortgage loans held for investment	1,442,366	72,756
Purchase of office property and equipment	(20,020)	(18,695)
Sale of mortgage servicing rights	15,184	15,568
Net cash used in investing activities	(6,185,361)	(2,685,269)
Cash flows from financing activities:		
Proceeds from issuance of financing on mortgage loans held for investment, net	7,410,872	2,644,417
Repayments of financing on mortgage loans held for investment	(1,365,980)	(68,022)
Convertible note proceeds, net		204,587
Proceeds from sale of warrant		24,389
Purchase of call option		(46,819)
Proceeds from notes payable, net	12,284	4,740
Change in restricted cash	(242,468)	(91,979)
Payment of dividends on common stock	(18,930)	(5,748)
Net proceeds from issuance of stock	7,968	5,018
Purchase of treasury stock		(58,569)

Net cash provided by financing activities	5,803,746	2,612,014
Net increase (decrease) in cash and cash equivalents	(112,500)	78,544
Cash and cash equivalents, beginning of period	278,598	176,669
Cash and cash equivalents, end of period	$ 166,098	$ 255,213
Supplemental cash flow disclosure:		
Interest paid	$ 217,811	$ 65,732
Income taxes paid	284,595	171,982
Supplemental non-cash financing activity:		
Restricted stock issued	$ 5,782	$ 5,020
Accrued dividends	7,838	
Reclassification of mortgage loans acquired for investment and related financing from mortgage loans held for sale and related financing		1,101,250

See accompanying notes to unaudited condensed consolidated financial statements.

NEW CENTURY FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

September 30, 2004 and 2003

1. Basis of Presentation

New Century TRS Holdings, Inc. (formerly known as New Century Financial Corporation) (New Century TRS), a Delaware corporation, was incorporated on November 17, 1995. New Century Mortgage Corporation, a wholly-owned subsidiary of New Century TRS (New Century Mortgage), commenced operations in February 1996 and is a mortgage finance company engaged in the business of originating, purchasing, selling and servicing mortgage loans secured primarily by first and second mortgages on single-family residences. NC Capital Corporation, a wholly-owned subsidiary of New Century Mortgage (NC Capital), was formed in December 1998 to conduct the secondary marketing activities of the Company (as defined below). New Century Credit Corporation (formerly known as Worth Funding Incorporated) (New Century Credit), a wholly-owned subsidiary of the Company, was acquired in March 2000 by New Century Mortgage. After consummation of the Merger (defined below), the Company purchased New Century Credit from New Century Mortgage.

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

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

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

As part of the REIT conversion transactions, on October 6, 2004, the Company consummated a public offering of 13,500,000 shares of its common stock at $58.00 per share for gross proceeds of approximately $783 million. Concurrent with the closing of the public offering, the Company sold 636,885 shares of its common stock in a private placement transaction to Friedman, Billings, Ramsey Group, Inc. for gross proceeds of approximately $35 million. The Company agreed to register for resale shares purchased by Friedman, Billings, Ramsey Group, Inc. in the private placement. The registration rights agreement requires that the Company file a registration statement 180 days after the closing of the private placement but no later than 210 days after such date. We intend to use the net proceeds of the public offering and the concurrent private placement for general working capital purposes, substantially all of which will be used to build a portfolio of self-originated mortgage loans and, if necessary to maintain our REIT status, to purchase mortgage-related assets from third parties.

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

NEW CENTURY FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

were approved for listing on the New York Stock Exchange, Inc. and commenced trading on October 1, 2004 under the ticker symbol NEW.

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

We have prepared the accompanying unaudited condensed consolidated financial statements in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine months ended September 30, 2004 are not necessarily indicative of the results that may be expected for the year ending December 31, 2004. For further information, refer to the consolidated financial statements and notes thereto included in New Century TRS s Annual Report on Form 10-K, as amended and supplemented, for the year ended December 31, 2003, filed by New Century TRS with the Securities and Exchange Commission.

Reclassification

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

Recent Accounting Developments

In March 2004, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 105 (SAB 105). SAB 105 contains specific guidance that significantly limits opportunities for registrants to recognize an asset related to a commitment to originate a mortgage loan that will be held for sale prior to funding the loan, which differs from the current accounting guidance provided by Statement of Financial Accounting Standards No. 149 (SFAS 149). SFAS 149 requires that the entity that makes the mortgage loan commitment record the commitment on its balance sheet at fair value, but does not address how to measure the fair value of the loan commitment. SAB 105 requires that fair value measurement of loan commitments include only differences between the guaranteed interest rate in the loan commitment and a market interest rate, excluding any expected cash flows related to the customer relationship or loan servicing. SAB 105 is effective for new loan commitments accounted for as derivatives entered into after March 31, 2004. SAB 105 permits registrants to continue to use previously applied accounting policies to commitments entered into on or before March 31, 2004.

We regularly quote interest rates to borrowers, which are generally subject to change by us. Although we typically honor such interest rate quotes, the quotes do not constitute interest rate locks, minimizing the potential interest rate exposure. However, the interest rate locks that we issue represent an insignificant portion of our business and we issue them only to meet certain regulatory requirements. We deem the fair value of the interest rate locks to be immaterial.

The Emerging Issues Task Force issued EITF Issue No. 04-8, The Effect of Contingently Convertible Debt on Diluted Earnings per Share (EITF 04 - 8) at the September 2004 EITF meeting. EITF 04-8 states that all issued securities that have embedded conversion features that are contingently exercisable upon occurrence of a market-price condition should be included in the calculation of diluted EPS, regardless of whether the market price trigger has been met. The FASB is presently in the process of amending certain aspects of FASB Statement No. 128, Earnings per Share. The consensus in EITF 04-8 will become effective in the period when the proposed amendment to Statement 128 becomes effective. The EITF 04-8 consensus must be applied by retroactive restatement based on the terms in effect and amounts outstanding on the last day of the fiscal period in which the consensus becomes effective. Depending on the effective date, all or part of New Century TRS s convertible senior notes may be included in the scope of the consensus. Due to the prospective application date, the Company cannot determine the impact, if any, of applying the consensus on its diluted earnings per share for the periods that include dates prior to January 1, 2004.

Cash and Cash Equivalents

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

Restricted Cash

As of September 30, 2004, restricted cash includes $81.4 million in cash held in a margin account associated with our interest rate risk management activities, $258.0 million in cash held in custodial accounts associated with our mortgage loans held for investment, and $20.0 million in cash held in a cash reserve account in connection with our asset-backed commercial paper facility. As of December 31, 2003, restricted cash included $31.5 million in cash held in a margin account associated with our interest rate risk management activities, $63.7 million in cash held in custodial accounts associated with our mortgage loans held for investment, and $21.7 million in cash held in a cash reserve account in connection with our asset-backed commercial paper facility.

Mortgage Loans Held for Sale

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

Mortgage Loans Held for Investment

Mortgage loans held for investment represent loans securitized through transactions structured as financings.

NEW CENTURY FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Mortgage loans held for investment are stated at amortized cost, including the outstanding principal balance, less the allowance for loan losses, plus net deferred origination costs. The financing related to these securitizations is included in our consolidated balance sheet as financing on mortgage loans held for investment.

In connection with our mortgage loans held for investment, we establish an allowance for loan losses based on our estimate of losses inherent and probable as of our balance sheet date. We charge off uncollectible loans at the time of liquidation. We evaluate the adequacy of this allowance each quarter, giving consideration to factors such as the current performance of the loans and the general economic environment. In order to estimate an appropriate allowance for losses on loans held for investment, we estimate losses using static pooling, which stratifies the loans held for investment into separately identified vintage pools. Using historic experience and taking into consideration each pool s credit characteristics, we estimate an allowance for credit losses, which we believe is adequate for known and inherent losses in the portfolio of mortgage loans held for investment. Provision for losses is charged to our consolidated statement of earnings. Losses incurred on mortgage loans held for investment are charged to the allowance.

Residual Interests in Securitizations

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

We generally structure loan securitizations as follows: First, we sell a portfolio of mortgage loans to a special purpose entity, or SPE, that has been established for the limited purpose of buying and reselling mortgage loans. The SPE then transfers the same mortgage loans to a Real Estate Mortgage Investment Conduit or Owner Trust (the REMIC or Trust), which is a qualifying special purpose entity, or QSPE as defined under Statement of Financial Accounting Standards No. 140 (SFAS 140). The Trust, in turn, issues interest-bearing asset-backed securities (the Certificates) generally in an amount equal to the aggregate principal balance of the mortgage loans. The Certificates are typically sold at face value and without recourse except that we provide representations and warranties customary to the mortgage banking industry to the Trust. One or more investors purchase these Certificates for cash. The Trust uses the cash proceeds to pay us the cash portion of the purchase price for the mortgage loans. The Trust also issues a certificate to us representing a residual interest in the payments on the securitized loans. In addition, we may provide a credit enhancement for the benefit of the investors in the form of additional collateral (Over-collateralization Account or OC Account) held by the Trust. The servicing agreements typically require that the OC Account be maintained at certain levels.

At the closing of each off-balance sheet securitization, we remove from our consolidated balance sheet the mortgage loans held for sale and add to our consolidated balance sheet (i) the cash received, (ii) the estimated fair value of the interest in the mortgage loans retained from the securitizations (Residuals), which consist of (a) the OC Account and (b) the net interest receivable, or NIR, and (iii) the estimated fair value of the servicing asset. The NIR represents the discounted estimated cash flows that we will receive in the future. The excess of the cash received and the assets retained over the carrying value of the loans sold, less transaction costs, equals the net gain on sale of mortgage loans recorded by us.

The NIMS are generally structured as follows: First, we sell or contribute the Residuals to a SPE that has been established for the limited purpose of receiving and selling asset-backed residual interests-in-securitization certificates. Next, the SPE transfers the Residuals to the Trust and the Trust, which is a QSPE as defined under SFAS 140, in turn issues interest-bearing asset-backed securities (the Bonds and Certificates). We sell the Residuals without recourse except that we provide representations and warranties to the Trust customary within the mortgage banking industry. One or more investors purchase the Bonds and Certificates, and the proceeds from the sale of the Bonds and Certificates, along with a residual interest certificate that is subordinate to the Bonds and Certificates, represent the consideration received by us for the sale of the Residuals.

At closing of each NIMS transaction, we remove from our consolidated balance sheet the carrying value of the Residuals sold and add to our consolidated balance sheet (i) the cash received and (ii) the estimated fair value of the portion of the Residuals retained, which consists of the NIR. The excess of the cash received and assets retained over the carrying value of the Residuals sold, less transaction costs, equals the net gain or loss on the sale of Residuals recorded by us.

NEW CENTURY FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

We allocate our basis in the mortgage loans and Residuals between the portion of the mortgage loans and Residuals sold through the Certificates and the portion retained (the Residuals and servicing assets) based on the relative fair values of those portions on the date of sale. We may recognize gains or losses attributable to the changes in the fair value of the Residuals, which are recorded at estimated fair value and accounted for as held-for-trading securities. We are not aware of an active market for the purchase or sale of Residuals and, accordingly, we determine the estimated fair value of the Residuals by discounting the expected cash flows released from the OC Account (the cash-out method) using a discount rate commensurate with the risks involved. For securitizations executed prior to 2004, we utilize a discount rate of 12.0% on the estimated cash flows released from the OC Account to value the Residuals through securitization transactions and 14.0% on the estimated cash flows released from the Trust to value Residuals through NIMS transactions. For the securitizations completed during 2004 (as described below), we utilize a discount rate of 14.5% on the estimated cash flows.

We are entitled to the cash flows from the Residuals that represent collections on the mortgage loans in excess of the amounts required to pay the Certificates principal and interest, the servicing fees and certain other fees, such as trustee and custodial fees. At the end of each collection period, the aggregate cash collections from the mortgage loans are allocated first to the base servicing fees and certain other fees, such as trustee and custodial fees, for the period, then to the Certificate holders for interest at the pass-through rate on the Certificates plus principal as defined in the servicing agreements. If the amount of cash required for the above allocations exceeds the amount collected during the collection period, the shortfall is drawn from the OC Account. If the cash collected during the period exceeds the amount necessary for the above allocation, and there is no shortfall in the related OC Account, the excess is released to us. If the OC Account balance is not at the required credit enhancement level, the excess cash collected is retained in the OC Account until the specified level is achieved. We are restricted from using the cash and collateral in the OC Account. Pursuant to certain servicing agreements, we may use cash held in the OC Account to make accelerated principal paydowns on the Certificates to create additional excess collateral in the OC Account. The specified credit enhancement levels are defined in our servicing agreements as the OC Account balance expressed generally as a percentage of the current collateral principal balance. For NIMS transactions, we receive cash flows once the holders of the Bonds and Certificates created in the NIMS transaction are fully paid.

The Annual Percentage Rate, or APR, on the mortgage loans is relatively high in comparison to the pass-through rate on the Certificates. In determining the value of the Residuals, we estimate the future rates of prepayments, prepayment penalties that we will receive, delinquencies, defaults and default loss severity as they affect the amount and timing of the estimated cash flows. We estimate average cumulative losses as a percentage of the original principal balance of the mortgage loans of 1.60% to 4.08% for adjustable-rate securities and 2.03% to 5.18% for fixed-rate securities. These estimates are based on historical loss data for the loans, the specific characteristics of the loans, and the existence of mortgage insurance. While the range of estimated cumulative pool losses is fairly broad, the weighted average cumulative pool loss estimate for the entire portfolio of residual assets was 3.89% at September 30, 2004. We estimate prepayments by evaluating historical prepayment performance of our loans and the impact of current trends. We use a prepayment curve to estimate the prepayment characteristics of the mortgage loans. The rate of increase, duration, severity, and decrease of the curve depends on the age and nature of the mortgage loans, primarily whether the mortgage loans are fixed or adjustable and the interest rate adjustment characteristics of the mortgage loans (6-month, 1-year, 2-year, 3-year, or 5-year adjustment periods). These prepayment curve and default estimates have resulted in weighted average lives of between 2.41 to 2.64 years for our adjustable-rate securities and 2.38 to 6.15 years for our fixed-rate securities.

During the nine months ended September 30, 2004, the Residuals provided $43.4 million, net, in cash flow to us. We perform an evaluation of the Residuals quarterly, taking into consideration trends in actual cash flow performance, industry and economic developments, as well as other relevant factors. For the quarter ended September 30, 2004, we updated the models for actual performance and changes in interest rates, and made some slight adjustments to the prepayment and loss assumptions, resulting in a $409,000 upward fair value adjustment for the quarter.

The Bond and Certificate holders and their securitization trusts have no recourse to us for failure of mortgage loan borrowers to pay when due. Our Residuals are subordinate to the Bonds and Certificates until the Bond and Certificate holders are fully paid.

Derivative Instruments Designated as Hedges

During the three and nine months ended September 30, 2004, we accounted for certain Euro Dollar futures and interest rate cap contracts designated and documented as hedges pursuant to the requirements of Statement of Financial Accounting Standard No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended (SFAS 133). Pursuant to SFAS 133 these contracts have been designated as hedging the exposure to variability of cash flows from our financing on mortgage loans held for investment attributable to interest rate risk. Hedge accounting requires that the effective portion of the gain or loss in the fair value of a derivative instrument designated as a hedge be reported in

NEW CENTURY FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

other comprehensive income, and the ineffective portion be reported in current earnings. Additionally, in June 2004, certain Euro Dollar futures contracts were designated as hedges of the fair values of certain fixed-rate mortgage loans held for investment, pursuant to SFAS 133. Hedge accounting requires that for a fair value hedge, changes in the fair value of the derivative instrument and changes in the fair value of the hedged asset or liability attributable to the hedged risk be reported in current earnings.

Stock-Based Compensation

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

As of September 30, 2004 and 2003, there were stock options outstanding for the purchase of 5,352,422 and 5,359,550 shares, respectively, of our common stock. The weighted average fair value of the stock options granted during the quarters ended September 30, 2004 and 2003 was $26.21 and $10.98, respectively. The weighted average fair value of the stock options granted during the nine months ended September 30, 2004 and 2003 was $19.66 and $9.42, respectively. The following table shows the pro forma net income as if the fair value method of SFAS 123 had been used to account for stock-based compensation expense (dollars in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Basic net earnings:				
As reported	$ 107,279	$ 64,878	$ 296,901	$ 171,432
Compensation expense, net of related tax effects	(1,562)	(990)	(4,066)	(2,637)
Pro forma	$ 105,717	$ 63,888	$ 292,835	$ 168,795
Diluted net earnings:				
As reported	$ 108,576	$ 64,878	$ 300,705	$ 171,432
Compensation expense, net of related tax effects	(1,562)	(990)	(4,066)	(2,637)
Pro forma	$ 107,014	$ 63,888	$ 296,639	$ 168,795

Basic earnings per share:				
As reported	$ 3.21	$ 1.92	$ 8.93	$ 5.03
Pro forma	3.16	1.89	8.81	4.96
Diluted earnings per share:				
As reported	$ 2.49	$ 1.75	$ 6.96	$ 4.58
Pro forma	2.49	1.77	6.97	4.62
Basic weighted average shares outstanding:				
As reported	33,405	33,725	33,241	34,063
Pro forma	33,405	33,725	33,241	34,063
Diluted weighted average shares outstanding				
As reported	43,687	37,060	43,195	37,427
Pro forma	42,990	36,108	42,575	36,518

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Mortgage Loans Held for Sale

A summary of mortgage loans held for sale, at the lower of cost or market at September 30, 2004 and December 31, 2003, were as follows (dollars in thousands):

	September 30, 2004	December 31, 2003
First trust deeds	$ 3,472,500	$ 3,307,749
Second trust deeds	430,159	75,517
Net deferred origination costs	34,403	38,945
	$ 3,937,062	$ 3,422,211

3. Mortgage Loans Held for Investment

The components of mortgage loans held for investment at September 30, 2004 and December 31, 2003 were as follows (dollars in thousands):

	September 30, 2004	December 31, 2003
Unpaid principal balance of mortgage loans	$ 10,894,227	$ 4,727,504
Allowance for loan losses	(84,656)	(26,251)
Net deferred origination costs	80,884	44,684
	$ 10,890,455	$ 4,745,937

At September 30, 2004, we had mortgage loans held for investment of approximately $75.9 million on which the accrual of interest had been discontinued. If these mortgage loans had been current throughout their terms, interest income would have increased by approximately $3.2 million for the quarter ended September 30, 2004.

The following table presents a summary of the activity for the allowance for losses on mortgage loans held for investment for the three and nine months ended September 30, 2004 and 2003 (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Beginning balance	$ 61,307	$ 7,686	$ 26,251	$
Additions	25,769	8,113	62,750	15,799
Charge-offs, net	(2,420)		(4,345)	
Ending balance	$ 84,656	$ 15,799	$ 84,656	$ 15,799

4. Residual Interests in Securitizations

Residual interests in securitizations consisted of the following components at September 30, 2004 and December 31, 2003 (dollars in thousands):

	September 30, 2004	December 31, 2003
Over-collateralization account	$ 180,733	$ 169,905
Net interest receivable (NIR)	23,057	9,593
Retained bond	3,510	
	$ 207,300	$ 179,498

The NIR balance above represents the discounted value of cash flows expected to be received from net interest spread, while the over-collateralization account represents the current, un-discounted balance of over-collateralization as of the period end. The retained bond represents a BBB- bond related to the Carrington second quarter 2004 off-balance sheet securitization transaction (as described below).

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes activity in the OC Accounts for the nine months ended September 30, 2004 and 2003 (dollars in thousands):

	Nine Months Ended September 30, 2004	Nine Months Ended September 30, 2003
Balance, beginning of period	$ 169,905	$ 185,658
Additional deposits to OC Accounts	20,880	5,263
Release of cash from OC Accounts	(10,052)	(18,581)
Balance, end of period	$ 180,733	$ 172,340

The following table summarizes activity in the NIR accounts for the nine months ended September 30, 2004 and 2003 (dollars in thousands):

	Nine Months Ended September 30, 2004	Nine Months Ended September 30, 2003
Balance, beginning of period	$ 9,593	$ 61,306
NIR gains	35,375	
Cash received from NIRs	(34,179)	(45,013)
Accretion of NIRs	18,629	18,582
Fair value adjustment	(6,361)	(1,494)
Balance, end of period	$ 23,057	$ 33,381

In the first quarter of 2004, we invested $2 million in Carrington Capital Management, LLC (the LLC) and $25 million in Carrington Mortgage Credit Fund I, LP (Carrington), which is sponsored by the LLC. Carrington acquires individual and pooled single-family residential sub-prime loans and securitizes them in transactions structured as sales. Carrington then sells certain securities to the mortgage-backed securities market and retains other securities for investment. Carrington may acquire additional assets (including regular and residual interests, whole loans, participation certificates, grantor trust and trust certificates, warehousing and servicing interests) in either the primary or secondary markets. We are currently the majority investor in Carrington, requiring us to consolidate Carrington s results in our financial statements for financial reporting purposes. However, we anticipate that Carrington will raise additional capital over the next two quarters. When we are no longer the owner of a majority of the limited partnership interests of Carrington, we expect that we will no longer be required to consolidate Carrington s results in our financial statements.

One year following our investment, we may redeem our interest in Carrington on a quarterly basis. In addition, within one year of our initial investment in Carrington, the general partner (GP) of the LLC is required to purchase not less than 3 loan pools from us at current market rates on behalf of Carrington, totaling not less than $750 million. We own 35% of the LLC and are entitled to 35% of the net earnings paid as a dividend annually for a total of 8 years. The GP will be entitled to an annual management fee of 1.5% as well as an incentive fee of 20% of annual net profits over a 7% preferred return. We will exchange our Class A (voting) interest in 5 years for the return of our capital and a contractually designated rate of return for Class B (non-voting) interests, which are callable at the end of year 8 for $1.00. The GP intends to register as an Investment Advisor and a Broker/Dealer. These investments are consolidated with our financial statements for financial reporting purposes. For the nine months ending September 30, 2004, Carrington executed two securitization transactions structured as a sale rather than financings, resulting in the addition of residual interests totaling $55.0 million, net of cash flows and accretion. We recognized a gain of $23.9 million related to the securitization of the loans.

5. Mortgage Servicing Assets

Mortgage servicing assets represent the carrying value of our mortgage loan servicing rights. The following table summarizes activity in mortgage servicing assets for the nine months ended September 30, 2004 and 2003 (dollars in thousands):

	Nine Months Ended September 30,	
	2004	**2003**
Balance, beginning of period	$ 1,900	$ 10,271
Additions	4,508	7,777
Sales of servicing rights		(15,568)
Amortization	(1,113)	(362)
Balance, end of period	$ 5,295	$ 2,118

We record mortgage servicing assets when we sell loans on a servicing retained basis and when we sell loans through whole loan sales to an investor in the current period and sell the servicing rights to a third party in a subsequent period.

The addition of $4.5 million for the nine months ending September 30, 2004 represents the value of servicing rights from the two off-balance sheet securitization transactions executed by Carrington. The addition of $7.8 million for the nine months ending September 30, 2003 represents the value of servicing rights held temporarily for loans sold during that period, pending the sale of those servicing rights to third parties in subsequent periods. We did not sell loans on a permanent servicing-retained basis during the first nine months of 2003.

In August 2004, we sold the servicing rights to a certain $1.7 billion portfolio of mortgage loans held for investment for $15.2 million. We recorded a $215,000 gain related to the sale of these servicing rights. This transaction resulted in a discount on the loans of $15.0 million which is being amortized over the life of the loans. As of September 30, 2004, we retain the right to service $9.2 billion of loans underlying our portfolio of mortgage loans held for investment. However, in accordance with generally accepted accounting principles, we do not record mortgage servicing assets for loans sold through securitizations structured as financings.

6. Goodwill

Goodwill is recorded in connection with the acquisition of new subsidiaries and is included in prepaid expenses and other assets. As of September 30, 2004 and December 31, 2003, we had goodwill of $12.7 million. No impairment existed at September 30, 2004.

7. Credit Facilities and Other Short-Term Borrowings

Credit facilities and other short-term borrowings consist of the following at September 30, 2004 and December 31, 2003 (dollars in thousands):

	September 30, 2004	December 31, 2003
A $700 million master repurchase agreement among New Century Credit, New Century Mortgage, NC Capital and CDC Mortgage Capital Inc. expiring in September 2005, secured by mortgage loans held for sale, bearing interest based on a margin over one-month LIBOR.	$ 524,740	$ 430,118
A $2.0 billion master loan and security agreement among New Century Credit, New Century Mortgage, NC Capital and Morgan Stanley Mortgage Capital Inc. expiring in January 2005, secured by mortgage loans held for sale, bearing interest based on a margin over one-month LIBOR.	228,709	284,643
A $75 million master loan and security agreement among New Century Mortgage, NC Capital, Citigroup Global Markets Realty Corp., successor to Salomon Brothers Realty Corp., expiring in December 2004, secured by delinquent loans and REO properties, bearing interest based on a margin over one-month LIBOR.	904	6,789
A $650 million repurchase agreement among New Century Credit, NC Capital and Citigroup Global Markets, successor to Salomon Brothers, expiring in December 2004, secured by mortgage loans held for sale, bearing interest based on a margin over one-month LIBOR.	180,887	468,809

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A $2.0 billion master repurchase agreement between New Century Funding A, a Delaware business trust which is a wholly-owned subsidiary of New Century Mortgage, and Bank of America, N.A., $1.0 billion of which is committed and $1.0 billion of which is uncommitted, expiring in May 2005, secured by mortgage loans held for sale, bearing interest based on a margin over one-month LIBOR.	737,158	697,201
A $2.0 billion asset-backed note purchase and security agreement between New Century Funding I, a special-purpose vehicle established as a Delaware statutory trust, which is a wholly-owned subsidiary of New Century Mortgage, and UBS Real Estate Securities Inc., $1.5 billion of which is committed and $500 million of which is uncommitted, expiring in June 2006, secured by mortgage loans held for sale, bearing interest based on a margin over one-month LIBOR.	1,721,475	994,815
A $150 million master repurchase agreement between New Century Funding SB-1, a Delaware business trust and wholly-owned subsidiary of New Century Mortgage, and Citigroup Global Markets, successor to Salomon Brothers, expiring in December 2004, secured by mortgage loans held for sale, bearing interest based on a margin over one-month LIBOR.		
A $2.0 billion asset-backed commercial paper facility for Von Karman Funding LLC, a wholly-owned subsidiary of New Century Mortgage, expiring in September 2006, secured by mortgage loans held for sale and cash generated through the sale of loans, bearing interest based on a margin over one-month LIBOR.		409,120
A $100 million master loan and security agreement between New Century Mortgage and Greenwich Capital Financial Products, Inc., which expired in June 2004, secured by small business commercial mortgage loans held for sale, bearing interest based on a margin over one-month LIBOR. This facility was replaced with the $250 million facility with Citigroup Global Markets.		20,342
A $250 million repurchase agreement between New Century Mortgage and Citigroup Global Markets, which expires in June 2005, secured by small balance commercial mortgage loans held for sale, bearing interest based on a margin over one-month LIBOR.	22,568	
An $800 million aggregation facility ($400 million of which is uncommitted) from Bear Stearns Mortgage Capital expiring in November 2004, secured by mortgage loans held for sale, bearing interest based on a margin over one-month LIBOR.	378,163	
A $400 million warehouse agreement between Carrington and Citigroup Global Markets which expires in April 2005. The uncommitted, renewable one-year agreement is secured by single family residential mortgage loans, bearing interest based on a margin over one-month LIBOR.	27,604	
	$ 3,822,208	$ 3,311,837

The various credit facilities contain certain restrictive financial and other covenants that require us to, among other things, restrict dividends, maintain certain levels of net worth, liquidity, available borrowing capacity, and debt-to-net worth ratios and to comply with regulatory and investor requirements. We were in compliance with these covenants at September 30, 2004. As a result of the Merger and the restructuring necessary for us to qualify as a REIT, we obtained the consent of the various lenders discussed above in order for the Company and/or one of its qualified REIT subsidiaries to succeed to New Century TRS s rights prior to the Merger. In addition to obtaining the consent of the various lenders, certain financial covenants were amended or modified. We believe that such amendments and modifications allow us to meet the Internal Revenue Code requirements for qualification as a REIT, which include various restrictions on ownership of our stock, requirements concerning distribution of taxable income and certain restrictions on the nature of assets and sources of income.

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8. Financing on Mortgage Loans Held for Investment

When we sell loans through securitizations structured as financings, the related bonds are added to our balance sheet. As of September 30, 2004 and December 31, 2003, the financing on mortgage loans held for investment consisted of the following (dollars in thousands):

	September 30, 2004	December 31, 2003
Securitized bonds	$ 10,828,992	$ 4,688,921
Financing on retained bonds	43,783	4,665
2003-NC5 NIMS bond	13,668	33,969
Debt issuance costs	(98,230)	(41,232)
Total financing on mortgage loans held for investment	$ 10,788,213	$ 4,686,323

9. Convertible Senior Notes Private Offering

In July 2003, New Century TRS closed a private offering of its $210 million of convertible senior notes due July 2008, or notes, pursuant to Rule 144A under the Securities Act of 1934. The notes bear interest at a rate of 3.50% per year and will be convertible into the Company s common stock at a conversion price of $34.80 per share upon the occurrence of certain events.

Effect of the Merger on the Notes

As a result of the Merger, the notes, which were convertible into shares of New Century TRS common stock prior to the Merger, became convertible into shares of the Company s common stock at the same conversion rate as in effect on the date of the Merger, subject to further adjustments upon the occurrence of certain events. On September 30, 2004, the Company, New Century TRS and the trustee under the indenture governing the notes entered into a supplemental indenture pursuant to which the Company agreed to issue shares of its common stock upon conversion of the notes under the indenture and New Century TRS agreed to continue to be responsible for all other obligations under the indenture. While the Company has agreed to issue shares of its common stock upon conversion of the notes, the conversion obligation represents New Century TRS s sole obligation and liability. The notes are currently convertible at a rate of 28.7366 shares of the Company s common stock for each $1,000 principal amount of notes, which is equivalent to a conversion price of approximately $34.80 per share (subject to certain adjustments).

Offer to Convert the Notes

On November 4, 2004, New Century TRS announced that it intends to make a tender offer to convert all of the notes. Holders who tender their notes in the offer will receive for each $1,000 principal amount (a) a total of 28.7366 shares of the Company s common stock issuable on conversion of the notes in accordance with the terms of the notes, (b) an additional amount payable in shares of the Company s common stock determined based on market conditions and other factors and (c) accrued and unpaid interest from July 3, 2004 payable in cash. The offer is contingent upon a number of conditions, including the Securities and Exchange Commission s declaration that the applicable registration statement is effective.

A registration statement relating to the offer has been filed by the Company and New Century TRS with the Securities and Exchange Commission but has not yet become effective. This Quarterly Report on Form 10-Q does not constitute an offer to exchange or sell, or the solicitation of an offer to exchange or buy, nor shall there be any exchange or sale of the above-referenced securities in any state in which such offer, exchange, solicitation or sale would be unlawful prior to registration or qualification under the securities laws of any such state.

Transactions Related to the Offer

In order to enable New Century TRS to deliver shares of the Company s common stock to tendering note holders in the offer, New Century TRS entered into a purchase agreement with the Company pursuant to which New Century TRS has agreed to purchase, for cash, that number of shares of the Company s common stock as is necessary for New Century TRS to satisfy its share delivery obligations under the offer. The purchase agreement also provides that New Century TRS will purchase, for cash, that number of shares of the Company s common stock as is necessary for New Century TRS to satisfy its obligations under the indenture to issue shares of the Company s common stock upon conversion of the notes. All such sales and purchases will be effected in an arm s-length manner for the then-fair market value of such shares of the Company s common stock. To the extent that such purchases cause New Century TRS to exceed the 9.8% restriction on beneficial ownership in value or in number of shares of the Company s common stock contained in the Company s charter, the board of directors of the Company has granted New Century TRS a waiver from such restriction.

In connection with the original issuance of the notes, New Century TRS entered into two agreements to simultaneously purchase a call option and sell a warrant on its common stock. The purpose of the option and warrant was to reduce the economic dilution of the conversion premium under the notes. The option granted to New Century TRS the right to purchase from an affiliate of Bear Stearns & Co. Inc., or Bear Stearns, one of the initial purchasers of the notes, at any time up to 6,034,675 shares of New Century TRS common stock at a strike price of $34.80 per share (subject to certain adjustments). The warrant granted to an affiliate of Bear Stearns the right to purchase from New Century TRS up to 6,034,668 shares of New Century TRS common stock for a limited period of time upon maturity of the notes at a price of $47.59 per share (subject to certain adjustments).

Like the notes, the option and warrant became exercisable for shares of the Company s common stock, rather than New Century TRS common stock, as a result of the Merger. Concurrent with the completion of the offer, we expect that New Century TRS and the affiliate of Bear Stearns will terminate the option and warrant. We refer to this termination

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

as the call spread settlement. Assuming all of the notes are tendered in the offer, New Century TRS expects to receive a yet to be determined amount from the affiliate of Bear Stearns in connection with the call spread settlement.

10. Interest Income

The following table presents the components of interest income for the three and nine months ended September 30, 2004 and 2003 (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	**2003**	**2004**	**2003**
Interest on mortgage loans held for sale	$ 112,382	$ 62,671	$ 270,445	$ 152,580
Interest on mortgage loans held for investment	148,308	22,299	325,117	38,194
Other interest income	40	18	73	77
	$ 260,730	$ 84,988	$ 595,635	$ 190,851

11. Interest Expense

The following table presents the components of interest expense for the three and nine months ended September 30, 2004 and 2003 (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	**2003**	**2004**	**2003**
Interest on credit facilities and other short-term borrowings	$ 41,013	$ 19,062	$ 90,699	$ 51,336
Interest on financing on mortgage loans held for investment	62,347	5,668	128,762	10,121
Interest on convertible notes	2,126	1,927	6,376	1,927
Other interest expense	1,956	1,277	4,875	1,850
	$ 107,442	$ 27,934	$ 230,712	$ 65,234

12. Hedging Activities

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

During 2003, we began using hedge accounting as defined by SFAS 133 for certain derivative financial instruments used to hedge cash flows related to our financing on mortgage loans held for investment. In June 2004, we began using hedge accounting for certain derivative financial instruments to hedge the fair value of certain of our mortgage loans held for investment and certain of our mortgage loans held for sale. We designate certain derivative financial instruments, Euro Dollar futures and interest rate cap contracts, as hedge instruments under SFAS 133, and, at trade date, these instruments and their hedging relationship are identified, designated and documented.

For derivative financial instruments designated as cash flow hedge instruments, we evaluate the effectiveness of these hedges against the interest payments related to our financing on mortgage loans held for investment being hedged to ensure that there remains a highly effective correlation in the hedge relationship. To hedge the adverse effect of interest rate changes on the cash flows as a result of changes in the benchmark interest rate, in our case LIBOR, of the interest payments related to our financing on mortgage loans held for investment (variable rate debt) being hedged, we use derivatives classified as cash flow hedges under SFAS 133. Once the hedge relationship is established, for those derivative instruments designated as qualifying cash flow hedges, the effective portion of the gain or loss on the derivative is reported as a component of other comprehensive income during the current period, and reclassified into earnings in the period(s) during which the hedged transaction affects earnings pursuant to SFAS 133. The ineffective portion and/or remaining gain or loss on the derivative instrument is recognized in earnings in the current period. The ineffective portion of these hedges resulted in a charge to earnings of approximately $705,000 and zero, respectively, for the three-month and nine-month

NEW CENTURY FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

periods ended September 30, 2004. There was no ineffective portion of these hedges during the three-month and nine-month periods ended September 30, 2003.

For derivative financial instruments designated as fair value hedge instruments, we evaluate the effectiveness of these hedges against the fair value of the asset being hedged to ensure that there remains a highly effective correlation in the hedge relationship. To hedge the adverse effect of interest rate changes on the fair value of the hedged assets as a result of changes in the benchmark interest rate, in our case LIBOR, we use derivatives classified as fair value hedges under SFAS 133. Once the hedge relationship is established, for those derivative instruments designated as qualifying fair value hedges, changes in the fair value of the derivative instruments and changes in the fair value of the hedged asset or liability attributable to the hedged risk are recorded in current earnings pursuant to SFAS 133. The charge to earnings was approximately $2.5 million for the three-month and nine-month periods ended September 30, 2004 related to this hedge, which was substantially offset by an increase in the fair value of the hedged asset. There were no derivatives designated as fair value hedges during the three-month and nine-month periods ended September 30, 2003.

We document the relationships between hedging instruments and hedged items, as well as our risk management objectives and strategies for undertaking various hedge transactions. This process includes linking derivatives to specific assets and liabilities on the consolidated balance sheet. We also assess, both at the inception of the hedge and on an ongoing basis, whether the derivatives used in hedging transactions are highly effective in offsetting changes in cash flows of the hedged items. When it is determined that a derivative is not highly effective as a hedge or that it has ceased to be a highly effective hedge, we discontinue hedge accounting prospectively.

When hedge accounting is discontinued because we determine that the derivative no longer qualifies as an effective hedge, the derivative will continue to be recorded on the balance sheet at its fair value. Any change in the fair value of a derivative no longer qualifying as an effective hedge is recognized in current period earnings. When a hedge is terminated, it is derecognized at the time of termination. For terminated hedges or hedges that no longer qualify as effective, the effective position previously recorded remains in other comprehensive income and continues to be amortized or accreted into earnings with the hedged item.

For derivative financial instruments not designated as hedge instruments, realized and unrealized changes in fair value are recognized in the period in which the changes occur.

As of September 30, 2004, we had open Euro Dollar futures contracts that are designated as hedging the variability in expected cash flows from the variable rate debt related to our financing on mortgage loans held for investment. The fair value of these contracts at September 30, 2004 was a $21.5 million liability and is included in accounts payable and accrued liabilities. The fair value of these contracts at September 30, 2003 was an $11.6 million liability, and is included in accounts payable and accrued liabilities.

Certain of our on-balance sheet securitizations are subject to interest rate cap contracts, or Caplets, designated and documented as cash flow hedges, used to mitigate interest rate risk. The change in the fair value of these interest rate cap contracts is recorded in other comprehensive income each period. Amounts are reclassified out of other comprehensive income as the hedged forecasted transactions impact earnings. For the three and nine months ended September 30, 2004, we recorded a charge to other comprehensive income of $2.2 million and $3.2 million, respectively, related to the change in fair value of these Caplets. The fair value of these caplets was $7.8 million at September 30, 2004, and is included in prepaid expenses and other assets.

The change in the fair value of Euro Dollar futures contracts, not designated and documented as hedges, used to mitigate interest rate risk in our residual assets and mortgage loans held for investment is recorded through earnings each period, and is included as a component of gain on sale. For the three months and nine months ended September 30, 2004, we recognized a loss of $606,000 and a gain of $431,000, respectively, and for the three months and nine months ended September 30, 2003, we recognized losses of $7.3 million and $14.0 million, respectively, related to the change in fair value of these contracts. The fair value of these contracts at September 30, 2004 was a $309,000 liability, and is included in accounts payable and accrued liabilities. The fair value of these contracts at September 30, 2003 was a $7.9 million liability, and is included in accounts payable and accrued liabilities.

Certain of our on-balance sheet securitizations are subject to interest rate cap contracts, not designated and documented as hedges, used to mitigate interest rate risk. The change in the fair value of these interest rate cap contracts is recorded through earnings each period, and is included as a component of interest expense. For the three and nine months ended September 30, 2004, we recognized interest expense of $382,000 and $720,000, respectively, related to the change in fair value of these cap contracts. The fair value of these cap contracts was $150,000 at September 30, 2004, and is included in prepaid expenses and other assets. The fair value of these cap contracts was immaterial at September 30, 2003.

NEW CENTURY FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

13. Earnings per Share

The following table illustrates the computation of basic and diluted earnings per share for the periods indicated (dollars in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Basic:				
Net earnings available to common stockholders	$ 107,279	$ 64,878	$ 296,901	$ 171,432
Weighted average common shares outstanding	33,405	33,725	33,241	34,063
Earnings per share	$ 3.21	$ 1.92	$ 8.93	$ 5.03
Diluted:				
Net earnings	$ 107,279	$ 64,878	$ 296,901	$ 171,432
Add: Interest and amortization of debt issuance costs on convertible notes and expense related to certain stock-based compensation arrangements, net of tax	1,297		3,804	
Diluted net earnings	$ 108,576	$ 64,878	$ 300,705	$ 171,432
Weighted average number of common shares outstanding	33,405	33,725	33,241	34,063
Dilutive effect of convertible notes, stock options and warrants	10,282	3,335	9,954	3,364
	43,687	37,060	43,195	37,427
Earnings per share	$ 2.49	$ 1.75	$ 6.96	$ 4.58

For the three and nine months ended September 30, 2004, we have included the effect of approximately 6.0 million shares of our common stock related to the notes in our computation of diluted earnings per share. These shares are included because a conversion trigger event has occurred. The closing price of our common stock exceeded $38.28 for more than 20 of the last 30 trading days during the three months ended March 31, 2004. Consequently, the notes are now convertible. Diluted earnings have been adjusted to add the interest expense and amortization of debt issuance costs recorded related to the notes, net of the applicable income tax effect and the 6.0 million shares of our common stock into which the notes may be converted are included in diluted shares outstanding. In addition, the compensation expense recorded related our Directors Deferred Compensation Plan, net of applicable income tax effect, and the 1,200 shares of our common stock into which the outstanding stock units held by two of our non-management directors may be converted are included in diluted shares outstanding.

Prior to the three and nine months ended September 30, 2004, a warrant to purchase 6.0 million shares of our common stock was excluded from our computation of diluted earnings per share because it was anti-dilutive. For the three and nine months ended September 30, 2004, approximately 437,000 and 24,000 shares related to the warrant, respectively, were included in the calculation of diluted earnings per share because they were dilutive.

For the three months ended September 30, 2004, options to purchase 100,000 shares of our common stock are excluded from the calculation of diluted earnings per share because their effect was anti-dilutive. For the nine months ended September 30, 2004, options to purchase 131,500 shares of our common stock are excluded from the calculation of diluted earnings per share because their effect was anti-dilutive.

For the three and nine months ended September 30, 2003, options to purchase 534,750 shares of our common stock were excluded from the calculation of diluted earnings per share because their effect was anti-dilutive.

14. Segment Reporting

The operating segments reported below are the segments for which separate financial information is available and for which revenues and operating income amounts are evaluated regularly by management in deciding how to allocate resources and in assessing performance. The accounting policies of the business segments are generally the same as those described in the summary of significant accounting policies, except as noted below.

NEW CENTURY FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The segment revenues and operating income amounts reported below include wholesale and retail operations, servicing and other income, and net interest income from our on-balance sheet securitizations. Estimated fair value of mortgage loans originated by our wholesale and retail divisions represents the amount of gain in excess of the segment s basis in its loan production that would be generated if the mortgage loans were sold.

Certain amounts are not evaluated at the segment level and are included in the segment net operating income reconciliation below. The unallocated gain represents the difference between the segment s fair value of mortgage loans originated as if they were sold and the actual gain recorded on loans sold by us.

Management does not identify assets to the segments and evaluates assets only at the consolidated level. As such, only operating results for the segments are included below (dollars in thousands):

	Three Months ended September 30, 2004	Three Months ended September 30, 2003	Nine Months ended September 30, 2004	Nine Months ended September 30, 2003
Funding Volume:				
Wholesale	$ 8,980,919	8,014,896	27,762,167	17,576,146
Retail	1,022,505	623,912	2,933,480	1,555,130
	$ 10,003,424	8,638,808	30,695,647	19,131,276
Additions to Mortgage Loans Held for Investment	$ 4,165,116	1,502,872	7,622,892	2,708,887
Segment Revenues:				
Wholesale	$ 250,740	244,944	826,928	583,543
Retail	61,208	53,144	171,493	131,532
Mortgage loans held for investment	148,308	22,299	325,117	38,194
Servicing & other	14,147	9,056	35,580	26,816
Interest income on mortgage loans held for sale and other net interest income	112,422	62,689	270,518	152,657
Elimination of allocated gain on sale and net deferred origination fees and expenses	(106,695)	(135,218)	(373,738)	(279,376)
Total revenues	$ 480,130	256,914	1,255,898	653,366
Segment Net Operating Income:				
Wholesale	$ 112,712	139,578	421,112	320,112
Retail	10,947	13,342	30,569	28,553
Mortgage loans held for investment	60,192	8,518	133,605	12,274

Servicing & other	6,044	4,331	14,276	10,455
Net interest income on mortgage loans held for sale and other net interest income	67,327	40,423	168,568	97,544
Elimination of allocated gain on sale	(57,901)	(86,857)	(212,646)	(147,699)
Unallocated shared general and administrative expenses	(17,209)	(7,784)	(54,519)	(27,497)
Total net operating income	$ 182,112	111,551	500,965	293,742

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Item 2. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

This Quarterly Report on Form 10-Q represents an update to the more detailed and comprehensive disclosures included in the Annual Report on Form 10-K of New Century TRS, as amended and supplemented, for the year ended December 31, 2003. As such, a reading of the Annual Report on Form 10-K of New Century TRS, as amended and supplemented, is necessary to obtain an informed understanding of the information below.

New Century TRS Holdings, Inc. (formerly known as New Century Financial Corporation) (New Century TRS), a Delaware corporation, was incorporated on November 17, 1995. New Century Mortgage Corporation, a wholly-owned subsidiary of New Century TRS (New Century Mortgage), commenced operations in February 1996 and is a mortgage finance company engaged in the business of originating, purchasing, selling and servicing mortgage loans secured primarily by first and second mortgages on single-family residences. NC Capital Corporation, a wholly-owned subsidiary of New Century Mortgage (NC Capital), was formed in December 1998 to conduct the secondary marketing activities of the Company (as defined below). New Century Credit Corporation (formerly known as Worth Funding Incorporated) (New Century Credit), a wholly-owned subsidiary of the Company, was acquired in March 2000 by New Century Mortgage. After the consummation of the Merger (defined below), the Company purchased New Century Credit from New Century Mortgage.

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

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

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

As part of the REIT conversion transactions, on October 6, 2004, the Company consummated a public offering of 13,500,000 shares of its common stock at $58.00 per share for gross proceeds of approximately $783 million. Concurrent with the closing of the public offering, the Company sold 636,885 shares of its common stock in a private placement transaction to Friedman, Billings, Ramsey Group, Inc. for gross proceeds of approximately $35 million. The Company agreed to register for resale shares purchased by Friedman, Billings, Ramsey Group, Inc. in the private placement. The registration rights agreement requires that the Company file a registration statement 180 days after the closing of the private placement but no later than 210 days after such date. We intend to use the net proceeds of the public offering and the concurrent private placement for general working capital purposes, substantially all of which will be used to build a portfolio of self-originated mortgage loans and, if necessary to maintain our REIT status, to purchase mortgage-related assets from third parties.

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

The Company

We are a REIT and one of the nation s largest non-prime mortgage finance companies. We originate, purchase, retain, sell and service primarily first mortgage products to borrowers nationwide. We focus on lending to individuals whose borrowing needs are generally not fulfilled by traditional financial institutions because they do not satisfy the credit, documentation or other underwriting standards prescribed by conventional mortgage lenders and loan buyers, such as Fannie Mae and Freddie Mac. We originate and purchase loans on the basis of the borrower s ability to repay the mortgage loan, the borrower s historical pattern of debt repayment and the amount of equity in the borrower s property, as measured by the borrower s loan-to-value ratio, or LTV. We have been originating and purchasing subprime loans since 1996 and believe we have developed a comprehensive and sophisticated process of credit evaluation and risk-based pricing that allows us to effectively manage the potentially higher risks associated with this segment of the mortgage industry.

Our borrowers generally have considerable equity in the property securing the loan (as evidenced by the weighted average LTV of loans we originated in 2004 of 81.1%), but have impaired or limited credit profiles or higher debt-to-income ratios than traditional mortgage lenders allow. Our borrowers also include individuals who, due to self-employment or other circumstances, have difficulty verifying their income, as well as individuals who prefer the prompt and personalized service we provide. We originate and purchase loans through wholesale and retail channels. Wholesale loans are originated or purchased from independent mortgage brokers by the wholesale division of one of our wholly-owned subsidiaries, New Century Mortgage. We do not purchase bulk pools of loans from third parties, although we do purchase closed loans on a flow basis from our correspondent lenders. Retail originations are made through New Century Mortgage s network of branch offices and its centralized telemarketing unit. After originating or purchasing loans, we then sell those loans through whole loan sales or securitizations. We may structure securitizations as sales (off-balance sheet securitizations) or financings (on-balance sheet securitizations). Under the on-balance sheet securitization structure, we do not recognize a gain on sale at the time of the transaction, but rather recognize net interest income as payments are received on the underlying loans.

Changes in Our Business as a Result of the Merger

As a result of the recently completed Merger and the related public offering, we expect that over time a significant source of our revenue will be interest income generated from our portfolio of mortgage loans held by the Company and its qualified REIT subsidiaries. We also expect to generate revenue from the sale of loans, servicing income and loan origination fees, all of which we initially expect to be generated by the Company s taxable REIT subsidiaries. We expect the primary components of our expenses to be interest expense on our warehouse lines and other borrowings and our securitizations, general and administrative expenses, and payroll and related expenses arising from our origination and servicing businesses.

We intend to continue to sell loans through the Company s taxable REIT subsidiaries and generate gain on sale, or GOS, income, origination fees and servicing income through those subsidiaries. Subject to the limitations imposed by applicable REIT tax rules, we expect to retain some or all of the after-tax earnings of the taxable REIT subsidiaries in such subsidiaries, enabling us to increase our capital and provide for future growth.

As a result of the Merger and the related transactions, we have made and will continue to make certain changes to our business operations, some of which are described below:

Loan origination, acquisition and servicing. We will continue to originate, underwrite, process, fund and service a majority of loans through one or more of our taxable REIT subsidiaries, including New Century Mortgage, in accordance with our existing policies, procedures and underwriting guidelines. In addition, we expect to be able to originate mortgage loans in a majority of states through us or one or more of our qualified REIT subsidiaries, including New Century Credit, which we purchased from New Century Mortgage after the Merger. Over time, we expect that we and/or one or more of our qualified REIT subsidiaries will become authorized to originate mortgage loans in the remaining states in which we or they are not currently authorized.

Loan sales. Prior to the recently completed Merger, New Century TRS sold most of its loans through whole loan sales or securitizations through NC Capital. We now intend to conduct non-real estate mortgage investment conduit, or REMIC, collateralized mortgage obligation, or CMO, securitization activities in one or more of our qualified REIT subsidiaries, such as New Century Mortgage Securities LLC, or NCMS. Non-REMIC CMOs are treated as debt for both generally accepted accounting principles and tax purposes, thereby resulting in no GOS being recognized for either generally accepted accounting principles or income tax purposes. The non-GOS treatment creates portfolio earnings for both financial reporting pursuant to generally accepted accounting principles and tax purposes. We have and will continue to purchase loans from New Century TRS or one or more of our other taxable REIT subsidiaries in arm s-length transactions at fair market value in order to enable us to meet the asset and income tests applicable to REITs. We will determine fair market value based on prevailing market prices for similar whole loan sale and securitization transactions executed with unaffiliated third parties.

Short-term financing. In connection with our conversion to a REIT, we and our qualified REIT subsidiaries have structured some of our existing financing facilities to allow our qualified REIT subsidiaries and our taxable REIT subsidiaries to share the facilities as co-borrowers. In addition, we expect to add new short-term financing facilities to originate loans. To the extent retained by us, ultimately, these loans will be financed through longer-term securitizations.

Long-term financing. We expect to continue financing our loan portfolio for the long-term through securitizations. If we or one of our qualified REIT subsidiaries were to securitize mortgage assets on a regular basis (other than through the issuance of non-REMIC CMOs), there is a substantial risk that the securities could be dealer property and that all of the profits from such sales would be subject to tax at the rate of 100% as income from prohibited transactions. We expect to securitize such mortgage assets through the issuance of non-REMIC CMOs, whereby we retain the equity interests in the mortgage-backed assets used as collateral in the securitization transaction.

Hedging. We currently use various derivative financial instruments to attempt to mitigate interest rate risks. When interest rates change, we expect the gain or loss on derivatives to be substantially offset by a related but inverse change in the value of the assets that we hold or the amount of future interest payments on the related liabilities. We expect to continue this hedging strategy; however, REIT qualification tests will limit the amount of income we can receive from financial derivatives in the Company. As a result, we may be required to conduct some hedging activities through one or more of our taxable REIT subsidiaries, which will subject the related hedging income to corporate income tax and, in some circumstances, may impair our ability to mitigate interest rate risk.

Overview

Our origination business relies on our ability to originate and purchase mortgage loans at a reasonable cost and to sell a portion of those loans in the secondary mortgage market at prices that result in an attractive operating margin. We measure our operating margin as the sum of the price we receive for our loans, plus the net interest we earn for the period of time we hold the loans, less the cost to originate the loans. For the past several years we have executed a secondary marketing strategy that included a combination of both whole loan sales and securitizations of our loans.

Loan origination volumes in our industry have historically fluctuated from year to year and are affected by such external factors as home values, the level of consumer debt and the overall condition of the economy. In addition, the premiums we receive from the secondary market for our loans have also fluctuated, are also influenced by the overall condition of the economy and, more importantly, the interest rate environment. As a consequence, the business of originating and selling loans is cyclical.

Until 2003, we typically structured our securitizations as sales for financial reporting purposes, and the gain on sale from loans sold through securitization was a significant percentage of our revenues. During 2003, we shifted our strategy to address the cyclical nature of our earnings with the goal of generating a more stable long-term earnings stream. Our principal strategy to achieve this goal is to hold loans on our balance sheet. Because our financing facilities are short-term in nature and generally do not allow loans to be financed through the facility for longer than 180 days, a securitization structure offers the most attractive means to finance loans on our balance sheet. Consequently, during 2003 we began to structure our securitizations as financings rather than sales. To support the goal of matching the timing of cash flows with the recognition of earnings on our loans, we make an initial cash investment so that the securitization trusts begin to return cash flow to us beginning in the first month following securitization. Therefore, we require cash and capital to make an initial investment, as well as to support the loans on our balance sheet. During 2003 and the first nine months of 2004, we sold between 75% to 80% of our loans through whole loan sales, providing the cash and capital to support the remainder that we added to our balance sheet. Our goal is to continue to add mortgage loans to our balance sheet in order to reduce the reliance on the origination and sale of loans for earnings and cash flows. While we expect to continue to grow our balance sheet, a significant portion of our net income will still come from our origination franchise.

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

Gain on Sale of Loans

Gain on sale of loans is affected by the condition of the secondary market for our loans. This market was very strong through 2003 as interest rates were generally declining. In the past few quarters, as interest rates began to rise, the underlying factors that affect secondary market pricing remained somewhat stable, although as short term rates rose faster than long-term rates (a flatter yield curve), the prices we receive for our loans began to decline relative to historic levels. Further, we and other lenders did not necessarily raise the interest rates we charge our borrowers consistent with increases in the overall interest rate environment, further reducing pricing and overall gain on sale margins in 2004 compared to 2003.

Net Interest Income on Mortgage Loans Held for Sale

We typically hold our mortgage loans held for sale for a period of 30 to 45 days before they are sold in the secondary market. During that time, we earn the coupon rate of interest paid by the borrower and we pay interest to the lenders that provide our financing facilities. During 2003, the difference between these interest rates was typically in excess of 5%. More recently, the margin has decreased below that level as short-term rates have increased more than our average coupon rates have. We manage the timing of our sales to optimize the net interest income we earn on the loans, while preserving the ability to sell the loans at the maximum price.

Loan Origination or Acquisition Costs

We also measure and monitor the cost to originate our loans. Such costs include the points and fees we may pay to brokers or correspondents, net of fees we receive from borrowers, plus our operating expenses associated with the origination business. We typically refer to this as our loan acquisition costs. From 2001 to 2003, our loan acquisition costs were steadily decreasing as a result of growth and technology initiatives. During 2004, our loan acquisition costs remained relatively stable as we have invested in new technology and other initiatives that we expect will result in lower loan acquisition costs in 2005 and beyond. We will continue to focus on reducing our loan acquisition costs so that we can maintain a strong operating margin in periods when the secondary market for our loans is not as favorable. We expect loan acquisition costs to be approximately 2.25% for the fourth quarter. Loan acquisition cost is defined as the fees paid to wholesale brokers and correspondents, direct loan origination costs, including commissions and corporate overhead costs, less points and fees received from borrowers, divided by total production volume. Loan acquisition costs do not include profit-based compensation, servicing division overhead, parent company expenses and start-up expenses.

Loan Originations and Purchases

As of September 30, 2004, our wholesale and retail divisions operated through 27 regional operating centers. Our wholesale division originated or purchased $27.8 billion in loans during the nine months ended September 30, 2004. As of September 30, 2004, our retail division originated loans through 74 sales offices, including our centralized telemarketing unit. Our retail division originated or purchased $2.9 billion in loans during the nine months ended September 30, 2004.

During the nine months ended September 30, 2004, approximately $16.5 billion, or 53.6%, of our mortgage production consisted of cash-out refinancings, where the borrowers refinanced their existing mortgages and received cash representing a portion of the equity in their homes. For the same period, approximately $10.7 billion, or 34.8% of our mortgage production was represented by home purchase finance loans. The remainder of our mortgage production was represented by transactions in which borrowers refinance their existing mortgages to obtain a better interest rate or loan maturity, or rate and term refinance transactions. For the nine months ended September 30, 2003, total originations consisted of $12.1 billion, or 63.4%, of cash-out refinancings, $4.5 billion, or 23.4%, of home purchase financing, and $2.5 billion, or 13.2%, of rate and term refinancings. Market and economic conditions, as well as our focus on increasing our home purchase business have resulted in the shift in mix between home purchase and cash-out refinancings. We believe that our current rate of business is sustainable and that our origination strategies and initiatives are consistent with that belief. If we are successful in maintaining this mix, we believe our exposure to interest rate cyclicality will be reduced.

We have experienced considerable growth of our interest only product. During the nine months ended September 30, 2004, originations of interest only loans totaled $5.7 billion, or 18.6%, of total originations. Interest only originations during the nine months ended September 30, 2003 totaled $353.0 million, or 1.8%, of total originations during the period. We believe our strict underwriting guidelines and the stronger credit characteristics of these loans mitigate the perceived higher risk associated with these loans.

For the nine months ended September 30, 2004, full documentation loans as a percentage of originations totaled $15.9 billion, or 51.7%, limited documentation loans totaled $1.4 billion, or 4.7%, and stated documentation loans totaled $13.4 billion, or 43.6%. Full documentation loans generally require applicants to submit two written forms of verification of stable income for at least 12 months. Limited documentation loans generally require applicants to submit 12 consecutive monthly bank statements on their individual bank accounts. Stated income documentation loans are based upon stated monthly income if the applicant meets certain criteria. For the nine months ended September 30, 2003, full documentation loans as a percentage of total originations totaled $11.3 billion, or 59.1%, limited documentation loans totaled $921.7 million, or 4.8%, and stated documentation loans totaled $6.9 billion, or 36.1%. Product mix is generally determined by economic and market conditions, including product introductions and offerings by competitors. As these factors change, product mix, including required documentation, fluctuates as well. Our rigorous underwriting standards and quality assurance programs are designed to insure that loan quality is consistent and meets our guidelines, even as the documentation type mix varies.

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2004	2003	2004	2003
Wholesale originations	$ 8,980,919	$ 8,014,896	$ 27,762,167	$ 17,576,146
Retail originations	1,022,505	623,912	2,933,480	1,555,130
Total originations	10,003,424	8,638,808	30,695,647	19,131,276
Fixed-rate mortgages	1,900,910	3,441,039	8,560,522	6,058,418
Adjustable-rate mortgages:				
Traditional	5,905,870	5,041,173	16,440,678	12,719,864
Interest Only	2,196,644	156,596	5,694,447	352,994
Total originations	10,003,424	8,638,808	30,695,647	19,131,276
Purchases	3,968,950	2,282,785	10,672,303	4,482,946
Refinances:				
Cash-out refinances	5,627,128	5,493,570	16,452,586	12,129,888
Rate/term refinances	407,346	862,453	3,570,758	2,518,442
Total originations	10,003,424	8,638,808	30,695,647	19,131,276
Full documentation	4,929,039	5,233,408	15,876,137	11,296,245
Limited documentation	470,544	361,946	1,448,757	921,719
Stated documentation	4,603,841	3,043,454	13,370,753	6,913,312
Total originations	10,003,424	8,638,808	30,695,647	19,131,276
Average principal balance of loans originated	$ 172	$ 176	$ 172	$ 166
Weighted average FICO score of loans originated	627	626	628	611
Percent of loans secured by first mortgages	95.4%	98.9%	96.1%	98.7%
Weighted average loan-to-value ratio(1)	81.1%	80.1%	81.1%	79.9%
Weighted average interest rates:				
Fixed-rate mortgages	8.0%	6.8%	7.2%	7.3%
Adjustable-rate mortgages initial rate	7.1%	7.2%	6.9%	7.4%
Adjustable-rate mortgages margin over index	5.5%	5.7%	5.5%	5.8%
Total originations	7.3%	7.1%	7.0%	7.4%
Percentage of loans originated in top two credit grades	84.9%	85.4%	85.6%	80.3%
Percentage of loans originations in bottom two credit grades	3.6%	2.6%	3.2%	3.1%

(1) Weighted average loan-to-value ratio is the LTV of the first lien mortgages and combined LTV of the second lien mortgages.

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Loan Sales and Securitizations

One of our significant sources of revenue is the recognition of gain on sale of our loans through whole loan sales and, until 2003, off-balance sheet securitizations. In a whole loan sale, we recognize and receive a cash gain upon sale. In an off-balance sheet securitization transaction structured as a sale for financial reporting purposes, we typically recognize a gain on sale at the time the loans are sold, and receive cash flows over the actual life of the loans. The use of a net interest margin transaction, or NIMS, concurrent with or shortly after an off-balance sheet securitization transaction allows us to receive a substantial portion of the gain in cash at the closing of the NIMS transaction, rather than over the actual life of the loans.

Since the first quarter of 2003, we have structured most of our securitizations as financings rather than sales. Such structures do not result in gain on sale at the time of the transaction, but rather yield interest income as the payments on the underlying mortgages are received. Off-balance sheet securitizations executed in 2004 relate to our investment in Carrington Mortgage Credit Fund I, LP described below. The following table sets forth secondary marketing transactions for the periods indicated (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	**2003**	**2004**	**2003**
Premium whole loan sales	$ 7,972,016	$ 4,854,522	$ 21,685,162	$ 13,782,787
Off-balance sheet securitizations	297,653		634,801	
Total premium sales	8,269,669	4,854,522	22,319,963	13,782,787
Discounted whole loan sales	53,522	83,420	144,197	191,496
Total sales	8,323,191	4,937,942	22,464,160	13,974,283
On-balance sheet securitizations	4,165,116	1,502,872	7,622,892	2,708,887
Total secondary market transactions	$ 12,488,307	$ 6,440,814	$ 30,087,052	$ 16,683,170

On-Balance Sheet Securitizations

During the three and nine months ended September 30, 2004, we completed two securitizations totaling $4.2 billion and four securitizations totaling $7.6 billion, respectively, which were structured as on-balance sheet securitizations for accounting purposes under SFAS No. 140. The portfolio-based accounting treatment for securitizations structured as financings and recorded on-balance sheet is designed to more closely match the recognition of income with the receipt of cash payments. Because we do not record gain on sale revenue in the period in which the on-balance sheet securitization occurs, the use of such portfolio-based accounting structures will result in lower income in the period in which the securitization occurs than would a traditional off-balance sheet securitization. However, the recognition of income as interest payments are received on the underlying mortgage loans is expected to result in higher income recognition in future periods than would an off-balance sheet securitization. During the nine months ended September 30, 2003, we completed three on-balance sheet securitizations totaling $2.7 billion. The increase in on-balance sheet securitizations in 2004 is the result of higher overall loan production volume coupled with our intent to retain approximately 20 to 30% of our volume.

Off-Balance Sheet Securitizations

During the nine months ended September 30, 2004 we completed two off-balance sheet transactions totaling $634.8 million, related to our investment in Carrington Mortgage Credit Fund I, LP (Carrington). During the nine months ended September 30, 2003, we did not complete any off-balance sheet securitization transactions.

In the first quarter of 2004, we invested $2 million in Carrington Capital Management, LLC (the LLC) and $25 million in Carrington, which is sponsored by the LLC. Carrington acquires individual and pooled single-family residential sub-prime loans and securitizes them in transactions structured as sales. Carrington then sells certain securities to the mortgage-backed securities market and retains other securities for investment. Carrington may acquire additional assets (including regular and residual interests, whole loans, participation certificates, grantor trust and trust certificates, warehousing and servicing interests) in either the primary or secondary markets. We are currently the majority investor in Carrington, requiring us to consolidate Carrington s results in our financial statements for financial reporting purposes. However, we anticipate that Carrington will raise additional capital over the next two quarters. When we are no longer the owner of a majority of the limited partnership interests of Carrington, we expect that we will no longer be required to consolidate Carrington s results in our financial statements.

One year following our investment, we may redeem our interest in Carrington on a quarterly basis. In addition, within one year of our initial investment in Carrington, the general partner (GP) of the LLC is required to purchase not less than 3 loan pools from us at current market rates on behalf of Carrington, totaling not less than $750 million. We own 35% of the LLC and are entitled to 35% of the net earnings paid as a dividend annually for a total of 8 years. The GP will be entitled to an annual management fee of 1.5% as well as an incentive fee of 20% of annual net profits over a 7% preferred return. We will exchange our Class A (voting) interest in 5 years for the return of our capital and a contractually designated rate of return for Class B (non-voting) interests, which are callable at the end of year 8 for $1.00. The GP intends to register as an Investment Advisor and a Broker/Dealer. These investments are consolidated with our financial statements for financial reporting purposes. For the nine months ending September 30, 2004, Carrington executed two securitization transactions structured as a sale rather than financings, resulting in the addition of residual interests totaling $55.0 million, net of cash flows and accretion. We recognized a gain of $23.9 million related to the securitization of the loans.

At the closing of an off-balance sheet securitization, we add to our balance sheet the residual interest retained based on our calculation of the present value of estimated future cash flows to be received by us. The residual interest we record consists of the overcollateralization, or OC, account and the net interest receivable, or NIR. Combined, these are referred to as the residual interests.

On a quarterly basis, we review the underlying assumptions to value each residual interest and adjust the carrying value of the securities based on actual experience and industry trends. To determine the residual asset value, we project cash flow for each security. To project cash flow, we use base assumptions for the constant prepayment rate, or CPR, and losses for each product type based on historical performance. We updated each security to reflect actual performance to date and we adjust base assumptions for CPR and losses based on historical experience to project performance of the security from that date forward. We then use the London Interbank Offered Rate, or LIBOR, forward curve to project future interest rates and compute cash flow projections for each security. We then discount the projected cash flows at a rate commensurate with the risk involved. At September 30, 2004, for securitizations executed prior to 2004, we used discount rates of 12% for residual interests and 14% for residual interests through NIMS transactions. For the securitizations completed during 2004, we utilize a discount rate of 14.5% on the estimated cash flows.

During the quarter ended September 30, 2004, as a result of our quarterly evaluation of the residual interests, we recorded a $409,000 increase in the fair value of the residual assets. This fair value adjustment represents the change in the estimated present value of future cash flows from the residual interests.

Discounted Loan Sales

For the quarter ended September 30, 2004, we sold $53.5 million in loans that had been repurchased from or rejected by whole loan investors, compared to $83.4 million in loans for the same period in 2003. Discounted sales as a percentage of whole loans sales declined to 0.67% for the quarter ended September 30, 2004 from 1.7% for the quarter ended September 30, 2003, as a result of lower repurchase rates in 2004. The total loss on these sales was 2.28% of the balance of the loans for the three months ended September 30, 2004, a decline of 48.5% compared to 4.43% for the three months ended September 30, 2003. The loss decreased primarily as a result of a stronger and more active secondary market for these types of loans in 2004 as well as the characteristics of the mortgage loans being sold.

Critical Accounting Policies

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

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

Allowance for Losses on Mortgage Loans Held for Investment

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

The allowance for losses on mortgage loans held for investment as a percentage of mortgage loans held for investment as of September 30, 2004 was approximately 0.8% of the unpaid principal balance of the loans.

Residual Interests in Securitizations

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

We generally structure loan securitizations as follows: First, we sell a portfolio of mortgage loans to a special purpose entity, or SPE, that has been established for the limited purpose of buying and reselling mortgage loans. The SPE then transfers the same mortgage loans to a Real Estate Mortgage Investment Conduit or Owner Trust (the REMIC or Trust), which is a qualifying special purpose entity, or QSPE as defined under Statement of Financial Accounting Standards No. 140 (SFAS 140). The Trust, in turn, issues interest-bearing asset-backed securities (the Certificates) generally in an amount equal to the aggregate principal balance of the mortgage loans. The Certificates are typically sold at face value and without recourse except that we provide representations and warranties customary to the mortgage banking industry to the Trust. One or more investors purchase the Certificates for cash. The Trust uses the cash proceeds to pay us the cash portion of the purchase price for the mortgage loans. The Trust also issues a certificate to us representing a residual interest in the payments on the securitized loans. In addition, we may provide a credit enhancement for the benefit of the investors in the form of additional collateral (Over-collateralization Account or OC Account) held by the Trust. The servicing agreements typically require that the OC Account be maintained at certain levels.

At the closing of each off-balance sheet securitization, we remove from our consolidated balance sheet the mortgage loans held for sale and add to our consolidated balance sheet (i) the cash received, (ii) the estimated fair value of the interest in the mortgage loans retained from the securitizations (Residuals), which consist of (a) the OC Account and (b) the NIR, and (iii) the estimated fair value of the servicing asset. The NIR represents the discounted estimated cash flows that we will receive in the future. The excess of the cash received and the assets retained over the carrying value of the loans sold, less transaction costs, equals the net gain on sale of mortgage loans recorded by us.

The NIMS are generally structured as follows: First, we sell or contribute the Residuals to a SPE that has been established for the limited purpose of receiving and selling asset-backed residual interests-in-securitization certificates. Next, the SPE transfers the Residuals to the Trust and the Trust, which is a QSPE as defined under SFAS 140, in turn issues interest-bearing asset-backed securities (the Bonds and Certificates). We sell the Residuals without recourse except that we provide representations and warranties to the Trust customary within the mortgage banking industry. One or more investors purchase the Bonds and Certificates, and the proceeds from the sale of the Bonds and Certificates, along with a residual interest certificate that is subordinate to the Bonds and Certificates, represent the consideration received by us for the sale of the Residuals.

At closing of each NIMS transaction, we remove from our consolidated balance sheet the carrying value of the

Residuals sold and add to our consolidated balance sheet (i) the cash received and (ii) the estimated fair value of the portion of the Residuals retained, which consists of the NIR. The excess of the cash received and assets retained over the carrying value of the Residuals sold, less transaction costs, equals the net gain or loss on the sale of Residuals recorded by us.

We allocate our basis in the mortgage loans and Residuals between the portion of the mortgage loans and Residuals sold through the Certificates and the portion retained (the Residuals and servicing assets) based on the relative fair values of those portions on the date of sale. We may recognize gains or losses attributable to the changes in the fair value of the Residuals, which are recorded at estimated fair value and accounted for as held-for-trading securities. We are not aware of an active market for the purchase or sale of Residuals and, accordingly, we determine the estimated fair value of the Residuals by discounting the expected cash flows released from the OC Account (the cash-out method) using a discount rate commensurate with the risks involved. For securitizations executed prior to 2004, we utilize a discount rate of 12.0% on the estimated cash flows released from the OC Account to value the Residuals through securitization transactions and 14.0% on the estimated cash flows released from the Trust to value Residuals through NIMS transactions. For the securitizations completed during 2004 (the Carrington transaction described above), we utilize a discount rate of 14.5% on the estimated cash flows.

We are entitled to the cash flows from the Residuals that represent collections on the mortgage loans in excess of the amounts required to pay the Certificates principal and interest, the servicing fees and certain other fees, such as trustee and custodial fees. At the end of each collection period, the aggregate cash collections from the mortgage loans are allocated first to the base servicing fees and certain other fees, such as trustee and custodial fees, for the period, then to the Certificate holders for interest at the pass-through rate on the Certificates plus principal as defined in the servicing agreements. If the amount of cash required for the above allocations exceeds the amount collected during the collection period, the shortfall is drawn from the OC Account. If the cash collected during the period exceeds the amount necessary for the above allocation, and there is no shortfall in the related OC Account, the excess is released to us. If the OC Account balance is not at the required credit enhancement level, the excess cash collected is retained in the OC Account until the specified level is achieved. We are restricted from using the cash and collateral in the OC Account. Pursuant to certain servicing agreements, we may use cash held in the OC Account to make accelerated principal paydowns on the Certificates to create additional excess collateral in the OC Account. The specified credit enhancement levels are defined in our servicing agreements as the OC Account balance expressed generally as a percentage of the current collateral principal balance. For NIMS transactions, we receive cash flows once the holders of the Bonds and Certificates created in the NIMS transaction are fully paid.

The Annual Percentage Rate, or APR, on the mortgage loans is relatively high in comparison to the pass-through rate on the Certificates. Accordingly, the Residuals described above are a significant asset. In determining the value of the Residuals, we estimate the future rates of prepayments, prepayment penalties that we will receive, delinquencies, defaults and default loss severity as they affect the amount and timing of the estimated cash flows. We estimate average cumulative losses as a percentage of the original principal balance of the mortgage loans of 1.60% to 4.08% for adjustable-rate securities and 2.03% to 5.18% for fixed-rate securities. These estimates are based on historical loss data for the loans, the specific characteristics of the loans, and the existence of mortgage insurance. While the range of estimated cumulative pool losses is fairly broad, the weighted average cumulative pool loss estimate for the entire portfolio of residual assets was 3.89% at September 30, 2004. We estimate prepayments by evaluating historical prepayment performance of our loans and the impact of current trends. We use a prepayment curve to estimate the prepayment characteristics of the mortgage loans. The rate of increase, duration, severity, and decrease of the curve depends on the age and nature of the mortgage loans, primarily whether the mortgage loans are fixed or adjustable and the interest rate adjustment characteristics of the mortgage loans (6-month, 1-year, 2-year, 3-year, or 5-year adjustment periods). These prepayment curve and default estimates have resulted in weighted average lives of between 2.41 to 2.64 years for our adjustable-rate securities and 2.38 to 6.15 years for our fixed-rate securities.

During the nine months ended September 30, 2004, the Residuals provided $43.4 million, net, in cash flow to us. We perform an evaluation of the Residuals quarterly, taking into consideration trends in actual cash flow performance, industry and economic developments, as well as other relevant factors. For the quarter ended September 30, 2004, we updated the models for actual performance and change in interest rates and made some slight adjustments to prepayment and loss assumptions, resulting in a $409,000 upward fair value adjustment for the quarter.

The Bond and Certificate holders and their securitization trusts have no recourse to us for failure of mortgage loan borrowers to pay when due. Our Residuals are subordinate to the Bonds and Certificates until the Bond and Certificate holders are fully paid.

Allowance for Repurchase Losses

The allowance for repurchase losses on loans sold relates to expenses incurred due to the potential repurchase of loans or indemnification of losses based on alleged violations of representations and warranties which are customary to the mortgage banking industry. Generally, repurchases are required within 90 days from the date the loans are sold. Occasionally, we may repurchase loans after 90 days have elapsed. Provisions for losses are charged to gain on sale of loans and credited to the allowance while actual losses are charged to the allowance. As of September 30, 2004 and December 31, 2003, approximately $8.4 billion and $6.8 billion, respectively, are subject to repurchase, representing loans sold during the third quarter of 2004 and the fourth quarter of 2003.

Gain on Sale of Loans

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