DYNEX CAPITAL INC
Form 10-Q
August 11, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

þ Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended June 30, 2008

or

o Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission File Number: 1-9819

DYNEX CAPITAL, INC.
(Exact name of registrant as specified in its charter)

Virginia (State or other jurisdiction of incorporation or organization)	52-1549373 (I.R.S. Employer Identification No.)
4551 Cox Road, Suite 300, Glen Allen, Virginia (Address of principal executive offices)	23060-6740 (Zip Code)

(804) 217-5800
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer	o	Accelerated filer	þ
Non-accelerated	o (Do not check if a smaller	Smaller reporting	o

filer	reporting company)	company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes	o	No	þ

On July 31, 2008, the registrant had 12,169,762 shares outstanding of common stock, $0.01 par value, which is the registrant's only class of common stock.

DYNEX CAPITAL, INC.
FORM 10-Q

INDEX

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

DYNEX CAPITAL, INC.
CONDENSED CONSOLIDATED
BALANCE SHEETS
(amounts in thousands except share data)

	June 30, 2008 (unaudited)	December 31, 2007
ASSETS		
Cash and cash equivalents	$ 42,501	$ 35,352
Other assets	5,378	5,671
	47,879	41,023
Investments:		
Securitized mortgage loans, net	258,826	278,463
Agency mortgage-backed securities	139,187	7,456
Other securities	15,690	21,775
Investment in joint venture	13,273	19,267
Other loans and investments	3,336	6,774
	430,312	333,735
	$ 478,191	$ 374,758
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES		
Securitization financing	$ 189,304	$ 204,385
Repurchase agreements	129,403	4,612
Obligation under payment agreement	11,663	16,796
Other liabilities	5,366	7,029
	335,736	232,822
Commitments and Contingencies (Note 14)		
SHAREHOLDERS' EQUITY		
Preferred stock, par value $0.01 per share, 50,000,000 shares authorized, 9.5% Cumulative Convertible Series D, 4,221,539 shares issued and outstanding ($43,218 aggregate liquidation preference)	41,749	41,749
Common stock, par value $0.01 per share, 100,000,000 shares authorized, 12,169,762 and 12,136,262 shares issued and outstanding, respectively	122	121
Additional paid-in capital	366,769	366,716
Accumulated other comprehensive (loss) income	(3,953)	1,093
Accumulated deficit	(262,232)	(267,743)
	142,455	141,936
	$ 478,191	$ 374,758

See notes to unaudited condensed consolidated financial statements.

1

DYNEX CAPITAL, INC.
CONDENSED CONSOLIDATED STATEMENTS
OF OPERATIONS AND COMPREHENSIVE INCOME (UNAUDITED)
(amounts in thousands except per share data)

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Interest income:				
Investments	$ 6,497	$ 7,236	$ 12,656	$ 14,712
Cash and cash equivalents	177	787	501	1,526
	6,674	8,023	13,157	16,238
Interest expense	4,173	5,060	8,235	10,814
Net interest income	2,501	2,963	4,922	5,424
(Provision for) recapture of loan losses	(321)	702	(347)	1,225
Net interest income after provision for loan losses	2,180	3,665	4,575	6,649
Equity in income (loss) of joint venture	560	672	(1,691)	1,302
(Loss) gain on sale of investments, net	(43)	6	2,050	–
Fair value adjustments, net	(173)	–	4,058	–
Other income (expense)	3,025	(478)	3,092	(1,018)
General and administrative expenses	(1,253)	(1,163)	(2,469)	(2,290)
Net income	4,296	2,702	9,615	4,643
Preferred stock dividends	(1,003)	(1,003)	(2,005)	(2,005)
Net income to common shareholders	$ 3,293	$ 1,699	$ 7,610	$ 2,638
Change in net unrealized gain (loss) on :				
Investments classified as available-for-sale	1,250	(602)	(1,123)	(476)
Investment in joint venture	(287)	(223)	(3,923)	606
Comprehensive income	$ 5,259	$ 1,877	$ 4,569	$ 4,773
Net income per common share:				
Basic	$ 0.27	$ 0.14	$ 0.63	$ 0.22
Diluted	$ 0.26	$ 0.14	$ 0.59	$ 0.22

See notes to unaudited condensed consolidated financial statements.

DYNEX CAPITAL, INC.
CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY (UNAUDITED)

Six Months Ended June 30, 2008
(amounts in thousands)

	Preferred Stock	Common Stock	Additional Paid-in Capital	Accumulated Other Compre–hen–sive (Loss) Income	Accumulated Deficit	Total
Balance at December 31, 2007	$ 41,749	$ 121	$ 366,716	$ 1,093	$ (267,743)	$ 141,936
Cumulative effect of adoption of SFAS 159	–	–	–	–	943	943
Net income	–	–	–	–	9,615	9,615
Other comprehensive income:						
Change in market value of securities and other investments	–	–	–	(2,995)	–	(2,995)
Reclassification adjustment for net gains included in net income	–	–	–	(2,051)	–	(2,051)
Total comprehensive income						4,569
Dividends on common stock	–	–	–	–	(3,042)	(3,042)
Dividends on preferred stock	–	–	–	–	(2,005)	(2,005)
Stock option issuance	–	–	13	–	–	13
Grant and vesting of restricted stock	–	1	40	–	–	41
Balance at June 30, 2008	$ 41,749	$ 122	$ 366,769	$ (3,953)	$ (262,232)	$ 142,455

See notes to unaudited condensed consolidated financial statements.

DYNEX CAPITAL, INC.
CONDENSED CONSOLIDATED STATEMENTS
OF CASH FLOWS (UNAUDITED)
(amounts in thousands)

	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Operating activities:		
Net income	$ 9,615	$ 4,643
Adjustments to reconcile net income to cash provided by operating activities:		
Equity in loss (income) of joint venture	1,691	(1,302)
Provision for (recapture of) loan losses	347	(1,225)
Gain on sale of investments	(2,050)	–
Fair value adjustments, net	(4,058)	–
Amortization and depreciation	(1,729)	(183)
Stock based compensation (benefit) expense	(152)	79
Net change in other assets and other liabilities	(1,040)	2,615
Net cash provided by operating activities	2,624	4,627
Investing activities:		
Principal payments received on securitized mortgage loans	19,175	27,702
Purchases of securities and other investments	(152,898)	(5,590)
Payments received on securities, other investments and other loans	7,714	5,836
Proceeds from sales of securities and other investments	23,937	129
Other	86	268
Net cash (used) provided by investing activities	(101,986)	28,345
Financing activities:		
Principal payments on securitization financing	(13,233)	(9,496)
Net borrowings under (repayments on) repurchase agreements	124,791	(15,832)
Proceeds from sale of common stock	–	37
Dividends paid	(5,047)	(2,005)
Net cash provided (used) by financing activities	106,511	(27,296)
Net increase in cash and cash equivalents	7,149	5,676
Cash and cash equivalents at beginning of period	35,352	56,880
Cash and cash equivalents at end of period	$ 42,501	$ 62,556

See notes to unaudited condensed consolidated financial statements.

DYNEX CAPITAL, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2008
(amounts in thousands except share and per share data)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and notes required by accounting principles generally accepted in the United States of America, hereinafter referred to as "generally accepted accounting principles," for complete financial statements. The condensed consolidated financial statements include the accounts of Dynex Capital, Inc. and its qualified real estate investment trust ("REIT") subsidiaries and taxable REIT subsidiary (together, "Dynex" or the "Company"). All intercompany balances and transactions have been eliminated in consolidation.

The Company consolidates entities in which it owns more than 50% of the voting equity and control does not rest with others and variable interest entities in which it is determined to be the primary beneficiary in accordance with Financial Interpretation ("FIN") 46(R). The Company follows the equity method of accounting for investments with greater than 20% and less than a 50% interest in partnerships and corporate joint ventures or when it is able to influence the financial and operating policies of the investee but owns less than 50% of the voting equity. For all other investments, the cost method is applied.

The Company believes it has complied with the requirements for qualification as a REIT under the Internal Revenue Code of 1986, as amended (the "Code"). To the extent the Company qualifies as a REIT for federal income tax purposes, it generally will not be subject to federal income tax on the amount of its income or gain that is distributed as dividends to shareholders.

In the opinion of management, all significant adjustments, consisting of normal recurring accruals considered necessary for a fair presentation of the condensed consolidated financial statements have been included. The financial statements presented are unaudited. Operating results for the three and six months ended June 30, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008. Certain information and footnote disclosures normally included in the consolidated financial statements prepared in accordance with generally accepted accounting principles have been omitted. The unaudited financial statements included herein should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2007, filed with the Securities and Exchange Commission (the "SEC").

The preparation of financial statements, in conformity with generally accepted accounting principles, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. The primary estimates inherent in the accompanying condensed consolidated financial statements are discussed below.

The Company uses estimates in establishing fair value for its financial instruments. All of the Company's securities are considered available-for-sale and are therefore carried in the accompanying financial statements at estimated fair value. Estimates of fair value for Agency mortgage-backed securities are based on market prices provided by multiple dealers. Estimates of fair value for other securities are based on market quotes for equity securities and dealer quotes for certain fixed income securities, where available. When market prices are not available for fixed income securities, fair value estimates are determined by calculating the present value of the projected cash flows of

5

the instruments using market-based assumptions such as estimated future interest rates and estimated market spreads to applicable indices for comparable securities, and using collateral based assumptions such as prepayment rates and credit loss assumptions based on the most recent performance and anticipated performance of the underlying collateral.

The Company evaluates all securities and other investments in its investment portfolio for other-than-temporary impairments. An investment is generally defined to be other-than-temporarily impaired if, for a maximum period of three consecutive quarters, the carrying value of such security exceeds its estimated fair value, and the Company estimates, based on projected future cash flows or other fair value determinants, that the fair value will remain below the carrying value for the foreseeable future. If an other-than-temporary impairment is deemed to exist, the Company records an impairment charge to adjust the carrying value of the investment down to its estimated fair value. In certain instances, as a result of the other-than-temporary impairment analysis, the recognition or accrual of interest will be discontinued and the investment will be placed on non-accrual status.

The Company also has credit risk on loans in its portfolio as discussed in Note 4. An allowance for loan losses has been estimated and established for currently existing losses in the loan portfolio, which are deemed probable as to their occurrence. The allowance for loan losses is evaluated and adjusted periodically by management based on the actual and estimated timing and amount of probable credit losses. Provisions made to increase the allowance for loan losses are presented as provision for loan losses or recapture of loan losses, in the accompanying condensed consolidated statements of operations. The Company's actual credit losses may differ from those estimates used to establish the allowance.

New Accounting Standards

In December 2007, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 160, "Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51" ("SFAS 160"). SFAS 160 addresses reporting requirements in the financial statements of non-controlling interests to their equity share of subsidiary investments. SFAS 160 applies to reporting periods beginning after December 15, 2008. The Company is currently evaluating the potential impact that the adoption of SFAS 160 will have on the Company's financial statements.

In December 2007, the FASB issued SFAS No. 141(R), "Business Combinations" ("SFAS 141(R)") which revised SFAS No. 141, "Business Combinations." This pronouncement is effective as of January 1, 2009. Under SFAS No. 141, organizations utilized the announcement date as the measurement date for the purchase price of the acquired entity. SFAS 141(R) requires measurement at the date the acquirer obtains control of the acquiree, generally referred to as the acquisition date. SFAS 141(R) will have a significant impact on the accounting for transaction costs, restructuring costs, as well as the initial recognition of contingent assets and liabilities assumed during a business combination. Under SFAS 141(R), adjustments to the acquired entity's deferred tax assets and uncertain tax position balances occurring outside the measurement period are recorded as a component of the income tax expense, rather than goodwill. As the provisions of SFAS 141(R) are applied prospectively, the impact cannot be determined until the transactions occur. The Company does not believe this pronouncement will have a material effect on its financial statements.

On March 20, 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133" ("SFAS 161"). SFAS 161 provides for enhanced disclosures about how and why an entity uses derivatives and how and where those derivatives and related hedged items are reported in the entity's financial statements. SFAS 161 also requires certain tabular formats for disclosing such information. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. SFAS 161 applies to all entities and all derivative instruments and related hedged items accounted for under SFAS 133. Among other things, SFAS 161 requires disclosures of an entity's objectives and strategies for using derivatives by primary underlying risk and certain disclosures about the potential future collateral or cash requirements as a result of contingent credit-related features. The Company is currently evaluating the impact, if any, that the adoption of SFAS 161 will have on the Company's financial statements.

On February 20, 2008, the FASB issued FASB Staff Position ("FSP") 140-3, "Accounting for Transfers of Financial Assets and Repurchase Financing Transactions," ("FSP 140-3"), which provides guidance on accounting for transfers of financial assets and repurchase financings. FSP 140-3 presumes that an initial transfer of a financial asset and a repurchase financing are considered part of the same arrangement (i.e., a linked transaction) under SFAS No. 140 "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" ("SFAS 140"). However, if certain criteria, as described in FSP 140-3, are met, the initial transfer and repurchase financing shall not be evaluated as a linked transaction and shall be evaluated separately under SFAS 140. If the linked transaction does not meet the requirements for sale accounting, the linked transaction shall generally be accounted for as a forward contract, as opposed to the current presentation, where the purchased asset and the repurchase liability are reflected separately on the balance sheet. FSP 140-3 is effective on a prospective basis for fiscal years beginning after November 15, 2008, with earlier application not permitted. The Company is currently evaluating the impact, if any, that the adoption of FSP 140-3 will have on the Company's financial statements.

NOTE 2 – NET INCOME PER COMMON SHARE

Net income per common share is presented on both a basic and diluted basis. Diluted net income per common share assumes the conversion of the convertible preferred stock into common stock, using the if-converted method, and stock options, using the treasury stock method, but only if these items are dilutive. The Series D preferred stock is convertible into one share of common stock for each share of preferred stock. The following tables reconcile the numerator and denominator for both basic and diluted net income per common share for the three and six months ended June 30, 2008 and 2007.

	Three Months Ended June 30,			
	2008		2007	
	Income	Weighted-Average Common Shares	Income	Weighted-Average Common Shares
Net income	$ 4,296		$ 2,702	
Preferred stock dividends	(1,003)		(1,003)	
Net income to common shareholders	3,293	12,169,762	1,699	12,136,262
Effect of dilutive items	1,003	4,228,905	–	3,173
Diluted	$ 4,296	16,398,667	$ 1,699	12,139,435
Net income per share:				
Basic		$ 0.27		$ 0.14
Diluted		$ 0.26		$ 0.14
Reconciliation of shares included in calculation of income per share due to dilutive effect:				
Net effect of dilutive:				
Convertible preferred stock	1,003	4,221,539	–	–
Stock options	–	7,366	–	3,173
	$ 1,003	4,228,905	$ –	3,173

7

	Six Months Ended June 30,			
	2008		2007	
	Income	Weighted-Average Common Shares	Income	Weighted-Average Common Shares
Net income	$ 9,615		$ 4,643	
Preferred stock dividends	(2,005)		(2,005)	
Net income to common shareholders	7,610	12,163,320	2,638	12,134,715
Effect of dilutive items	2,005	4,229,464	–	1,909
Diluted	$ 9,615	16,392,784	$ 2,638	12,136,624
Net income per share:				
Basic		$ 0.63		$ 0.22
Diluted		$ 0.59		$ 0.22
Reconciliation of shares included in calculation of income per share due to dilutive effect:				
Net effect of dilutive:				
Convertible preferred stock	2,005	4,221,539	–	–
Stock options	–	7,925	–	1,909
	$ 2,005	4,229,464	$ –	1,909

The following securities were excluded from the calculation of diluted income per share, as their inclusion would be anti-dilutive:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Shares issuable under stock option awards	50,000	60,000	50,000	60,000
Convertible preferred stock	–	4,221,539	–	4,221,539

NOTE 3 – SECURITIZED MORTGAGE LOANS, NET

The following table summarizes the components of securitized mortgage loans at June 30, 2008 and December 31, 2007:

	June 30, 2008	December 31, 2007
Securitized mortgage loans:		
Commercial mortgage loans	$ 176,021	$ 185,998
Single-family mortgage loans	77,012	86,088
	253,033	272,086
Funds held by trustees, including funds held for defeased loans	7,125	7,225
Accrued interest receivable	1,737	1,940
Unamortized discounts and premiums, net	(3)	(67)
Loans, at amortized cost	261,892	281,184
Allowance for loan losses	(3,066)	(2,721)
	$ 258,826	$ 278,463

All of the securitized mortgage loans are encumbered by securitization financing bonds.

NOTE 4 – ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses is included in securitized mortgage loans, net in the accompanying condensed consolidated balance sheets. The following table summarizes the aggregate activity for the allowance for loan losses for the three-month and six-month periods ended June 30, 2008 and 2007:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Allowance at beginning of period	$ 2,745	$ 3,538	$ 2,721	$ 4,495
Provision for (recapture of) loan losses	321	(702)	347	(1,225)
Charge-offs, net of recoveries	–	(31)	(2)	(465)
Allowance at end of period	$ 3,066	$ 2,805	$ 3,066	$ 2,805

The Company identified $11,500 of impaired commercial loans at June 30, 2008 compared to $13,792 of impaired commercial loans at December 31, 2007, none of which were delinquent.

The following table presents certain information on impaired securitized commercial mortgage loans at December 31, 2007 and June 30, 2008.

	Investment in Impaired Loans	Allowance for Loan Losses	Investment in Excess of Allowance
December 31, 2007	$ 13,792	$ 2,590	$ 11,202
June 30, 2008	11,500	2,921	8,579

NOTE 5 – AGENCY MORTGAGE-BACKED SECURITIES

The Company’s agency mortgage-backed securities (“Agency RMBS”) are debt securities collateralized by single-family mortgage loans, on which the payment of principal and interest has been guaranteed by Federal National

Mortgage Corporation ("Fannie Mae") or Federal Home Loan Mortgage Corporation ("Freddie Mac"). The Company's Agency RMBS are comprised primarily of hybrid RMBS, which have interest rates that are fixed for a specified period and thereafter generally reset annually. At June 30, 2008, the Company's Agency RMBS had a weighted average of 17 months to reset.

The following table presents the components of the Company's investment in Agency RMBS as of June 30, 2008 and December 31, 2007:

	June 30, 2008	December 31, 2007
Principal/par value	$ 137,573	$ 7,400
Purchase premiums	1,637	15
Purchase discounts	(3)	(4)
Amortized cost	139,207	7,411
Gross unrealized gains	140	45
Gross unrealized losses	(160)	–
Fair value	$ 139,187	$ 7,456
Weighted average yield	4.85%	5.43%

The Company purchased approximately $142,911 of Agency RMBS during the six-month period ended June 30, 2008 and financed the purchases with repurchase agreements of $128,428. Of the Agency RMBS balances at June 30, 2008 and December 31, 2007, Agency RMBS with a fair value of $138,784 and none were pledged as collateral under the repurchase agreements, respectively. The Company also sold a $5,795 Agency RMBS during the period at a gain of $14.

NOTE 6 – OTHER SECURITIES

The following table summarizes the amortized cost basis and fair value of the Company's other securities, all of which are classified as available-for-sale, and the related average effective interest rates at June 30, 2008 and December 31, 2007:

	June 30, 2008		December 31, 2007	
	Value	Weighted Average Yield	Value	Weighted Average Yield
Non-agency mortgage-backed securities	$ 7,149	7.11%	$ 7,684	6.85%
Corporate debt securities	–	–%	4,722	11.75%
Equity securities of publicly traded companies	8,237		7,704	
	15,386		20,110	
Gross unrealized gains	929		2,361	
Gross unrealized losses	(625)		(696)	
Securities, available-for-sale at fair value	$ 15,690		$ 21,775	

The non-agency mortgage-backed securities consist principally of fixed rate securities collateralized by single-family residential loans originated in 1994.

The Company sold approximately $9,428 of equity securities during the six months ended June 30, 2008, on which it recognized a gain of $2,225, and purchased approximately $9,988 of equity securities during that period. The Company also sold the corporate debt security during the second quarter of 2008, on which it recognized a loss of $187.

NOTE 7 — INVESTMENT IN JOINT VENTURE

The Company, through a wholly-owned subsidiary, holds a 49.875% interest in a joint venture, Copperhead Ventures, LLC, primarily between the Company and DBAH Capital, LLC, an affiliate of Deutsche Bank, A. G.

The Company accounts for its investment in the joint venture using the equity method, under which it recognizes its proportionate share of the joint venture's earnings and comprehensive income. The Company's interest in the earnings (loss) from the joint venture was income of $560 and a loss of $1,691 for the three and six months ended June 30, 2008, respectively. The Company's interest in other comprehensive income (loss) from the joint venture was a loss of $287 and $3,923 for the three and six months ended June 30, 2008, respectively.

The joint venture had total assets at June 30, 2008 of $26,131, which were comprised primarily of $6,918 of cash and cash equivalents, $7,316 of available-for-sale subordinate commercial mortgage-backed securities, a financial instrument backed by commercial mortgage loans accounted for under SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" with a fair value of $11,663 and other assets of $234.

NOTE 8 – OTHER LOANS AND INVESTMENTS

The following table summarizes the Company's other loans and investments at June 30, 2008 and December 31, 2007:

	June 30, 2008	December 31, 2007
Single-family mortgage loans	$ 2,143	$ 2,486
Multifamily and commercial mortgage loan participations	907	927
Unamortized discounts on mortgage loans	(261)	(289)
Mortgage loans, net	2,789	3,124
Delinquent property tax receivable securities	547	2,127
Notes receivable and other investments	–	1,523
Other loans and investments	$ 3,336	$ 6,774

NOTE 9 – FAIR VALUE MEASUREMENTS

On January 1, 2008, the Company adopted the provisions of SFAS No. 157, "Fair Value Measurements" ("SFAS 157") for all assets that are measured at fair value and for its obligation to joint venture under payment agreement liability. Fair value is defined as the price at which an asset could be exchanged in a current transaction between knowledgeable, willing parties. A liability's fair value is defined as the amount that would be paid to transfer the liability to a new obligor, not the amount that would be paid to settle the liability with the creditor. Where available, fair value is based on observable market prices or parameters or derived from such prices or parameters. Where observable prices or inputs are not available, valuation models are applied. These valuation techniques involve some level of management estimation and judgment, the degree of which is dependent on the price transparency for the instruments or market and the instruments' complexity.

Assets and liabilities recorded at fair value in the condensed consolidated balance sheets are categorized based upon the level of judgment associated with the inputs used to measure their fair value. Hierarchical levels, defined by SFAS 157 and directly related to the amount of subjectivity associated with the inputs to fair valuation of these assets and liabilities, are as follows:

Level 1 — Inputs are unadjusted, quoted prices in active markets for identical assets or liabilities at the measurement date. The types of assets and liabilities carried at Level 1 fair value generally are equity securities listed in active markets.

Level 2 — Inputs (other than quoted prices included in Level 1) are either directly or indirectly observable for the asset or liability through correlation with market data at the measurement date and for the duration of the instrument's anticipated life. Fair valued assets and liabilities that are generally included in this category are Agency RMBS.

Level 3 — Inputs reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date. Consideration is given to the risk inherent in the valuation technique and the risk inherent in the inputs to the model. Generally, assets and liabilities carried at fair value and included in this category are non-agency mortgage-backed securities, delinquent property tax receivables and the obligation under payment agreement liability.

The following table presents the Company's assets and liabilities at June 30, 2008, which are carried at fair value, segregated by the hierarchy level of the fair value estimate:

		Fair Value Measurements		
	Fair Value	Level 1	Level 2	Level 3
Assets				
Agency RMBS	$ 139,187	$ –	$ 139,187	$ –
Non-agency mortgage-backed securities	7,012	–	–	7,012
Equity securities	8,678	8,678	–	–
Other	547	–	–	547
Total assets carried at fair value	$ 155,424	$ 8,678	$ 139,187	$ 7,559
Liabilities				
Obligation under payment agreement	$ 11,663	$ –	$ –	$ 11,663
Total liabilities carried at fair value	$ 11,663	$ –	$ –	$ 11,663

The following tables present the reconciliations of the beginning and ending balances of the Level 3 fair value estimates for the three and six month periods ended June 30, 2008:

	Level 3 Fair Values				
	Non-agency mortgage-backed securities	Corporate debt securities	Other	Total assets	Obligation under payment agreement
Balance at April 1, 2008	$ 7,402	$ 4,022	$ 482	$ 11,906	$ 11,244
Total realized and unrealized gains (losses)					
Included in earnings	–	(187)	(7)	(194)	419
Included in other comprehensive income (loss)	(138)	–	304	166	–
Purchases, sales, issuances and other settlements, net	(252)	(3,835)	(232)	(4,319)	–
Transfers in and/or out of Level 3	–	–	–	–	–
Balance at June 30, 2008	$ 7,012	$ –	$ 547	$ 7,559	$ 11,663

	Level 3 Fair Values				
	Non-agency mortgage-backed securities	Corporate debt securities	Other	Total assets	Obligation under payment agreement
Balance at January 1, 2008	$ 7,726	$ 4,347	$ 2,127	$ 14,200	$ 15,473
Total realized and unrealized gains (losses)					
Included in earnings	–	(187)	(2)	(189)	(3,810)
Included in other comprehensive income (loss)	(180)	375	304	499	–
Purchases, sales, issuances and other settlements, net	(534)	(4,535)	(1,882)	(6,951)	–
Transfers in and/or out of Level 3	–	–	–	–	–
Balance at June 30, 2008	$ 7,012	$ –	$ 547	$ 7,559	$ 11,663

There were no assets or liabilities which were measured at fair value on a non-recurring basis during the three or six months ended June 30, 2008.

NOTE 10 – SECURITIZATION FINANCING

The Company, through limited-purpose finance subsidiaries, has issued bonds pursuant to indentures in the form of non-recourse securitization financing. Each series of securitization financing may consist of various classes of bonds, either at fixed or variable rates of interest and having varying repayment terms. The Company, on occasion, may retain bonds or redeem bonds and hold such bonds outstanding for possible future resale or reissuance. Payments received on securitized mortgage loans and any reinvestment income earned thereon are used to make payments on the bonds.

The obligations under the securitization financings are payable solely from the securitized mortgage loans and are otherwise non-recourse to the Company. The stated maturity date for each class of bonds is generally calculated based on the final scheduled payment date of the underlying collateral pledged. The actual maturity of each class will be directly affected by the rate of principal prepayments on the related collateral. Each series is also subject to redemption at the Company’s option according to specific terms of the respective indentures. As a result, the actual maturity of any class of a series of securitization financing is likely to occur earlier than its stated maturity.

The Company has three series of bonds remaining outstanding pursuant to three separate indentures. One series with a principal amount of $31,381 is collateralized by $77,012 in single-family mortgage loans. The two remaining series with principal amounts of $22,698 and $134,586, respectively, are collateralized by commercial mortgage loans with unpaid principal balances at June 30, 2008 of $27,516 and $148,505, respectively.

The components of non-recourse securitization financing along with certain other information at June 30, 2008 and December 31, 2007 are summarized as follows:

	June 30, 2008		December 31, 2007	
	Bonds Outstanding	Range of Interest Rates	Bonds Outstanding	Range of Interest Rates
Fixed-rate classes	$ 157,284	6.6% - 8.8%	$ 167,398	6.6% - 8.8%
Variable-rate classes	31,381	2.7%	34,500	5.1%
Accrued interest payable	1,067		1,186	
Deferred costs	(1,483)		(1,851)	
Unamortized net bond premium	1,055		3,152	
	$ 189,304		$ 204,385	
Range of stated maturities	2024-2027		2024-2027	
Estimated weighted average life	3.6 years		3.3 years	
Number of series	3		3	

At June 30, 2008, the weighted-average effective rate of the coupon on the bonds outstanding was 6.2%. The average effective rate on the bonds was 6.9% and 7.2% for the six months ended June 30, 2008 and the year ended December 31, 2007, respectively.

On June 15, 2008, the Company redeemed one fixed rate bond outstanding at par as permitted by the related securitization trust's indenture. This bond had an unamortized premium of $1,247 on the redemption date, which the Company recognized as income, and is reported in "Other income (expense)" in the condensed consolidated statement of operations for the quarter.

NOTE 11 – REPURCHASE AGREEMENTS

The Company uses repurchase agreements, which are recourse to the Company, to finance certain of its investments. The Company had repurchase agreements of $129,403 and $4,612 at June 30, 2008 and December 31, 2007, respectively, which were collateralized by securities with a fair value of $175,211 and $42,975 at June 30, 2008 and December 31, 2007, respectively.

At June 30, 2008 and December 31, 2007, the repurchase agreements had a weighted average interest rate of 2.54% and 5.07%, respectively. The following table presents the Company's repurchase agreements as of June 30, 2008 and December 31, 2007 by their maturities:

	June 30, 2008		December 31, 2007	
Maturity	Balance	Weighted Average Rate	Balance	Weighted Average Rate
Less than 30 days	$ 99,077	2.56%	$ 4,612	5.07%
31 to 90 days	30,326	2.50	–	–
	$ 129,403	2.54%	$ 4,612	5.07%

NOTE 12 – OBLIGATION UNDER PAYMENT AGREEMENT

Obligation under payment agreement represents the fair value of payments due to the joint venture discussed in Note 7. The amounts due under the payment agreement are based on the amounts received monthly by the Company on certain securitized mortgage loans with an unpaid principal balance of $148,506 at June 30, 2008, after payment of the associated securitization financing bonds outstanding with an unpaid principal balance of $134,586 at June 30,

2008. The present value of the payment agreement was determined based on the total estimated future payments due discounted at a weighted average rate of 25.5%. Factors which significantly impact the valuation of the payment agreement include the credit performance of the underlying securitized mortgage loans, estimated prepayments on the loans and the weighted average discount rate used on the cash flows.

NOTE 13 – PREFERRED AND COMMON STOCK

The Company is authorized to issue up to 50,000,000 shares of preferred stock. For all series issued, dividends are cumulative from the date of issue and are payable quarterly in arrears. The dividend per share is equal to the greater of (i) the per quarter base rate of $0.2375 for Series D, or (ii) the quarterly dividend declared on the Company's common stock. One share of Series D preferred stock is convertible at any time at the option of the holder into one share of common stock. The series is redeemable by the Company at any time, in whole or in part, (i) at a rate of one share of preferred stock for one share of common stock, plus accrued and unpaid dividends, provided that for 20 trading days within any period of 30 consecutive trading days the closing price of the common stock equals or exceeds the issue price of $10, or (ii) for cash at the issue price, plus any accrued and unpaid dividends.

In the event of liquidation, the holders of the Company's Series D preferred stock will be entitled to receive out of the Company's assets, prior to any such distribution to the common shareholders, the issue price per share in cash, plus any accrued and unpaid dividends. If the Company fails to pay dividends for two consecutive quarters or if the Company fails to maintain consolidated shareholders' equity of at least 200% of the aggregate issue price of the Series D preferred stock, then these shares automatically convert into a new series of 9.50% senior notes. The Company paid dividends of $0.95 per share of Series D preferred stock for each of the years ended December 31, 2007, 2006 and 2005.

The following table presents the changes in the number of preferred and common shares outstanding:

	Shares	
	Preferred Series D	Common
December 31, 2007	4,221,539	12,136,262
Restricted shares granted	-	33,500
June 30, 2008	4,221,539	12,169,762

The following table presents the preferred and common dividends paid from January 1, 2008 through June 30, 2008:

Declaration Date	Record Date	Payment Date	Dividend per Share Common	Dividend per Share Preferred
Common Stock				
February 5, 2008	February 15, 2008	February 29, 2008	$0.10	–
May 12, 2008	May 22, 2008	May 30, 2008	0.15	–
Preferred Stock				
March 19, 2008	March 31, 2008	April 30, 2008	–	$0.2375
June 18, 2008	June 30, 2008	July 31, 2008	–	0.2375

Shelf Registration

On February 29, 2008, the Company filed a shelf registration statement on Form S-3, which became effective on April 17, 2008. The shelf registration permits the Company to sell up to $1.0 billion of securities, including common stock, preferred stock, debt securities and warrants. No shares had been sold or otherwise issued under this shelf registration as of June 30, 2008.

NOTE 14 – COMMITMENTS AND CONTINGENCIES

The Company and its subsidiaries may be involved in certain litigation matters arising in the ordinary course of business from time to time. Although the ultimate outcome of these matters cannot be ascertained at this time, and the results of legal proceedings cannot be predicted with certainty, the Company believes, based on current knowledge, that the resolution of these matters will not have a material adverse effect on the Company's financial position or results of operations.

Information on litigation arising out of the ordinary course of business is described below.

One of the Company's subsidiaries, GLS Capital, Inc. ("GLS"), and the County of Allegheny, Pennsylvania ("Allegheny County"), are defendants in a class action lawsuit filed in 1997 in the Court of Common Pleas of Allegheny County, Pennsylvania (the "Court of Common Pleas"). Plaintiffs allege that GLS illegally charged the taxpayers of Allegheny County certain attorney fees, costs and expenses and interest, in the collection of delinquent property tax receivables owned by GLS which were purchased from Allegheny County. In 2007, the Court of Common Pleas stayed this action pending the outcome of other litigation before the Pennsylvania Supreme Court in which GLS is not directly involved but has filed an amicus brief in support of the defendants. Several of the allegations in that lawsuit are similar to those being made against GLS in this litigation. Plaintiffs have not enumerated their damages in this matter, and the Company believes that the ultimate outcome of this litigation will not have a material impact on its financial condition, but may have a material impact on its reported results for the particular period presented.

Dynex Capital, Inc. and Dynex Commercial, Inc. ("DCI"), a former affiliate of the Company and now known as DCI Commercial, Inc., were appellees (or respondents) in the Court of Appeals for the Fifth Judicial District of Texas at Dallas, related to the matter of Basic Capital Management et al. (collectively, "BCM" or the "Plaintiffs") versus DCI et al. The appeal sought to overturn the trial court's judgment in the Company's and DCI's favor which denied recovery to Plaintiffs. Plaintiffs sought a reversal of the trial court's judgment, and sought rendition of judgment against the Company for alleged breach of loan agreements for tenant improvements in the amount of $253. They also sought reversal of the trial court's judgment and rendition of judgment against DCI in favor of BCM under two mutually exclusive damage models, for $2,200 and $25,600, respectively, related to the alleged breach by DCI of a $160,000 "master" loan commitment. Plaintiffs also sought reversal and rendition of a judgment in their favor for attorneys' fees in the amount of $2,100. Alternatively, Plaintiffs sought a new trial. On February 22, 2008, the Court of Appeals ruled in favor of the Company and DCI, upholding the trial court's judgment. On May 7, 2008, Plaintiffs filed an appeal with the Supreme Court of Texas seeking to reverse the decision of the Court of Appeals. Even if Plaintiffs were to be successful on appeal, DCI is a former affiliate of the Company, and the Company believes that it would have no obligation for amounts, if any, awarded to the Plaintiffs as a result of the actions of DCI.

Dynex Capital, Inc. and MERIT Securities Corporation, a subsidiary, were defendants in a putative class action complaint alleging violations of the federal securities laws in the United States District Court for the Southern District of New York ("District Court") by the Teamsters Local 445 Freight Division Pension Fund ("Teamsters"). The complaint was filed on February 7, 2005, and purported to be a class action on behalf of purchasers between February 2000 and May 2004 of MERIT Series 12 and MERIT Series 13 securitization financing bonds (the "Bonds"), which are collateralized by manufactured housing loans. The complaint sought unspecified damages and alleged, among other things, misrepresentations in connection with the issuance of and subsequent reporting on the Bonds. The complaint initially named the Company's former president and its current Chief Operating Officer as defendants. On February 10, 2006, the District Court dismissed the claims against the Company's former president and its current Chief Operating Officer, but did not dismiss the claims against the Company or MERIT. The Company and MERIT petitioned for an interlocutory appeal with the United States Court of Appeals for the Second Circuit ("Second Circuit"). The Second Circuit granted the Company's petition on September 15, 2006 and heard oral argument on the appeal on January 30,

2008. On June 27, 2008, the Second Circuit ruled in the Company’s favor ordering the District Court to dismiss the litigation against the Company and MERIT but with leave for Teamsters to amend and replead. Teamsters filed an amended complaint on August 6, 2008 with the District Court.

The Company is currently evaluating the amended complaint and intends to vigorously defend itself in this matter. Although no assurance can be given with respect to the ultimate outcome of this matter, the Company believes the resolution of this matter will not have a material effect on its consolidated balance sheet but could materially affect its consolidated results of operations in a given year or period.

NOTE 15 – STOCK BASED COMPENSATION

Pursuant to the Company's 2004 Stock Incentive Plan, as approved by the shareholders at the Company's 2005 annual shareholders' meeting (the "Stock Incentive Plan"), the Company may grant to eligible officers, directors and employees stock options, stock appreciation rights ("SARs") and restricted stock awards. An aggregate of 1,500,000 shares of common stock is available for distribution pursuant to the Stock Incentive Plan. The Company may also grant dividend equivalent rights ("DERs") in connection with the grant of options or SARs.

On February 4, 2008, the Company granted 33,500 shares of restricted common stock to certain of its employees and officers under the Stock Incentive Plan. Of the restricted stock granted, 3,500 shares vest 25% per quarter in 2008. The remaining 30,000 shares of restricted stock vest 25% per year (on the grant date anniversary) over the next four years. The weighted average grant date fair value of the restricted stock grants was $8.80 per share for a total compensation cost of $294, which will be recognized evenly over the vesting period. The Company recognized expense related to the restricted stock granted of $24 and $40 for the three and six month periods ended June 30, 2008, respectively.

On May 16, 2008, the Company granted options to acquire an aggregate of 25,000 shares of common stock to its directors under the Stock Incentive Plan for which the Company recognized an expense of approximately $13. The options vested immediately, expire on May 16, 2013 and have an exercise price of $9.81 per share, which was 110% of the closing price of the Company's common stock on the grant date. The weighted average grant-date fair value of the options granted was $0.50 on the grant date.

The following table presents a summary of the SAR activity for the Stock Incentive Plan:

	Three Months Ended June 30, 2008		Six Months Ended June 30, 2008	
	Number of Shares	Weighted-Average Exercise Price	Number of Shares	Weighted-Average Exercise Price
SARs outstanding at beginning of period	278,146	$ 7.27	278,146	$ 7.27
SARs granted	–	–	–	–
SARs forfeited or redeemed	–	–	–	–
SARs exercised	–	–	–	–
SARs outstanding at end of period	278,146	$ 7.27	278,146	$ 7.27
SARs vested and exercisable	149,860	$ 7.41	149,860	$ 7.41

The following table presents a summary of the option activity for the Stock Incentive Plan:

	Three Months Ended June 30, 2008			Six Months Ended June 30, 2008		
	Number of Shares		Weighted-Average Exercise Price	Number of Shares		Weighted-Average Exercise Price
Options outstanding at beginning of period	95,000	$	8.28	95,000	$	8.28
Options granted	25,000		9.81	25,000		9.81
Options forfeited or redeemed	–		–	–		–
Options exercised	–		–	–		–
Options outstanding at end of period	120,000	$	8.60	120,000	$	8.60
Options vested and exercisable	120,000	$	8.60	120,000	$	8.60

The Company recognized a stock based compensation benefit of $123 and $206 for the three and six months ended June 30, 2008, respectively, and stock based compensation expense of $135 and $207 for the three and six months ended June 30, 2007, respectively. The total compensation cost related to non-vested awards was $113 and $518 at June 30, 2008 and 2007, respectively, and will be recognized as the awards vest.

As required by SFAS No. 123(R) "Share-Based Payment", stock options, which are settleable only in shares of common stock, have been treated as equity awards, with their fair value measured at the grant date, and SARs, which are settleable in cash, have been treated as liability awards, with their fair value measured at the grant date and remeasured at the end of each reporting period. The fair value of SARs was estimated at June 30, 2008 using the Black-Scholes option valuation model based upon the assumptions in the table below.

The following table describes the weighted average of assumptions used for calculating the fair value of SARs outstanding at June 30, 2008.

	SARs Fair Value June 30, 2008
Expected volatility	16.73%-17.69%
Weighted-average volatility	17.07%
Expected dividends	6.980%
Expected term (in months)	46
Risk-free rate	3.21%

NOTE 16 – SUBSEQUENT EVENT

On July 1, 2008, the Company was relieved of certain mortgage servicing obligations with a recorded balance of $3.5 million at June 30, 2008. The obligations related to payments required to be made by the Company to a former affiliate who was the servicer of manufactured housing loans originated by the Company in 1998 and 1999. The servicer resigned effective July 1, 2008, with the immediate effect that the Company was relieved of any obligation to make further payments. At June 30, 2008, this $3.5 million was included in other liabilities. As a result of being released from these obligations, the Company will recognize a benefit of $3.5 million in the quarter ending September 30, 2008.

18

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

The following discussion and analysis of our financial condition and results of operations as of and for the three-month and six-month periods ended June 30, 2008 should be read in conjunction with our Condensed Consolidated Financial Statements (unaudited) and the accompanying Notes to Condensed Consolidated Financial Statements (unaudited) included in this report.

OVERVIEW

Our Business

We are a specialty finance company organized as a real estate investment trust ("REIT"), which invests in mortgage loans and securities on a leveraged basis. We were incorporated in Virginia on December 18, 1987, and commenced operations in February, 1988. We invest in residential mortgage backed securities ("RMBS") issued or guaranteed by a federally chartered corporation, such as Federal National Mortgage Corporation ("Fannie Mae") or Federal Home Loan Mortgage Corporation ("Freddie Mac"), or an agency of the U.S. government, such as Government National Mortgage Association ("Ginnie Mae"). RMBS issued or guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae are commonly referred to as "Agency RMBS". We began investing in Agency RMBS as our principal business strategy beginning in the first quarter of 2008.

We also have invested in securitized residential and commercial mortgage loans, non-Agency RMBS and, through a joint venture, commercial mortgage-backed securities. Substantially all of these loans and securities, including those owned by the joint venture, consist of or are secured by first lien mortgages which were originated by us from 1992 to 1998. We are no longer actively originating loans and are not reinvesting our capital in these types of assets. As these assets are repaid and our capital is returned, we currently anticipate reinvesting these proceeds in Agency RMBS provided that this investment strategy continues to yield acceptable risk-adjusted returns at appropriate amounts of leverage. We are evaluating ways to accelerate the return of our capital in certain of these investments, including those held by the joint venture. This may include the sale of certain of these investments or an increase in the leverage on these investments.

We have generally financed our investments through a combination of securitization financing, repurchase agreements and equity capital. We employ leverage in order to increase the overall yield on our invested capital. Our primary source of income is net interest income, which is the excess of the interest income earned on our investments over the cost of financing these investments. We may occasionally sell investments prior to their maturity.

At June 30, 2008, we had total investments of approximately $430.3 million. Our investments consisted of $139.2 million of Agency RMBS, $78.5 million of securitized single-family mortgage loans and $180.3 million of securitized commercial mortgage loans. We have a $13.3 million investment in a joint venture which owns subordinate commercial mortgage-backed securities and cash. We also had $8.7 million of equity securities and $7.0 million in non-agency mortgage-backed securities ("non-Agency RMBS"). A discussion of our investments and recent activity is included under "Financial Condition" below.

As a REIT, we are required to distribute to shareholders as dividends at least 90% of our taxable income, which is our income as calculated for tax, after consideration of any tax net operating loss ("NOL") carryforwards. We had an NOL carryforward of approximately $150 million at December 31, 2007, although we have not finalized our 2007 federal income tax return. These tax NOLs were principally generated during 1999 and 2000 and do not begin to meaningfully expire until 2019. Provided that we do not experience an ownership shift as defined under Section 382 of the Code, we may utilize the tax NOLs to offset distribution requirements for our REIT taxable income with certain limitations. If we do incur an ownership shift under Section 382 of the Code then the use of the NOLs to offset REIT distribution requirements may be limited.

Investment Strategy

Our principal investment strategy today involves the investment of our capital in Agency RMBS. We expect to invest most of our capital in Hybrid Agency ARMs and Agency ARMs (both defined below), and to a lesser extent, fixed-rate Agency RMBS.

Hybrid Agency ARMs are RMBS securities collateralized by adjustable mortgage loans. Hybrid adjustable rate mortgage loans are loans which have a fixed rate of interest for a specified period (typically three to seven years) and which then adjust their interest rate at least annually to an increment over a specified interest rate index as further discussed below. Agency ARMs are RMBS securities collateralized by adjustable rate mortgage loans which have interest rates that generally will adjust at least annually to an increment over a specified interest rate index. Agency ARMs may be collateralized by Hybrid Agency ARMs that are past their fixed rate periods.

Interest rates on the adjustable rate loans collateralizing the Hybrid Agency ARMs or Agency ARMs are based on specific index rates, such as the one-year constant maturity treasury (“CMT”) rate, the London Interbank Offered Rate (“LIBOR”) the Federal Reserve U.S. 12-month cumulative average one-year CMT (“MTA”) or the 11th District Cost of Funds Index (“COFI”). These loans will typically have interim and lifetime caps on interest rate adjustments (“interest rate caps”) limiting the amount that the rates on these loans may reset in any given period.

Financing Strategy

We finance our acquisition of Agency RMBS by borrowing against a substantial portion of the market value of these assets utilizing repurchase agreements. Repurchase agreements are financings under which we will pledge our Agency RMBS as collateral to secure loans made by repurchase agreement counterparties. The amount borrowed under a repurchase agreement is limited to a specified percentage of the estimated market value of the pledged collateral. Under repurchase agreements, a lender may require that we pledge additional assets (i.e., by initiating a margin call) in the event the estimated market value of our existing pledged collateral declines below a specified percentage during the term of the borrowing. Our pledged collateral fluctuates in value due to, among other things, changes in market interest rates, changes in market risk premiums and principal repayments. We generally expect to maintain an effective debt to equity capital ratio of between five and nine times our equity capital invested in Agency RMBS, although the ratio may vary from time to time depending upon market conditions and other factors.

Generally, repurchase agreement borrowings will have a term of one month and carry a rate of interest based on a spread to LIBOR. Interest rates on Agency RMBS assets will not reset as frequently as the interest rates on repurchase agreement borrowings. As a result, we are exposed to reductions in our net interest income earned during a period of rising rates. In an effort to protect our net interest income during a period of rising interest rates, we anticipate extending the interest rate reset dates on our repurchase agreement borrowings by negotiating terms with the counterparty. In addition, in a period of rising rates we may experience a decline in the carrying value of our Agency RMBS, which would impact our shareholders’ equity and common book value per share. In an effort to protect our book value per common share as well as our net interest income during a period of rising rates, we may also utilize derivative financial instruments such as interest rate swap agreements. An interest rate swap agreement would allow us to fix the borrowing cost on a portion of our repurchase agreement financing for a specified period of time.

We may also use interest rate cap agreements. An interest rate cap agreement is a contract whereby we, as the purchaser, pay a fee in exchange for the right to receive payments equal to the principal (i.e., notional amount) times the difference between a specified interest rate and a future interest rate during a defined “active” period of time. Interest rate cap agreements should protect our net interest income in a rapidly rising interest rate environment.

In the future, we may use other sources of funding in addition to repurchase agreements to finance our Agency RMBS portfolio, including but not limited to, other types of collateralized borrowings, loan agreements, lines of credit, commercial paper or the issuance of equity or debt securities.

Our Board of Directors declared a dividend of $0.15 per common share for the second quarter of 2008 and expects to pay a dividend in the third and fourth quarters of 2008.

CRITICAL ACCOUNTING POLICIES

The discussion and analysis of our financial condition and results of operations are based in large part upon our consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States of America. The preparation of the financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reported period. Actual results could differ from those estimates.

Critical accounting policies are defined as those that are reflective of significant judgments or uncertainties, and which may result in materially different results under different assumptions and conditions, or the application of which may have a material impact on our financial statements. The following are our critical accounting policies.

Consolidation of Subsidiaries. The consolidated financial statements represent our accounts after the elimination of inter-company transactions. We consolidate entities in which we own more than 50% of the voting equity and control of the entity does not rest with others and variable interest entities in which we are determined to be the primary beneficiary in accordance with Financial Interpretation (“FIN”) 46(R). We follow the equity method of accounting for investments with greater than 20% and less than a 50% interest in partnerships and corporate joint ventures or when we are able to influence the financial and operating policies of the investee but own less than 50% of the voting equity. For all other investments, the cost method is applied.

Securitization. We have securitized loans and securities in a securitization financing transaction by transferring financial assets to a wholly owned trust, with the trust issuing non-recourse bonds pursuant to an indenture. Generally, we retain some form of control over the transferred assets, and/or the trust is not deemed to be a qualified special purpose entity. In instances where the trust is deemed not to be a qualified special purpose entity, the trust is included in our consolidated financial statements. A transfer of financial assets in which we surrender control over those assets is accounted for as a sale to the extent that consideration, other than beneficial interests in the transferred assets, is received in exchange. For accounting and tax purposes, the loans and securities financed through the issuance of bonds in a securitization financing transaction are treated as our assets, and the associated bonds issued are treated as our debt as securitization financing. We may retain certain of the bonds issued by the trust and will generally transfer collateral in excess of the bonds issued. This excess is typically referred to as over-collateralization. Each securitization trust generally provides us with the right to redeem, at our option, the remaining outstanding bonds prior to their maturity date.

Impairments. We evaluate all securities in our investment portfolio for other-than-temporary impairments. A security is generally defined to be other-than-temporarily impaired if, for a maximum period of three consecutive quarters, the carrying value of such security exceeds its estimated fair value, and we estimate, based on projected future cash flows or other fair value determinants, that the fair value will remain below the carrying value for the foreseeable future. If an other-than-temporary impairment is deemed to exist, we record an impairment charge to adjust the carrying value of the security down to its estimated fair value. In certain instances, as a result of the other-than-temporary impairment analysis, the recognition or accrual of interest will be discontinued and the security will be placed on non-accrual status.

We consider impairments of other investments to be other-than-temporary when the fair value remains below the carrying value for three consecutive quarters. If the impairment is determined to be other-than-temporary, an impairment charge is recorded in order to adjust the carrying value of the investment to its estimated value.

Allowance for Loan Losses. We have credit risk on loans pledged in securitization financing transactions and classified as securitized mortgage loans in our investment portfolio. An allowance for loan losses has been estimated and established for currently existing probable losses. Factors considered in establishing an allowance include current loan delinquencies, historical cure rates of delinquent loans, and historical and anticipated loss severity of the loans as they are liquidated. The allowance for loan losses is evaluated and adjusted periodically by management based on the actual and estimated timing and amount of probable credit losses, using the above factors, as well as industry loss experience. Where loans are considered homogeneous, the allowance for losses is established and evaluated on a pool basis. Otherwise, the allowance for losses is established and evaluated on a loan-specific basis. Provisions made to increase the allowance are a current period expense to operations. Single-family loans are considered impaired when they are 60-days past due. Commercial mortgage loans are evaluated on an individual basis for impairment. Generally, a commercial loan with a debt service coverage ratio of less than one is considered impaired. However, based on the attributes of the respective loan, or the attributes of the underlying real estate which secures the loan, commercial loans with a debt service ratio less than one may not be considered impaired; conversely, commercial loans with a debt service coverage ratio greater than one may be considered impaired. Certain of the commercial mortgage loans are covered by loan guarantees that limit the our exposure on these loans. The level of allowance for loan losses required for these loans is reduced by the amount of applicable loan guarantees. Our actual credit losses may differ from the estimates used to establish the allowance.

FINANCIAL CONDITION

Below is a discussion of our financial condition.

(amounts in thousands except per share data)	June 30, 2008	December 31, 2007
Investments:		
Securitized mortgage loans, net	$ 258,826	$ 278,463
Agency RMBS	139,187	7,456
Other securities	15,690	21,775
Investment in joint venture	13,273	19,267
Other loans and investments	3,336	6,774
Securitization financing		