WEBSTER FINANCIAL CORP
Form 10-Q
November 05, 2015
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 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 September 30, 2015

Commission File Number: 001-31486

WEBSTER FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

Delaware	06-1187536
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

145 Bank Street, Waterbury, Connecticut 06702
(Address and zip code of principal executive offices)

(203) 578-2202
(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. þ Yes o No
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). þ Yes o No
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 þ Accelerated filer o Non-accelerated filer o Smaller reporting company o
Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). o Yes þ No
The number of shares of common stock, par value $.01 per share, outstanding as of October 30, 2015 was 91,678,361.

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PART I. – FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
WEBSTER FINANCIAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)	September 30, 2015 (Unaudited)	December 31, 2014
Assets:		
Cash and due from banks	$251,898	$261,544
Interest-bearing deposits	19,257	132,695
Securities available-for-sale, at fair value	3,015,417	2,793,873
Securities held-to-maturity (fair value of $4,023,546 and $3,948,706)	3,951,208	3,872,955
Federal Home Loan Bank and Federal Reserve Bank stock	184,280	193,290
Loans held for sale	38,331	67,952
Loans and leases	15,216,525	13,900,025
Allowance for loan and lease losses	(172,992)	(159,264)
Loans and leases, net	15,043,533	13,740,761
Deferred tax asset, net	84,743	73,873
Premises and equipment, net	127,216	121,933
Goodwill	538,373	529,887
Other intangible assets, net	40,914	2,666
Cash surrender value of life insurance policies	449,711	440,073
Accrued interest receivable and other assets	324,901	301,670
Total assets	$24,069,782	$22,533,172
Liabilities and shareholders' equity:		
Deposits:		
Non-interest-bearing	$3,551,229	$3,598,872
Interest-bearing	14,031,001	12,052,733
Total deposits	17,582,230	15,651,605
Securities sold under agreements to repurchase and other borrowings	1,002,018	1,250,756
Federal Home Loan Bank advances	2,609,212	2,859,431
Long-term debt	226,327	226,237
Accrued expenses and other liabilities	247,450	222,328
Total liabilities	21,667,237	20,210,357
Shareholders' equity:		
Preferred stock, $.01 par value; Authorized - 3,000,000 shares:		
Series A issued and outstanding (28,939 shares at December 31, 2014)	—	28,939
Series E issued and outstanding (5,060 shares)	122,710	122,710
Common stock, $.01 par value; Authorized - 200,000,000 shares:		
Issued (93,648,572 and 93,623,090 shares)	936	936
Paid-in capital	1,124,823	1,127,534
Retained earnings	1,288,261	1,202,251
Treasury stock, at cost (2,136,436 and 3,241,555 shares)	(74,666)	(103,294)
Accumulated other comprehensive loss, net of tax	(59,519)	(56,261)
Total shareholders' equity	2,402,545	2,322,815
Total liabilities and shareholders' equity	$24,069,782	$22,533,172

See accompanying Notes to Condensed Consolidated Financial Statements.

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WEBSTER FINANCIAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

	Three months ended September 30,		Nine months ended September 30,	
(In thousands, except per share data)	2015	2014	2015	2014
Interest Income:				
Interest and fees on loans and leases	$140,520	$129,227	$406,937	$379,008
Taxable interest and dividends on securities	47,230	46,349	141,739	142,442
Non-taxable interest on securities	3,891	4,099	11,905	13,109
Loans held for sale	357	239	1,299	631
Total interest income	191,998	179,914	561,880	535,190
Interest Expense:				
Deposits	11,480	11,345	34,555	32,840
Securities sold under agreements to repurchase and other borrowings	4,138	4,587	12,711	14,874
Federal Home Loan Bank advances	5,949	4,203	16,099	12,052
Long-term debt	2,421	2,409	7,230	7,631
Total interest expense	23,988	22,544	70,595	67,397
Net interest income	168,010	157,370	491,285	467,793
Provision for loan and lease losses	13,000	9,500	35,500	27,750
Net interest income after provision for loan and lease losses	155,010	147,870	455,785	440,043
Non-interest Income:				
Deposit service fees	35,229	26,489	102,347	77,503
Loan related fees	8,305	5,479	19,713	14,851
Wealth and investment services	7,761	8,762	24,434	26,429
Mortgage banking activities	1,441	1,805	5,519	3,093
Increase in cash surrender value of life insurance policies	3,288	3,346	9,637	9,900
Gain on sale of investment securities, net	—	42	529	4,378
Impairment loss recognized in earnings	(82)	(85)	(82)	(246)
Other income	5,513	5,071	17,099	12,425
Total non-interest income	61,455	50,909	179,196	148,333
Non-interest Expense:				
Compensation and benefits	73,378	66,849	218,285	198,931
Occupancy	11,987	11,557	37,263	35,807
Technology and equipment	21,336	15,419	60,808	46,166
Intangible assets amortization	1,621	432	4,752	2,269
Marketing	4,099	4,032	12,520	11,461
Professional and outside services	2,896	2,470	8,224	6,441
Deposit insurance	6,067	5,938	17,800	16,814
Other expense	18,470	17,801	51,738	53,547
Total non-interest expense	139,854	124,498	411,390	371,436
Income before income tax expense	76,611	74,281	223,591	216,940
Income tax expense	25,075	23,824	69,830	68,220
Net income	51,536	50,457	153,761	148,720
Preferred stock dividends	(2,024)	(2,639)	(6,687)	(7,917)
Net income available to common shareholders	$49,512	$47,818	$147,074	$140,803
Net income per common share:				
Basic	$0.54	$0.53	$1.61	$1.56

Diluted	0.54	0.53	1.60	1.55

See accompanying Notes to Condensed Consolidated Financial Statements.

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WEBSTER FINANCIAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)

	Three months ended September 30,		Nine months ended September 30,	
(In thousands)	2015	2014	2015	2014
Net income	$51,536	$50,457	$153,761	$148,720
Other comprehensive income (loss), net of tax:				
Total available-for-sale and transferred securities	712	(8,097)	(6,248)	15,776
Total derivative instruments	(519)	1,673	42	(4,571)
Total defined benefit pension and other postretirement benefit plans	983	500	2,948	1,425
Other comprehensive income (loss), net of tax	1,176	(5,924)	(3,258)	12,630
Comprehensive income	$52,712	$44,533	$150,503	$161,350

See accompanying Notes to Condensed Consolidated Financial Statements.

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WEBSTER FINANCIAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY (Unaudited)

(In thousands, except per share data)	Preferred Stock	Common Stock	Paid-In Capital	Retained Earnings	Treasury Stock, at cost	Accumulated Other Comprehensive Loss, Net of Tax	Total Shareholders' Equity
Balance at December 31, 2014	$151,649	$936	$1,127,534	$1,202,251	$(103,294)	$(56,261)	$2,322,815
Net income	—	—	—	153,761	—	—	153,761
Other comprehensive loss, net of tax	—	—	—	—	—	(3,258)	(3,258)
Dividends on common stock and dividend equivalents declared $0.66 per share	—	—	87	(60,236)	—	—	(60,149)
Dividends on Series A preferred stock $21.25 per share	—	—	—	(615)	—	—	(615)
Dividends on Series E preferred stock $1,200.00 per share	—	—	—	(6,072)	—	—	(6,072)
Common stock issued	—	—	—	—	—	—	—
Preferred stock conversion	(28,939)	—	(3,429)	—	32,368	—	—
Stock-based compensation, net of tax impact	—	—	2,778	(828)	8,454	—	10,404
Exercise of stock options	—	—	(2,124)	—	4,686	—	2,562
Shares acquired related to employee share-based compensation plans	—	—	—	—	(4,316)	—	(4,316)
Common stock repurchased	—	—	—	—	(12,564)	—	(12,564)
Common stock warrants repurchased	—	—	(23)	—	—	—	(23)
Balance at September 30, 2015	$122,710	$936	$1,124,823	$1,288,261	$(74,666)	$(59,519)	$2,402,545

(In thousands, except per share data)	Preferred Stock	Common Stock	Paid-In Capital	Retained Earnings	Treasury Stock, at cost	Accumulated Other Comprehensive Loss, Net of Tax	Total Shareholders' Equity
Balance at December 31, 2013	$151,649	$934	$1,125,584	$1,080,488	$(100,918)	$(48,549)	$2,209,188
Cumulative effect of change in accounting principle	—	—	—	160	—	—	160
Net income	—	—	—	148,720	—	—	148,720
Other comprehensive income, net of tax	—	—	—	—	—	12,630	12,630
Dividends on common stock and dividend equivalents declared $0.55 per share	—	—	41	(49,672)	—	—	(49,631)
Dividends on Series A preferred stock $63.75 per share	—	—	—	(1,845)	—	—	(1,845)
	—	—	—	(6,072)	—	—	(6,072)

Dividends on Series E preferred stock $1,200.00 per share							
Common stock issued	—	—	436	—	—	—	436
Stock-based compensation, net of tax impact	—	—	3,909	736	3,982	—	8,627
Exercise of stock options	—	—	(1,517)	—	3,256	—	1,739
Shares acquired related to employee share-based compensation plans	—	—	—	—	(2,218)	—	(2,218)
Common stock repurchased	—	—	—	—	(10,741)	—	(10,741)
Balance at September 30, 2014	$151,649	$934	$1,128,453	$1,172,515	$(106,639)	$ (35,919)	$2,310,993

See accompanying Notes to Condensed Consolidated Financial Statements.

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WEBSTER FINANCIAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

(In thousands)	Nine months ended September 30, 2015	2014
Operating Activities:		
Net income	$153,761	$148,720
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan and lease losses	35,500	27,750
Deferred tax benefit	(7,272)	(4,388)
Depreciation and amortization	25,991	23,509
Amortization of earning assets and funding, premium/discount, net	41,704	37,127
Stock-based compensation	8,283	7,793
Gain on sale, net of write-down, on foreclosed and repossessed assets	(69)	(1,059)
Gain on sale, net of write-down, on premises and equipment	(249)	(349)
Impairment loss recognized in earnings	82	246
Gain on the sale of investment securities, net	(529)	(4,378)
Increase in cash surrender value of life insurance policies	(9,637)	(9,900)
Gain from life insurance policies	(220)	(671)
Gain, net on sale of loans held for sale	(5,519)	(3,093)
Proceeds from sale of loans held for sale	352,300	207,530
Origination of loans held for sale	(351,236)	(209,585)
Net increase in accrued interest receivable and other assets	(52,271)	(41,631)
Net increase in accrued expenses and other liabilities	21,282	19,485
Net cash provided by operating activities	211,901	197,106
Investing Activities:		
Net decrease (increase) in interest-bearing deposits	113,438	(81,720)
Purchases of available for sale securities	(737,184)	(92,343)
Proceeds from maturities and principal payments of available for sale securities	452,397	317,973
Proceeds from sales of available for sale securities	65,643	38,075
Purchases of held-to-maturity securities	(639,699)	(732,767)
Proceeds from maturities and principal payments of held-to-maturity securities	538,772	431,571
Net proceeds (purchase) of Federal Home Loan Bank stock	9,010	(12,296)
Net increase in loans	(1,345,816)	(840,704)
Proceeds from sale of loans not originated for sale	33,100	—
Proceeds from life insurance policies	3,912	760
Proceeds from the sale of foreclosed and repossessed assets	7,783	7,804
Proceeds from the sale of premises and equipment	650	2,641
Purchases of premises and equipment	(26,801)	(19,908)
Acquisition of business, net of cash acquired	1,396,414	—
Net cash used for investing activities	(128,381)	(980,914)

See accompanying Notes to Condensed Consolidated Financial Statements.

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WEBSTER FINANCIAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited), continued

(In thousands)	Nine months ended September 30, 2015	2014
Financing Activities:		
Net increase in deposits	484,568	692,860
Proceeds from Federal Home Loan Bank advances	9,100,000	5,352,931
Repayments of Federal Home Loan Bank advances	(9,350,209)	(5,115,130)
Net decrease in securities sold under agreements to repurchase and other borrowings	(248,738)	(94,687)
Issuance of long-term debt	—	150,000
Repayment of long-term debt	—	(150,000)
Debt issuance costs	—	(1,349)
Dividends paid to common shareholders	(59,890)	(49,672)
Dividends paid to preferred shareholders	(6,687)	(7,917)
Exercise of stock options	2,562	1,739
Excess tax benefits from stock-based compensation	2,131	1,068
Common stock issued	—	436
Common stock repurchased	(12,564)	(10,741)
Shares acquired related to employee share-based compensation plans	(4,316)	(2,218)
Common stock warrants repurchased	(23)	—
Net cash (used for) provided by financing activities	(93,166)	767,320
Net decrease in cash and due from banks	(9,646)	(16,488)
Cash and due from banks at beginning of period	261,544	223,616
Cash and due from banks at end of period	$251,898	$207,128
Supplemental disclosure of cash flow information:		
Interest paid	$73,283	$69,737
Income taxes paid	79,564	82,155
Noncash investing and financing activities:		
Transfer of loans and leases to foreclosed properties and repossessed assets	$6,582	$3,289
Transfer of loans from portfolio to loans-held-for-sale	186	—
Deposits assumed in business acquisition	1,446,899	—
Preferred stock conversion	28,939	—

See accompanying Notes to Condensed Consolidated Financial Statements.

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Note 1: Summary of Significant Accounting Policies

Nature of Operations

Webster Financial Corporation (collectively, with its consolidated subsidiaries, “Webster” or the “Company”) is a bank holding company and financial holding company under the Bank Holding Company Act of 1956, as amended, incorporated under the laws of Delaware in 1986 and headquartered in Waterbury, Connecticut. At September 30, 2015, Webster Financial Corporation's principal asset is all of the outstanding capital stock of Webster Bank, National Association ("Webster Bank").

Webster, through Webster Bank and various non-banking financial services subsidiaries, delivers financial services to individuals, families, and businesses primarily from New York to Massachusetts. Webster provides business and consumer banking, mortgage lending, financial planning, trust, and investment services through banking offices, ATMs, telephone banking, mobile banking, and its internet website (www.websterbank.com). Webster also offers equipment financing, commercial real estate lending, and asset-based lending primarily across the Northeast. On a nationwide basis, through its HSA Bank division, Webster Bank offers and administers health savings accounts, flexible spending accounts, health reimbursement accounts, and commuter benefits.

Basis of Presentation

The accounting and reporting policies of the Company that materially affect its financial statements conform with U.S. Generally Accepted Accounting Principles ("GAAP"). The accompanying unaudited Condensed Consolidated Financial Statements of the Company have been prepared in conformity with the instructions for Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all the information and notes required by GAAP for complete financial statements and should be read in conjunction with the Company's Consolidated Financial Statements, and notes thereto, for the year ended December 31, 2014, included in the Company's Annual Report on Form 10-K filed with the SEC on February 27, 2015.

The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the amounts of assets and liabilities as of the date of the financial statements as well as income and expense during the period. Actual results could differ from those estimates. Operating results for the interim periods disclosed herein are not necessarily indicative of the results that may be expected for the full year or any future period.

Certain prior period amounts have been reclassified to conform to the current year's presentation. These reclassifications had an immaterial effect on net income, comprehensive income, total assets, total liabilities, total shareholders' equity, net cash provided by operating activities, net cash used for investing activities, and net cash provided by financing activities.

Acquisition

On January 13, 2015 (the "acquisition date”), Webster Bank completed its acquisition of the health savings account business of JPMorgan Chase Bank, N.A. The results of the acquisition have been included in the financial statements from the acquisition date. See Note 2: Acquisition for further information.

Modifications to Significant Accounting Policies

Non-accrual loans. Effective during the first quarter of 2015, residential loans that are more than 90 days past due, fully insured against loss, and in the process of collection, remain accruing loans and are reported as 90 days or more past due and accruing. Previously, these loans were placed on non-accrual when payments were 90 days or more past due. For presentation purposes, previously reported amounts have been reclassified to conform to the current year presentation. The change in accounting policy did not have a material impact on the financial statements.

Other intangible assets. Other intangible assets with finite useful lives are amortized to non-interest expense over their estimated useful lives. Effective during the first quarter of 2015, core deposit intangibles resulting from the health savings account acquisition are amortized on an accelerated basis over their estimated useful lives. Core deposit intangibles existing prior to the health savings account acquisition will continue to be amortized on a straight line basis over their remaining estimated useful lives. Intangible assets relating to customer relationships are amortized on a straight line basis over their estimated useful lives.

Recently Adopted Accounting Standards Updates

ASU No. 2014-01 - Investments - Equity Method and Joint Ventures (Topic 323) - "Accounting for Investments in Qualified Affordable Housing Projects (a consensus of the FASB Emerging Issues Task Force)." The Update requires an entity to disclose information about its investments in qualified affordable housing projects and provides an accounting policy election for it to account for such investments using the proportional amortization method. Under that method, the initial cost of an investment is amortized in proportion to its tax credits and other tax benefits as a component of income tax expense or benefit. The decision to apply the proportionate amortization method is to be applied consistently to all such investments. The Company adopted this Update effective January 1, 2015 and retrospectively applied the effects of its accounting policy decision to use the proportional amortization method, as Webster believes presenting the investment performance net of taxes as a component of income tax expense or benefit better represents the economics of such investments. The change had no material effect on the Company's financial statements.

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ASU No. 2014-04, Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40) - "Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force)." The Update clarifies that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (i) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (ii) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar agreement. In addition, the Update requires disclosure of both the amount of foreclosed residential real estate property held by the creditor and the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure in accordance with local requirements of the applicable jurisdiction. The Update was adopted during the first quarter of 2015, by prospective transition, and did not have a material impact on the Company's financial statements.

ASU No. 2014-11 - Transfers and Servicing (Topic 860) - “Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures.” The Update requires two accounting changes: (i) repurchase-to-maturity transactions are to be accounted for as secured borrowings; and (ii) with respect to repurchase financing arrangements, accounting is required for a transfer of a financial asset contemporaneously with a repurchase agreement with the same counterparty, which will result in secured borrowing accounting for the repurchase agreement. Additionally, disclosure requirements have been expanded to include a disaggregation of collateral used for secured borrowings, and contractual maturity disclosure has been expanded to interim periods. The Update was adopted during the first quarter of 2015 and did not have a material impact on the Company's financial statements.

ASU No. 2014-14, Receivables-Troubled Debt Restructurings by Creditors (Subtopic 310-40) - "Classification of Certain Government-Guaranteed Residential Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force)." The Update has been issued to reduce diversity in practice in the classification of foreclosed residential mortgage loans held by creditors that are fully guaranteed under certain government programs, including the Federal Housing Administration guarantees. A residential mortgage loan would be derecognized, and a separate other receivable would be recognized upon foreclosure if the loan has both of the following characteristics: (i) the loan has a government guarantee that is not separable from the loan before foreclosure entitling the creditor to the full unpaid principal balance of the loan; and (ii) at the time of foreclosure, the creditor has the intent to make a claim on the guarantee and the ability to recover the full unpaid principal balance of the loan through the guarantee. Notably, upon foreclosure, the separate other receivable would be measured based on the current amount of the loan balance expected to be recovered under the guarantee. The Update was adopted during the first quarter of 2015 and did not have a material impact on the Company's financial statements.

Recently Issued Accounting Standards Updates

ASU No. 2014-09 - Revenue from Contracts with Customers (Topic 606). The Update establishes a single comprehensive model for an entity to recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled, and will supersede nearly all existing revenue recognition guidance, and clarify and converge revenue recognition principles under US GAAP and IFRS. The update outlines five steps to recognizing revenue: (i) identify the contracts with the customer; (ii) identify the separate performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the separate performance obligations; and (v) recognize revenue when each performance obligation is satisfied. The update requires more comprehensive disclosures, relating to quantitative and qualitative information for amounts, timing, the nature and uncertainty of revenue, and cash flows arising from contracts with customers, which will mainly impact construction and high-tech industries. The most significant potential impact to banking entities relates to less prescriptive derecognition requirements on the sale of owned real estate properties. An entity may elect either a full retrospective or a modified retrospective application. ASU No. 2015-14 - Revenue from Contracts with Customers (Topic 606), defers the effective date of Update No. 2014-09 for all entities by one year. The Company will apply the guidance in Update 2014-09 to annual and interim periods beginning after December 15, 2017. The Company intends to adopt the Update during the first quarter of 2018. Adoption is not anticipated to have a material impact on the Company's financial statements.

ASU No. 2015-02 - Consolidation (Topic 810) - "Amendments to the Consolidation Analysis." The Update affects limited partnerships and similar legal entities, the evaluation of fees paid to a decision maker or a service provider as a variable interest, the effect of fee arrangements and related parties on the primary beneficiary determination, and certain investment funds. The Company intends to adopt the Update during the first quarter of 2016. Adoption is not anticipated to have a material impact on the Company's financial statements.

ASU No. 2015-03 - Interest - Imputation of Interest (Subtopic 835-30) - "Simplifying the Presentation of Debt Issuance Costs." The Update simplifies the presentation of debt issuance costs, by requiring that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in this Update. An entity should apply the Update on a retrospective basis. The Company intends to adopt the Update during the first quarter of 2016. Adoption is not anticipated to have a material impact on the Company's financial statements.

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ASU No. 2015-07 - Fair Value Measurement (Topic 820) - "Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or its Equivalent) (a consensus of the FASB Emerging Issues Task Force)." The Update removes the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient. The Update also removes the requirement to make certain disclosures for all investments that are eligible to be measured at fair value using the net asset value per share practical expedient. Rather, those disclosures are limited to investments for which the entity has elected to measure the fair value using that practical expedient. An entity should apply the Update on a retrospective basis. The Company intends to adopt the Update during the first quarter of 2016. Adoption is not anticipated to have a material impact on the Company's financial statements.

ASU No. 2015-12 - Plan Accounting-Defined Benefit Pension Plans (Topic 960), Defined Contribution Pension Plans (Topic 962), Health and Welfare Benefit Plans (Topic 965) - "(Part I) Fully Benefit-Responsive Investment Contracts, (Part II) Plan Investment Disclosures, (Part III) Measurement Date Practical Expedient (consensuses of the Emerging Issues Task Force)." The Update has been issued to (I) designate contract value as the only required measure for fully benefit-responsive investment contracts; (II) simplify and make more effective the investment disclosure requirements under Topic 820 and Topics 960, 962, and 965 for employee benefit plans; and (III) provide a similar measurement date practical expedient for employee benefit plans. The Company intends to adopt the Update during the first quarter of 2016. Adoption is not anticipated to have a material impact on the Company's financial statements.

ASU No. 2015-15 - Interest-Imputation of Interest (Subtopic 835-30) - "Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements - Amendments to SEC Paragraphs Pursuant to Staff Announcement at June 18, 2015 EITF Meeting (SEC Update)." - The Update amends ASC Subtopic 835-30 to address debt issuance costs associated with line-of-credit arrangements. ASU No. 2015-03, which requires entities to present debt issuance costs, related to a recognized debt liability as a direct deduction from the carrying amount of that debt liability, did not address presentation or subsequent measurement of debt issuance costs related to line-of-credit arrangements. The Update permits an entity to defer and present debt issuance costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement. The Company intends to adopt the Update during the first quarter of 2016. Adoption is not anticipated to have a material impact on the Company's financial statements.

ASU No. 2015-16 - Business Combinations (Topic 805) - "Simplifying the Accounting for Measurement - Period Adjustments." The Update simplifies the accounting for adjustments made to provisional amounts recognized in a business combination. First, the Update requires that the acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amount is determined. The acquirer also should record, in the same period’s financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. Second, the Update should be applied prospectively to adjustments to provisional amounts that are identified after December 15, 2015 and that are within the measurement period. Upon transition, an entity would be required to disclose the nature of, and reason for, the change in accounting principle. An entity would provide that disclosure in the first annual period of adoption and in the interim periods within the first annual period. The Company intends to adopt the Update during the first quarter of 2016. Adoption is not anticipated to have a material impact on the Company's financial statements.

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Note 2: Acquisition

On January 13, 2015, Webster Bank completed its acquisition of the health savings account business of JPMorgan Chase Bank, N.A. As a result of the acquisition, the Company became the leading administrator of health savings accounts on a nationwide basis. The acquisition significantly augments a source of stable, low cost, long duration deposits.

The acquisition date fair value of the net consideration transferred consisted of the following:

(In thousands)	At January 13, 2015
Cash	$50,485
Contingent consideration [1]	(5,000)
Total net consideration transferred	$45,485

(1) The contingent consideration arrangement entitles the Company to receive a rebate of the premium paid for account attrition that occurs during the eighteen-month period beginning on January 13, 2015, the closing date of the transaction.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the acquisition date:

(In thousands)	At January 13, 2015
Cash	$1,446,898
Intangible assets	43,000
Total identifiable assets acquired	$1,489,898
Deposits	$1,446,899
Contingent liability	6,000
Total liabilities assumed	$1,452,899
Net identifiable assets acquired	$36,999
Goodwill	8,486
Net assets acquired	$45,485

The fair value of the acquired identifiable intangible assets includes core deposit intangibles and customer relationships. The Company is in the process of completing its analysis of fair value of the assets acquired and liabilities assumed; thus, the measurements of identifiable intangible assets, goodwill, and contingencies are subject to change. Refer to Note 6: Goodwill and Other Intangible Assets for additional information relating to the initial amounts of goodwill and other intangible assets recognized.

The contingent liability represents an obligation that existed at the acquisition date. Accordingly, Webster assumed the liability as part of the transaction and has accounted for it at fair value.

Refer to Note 15: Fair Value Measurements for additional information on the contingent liability and contingent consideration recorded.

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Note 3: Investment Securities

Summaries of the amortized cost and fair value of investment securities are presented below:

(In thousands)	At September 30, 2015 Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	At December 31, 2014 Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:								
U.S. Treasury Bills	$675	$—	$—	$675	$525	$—	$—	$525
Agency collateralized mortgage obligations (“agency CMO”)	552,403	9,274	(1,177)	560,500	543,417	8,636	(1,065)	550,988
Agency mortgage-backed securities (“agency MBS”)	1,121,513	9,215	(10,217)	1,120,511	1,030,724	10,462	(12,668)	1,028,518
Agency commercial mortgage-backed securities (“agency CMBS”)	151,384	2,095	—	153,479	80,400	—	(134)	80,266
Non-agency commercial mortgage-backed securities agency (“non-agency CMBS”)	601,570	11,407	(1,152)	611,825	534,631	18,885	(123)	553,393
Collateralized loan obligations ("CLO")	421,592	745	(2,689)	419,648	426,269	482	(1,017)	425,734
Single issuer trust preferred securities	42,116	—	(4,333)	37,783	41,981	—	(3,736)	38,245
Corporate debt securities	104,661	3,249	—	107,910	106,520	3,781	—	110,301
Equity securities - financial institutions	3,499	—	(413)	3,086	3,500	2,403	—	5,903
Securities available-for-sale	$2,999,413	$35,985	$(19,981)	$3,015,417	$2,767,967	$44,649	$(18,743)	$2,793,873
Held-to-maturity:								
Agency CMO	$400,641	$6,885	$(639)	$406,887	$442,129	$6,584	$(739)	$447,974
Agency MBS	2,094,328	46,172	(10,805)	2,129,695	2,134,319	57,196	(11,340)	2,180,175
Agency CMBS	691,638	13,274	—	704,912	578,687	1,597	(1,143)	579,141
Municipal bonds and notes	399,314	10,474	(1,627)	408,161	373,211	15,138	(55)	388,294
Non-agency CMBS	361,399	8,866	(317)	369,948	338,723	9,428	(1,015)	347,136
Private Label MBS	3,888	55	—	3,943	5,886	100	—	5,986
Securities held-to-maturity	$3,951,208	$85,726	$(13,388)	$4,023,546	$3,872,955	$90,043	$(14,292)	$3,948,706

Other-Than-Temporary Impairment ("OTTI")

The balance of OTTI, included in the amortized cost columns above, is related to certain CLO securities that are considered Covered Funds as defined by Section 619 of the Dodd-Frank Act, which continue to decline due to CLO deal refinancing and modifications.

To the extent that changes occur in interest rates, credit movements, and other factors that influence the fair value of its investment securities, the Company may be required to record impairment charges for OTTI in future periods.

The following table presents the changes in OTTI:

	Three months ended September 30,		Nine months ended September 30,	
(In thousands)	2015	2014	2015	2014
Balance of OTTI, beginning of period	$3,178	$9,738	$3,696	$16,633
Reduction for securities sold or called	—	(7,026)	(518)	(14,082)
Additions for OTTI not previously recognized	82	85	82	246
Balance of OTTI, end of period	$3,260	$2,797	$3,260	$2,797

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Gross Unrealized Losses and Fair Value
The following tables provide information on the gross unrealized losses and fair value of investment securities with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment security type and length of time that individual investment securities have been in a continuous unrealized loss position:

	At September 30, 2015						
	Less Than Twelve Months		Twelve Months or Longer		Total		
(Dollars in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	# of Holdings	Fair Value	Unrealized Losses
Available-for-sale:							
Agency CMO	$105,064	$(692)	$ 28,283	$ (485)	7	$133,347	$(1,177)
Agency MBS	374,981	(2,285)	370,303	(7,932)	73	745,284	(10,217)
Agency CMBS	—	—	—	—	—	—	—
Non-agency CMBS	166,633	(1,114)	9,362	(38)	23	175,995	(1,152)
CLO	208,007	(2,689)	—	—	11	208,007	(2,689)
Single issuer trust preferred securities	4,025	(183)	33,758	(4,150)	8	37,783	(4,333)
Equity securities - financial institutions	3,086	(413)	—	—	1	3,086	(413)
Total available-for-sale in an unrealized loss position	$861,796	$(7,376)	$ 441,706	$ (12,605)	123	$1,303,502	$(19,981)
Held-to-maturity:							
Agency CMO	$38,996	$(290)	$ 21,655	$ (349)	4	$60,651	$(639)
Agency MBS	346,578	(2,800)	487,316	(8,005)	61	833,894	(10,805)
Agency CMBS	—	—	—	—	—	—	—
Municipal bonds and notes	64,081	(1,601)	3,360	(26)	58	67,441	(1,627)
Non-agency CMBS	49,511	(183)	30,757	(134)	7	80,268	(317)
Total held-to-maturity in an unrealized loss position	$499,166	$(4,874)	$ 543,088	$ (8,514)	130	$1,042,254	$(13,388)

	At December 31, 2014						
	Less Than Twelve Months		Twelve Months or Longer		Total		
(Dollars in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	# of Holdings	Fair Value	Unrealized Losses
Available-for-sale:							
Agency CMO	$47,217	$(240)	$ 35,968	$ (825)	8	$83,185	$(1,065)
Agency MBS	3,691	(18)	641,355	(12,650)	64	645,046	(12,668)
Agency CMBS	80,266	(134)	—	—	4	80,266	(134)
Non-agency CMBS	24,932	(117)	9,396	(6)	4	34,328	(123)
CLO	99,221	(1,017)	—	—	6	99,221	(1,017)
Single issuer trust preferred securities	4,150	(36)	34,095	(3,700)	8	38,245	(3,736)
Equity securities - financial institutions	$—	$—	$ —	$ —	—	$—	$—
Total available-for-sale in an unrealized loss position	$259,477	$(1,562)	$ 720,814	$ (17,181)	94	$980,291	$(18,743)
Held-to-maturity:							
Agency CMO	$52,172	$(187)	$ 24,942	$ (552)	6	$77,114	$(739)
Agency MBS	20,791	(86)	608,568	(11,254)	44	629,359	(11,340)
Agency CMBS	324,394	(1,143)	—	—	17	324,394	(1,143)
Municipal bonds and notes	5,341	(23)	3,074	(32)	15	8,415	(55)

Non-agency CMBS	13,003	(30)	65,913	(985)	7	78,916	(1,015)
Total held-to-maturity in an unrealized loss position	$415,701	$(1,469)	$ 702,497	$ (12,823)	89	$1,118,198	$(14,292)

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The following discussions by investment security type, summarize the basis for evaluating if investment securities within the Company's available-for-sale and held-to-maturity portfolios were other-than-temporarily impaired at September 30, 2015. Unless otherwise noted for an investment security type, management does not intend to sell these investments and has determined, based upon available evidence, that it is more likely than not that the Company will not be required to sell these securities before the recovery of their amortized cost.

Available-for-Sale Impairment Analysis

Agency CMO. There were unrealized losses of $1.2 million on the Company's investment in agency CMO at September 30, 2015 compared to $1.1 million at December 31, 2014. Unrealized losses were essentially flat at September 30, 2015 compared to December 31, 2014. The contractual cash flows for these investments are performing as expected, and there has been no change in the underlying credit quality. The Company does not consider these securities to be other-than-temporarily impaired at September 30, 2015.

Agency MBS. There were unrealized losses of $10.2 million on the Company's investment in agency MBS at September 30, 2015 compared to $12.7 million at December 31, 2014. Unrealized losses decreased due to lower market rates which resulted in higher security prices at September 30, 2015 compared to December 31, 2014. These investments are issued by a government or a government-sponsored agency and, therefore, are backed by certain government guarantees, either direct or indirect. There has been no change in the credit quality, and the contractual cash flows are performing as expected. The Company does not consider these securities to be other-than-temporarily impaired at September 30, 2015.

Non Agency CMBS. There were unrealized losses of $1.2 million on the Company's investment in non-agency CMBS at September 30, 2015 compared to $0.1 million at December 31, 2014. The composition of non-agency CMBS in the available-for-sale portfolio experienced increased market spreads which resulted in greater unrealized losses at September 30, 2015 compared to December 31, 2014. Internal and external metrics are considered when evaluating potential other-than temporary impairment. Internal stress tests are performed on individual bonds to monitor potential losses under stress scenarios. The contractual cash flows for these investments are performing as expected. The Company does not consider these securities to be other-than-temporarily impaired at September 30, 2015.

CLO. There were unrealized losses of $2.7 million on the Company's investments in CLO at September 30, 2015 compared to $1.0 million at December 31, 2014. Unrealized losses increased due to higher market spreads for the asset class which resulted in lower security prices at September 30, 2015 compared to December 31, 2014. The Company does not consider these securities to be other-than-temporarily impaired at September 30, 2015.

Single issuer trust preferred securities. There were unrealized losses of $4.3 million on the Company's investment in single issuer trust preferred securities at September 30, 2015 compared to $3.7 million at December 31, 2014. Unrealized losses increased due to higher market spreads for the asset class which resulted in lower security prices at September 30, 2015 compared to December 31, 2014. The single issuer portfolio consists of four investments issued by three large capitalization money center financial institutions, which continue to service the debt. The Company does not consider these securities to be other-than-temporarily impaired at September 30, 2015.

Held-to-Maturity Impairment Analysis

Agency CMO. There were unrealized losses of $0.6 million on the Company's investment in agency CMO at September 30, 2015 compared to $0.7 million at December 31, 2014. Unrealized losses were essentially flat at September 30, 2015 compared to December 31, 2014. The contractual cash flows for these investments are performing as expected, and there has been no change in the underlying credit quality. The Company does not consider these securities to be other-than-temporarily impaired at September 30, 2015.

Agency MBS. There were unrealized losses of $10.8 million on the Company's investment in agency MBS at September 30, 2015 compared to $11.3 million at December 31, 2014. Unrealized losses decreased due to lower market rates which resulted in higher security prices at September 30, 2015 compared to December 31, 2014. These investments are issued by a government or a government-sponsored agency and, therefore, are backed by certain government guarantees, either direct or indirect. There has been no change in the credit quality, and the contractual cash flows are performing as expected. The Company does not consider these securities to be other-than-temporarily impaired at September 30, 2015.

Municipal bonds and notes. There were unrealized losses of $1.6 million on the Company’s investment in municipal bonds and notes at September 30, 2015 compared to $0.1 million at December 31, 2014. Unrealized losses increased due to higher market spreads on recently purchased securities which resulted in lower security prices. The Company does not consider these securities to be other-than-temporarily impaired at September 30, 2015.

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Non-agency CMBS. There were unrealized losses of $0.3 million on the Company's investment in non-agency CMBS at September 30, 2015 compared to $1.0 million unrealized losses at December 31, 2014. Unrealized losses decreased due to lower market rates which resulted in higher security prices at September 30, 2015 compared to December 31, 2014. Internal and external metrics are considered when evaluating potential other-than temporary impairment. Internal stress tests are performed on individual bonds to monitor potential losses under stress scenarios. The contractual cash flows for these investments are performing as expected. The Company does not consider these securities to be other-than-temporarily impaired at September 30, 2015.

Sales of Available-for Sale Securities

The following table provides information on sales of available-for-sale securities:

(In thousands)	Three months ended September 30, 2015	Three months ended September 30, 2014	Nine months ended September 30, 2015	Nine months ended September 30, 2014
Proceeds from sales	$2,500	$41,691	$37,465	$63,386
Gross realized gains on sales	$—	$1,812	$529	$6,148
Gross realized losses on sales	—	(1,770)	—	(1,770)
Gain on sale of investment securities, net	$—	$42	$529	$4,378

Contractual Maturities

The amortized cost and fair value of debt securities at September 30, 2015, by contractual maturity, are set forth below:

(In thousands)	Available-for-Sale Amortized Cost	Available-for-Sale Fair Value	Held-to-Maturity Amortized Cost	Held-to-Maturity Fair Value
Due in one year or less	$5,690	$5,719	$320	$325
Due after one year through five years	129,662	132,666	37,407	38,597
Due after five through ten years	429,814	429,663	56,901	58,852
Due after ten years	2,430,748	2,444,283	3,856,580	3,925,772
Total debt securities	$2,995,914	$3,012,331	$3,951,208	$4,023,546

For the maturity schedule above, mortgage-backed securities and collateralized loan obligations, which are not due at a single maturity date, have been categorized based on the maturity date of the underlying collateral. Actual principal cash flows may differ from this maturity date presentation because borrowers have the right to prepay obligations with or without prepayment penalties. At September 30, 2015, the Company had a carrying value of $946.1 million in callable securities in its CMBS, CLO, and municipal bond portfolios. The Company considers these factors in the evaluation of its interest rate risk profile. These maturities do not reflect actual duration which is impacted by prepayments.

Securities with a carrying value totaling $2.9 billion at September 30, 2015 and December 31, 2014 were pledged to secure public funds, trust deposits, repurchase agreements, and for other purposes, as required or permitted by law. At September 30, 2015 and December 31, 2014, the Company had no investments in obligations of individual states, counties, or municipalities which exceeded 10% of consolidated shareholders' equity.

(1,746)

Common stock dividends paid deduction

(12,343) (796) (25,979)

Total provision

$ $ $

9. PREFERRED STOCK

The Board of Trustees, or a duly authorized committee thereof, may issue up to 200,000,000 shares of preferred stock from time to time in one or more classes or series. In addition, the Board of Trustees, or duly authorized committee thereof, may fix the preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends or other distributions, qualifications and terms and conditions of redemption.

9.75% Series A Perpetual Cumulative Preferred Shares

The Board of Trustees and a duly authorized committee thereof has classified and designated 4,093,678 preferred shares as Series A Preferred Shares. At June 30, 2005 and December 31, 2004, there were 4,093,678 preferred shares issued and outstanding.

In March and June of 2005, the REIT s board of trustees declared a quarterly cash dividend on the preferred shares at the rate of $0.609375 per share to shareholders of record on March 15 and June 15, which aggregated $5.0 million for the six months ended June 30, 2005.

The Series A Preferred Shares contain covenants requiring the REIT to maintain a total shareholders equity balance and total loans held for investment of at least $50.0 million and $2.0 billion, respectively, commencing on December 31, 2004 and at the end of each quarter thereafter, and, commencing with each of the four quarters ending December 31, 2005, to maintain a cumulative unencumbered cash flow greater than or equal to six times the cumulative preferred dividends required in those four quarters. If the REIT is not in compliance with any of these covenants, no dividends can be declared on the REIT s common shares until it is in compliance with all covenants as of the end of two successive quarters. As of June 30, 2005, the REIT was in compliance with the covenants applicable to date in 2005.

Accredited irrevocably and unconditionally agrees to pay in full to the holders of each share of the REIT s Series A Preferred Shares, as and when due, regardless of any defense, right of set-off or counterclaim which the REIT or Accredited may have or assert: (i) all accrued and unpaid dividends (whether or not declared) payable on the REIT s Series A Preferred Shares, (ii) the redemption price (including all accrued and unpaid dividends) payable with respect to any of the REIT s Series A Preferred Shares redeemed by the REIT and (iii) the liquidation preference, if any, payable with respect to any of the REIT s Series A Preferred Shares. Accredited s guarantee is subordinated in right of payment to Accredited s indebtedness, on parity with the most senior class of Accredited s preferred stock and senior to Accredited s common stock.

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ACCREDITED MORTGAGE LOAN REIT TRUST

NOTES TO UNAUDITED FINANCIAL STATEMENTS (Continued)

10. RECEIVABLE FROM PARENT AND ADMINISTRATION AND SERVICING AGREEMENT WITH PARENT

The REIT has an administration and servicing agreement with its parent company, AHL, whereby AHL provides loan servicing, treasury, accounting, tax and other administrative services for the REIT in exchange for a management fee equal to 0.5% per year on the outstanding principal balance of the loans serviced, plus miscellaneous fee income collected from mortgagors including late payment charges, assumption fees and similar items. Under this agreement, either party agrees to pay interest on the net average balance payable to the other party at an annual rate equal to the Six-Month LIBOR plus 1.0%. Management fee expense and interest income under this agreement totaled $6.2 million and $0.2 million, respectively for the three months ended June 30, 2005, and $11.5 million and $0.4 million for the six months ended June 30, 2005. At June 30, 2005 and December 31, 2004, the net receivable from parent was $16.0 million and $15.2 million, respectively.

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

The following discussion should be reviewed in conjunction with our consolidated financial statements and the related notes and other financial information appearing elsewhere in this report. In addition to historical information, the following discussion and other parts of this document contain forward-looking information that involves risks and uncertainties. Please refer to the section entitled Forward-Looking Statements on page 3 of this Form 10-Q. Our actual results could differ materially from those anticipated by such forward-looking information due to factors discussed under the section entitled Risk Factors That May Affect Future Results and elsewhere in this report.

General

Accredited is a mortgage banking company that originates, finances, securitizes, services and sells non-prime mortgage loans secured by residential real estate throughout the United States, and, to a lesser extent, in Canada. We focus on borrowers who may not meet conforming underwriting guidelines because of higher loan-to-value ratios, the nature or absence of income documentation, limited credit histories, high levels of consumer debt, or past credit difficulties. We originate our loans primarily through independent mortgage brokers and, to a lesser extent, through our direct sales force in our retail offices. We primarily sell our loans in whole loan sales or we securitize our loans.

On May 4, 2004, we formed a Maryland real estate investment trust, Accredited Mortgage Loan REIT Trust (the REIT), for the purpose of acquiring, holding and managing real estate assets. All of the outstanding common shares of beneficial interest of the REIT are held by Accredited Home Lenders, Inc., which in turn is a wholly owned subsidiary of Accredited Home Lenders Holding Co. The REIT intends to elect to be taxed as a real estate investment trust and to comply with the provisions of the Internal Revenue Code with respect thereto. Accordingly, the REIT will generally not be subject to federal or state income tax to the extent that it timely distributes its taxable income to its shareholders and satisfies the real estate investment trust requirements and certain asset, income and share ownership tests are met.

Revenue Model

Our operations generate revenues in three ways:

Interest income. We have two primary components to our interest income. We generate interest income over the life of the loan on the loans we have securitized in structures that require financing treatment. This interest is partially offset by the interest we pay on the bonds that we issue to fund these loans. We also generate interest income on loans held for sale and for securitization from the time we originate the loan until the time we sell or securitize the loan. This interest income is partially offset by our borrowing costs under our warehouse credit facilities used to finance these loans.

Gain on sale of loans. We generate gain on sale of loans by selling the loans we originate for a premium.

Loan servicing income. Our loan servicing income represents all contractual and ancillary servicing revenue for loans that Accredited services for others, net of servicing costs and amortization of mortgage servicing rights.

Our revenues also include net gain or loss on mortgage-related securities and derivatives, on our loans held for sale, and some of our loans held for investment, which reflect changes in the value of these instruments based on market conditions.

While we currently generate the majority of our earnings and cash flows from whole loan sales, we intend to increase the percentage of our earnings and cash flows received from securitizations whereby we retain an interest in the mortgage loans that we have sold. These transactions will continue to be legally structured as sales,

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but for accounting purposes may be structured as a financing under SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities a replacement of FASB Statement No. 125*. This portfolio-based accounting more closely matches the recognition of income with the actual receipt of cash payments. Also, such securitization structures are consistent with our strategy to predominantly generate cash-based earnings.

We anticipate that our results of operations may fluctuate on a quarterly and annual basis. The timing and degree of fluctuation will depend upon several factors, including competition, economic slowdowns and increased interest rates in addition to those discussed under Risk Factors That May Affect Future Results. Although we have experienced growth in recent years, we cannot assure you that we will be able to sustain revenue growth or maintain profitability on a quarterly or annual basis or that our growth will be consistent with predictions or forecasts.

Results Of Operations

Three Months Ended June 30, 2005 Compared to the Three Months Ended June 30, 2004

Executive Summary

Net income was $39.6 million for the three months ended June 30, 2005, or $1.81 per diluted share, an increase of 15.4% from $34.3 million, or $1.60 per diluted share in 2004.

The increase in net income was primarily driven by a 38.5% increase in net interest income after provision and a 10.5% increase in gain on whole loan sales. Whole loan sales of $2.8 billion during the three months ended June 30, 2005, resulted in gains recorded of $85.8 million, representing an average premium of 3.12% in 2005, versus 4.29% for the same period in 2004.

Mortgage loan origination volume increased 23.3% from $3.4 billion for the three months ended June 30, 2004 to $4.1 billion in 2005, and our serviced loans increased 49.9% from $5.5 billion at June 30, 2004 to $8.3 billion at June 30, 2005. This growth was achieved by penetrating new and existing markets through 310 net new employees from June 30, 2004 to June 30, 2005.

Origination costs net of points and fees declined to 1.73% during the three months ended June 30, 2005 from 1.76% during the same period in 2004.

Revenue from net interest income after provision increased from 32.8% of total net revenues for the three months ended June 30, 2004 to 37.4% in 2005 reflecting the growth in net interest income after provision of 38.5% which outpaced our growth in gain on sale of loans of 10.5%.

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Net Revenues

Net revenues and key indicators that affect our net revenues are as follows for the three months ended June 30:

	2005	2004	Increase (Decrease)	% Change
		(Dollars in thousands)		
Interest income(1)	$ 141,154	$ 84,673	$ 56,481	66.7%
Interest expense(2)	(68,124)	(28,093)	40,031	142.5%
Net interest income	73,030	56,580	16,450	29.1%
Provision for losses	(19,360)	(17,843)	1,517	8.5%
Net interest income after provision	53,670	38,737	14,933	38.5%
Gain on sale of loans	85,780	77,619	8,161	10.5%
Loan servicing income	2,724	1,646	1,078	65.5%
Other income	1,508	11	1,497	N/A
Total net revenues	$ 143,682	$ 118,013	$ 25,669	21.8%
Net interest income after provision as percentage of net revenues	37.4%	32.8%		
Gain on sale of loans as a percentage of net revenues	59.7%	65.8%		
Mortgage loan originations	$ 4,139,421	$ 3,357,118	$ 782,303	23.3%
Whole loan sales	$ 2,831,815	$ 1,903,940	$ 927,875	48.7%
Mortgage loans securitized	$ 1,007,809	$ 707,200	$ 300,609	42.5%
Average inventory of mortgage loans	$ 7,410,808	$ 4,592,523	$ 2,818,285	61.4%
Annualized interest income as a percentage of average inventory of mortgage loans (Yield)	7.62%	7.37%		
Average outstanding borrowings	$ 7,017,165	$ 4,428,834	$ 2,588,331	58.4%

(1) Interest income includes prepayment penalty income, gains and losses from hedging activities and contractually designated servicing income on our balance sheet securitizations treated as interest income for accounting purposes.
(2) Interest expense includes gains and losses from hedging activities and amortization of debt issuance costs.

Interest Income. Interest income increased 66.7% during the three months ended June 30, 2005 from the comparable period in 2004 reflecting the 61.4% increase in our average inventory of mortgage loans during the period and an increase in the total yield on our average inventory of mortgage loans outstanding during the three months ended June 30, 2005 when compared to the same period in 2004. The increase in our average inventory of mortgage loans is due to higher loan origination volume during the twelve months ended June 30, 2005 with an increased percentage of those loans retained on our balance sheet through securitizations as compared to disposition of those loans through whole loan sales. The increase in our average yield reflects the increase in pricing of loan originations over the past year.

Interest Expense. The increase in interest expense during the three months ended June 30, 2005 of 142.5% reflects an increase in our average outstanding borrowings, which increased from $4.4 billion during the three months ended June 30, 2004 to $7.0 billion during the same period in 2005, or 58.4%. The increase in interest expense also resulted from a net increase in our average borrowing rates, which increased from 2.63% on our warehouse lines during the three months ended June 30, 2004 to 4.32% during the same period in 2005, and from 2.45% in 2004 on our securitization debt to 3.67% during the same period in 2005.

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The components of our net interest margin are as follows for the three months ended June 30:

	2005			2004		
	Interest Income (Expense)	Average Balance Outstanding	Average Rate	Interest Income (Expense)	Average Balance Outstanding	Average Rate
	(Dollars in thousands)					
Warehouse:						
Interest income	$ 48,283	$ 2,555,689	7.56%	$ 40,249	$ 2,266,248	7.11%
Interest expense	(25,045)	2,320,435	(4.32)	(14,247)	2,167,863	(2.63)
Spread	23,238		3.24%	26,002		4.48%
Securitizations:						
Interest income	92,871	4,855,119	7.65%	44,424	2,326,275	7.64%
Interest expense	(43,079)	4,696,730	(3.67)	(13,846)	2,260,971	(2.45)
Spread	49,792		3.98%	30,578		5.19%
Net interest margin	$ 73,030	$ 7,410,808	3.94%	$ 56,580	$ 4,592,523	4.93%

The net interest spread for our warehouse loans declined from 4.48% during the three months ended June 30, 2004 to 3.24% for the comparable period in 2005. This is due to the One-Month LIBOR, which our borrowing costs are indexed to, increasing by more than the average mortgage coupon rate earned on our loan portfolio. This effect was partially offset by a reduction in the spread of the borrowing costs over One-Month LIBOR charged by the warehouse credit facilities, as well as a reduction in the borrowing costs due to the formation of a special purpose entity which issues commercial paper to finance a portion of the loan portfolio held for sale and securitization. The reduced mortgage coupon rate relative to borrowing costs reflects increased competition from other lenders combined with a flattening of the yield curve. This trend may continue if the yield curve continues to flatten, as suggested by the current forward rates, or if competitive pressures increase.

The net interest spread for our securitized loans declined from 5.19% during the three months ended June 30, 2004 to 3.98% for the comparable period in 2005. The decline reflects higher cost of borrowings due to market interest rates increasing, and a greater mix of variable rate bonds to fixed rate bonds in 2005. The yield for the current period was roughly unchanged from the comparable period in 2004 as the lower coupon rate was offset by lower net losses from hedge accounting. The spread may continue to decline if short-term rates increase further, as suggested by the forward curve.

Provision for Losses. The provision for losses is comprised of the following for the three months ended June 30:

	2005	2004	Increase (Decrease)	% Change
	(Dollars in thousands)			
Current period provision for:				

Mortgage loans held for sale	$ (42)	$ 1,567	$ (1,609)	102.7%
Mortgage loans held for investment	15,901	15,635	266	1.7%
Repurchases and real estate owned	3,501	640	2,861	447.0%
Total provision for losses	$ 19,360	$ 17,843	$ 1,518	8.5%
Reserve balance at period end:				
Mortgage loans held for sale	$ 19,119	$ 13,698	$ 5,421	39.6%
Mortgage loans held for investment	84,228	39,077	45,151	115.5%
Total reserve balance on mortgage loans	$ 103,347	$ 52,775	$ 50,572	95.8%
Principal balance at period end:				
Mortgage loans held for sale	$ 2,201,306	$ 1,988,063	$ 213,243	10.7%
Mortgage loans held for investment	5,956,247	3,303,045	2,653,202	80.3%
Total principal balance at period end	$ 8,157,553	$ 5,291,108	$ 2,866,445	54.2%
Reserve balance on mortgage loans as a percentage of the principal balance at period end	1.3%	1.0%		

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The 8.5% increase in our total provision for losses during the three months ended June 30, 2005 results from the 54.4% increase during 2005 in our total mortgage loan principal balance and the increase in the total reserve balance on mortgage loans as a percentage of the principal balance outstanding at period end, which increased from 1.0% at June 30, 2004 to 1.3% at June 30, 2005. The increase in the total reserve percentage is due primarily to higher default and loss severity assumptions used in determining our expected losses, partially caused by an increase in the weighted-average seasoning of our loans held for investment.

Accredited monitors net interest income after provision as a percentage of net revenues in order to track its progress toward producing more stable, predictable earnings from our loan portfolio. We estimate that this ratio is also representative of the portfolio s contribution to profitability. The net interest income after provision as percentage of net revenues increased from 32.8% for the three months ended June 30, 2004 to 37.4% for the comparable period in 2005. This increase reflects our quarterly securitization program, which caused the growth in net interest income after provision of 38.5% to outpace our growth in gain on sale of loans of 10.5%.

Gain on Sale of Loans. The components of the gain on sale of loans and the calculation of our average whole loan premium are as follows for the three months ended June 30:

	2005		2004	
	Amount	Percentage	Amount	Percentage
	(Dollars in thousands)			
Gross gain on whole loan sales	$ 89,386		$ 75,843	
Gain on sale of loans acquired in clean-up call	2,646			
Net gain (loss) on derivatives	(998)		5,820	
Provision for premium recapture	(1,409)		(947)	
Net origination points and fees	8,896		8,061	
Direct loan origination expenses	(12,741)		(11,158)	
Total net gain on sale of loans	$ 85,780		$ 77,619	
Gross gain on whole loan sales(1)	$ 89,386	3.16%	$ 75,843	3.98%
Net gain (loss) on derivatives(1)	(998)	(0.04)	5,820	0.31
Net premium received on whole loan sales(1)	$ 88,388	3.12	$ 81,663	4.29
Less: Net cost to originate(2)		(1.73)		(1.76)
Net profit margin on whole loan sales		1.39%		2.53%
Whole loan sales	$ 2,831,815		$ 1,903,940	

(1) Reflects the cash premium that we receive on our whole loan sales. The percentages are determined by dividing the gain by whole loan sales.

(2) Net cost to originate loans is defined as total operating expenses, less loan servicing related costs, plus yield spread premiums paid, less points and fees collected, all prior to any deferrals of origination costs for accounting purposes. Refer to our discussion of expenses below for the calculation of this percentage.

Gain on sale of loans increased 10.5% during the three months ended June 30, 2005 from the comparable period in 2004 due to a higher volume of whole loan sales for cash, enabled by higher loan origination volume during the period in 2005. Our average whole loan premiums, however, net of hedging gains and losses, and excluding gains associated with called securitizations, decreased from 4.29% for the three months ended June 30, 2004 to 3.12% for the same period in 2005 primarily due to lower interest rate margins reflecting price competition as money costs increased throughout the year. In the calculation of the net profit margin on whole loan sales percentage for the three months ended June 30, 2005, we excluded $2.6 million of gain related to the call and subsequent sale of loans included in a securitization trust that had previously been held off balance sheet.

Loan Servicing Income. Loan servicing income increased 65.5% during the three months ended June 30, 2005 from the comparable period in 2004 due primarily to higher interim balances as compared to prior periods and ancillary fees.

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Operating Expenses. Operating expenses are as follows for the three months ended June 30:

	2005	2004	Increase	% Change
	(Dollars in thousands)			
Salaries, wages and benefits	$ 49,696	$ 39,858	$ 9,838	24.7%
General and administrative	12,486	11,044	1,442	13.1%
Occupancy	5,424	4,678	746	15.9%
Advertising and promotion	3,985	3,027	958	31.6%
Depreciation and amortization	3,526	2,249	1,277	56.8%
Total operating expenses	$ 75,117	$ 60,856	$ 14,261	23.4%
Total serviced loans at period end	$ 8,287,917	$ 5,528,041	$ 2,759,876	49.9%
Total number of employees at period end	2,503	2,193	310	14.1%

Salaries, Wages and Benefits. Salaries, wages and benefits increased 24.7% during the three months ended June 30, 2005 due to growth in the number of employees of 14.1%, and growth of bonus, commission and amortization of deferred compensation at rates faster than employee growth as compared to the same period in 2004.

General and Administrative. General and administrative expenses increased 13.1% during the three months ended June 30, 2005 and reflect costs associated with the 23.3% increase in loan origination volume, the 49.9% increase in our servicing portfolio and the 14.1% increase in the number of employees as compared to the same period in 2004. The increase also includes higher audit fees partly related to the new audit procedures required under the Sarbanes-Oxley Act of 2002.

Occupancy. Occupancy expense increased 15.9% during the three months ended June 30, 2005 due to 8, or 15.1%, more office sites leased over the prior year s second quarter as we continue to penetrate new geographic markets, as well as an increase in square footage at some existing sites.

Advertising and Promotion. Advertising and promotion expenses increased 31.6% during the three months ended June 30, 2005 due primarily to increased spending on referrals and leads to support our growth in retail loan originations.

Depreciation and Amortization. Depreciation and amortization increased during the three months ended June 30, 2005 due to additional investments in technology and infrastructure to support the increase in our production, number of employees and offices during 2005.

Net Cost to Originate. We monitor our net cost to originate mortgage loans as we believe that it provides a measurement of efficiency in our mortgage loan origination process. The calculation of this net cost to originate is as follows for the three months ended June 30:

	2005	2004	% Change

	(Dollars in thousands)		
Total operating expenses	$ 75,117	$ 60,856	
Add: deferred direct loan origination expenses(1)	16,536	15,348	
Less: servicing cost(2)	(5,803)	(3,063)	
Loan origination expenses	85,850	73,141	17.4%
Less: deferred net origination points and fees (3)	(14,328)	(14,101)	
Net cost to originate	$ 71,522	$ 59,040	21.1%
Total mortgage loan originations	$ 4,139,421	$ 3,357,118	23.3%
Loan origination expenses as a percentage of volume	2.07%	2.18%	
Net cost to originate as percentage of volume	1.73%	1.76%	

(1) Represents the amount of direct expenses incurred and deferred in the period in accordance with Financial Accounting Standard No. 91.
(2) Servicing cost consists of direct expenses and allocated corporate overhead.
(3) Deferred net origination points and fees represent amounts received from borrowers during the period less amounts paid to brokers on all loans originated during the period.

The net cost to originate mortgage loans as a percentage of total mortgage loan origination volume declined from 1.76% for the three months ended June 30, 2004 to 1.73% for the same period in 2005 as a result of the 23.3% increase in mortgage loan origination volume that outpaced our 17.4% increase in loan origination expenses, partially offset by a reduction in points and fees received.

Income Taxes. The provision for income taxes as a percentage of pre-tax income was 38.6% for the three months ended June 30, 2005 compared with 40.0% for the same period in 2004. The decrease in the effective tax rate is due primarily to the fact that dividends paid by the REIT to the preferred shareholders of the REIT are not subject to federal or state tax at the corporate level. The two major components of our effective tax rate are the federal corporate tax rate of 35.0% and the effective state income tax rates. We operate and pay tax in nearly every state. Changes in the effective state tax rate occur due to changes in our business activities in various states, as well as the various states tax structures and rates, causing a slight benefit in 2005 when compared to 2004.

REIT Operating Results (included in Consolidated Results). Net revenues for the REIT were $43.9 million for the three months ended June 30, 2005. The REIT incurred expenses of $6.2 million for the same period related to servicing and management fees charged by AHL in accordance with an administration and servicing agreement between the two parties. Resulting net income for the same period was $37.8 million.

Six Months Ended June 30, 2005 Compared to the Six Months Ended June 30, 2004

Executive Summary

Net income was $70.9 million for the six months ended June 30, 2005, or $3.24 per diluted share, an increase of 24.8% from $56.8 million in 2004.

The increase in net income was primarily driven by a 49.8% increase in net interest income after provision and a 15.0% increase in gain on whole loan sales. Whole loan sales of $4.9 billion during the six months ended June 30, 2005, resulted in gains recorded of $152.2 million, representing an average premium of 3.18% in 2005, versus 4.01% for the same period in 2004.

Mortgage loan origination volume increased 28.4% from $5.7 billion for the six months ended June 30, 2004 to $7.4 billion in 2005, and our serviced loans increased 49.9% from $5.5 billion at June 30, 2004 to $8.3 billion at June 30, 2005. This growth was achieved by penetrating new and existing markets through 310 net new employees from June 30, 2004 to June 30, 2005.

Origination costs net of points and fees declined to 1.83% during the six months ended June 30, 2005 from 1.95% during the same period in 2004.

Revenue from net interest income after provision increased from 34.1% of total net revenues for the six months ended June 30, 2004 to 39.9% in 2005 reflecting the growth in net interest income after provision of 49.8% which outpaced our growth in gain on sale of

loans of 15.0%.

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Net Revenues

Net revenues and key indicators that affect our net revenues are as follows for the six months ended June 30:

	2005	2004	Increase (Decrease)	% Change
		(Dollars in thousands)		
Interest income(1)	$ 266,047	$ 145,299	$ 120,748	83.1%
Interest expense(2)	(122,451)	(49,023)	73,428	149.8%
Net interest income	143,596	96,276	47,320	49.2%
Provision for losses	(37,297)	(25,292)	12,005	47.5%
Net interest income after provision	106,299	70,984	35,315	49.8%
Gain on sale of loans	152,243	132,349	19,894	15.0%
Loan servicing income	4,839	3,209	1,630	50.8%
Other income	3,339	1,916	1,423	74.3%
Total net revenues	$ 266,720	$ 208,458	$ 58,262	27.9%
Net interest income after provision as percentage of net revenues	39.9%	34.1%		
Gain on sale of loans as a percentage of net revenues	57.1%	63.5%		
Mortgage loan originations	$ 7,369,294	$ 5,738,876	$ 1,630,418	28.4%
Whole loan sales	$ 4,936,782	$ 3,483,756	$ 1,453,026	41.7%
Mortgage loans securitized	$ 1,925,038	$ 1,212,125	$ 712,913	58.8%
Average inventory of mortgage loans	$ 7,028,656	$ 3,986,184	$ 3,042,472	76.3%
Annualized interest income as a percentage of average inventory of mortgage loans (Yield)	7.57%	7.29%		
Average outstanding borrowings	$ 6,627,706	$ 3,817,606	$ 2,810,100	73.6%

(1) Interest income includes prepayment penalty income and gains and losses from hedging activities and contractually designated servicing income on our on balance sheet securitizations treated as interest income for accounting purposes.
(2) Interest expense includes gains and losses from hedging activities and amortization of debt issuance costs.

Interest Income. Interest income increased 83.1% during the six months ended June 30, 2005 from the comparable period in 2004 reflecting the 76.3% increase in our average inventory of mortgage loans during the period and an increase in the total yield on our average inventory of mortgage loans outstanding during the six months ended June 30, 2005 when compared to the same period in 2004. The increase in our average inventory of mortgage loans is due to higher loan origination volume during the twelve months ended June 30, 2005 with an increased percentage of those loans retained on our balance sheet through securitizations as compared to disposition of those loans through whole loan sales. The increase in our average yield reflects lower net losses from hedge accounting.

We currently expect interest income to increase primarily from modest origination growth on our expanded platform and future securitizations. In the future, to the extent we continue to complete new securitizations, our interest income will be higher and our gain on sale revenue will be lower than it would have been otherwise. If whole loan sales increase in future quarters, this could reduce the mix of revenues from our portfolio.

Interest Expense. The increase in interest expense during the six months ended June 30, 2005 of 149.8% reflects an increase in our average outstanding borrowings, which increased from $3.8 billion during the six months ended June 30, 2004 to $6.6 billion during the same period in 2005, or 73.6%. The increase in interest expense also resulted from a net increase in our average borrowing rates, which increased from 2.67% on our warehouse lines during the six months ended June 30, 2004 to 4.19% during the same period in 2005, and from 2.49% in 2004 on our securitization debt to 3.45% during the same period in 2005.

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We currently expect interest expense to increase as our borrowings increase to support the expected growth in our loan portfolio.

The components of our net interest margin are as follows for the six months ended June 30:

	2005			2004		
	Interest Income (Expense)	Average Balance Outstanding	Average Rate	Interest Income (Expense)	Average Balance Outstanding	Average Rate
	(Dollars in thousands)					
Warehouse:						
Interest income	$ 91,812	$ 2,446,600	7.51%	$ 66,677	$ 1,853,007	7.20%
Interest expense	(46,197)	2,203,827	(4.19)	(23,215)	1,741,100	(2.67)
Spread	45,615		3.32%	43,462		4.53%
Securitizations:						
Interest income	174,235	4,582,057	7.61%	78,622	2,133,177	7.37%
Interest expense	(76,254)	4,423,879	(3.45)	(25,808)	2,076,506	(2.49)
Spread	97,981		4.16%	52,814		4.88%
Net interest margin	$ 143,596	$ 7,028,657	4.09%	$ 96,276	$ 3,986,184	4.83%

The net interest spread for our warehouse loans declined from 4.53% during the six months ended June 30, 2004 to 3.32% for the comparable period in 2005. This is due to the One-Month LIBOR, which our borrowing costs are indexed to, increasing by more than the average coupon rate earned on our loan portfolio. This effect was partially offset by a reduction in the spread of the borrowing costs over One-Month LIBOR charged by the warehouse credit facilities, as well as a reduction in the borrowing costs due to the formation of a special purpose entity which issues commercial paper to finance a portion of the loan portfolio held for sale. The reduced coupon rate relative to borrowing costs reflects increased competition from other lenders combined with a flattening of the yield curve. This trend may continue if the yield curve continues to flatten, as suggested by the current forward rates, or if competitive pressures increase.

The net interest spread for our securitized loans declined from 4.88% during the six months ended June 30, 2004 to 4.16% for the comparable period in 2005. The decline reflects higher cost of borrowings due to market interest rates increasing, and a greater mix of variable rate bonds to fixed rate bonds in 2005. The yield for the six months ended June 30, 2005 period increased due to lower net losses from hedge accounting partially offset by a decrease in the coupon rate.

Provision for Losses. The provision for losses is comprised of the following for the six months ended June 30:

	2005	2004	Increase (Decrease)	% Change

	(Dollars in thousands)			
Current period provision for:				
Mortgage loans held for sale	$ 4,343	$ 3,661	$ 682	18.6%
Mortgage loans held for investment	25,987	20,692	5,295	25.6%
Repurchases and real estate owned	6,967	938	6,029	642.6%
Total provision for losses	$ 37,297	$ 25,292	$ 12,006	47.5%
Reserve balance at period end:				
Mortgage loans held for sale	$ 19,119	$ 13,698	$ 5,421	39.6%
Mortgage loans held for investment	84,228	39,077	45,151	115.5%
Total reserve balance on mortgage loans	$ 103,347	$ 52,775	$ 50,572	95.8%
Principal balance at period end:				
Mortgage loans held for sale	$ 2,201,306	$ 1,988,063	$ 213,243	10.7%
Mortgage loans held for investment	5,956,247	3,303,045	2,653,202	80.3%
Total principal balance at period end	$ 8,157,553	$ 5,291,108	$ 2,866,445	54.2%
Reserve balance on mortgage loans as a percentage of the principal balance at period end	1.3%	1.0%		

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The 47.5% increase in our total provision for losses during the six months ended June 30, 2005 results from the 54.3% increase during 2005 in our total mortgage loan principal balance and the increase in the total reserve balance on mortgage loans as a percentage of the principal balance outstanding at period end, which increased from 1.0% at June 30, 2004 to 1.3% at June 30, 2005. The increase in the total reserve percentage is due primarily to higher default and loss severity assumptions used in determining our expected losses, partially caused by an increase in the weighted-average seasoning of our loans held for investment.

We currently expect our total provision for losses to increase in 2005 commensurate with our average on-balance sheet loan portfolio.

Accredited monitors net interest income after provision as a percentage of net revenues in order to track its progress toward producing more stable, predictable earnings from our loan portfolio. We estimate that this ratio is also representative of the portfolio s contribution to profitability. The net interest income after provision as percentage of net revenues increased from 34.1% for the six months ended June 30, 2004 to 39.9% for the comparable period in 2005. This increase reflects our quarterly securitization program, which caused the growth in net interest income after provision of 49.8% to outpace our growth in gain on sale of loans of 15.0%.

Gain on Sale of Loans. The components of the gain on sale of loans and the calculation of our average whole loan premium are as follows for the six months ended June 30:

	2005		2004	
	Amount	Percentage	Amount	Percentage
	(Dollars in thousands)			
Gross gain on whole loan sales	$ 151,423		$ 139,110	
Gain on sale of loans required in clean-up call	2,646			
Net gain (loss) on derivatives	5,764		432	
Provision for premium recapture	(2,463)		(1,553)	
Net origination points and fees	17,213		15,893	
Direct loan origination expenses	(22,340)		(21,533)	
Total net gain on sale of loans	$ 152,243		$ 132,349	
Gross gain on whole loan sales(1)	$ 151,423	3.06%	$ 139,110	4.00%
Net gain (loss) on derivatives(1)	5,764	0.12	432	0.01
Net premium received on whole loan sales(1)	$ 157,187	3.18	$ 139,542	4.01
Less: Net cost to originate(2)		(1.83)		(1.95)
Net profit margin on whole loan sales		1.35%		2.06%
Whole loan sales	$ 4,936,782		$ 3,483,756	

(1) Reflects the cash premium that we receive on our whole loan sales. The percentages are determined by dividing the gain by whole loan sales.

(2) Net cost to originate loans is defined as total operating expenses, less loan servicing related costs, plus yield spread premiums, less points and fees collected, all prior to any deferrals of origination costs for accounting purposes. Refer to our discussion of expenses below for the

calculation of this percentage.

Gain on sale of loans increased 15.0% during the six months ended June 30, 2005 from the comparable period in 2004 due to a higher volume of whole loan sales for cash, enabled by higher loan origination volume during the period in 2005. Our average whole loan premiums, however, net of hedging gains and losses, and excluding gains associated with called securitizations, decreased from 4.01% for the six months ended June 30, 2004 to 3.18% for the same period in 2005 primarily from lower interest rate margins reflecting price competition as money costs increased throughout the year. In the calculation of the net profit margin on whole loan sales percentage for the six months ended June 30, 2005, we excluded $2.6 million of gain related to the call and subsequent sale of loans included in a securitization trust that had previously been held off balance sheet.

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Loan Servicing Income. Loan servicing income increased 50.8% during the six months ended June 30, 2005 from the comparable period in 2004 due primarily to higher interim servicing balances and ancillary fees.

Operating Expenses. Operating expenses are as follows for the six months ended June 30:

	2005	2004	Increase	% Change
		(Dollars in thousands)		
Salaries, wages and benefits	$ 92,123	$ 75,113	$ 17,010	22.6%
General and administrative	25,579	20,631	4,948	24.0%
Occupancy	10,447	8,531	1,916	22.5%
Advertising and promotion	8,092	5,493	2,599	47.3%
Depreciation and amortization	6,930	4,023	2,907	72.3%
Total operating expenses	$ 143,171	$ 113,791	$ 29,380	25.8%
Total serviced loans at period end	$ 8,287,917	$ 5,528,041	$ 2,759,876	49.9%
Total number of employees at period end	2,503	2,193	310	14.1%

Salaries, Wages and Benefits. Salaries, wages and benefits increased 22.6% during the six months ended June 30, 2005 due to growth in the number of employees of 14.1% and growth of amortization from the deferred compensation program at a rate faster than employee growth as compared to the same period in 2004.

General and Administrative. General and administrative expenses increased 24.0% during the six months ended June 30, 2005 and reflect costs associated with the 28.4% increase in loan origination volume, the 49.9% increase in our servicing portfolio and the 14.1% increase in the number of employees as compared to the same period in 2004. The increase also includes higher audit fees partly related to the new audit procedures required under the Sarbanes-Oxley Act of 2002, and higher technology-related consulting expense.

Occupancy. Occupancy expense increased 22.5% during the six months ended June 30, 2005 due to 8, or 15.1%, more office sites leased over the prior year s six months as we continue to penetrate new geographic markets, as well as an increase in square footage at some existing sites.

Advertising and Promotion. Advertising and promotion expenses increased 47.3% during the six months ended June 30, 2005 due primarily to increased spending on referrals and leads to support our growth in retail loan originations.

Depreciation and Amortization. Depreciation and amortization increased during the six months ended June 30, 2005 due to additional investments in technology and infrastructure to support the increase in our production, number of employees and offices during 2005.

Net Cost to Originate. We monitor our net cost to originate mortgage loans as we believe that it provides a measurement of efficiency in our mortgage loan origination process. The calculation of this net cost to originate is as follows for the six months ended June 30:

	2005	2004	% Change
	(Dollars in thousands)		
Total operating expenses	$ 143,171	$ 113,791	
Add: deferred direct loan origination expenses(1)	29,926	28,573	
Less: servicing cost(2)	(11,527)	(5,896)	
Loan origination expenses	161,570	136,468	18.4%
Less: deferred net origination points and fees(3)	(26,902)	(24,595)	
Net cost to originate	$ 134,668	$ 111,873	20.4%
Total mortgage loan originations	$ 7,369,294	$ 5,738,876	28.4%
Loan origination expenses as percentage of volume	2.19%	2.38%	
Net cost to originate as percentage of volume	1.83%	1.95%	

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(1) Represents the amount of direct expenses incurred and deferred in the period in accordance with Financial Accounting Standard No. 91.
(2) Servicing cost consists of direct expenses and allocated corporate overhead.
(3) Deferred net origination points and fees represent amounts received from borrowers during the period less amounts paid to brokers on all loans originated during the period.

The net cost to originate mortgage loans as a percentage of total mortgage loan origination volume declined from 1.95% for the six months ended June 30, 2004 to 1.83% for the same period in 2005 as a result of the 28.4% increase in mortgage loan origination volume that outpaced our 18.4% increase in loan origination expenses, partially offset by a reduction in points and fees received.

Income Taxes. The provision for income taxes as a percentage of pre-tax income was 38.6% for the six months ended June 30, 2005 compared with 40.0% for the same period in 2004. The decrease in the effective tax rate is due primarily to the fact that dividends paid by the REIT to the preferred shareholders of the REIT are not subject to federal or state tax at the corporate level. The two major components of our effective tax rate are the federal corporate tax rate of 35.0% and the effective state income tax rates. We operate and pay tax in nearly every state. Changes in the effective state tax rate occur due to changes in our business activities in various states, as well as the various states tax structures and rates, causing a slight benefit in 2005 when compared to 2004.

REIT Operating Results (included in Consolidated Results). Net revenues for the REIT were $90.8 million for the six months ended June 30, 2005. The REIT incurred expenses of $11.5 million for the same period related to servicing and management fees charged by AHL in accordance with an administration and servicing agreement between the two parties, and $0.1 million in direct general and administrative costs for professional services. Resulting net income for the same period was $79.2 million.

Liquidity And Capital Resources

As a mortgage banking company, our cash requirements include the funding of mortgage loan originations, interest expense on and repayment of principal on warehouse credit facilities, asset-backed commercial paper, securitization bond financing, operational expenses, servicing advances, hedging margin requirements, and tax payments. Our cash requirements also included the funding of quarterly dividends on preferred shares issued by our REIT subsidiary. We fund these cash requirements with cash received from loan sales, borrowings under warehouse credit facilities and securitization bond financing secured by mortgage loans, cash distributions from our mortgage-related securities, interest collections on loans held for sale and loans held for investment, servicing fees and other servicing income, and points and fees collected from the origination of loans.

Our liquidity strategy is to maintain sufficient and diversified warehouse credit facilities and asset-backed commercial paper to finance our mortgage loan originations, to maintain strong relationships with a diverse group of whole loan purchasers, and to maintain the ability to execute our own securitizations. This provides us with the ability to finance our growing origination operations and to maximize our realization of the value of loans we originate. Net cash used in operating activities totaled $1.1 billion and $0.8 billion during the three months ended June 30, 2005 and 2004, respectively. The negative cash flow for these periods reflects primarily our funding of loans held for sale and investment that are either not entirely sold in the same period or financed with proceeds reported in our cash flows from financing activities.

Warehouse Facilities

We use our various warehouse credit facilities to finance the actual funding of our loan originations. We then sell or securitize our mortgage loans generally within one to four months from origination and pay down the warehouse credit facilities with the proceeds. At June 30, 2005, we had voluntary and recoverable warehouse line paydowns of $157.0 million that increased our warehouse line availability by a corresponding amount. These voluntary and recoverable warehouse line paydowns plus cash of $79.7 million brought our total liquidity to $236.7 million at June 30, 2005. The majority of our current warehouse credit facilities are committed lines,

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whereby the lender is obligated to fund up to the committed amount subject to us meeting various financial and other covenants. A portion of one of our warehouse lines is, and in the future some may be, uncommitted, which means that the lender may fund the uncommitted amount at its discretion. The majority of our current warehouse credit facilities also contain a sub-limit for wet funding, which is the funding of loans for which the collateral custodian has not yet received the related loan documents. Our warehouse credit facilities generally have a one or two year term.

Except as otherwise noted below, all of our warehouse credit facilities accrue interest at a rate based upon One-Month LIBOR plus a specified spread and as of August 5, 2005 have other material terms and features as follows:

Warehouse Lender	Committed Amount	Uncommitted Amount	Total Facility Amount	Portion Available for Wet Funding	Expiration Date
			(In millions)		
Morgan Stanley Bank and Morgan Stanley Mortgage Capital Inc.	$ 650	$	$ 650	$ 100	July 2007
Merrill Lynch Mortgage Capital Inc	650		650	260	October 2005
IXIS Real Estate Capital Inc. (CDC)	600		600	240	November 2005
Credit Suisse First Boston Mortgage Capital LLC	500	100	600	240	December 2005
Residential Funding Corporation	300		300	150	October 2005
Lehman Brothers Bank, FSB	500		500	110	August 2005
Goldman Sachs Mortgage Company	660		660	120	December 2006
HSBC Mortgage Services Warehouse Lending Inc.	40		40	40	August 2005
Total	$ 3,900	$ 100	$ 4,000	$ 1,260	

At June 30, 2005, Accredited Home Lenders Canada, Inc. entered into a 100.0 million Canadian dollar (approximately $81.6 million U.S. dollars at June 30, 2005) warehouse credit facility. The credit facility is collateralized by Canadian mortgage loans, is guaranteed by the AHLHC and expires June 30, 2006. There were no amounts outstanding under this facility at June 30, 2005.

Certain of our credit facilities include sublimits for aged and delinquent loans, as well as for real estate owned (properties acquired through foreclosure of defaulted mortgage loans or through deeds in lieu of foreclosure) and subordinated asset-backed bonds.

Our warehouse and other credit facilities contain customary covenants including minimum liquidity, profitability and net worth requirements, and limitations on other indebtedness. If we fail to comply with any of these covenants or otherwise default under a facility, the lender has the right to terminate the facility and require immediate repayment that may require sale of the collateral at less than optimal terms. In addition, if we default under one facility, it would generally trigger a default under our other facilities. As of June 30, 2005, we were in compliance with all covenant requirements for each of the facilities.

Asset Backed Commercial Paper Facility

During the second quarter of 2005, Accredited issued commercial paper in the form of short-term secured liquidity notes (SLNs) with initial maturities ranging from one to 180 days and $40.0 million of subordinated notes maturing in five years. The SLNs bear interest at customary commercial paper market rates, which vary depending on the prevailing market conditions. The capacity of this facility at June 30, 2005 was $1.0 billion, of which $988.5 million was outstanding at that date. For the fifty-two days during the quarter this facility was outstanding, the average borrowings outstanding under this facility were $634.2 million, and the weighted average interest rate was approximately 3.5%. The facility is collateralized by mortgage loans held for sale.

REIT Activity

At June 30, 2005 the REIT had cash of $42.0 million, an increase of $38.0 million from December 31, 2004. During the six months ended June 30, 2005, net cash provided by operating activities totaled $75.4 million, net cash from REIT investing activities totaled $807.9 million and net cash used in REIT financing activities totaled $845.4 million.

In February 2005, we closed a securitization containing $917.2 million of first priority residential mortgage loans through the REIT. The securitization utilized a senior/subordinated structure consisting of senior and subordinated notes with original principal balances totaling $903.5 million and a final stated maturity date of April 2035. The securitization is structured as a financing; therefore, both the mortgage loans and the debt represented by the notes will remain on our consolidated balance sheet. We used the proceeds from the securitization primarily to repay warehouse financing for the mortgage loans.

In May 2005, we closed a securitization containing $1.0 billion of primarily first priority residential mortgage loans through the REIT. The securitization utilized a senior/subordinated structure consisting of senior and subordinated notes with original principal balances totaling $1.0 billion and a final stated maturity date of July 2035. The securitization is structured as a financing; therefore, both the mortgage loans and the debt represented by the notes will remain on our consolidated balance sheet. We used the proceeds from the securitization primarily to repay warehouse financing for the mortgage loans.

In March and June of 2005, the REIT s board of trustees declared a quarterly cash dividend on the preferred shares at the rate of $0.609375 per share to shareholders of record on March 15 and June 15, which aggregated $5.0 million for the six months ended June 30, 2005.

AHLHC irrevocably and unconditionally agrees to pay in full to the holders of each share of the REIT s Series A Preferred Shares, as and when due, regardless of any defense, right of set-off or counterclaim which the REIT or Accredited may have or assert: (i) all accrued and unpaid dividends (whether or not declared) payable on the REIT s Series A Preferred Shares, (ii) the redemption price (including all accrued and unpaid dividends) payable with respect to any of the REIT s Series A Preferred Shares redeemed by the REIT and (iii) the liquidation preference, if any, payable with respect to any of the REIT s Series A Preferred Shares. AHLHC s guarantee is subordinated in right of payment to AHLHC s indebtedness, on parity with the most senior class of AHLHC s preferred stock and senior to AHLHC s common stock. At June 30, 2005, the aggregate redemption value of the total preferred shares outstanding was $102.3 million. Based on total preferred shares outstanding at June 30, 2005, the REIT s current annual dividend obligation totals $10.0 million.

Subject to the various uncertainties described above, and assuming that we will be able to successfully execute our liquidity strategy, we anticipate that our liquidity, credit facilities and capital resources will be sufficient to fund our operations for the foreseeable future.

Market Risk

Market risks generally represent the risk of loss that may result from the potential change in the value of a financial instrument due to fluctuations in interest and foreign exchange rates and in equity and commodity prices. Our market risk relates primarily to interest rate fluctuations. We may be directly affected by the level of and fluctuations in interest rates, which affect the spread between the rate of interest received on our mortgage loans and the related financing rate. Our profitability could be adversely affected during any period of unexpected or rapid changes in interest rates, by impacting the value of loans held for sale, loans held for investment and loans sold with retained interests. A

significant change in interest rates could also change the level of loan prepayments, thereby adversely affecting our long-term net interest income and servicing income.

The objective of interest rate risk management is to control the effects that interest rate fluctuations have on the value of our assets and liabilities. Our management of interest rate risk is intended to mitigate the volatility of

earnings associated with fluctuations in the unrealized gain (loss) on mortgage-related securities, the market value of loans held for sale and the net interest on loans held for investment due to changes in the current market rate of interest.

We use several internal reports and risk management strategies to monitor, evaluate, and manage the risk profile of our loan portfolio in response to changes in the market risk. We cannot assure you, however, that we will adequately offset all risks associated with interest rate fluctuations impacting our loan portfolio.

Derivative Instruments and Hedging Activities

As part of our interest rate management process, we use derivative financial instruments such as Eurodollar futures and options on Eurodollar futures. In connection with five of our securitizations structured as financings, we entered into interest rate cap agreements. In connection with three of our securitizations structured as financings, we entered into interest rate swap agreements. It is not our policy to use derivatives to speculate on interest rates. In accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended and interpreted, derivative financial instruments are reported on the consolidated balance sheets at their fair value.

Fair Value Hedges

We designate certain derivative financial instruments as hedge instruments under SFAS No. 133, and, at trade date, these instruments and their hedging relationship are identified, designated and documented. For derivative financial instruments designated as hedge instruments, we evaluate the effectiveness of these hedges against the mortgage loans being hedged to ensure that there remains adequate correlation in the hedge relationship. To hedge the adverse effect of interest rate changes on the fair market value of mortgage loans held for sale or securitization, we use derivatives as fair value hedges under SFAS No. 133. Once the hedge relationship is established, the realized and unrealized changes in fair value of both the hedge instruments and mortgage loans are recognized in the consolidated statement of operations in the period in which the changes occur. Any change in the fair value of mortgage loans held for sale recognized as a result of hedge accounting is reversed at the time the mortgage loans are sold. The net amount recorded in the consolidated statement of operations is referred to as hedge ineffectiveness.

Cash Flow Hedges

During the third quarter of 2004, we implemented the use of cash flow hedging on our securitization debt under SFAS No. 133. Pursuant to SFAS No. 133, hedge instruments have been designated as hedging the exposure to variability of cash flows from our securitization debt attributable to interest rate risk. Cash flow hedge accounting requires that the effective portion of the gain or loss in the fair value of a derivative instrument designated as a hedge be reported as a component of other comprehensive income in stockholders equity, and recorded into earnings in the period during which the hedged transaction affects earnings pursuant to SFAS No. 133. The ineffective portion on the derivative instrument is reported in current earnings as a component of interest expense.

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

Interest Rate Simulation Sensitivity Analysis

Changes in market interest rates affect our estimations of the fair value of our mortgage loans held for sale, loans held for investment and the fair value of our mortgage-related securities and related derivatives. Changes in fair value that are stated below are derived based upon immediate and equal changes to market interest rates of

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various maturities. All derivative financial instruments and interest rate sensitive financial assets and liabilities have been included within the sensitivity analysis presented. We model the change in value of our derivative financial instruments using outside valuation models generally recognized within the industry. Projected changes in the value of our loans as stated below are determined based on the change in net present value arising from the selected hypothetical changes in market interest rates. We are exposed to interest rate risk from the time the loans are funded to the time the loans are settled because the interest paid on the various warehouse facilities is based on the spot One-Month LIBOR rate. The interest rate risk associated with the interest expense paid on the various warehouse facilities has been included based on the average holding period from the time of funding to settlement. Changes in the fair value of our derivative positions with optionality have been included based on an immediate and equal change in market interest rates. The base or current interest rate curve is adjusted by the levels shown below as of June 30, 2005:

	+50 bp	+100 bp	-50 bp	-100 bp
	(In thousands)			
Change in fair value of:				
Mortgage loans committed and held for sale	$ (25,320)	$ (50,218)	$ 25,755	$ 51,960
Derivatives related to mortgage loans committed and held for sale	21,988	43,975	(21,988)	(43,975)
Warehouse debt and asset backed commercial paper	(1,433)	(2,867)	1,433	2,867
Securitized debt subject to portfolio-based accounting and mortgage-related securities	(36,910)	(73,200)	37,683	76,210
Derivatives related to securitized debt subject to portfolio-based accounting and mortgage-related securities	29,910	60,447	(29,181)	(57,253)
Total	$ (11,765)	$ (21,863)	$ 13,702	$ 29,809

The simulation analysis reflects our efforts to balance the repricing characteristics of our interest-bearing assets and liabilities.

Contractual Obligations

Our February 2005 and May 2005 securitizations significantly increased our securitization bond financing balance from the balance at December 31, 2004. The following table summarizes our contractual obligations for securitization bond financing, excluding future interest, at June 30, 2005, and the effect such obligations are expected to have on our liquidity and cash flows in future periods:

	Payments Due by Calendar Period				
	Total	Less than 1 year	1-3 Years	3-5 Years	More than 5 Years
	(In thousands)				
Securitization bond financing(1)	$ 5,048,224	$ 718,483	$ 2,808,614	$ 910,018	$ 611,109

(1) Amounts represent the expected repayment requirements based on anticipated receipts of principal and interest on underlying mortgage loan collateral using historical prepayment speeds. The securitization bond financing represents obligations of the respective trusts that issue the notes and the assets sold to these issuers are not available to satisfy claims of Accredited s creditors. The noteholders recourse is limited to the pledged collateral.

Off-Balance Sheet Financing Arrangements

In the normal course of business, in order to meet the financing needs of our borrowers, we are a party to various financial instruments with off-balance sheet risk. These financial instruments primarily represent commitments to individual borrowers to fund their loans. These instruments involve, to varying degrees, elements of interest rate risk and credit risk in excess of the amount recognized in the consolidated balance

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sheets. We seek to mitigate the credit risk by evaluating the creditworthiness of potential mortgage loan borrowers on a case-by-case basis. We do not guarantee interest rates to potential borrowers when an application is received. Interest rates conditionally approved following the initial underwriting of applications are subject to adjustment if any conditions are not satisfied. We commit to originating loans, in many cases dependent upon the borrower s satisfying various conditions. These commitments to fund individual borrower loans totaled $649.7 million as of June 30, 2005.

During 2000, Accredited executed its own securitization structured as a sale of $174.7 million of mortgage loans originated or acquired by Accredited. The senior securities were sold to third parties, and Accredited retained a subordinated residual interest. In May 2005, the residual interest was extinguished by Accredited in a clean-up call and the loans were recorded on our books. As of June 30, 2005 we had sold nearly 80% of the loans received in the clean-up call. Prior to the clean-up call, Accredited s receipt of such excess cash flows was delayed to the extent that such securitization provides credit enhancement to the senior security holders by requiring the retention in a reserve account and/or the distribution to the senior security holders, as an accelerated amortization of the principal balance of their securities, of certain amounts otherwise payable to Accredited as the residual interest holder.

During 2002, 2001 and 2000, Accredited sold to a third-party investor (and former related party) $75.8 million, $299.8 million and $321.0 million, respectively, of mortgage loans originated or acquired by Accredited. At June 30, 2002, the related party had a beneficial ownership interest in Accredited related to a convertible debt facility that existed at that date. Subsequently, all ownership and beneficial ownership interest were sold in connection with our initial public offering in 2003, ceasing the related party relationship. The loans were sold pursuant to three separate commitments, each for a twelve-month period different from the calendar year. Pursuant to the agreement with the investor, Accredited is entitled to receive payments based upon the amount of excess cash flows generated by Accredited s sold loans under each commitment. The excess cash flows consist of the interest paid by the obligors of Accredited s sold loans, less the sum of a specified yield payable to the investor, servicing fees and credit losses on Accredited s sold loans. In general, if credit losses result in a negative excess cash flow, Accredited is obligated to pay the shortfall to the investor; provided, however, that Accredited is not obligated to reimburse the investor for credit losses in excess of 10% of the aggregate outstanding principal balance of the mortgage loans purchased by the investor under each commitment. The aggregate outstanding principal balance of the mortgage loans purchased by the investor totaled $127.7 million at June 30, 2005. Accredited is also entitled to all prepayment penalties collected, as long as the rate of prepayments stay below certain thresholds. Should the thresholds be exceeded, then Accredited must share the prepayment penalties collected with the investor.

AHLHC irrevocably and unconditionally agrees to pay in full to the holders of each share of the REIT s Series A Preferred Shares, as and when due, regardless of any defense, right of set-off or counterclaim which the REIT or Accredited may have or assert: (i) all accrued and unpaid dividends (whether or not declared) payable on the REIT s Series A Preferred Shares, (ii) the redemption price (including all accrued and unpaid dividends) payable with respect to any of the REIT s Series A Preferred Shares redeemed by the REIT and (iii) the liquidation preference, if any, payable with respect to any of the REIT s Series A Preferred Shares. AHLHC s guarantee is subordinated in right of payment to AHLHC s indebtedness, on parity with the most senior class of AHLHC s preferred stock and senior to AHLHC s common stock. At June 30, 2005, the aggregate redemption value of the total preferred shares outstanding was $102.3 million. Based on total preferred shares outstanding at June 30, 2005, the REIT s current annual dividend obligation totals $10.0 million.

Critical Accounting Policies

Accounting for Our Loan Sales

We generally sell our loans in transactions that are accounted for in our financial statements as securitizations structured as a financing or whole loan sales.

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We completed one securitization during the quarter ended June 30, 2005 and 2004, which were structured as financings. The transactions were legally structured as sales of mortgage loans, but for accounting purposes were treated as financings under SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities a replacement of FASB Statement No. 125*. When we enter into a securitization structured as a financing, the loans remain on our balance sheet, retained interests are not created, and debt securities issued in the securitization replace the warehouse debt originally associated with the securitized mortgage loans. We record interest income on the mortgage loans and interest expense on the debt securities, as well as ancillary fees, over the life of the securitization, instead of recognizing a gain or loss upon closing of the transaction.

When we sell our mortgage loans in whole loan sale transactions, the transaction is structured as a sale of mortgage loans for legal and accounting purposes and we dispose of our entire interest in the loans. Gain on sale revenue is recorded at the time we sell loans, but not when we securitize loans in transactions structured as financings. Accordingly, our financial results are significantly impacted by the timing of our loan sales and the securitization structure we may elect to implement. If we hold a significant pool of loans at the end of a reporting period, those loans will remain on our balance sheet, along with the related debt used to fund the loans. The revenue that we generate from those loans will not be recorded until the subsequent reporting period when we sell the loans. If we elect to complete a securitization structured as a financing rather than a transaction that would generate gain on sale revenue, our gain on sale revenue will be lower and our interest income will be higher than it would have been otherwise. A number of factors influence the timing of our loan sales, our targeted disposition strategy and the whole loan sale premiums we receive, including the current market demand for our loans, the quality of the loans we originate, the sufficiency of our loan documentation, liquidity needs, and our strategic objectives. From time to time, management has delayed the sale of loans to a later period, and may do so again in the future.

Estimates

The preparation of our financial statements requires us to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although we base our estimates and assumptions on historical experience and on various other factors that we believe to be reasonable under the circumstances, our management exercises significant judgment in the final determination of our estimates. Actual results may differ from these estimates. The following areas require significant judgments by management:

- provision for losses; and
- interest rate risk, derivatives and hedging strategies.

Provisions for Losses

We provide market valuation adjustments on certain nonperforming loans, other loans we hold for sale and real estate owned. These adjustments are based upon our estimate of expected losses, calculated using loss severity and loss frequency rate assumptions, and are based upon the value that we could reasonably expect to obtain from a sale, other than in a forced or liquidation sale. An allowance for losses on mortgage loans held for investment is recorded in an amount sufficient to maintain appropriate coverage for probable losses on such loans. The provision for losses also includes net losses on real estate owned. We also accrue for liabilities associated with loans sold, which we may be requested to repurchase due to breaches of representations and warranties and early payment defaults. We periodically evaluate the estimates used in calculating expected losses, and adjustments are reported in earnings. As these estimates are influenced by factors outside of our control and as uncertainty is inherent in these estimates, it is reasonably possible that they could change.

Our estimate of expected losses could increase if our actual loss experience or repurchase activity is different than originally estimated, or if economic factors change the value we could reasonably expect to obtain

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from a sale. In particular, if actual losses increase or if values reasonably expected to be obtained from a sale decrease, the provision for losses would increase. Any increase in the provision for losses would adversely affect our results of operations.

Interest Rate Risk, Derivatives and Hedging

We regularly originate, securitize and sell fixed and variable rate loans. We face three primary periods of interest rate risk: during the period from approval of a loan application through loan funding; on our loans held for sale from the time of funding to the date of sale; and on the loans underlying our mortgage-related securities and on our loans held for investment subject to portfolio-based accounting.

Interest rate risk exists during the period from approval of a loan application through loan funding and from the time of funding to the date of sale because the premium earned on the sale of these loans is partially contingent upon the then-current market rate of interest for loans as compared to the contractual interest rate of the loans. Our use of derivatives is intended to mitigate the volatility of earnings associated with fluctuations in the gain on sale of loans due to changes in the current market rate of interest.

The interest rate risk on the loans underlying our mortgage-related securities and on our loans held for investment subject to portfolio-based accounting exists because some of these loans have fixed interest rates for a period of two, three or five years while the rate passed through to the investors in the mortgage-related securities and the holders of the securitization bonds is based upon an adjustable rate. We also have interest rate risk for six month adjustable loans and when the loans become adjustable after their two, three or five year fixed rate period. This is due to the loan rates resetting every six months, subject to various caps and floors, versus the monthly reset on the rate passed through to the investors in the mortgage-related securities and holders of the securitization bonds. Our use of derivatives is intended to mitigate the volatility of earnings associated with fluctuations in the unrealized gain (loss) on the mortgage-related securities and changes in the cash flows of our loans held for investment subject to portfolio-based accounting due to changes in LIBOR rates.

As part of our interest rate management process, we use derivative financial instruments such as interest rate swaps and caps, Eurodollar futures and options on Eurodollar futures. In connection with the securitizations structured as financings, we have entered into interest rate cap agreements and interest rate swap agreements. We do not use derivatives to speculate on interest rates. In accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended and interpreted, derivative financial instruments are reported on the consolidated balance sheets at their fair value.

Fair Value Hedges

We designate certain derivative financial instruments as hedge instruments under SFAS No. 133, and at trade date, these instruments and their hedging relationship are identified, designated and documented. For derivative financial instruments designated as hedge instruments, we evaluate the effectiveness of these hedges against the mortgage loans being hedged to ensure there remains a highly effective correlation in the hedge relationship. To hedge the effect of interest rate changes on the fair value of mortgage loans held for sale, we are using derivatives as fair value hedges under SFAS No. 133. Once the hedge relationship is established, the realized and unrealized changes in fair value of both the hedge instrument and mortgage loans are recognized in the period in which the changes occur. Any change in the fair value of mortgage loans held for sale recognized as a result of hedge accounting is reversed at the time we sell the mortgage loans. This results in a correspondingly higher or lower gain on sale revenue at such time. The net amount recorded in the consolidated statements of operations is referred to as hedge ineffectiveness.

Cash Flow Hedges

During the third quarter 2004, we implemented the use of cash flow hedge accounting on our securitization debt under SFAS No. 133. Pursuant to SFAS No. 133, hedge instruments have been designated as hedging the

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exposure to variability of cash flows from our securitization debt attributable to interest rate risk. Cash flow hedge accounting requires that the effective portion of the gain or loss in the fair value of a derivative instrument designated as a hedge be reported in other comprehensive income, and that the ineffective portion be reported in current earnings.

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

Recently Issued Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board issued a revision of SFAS No. 123, *Accounting for Stock-Based Compensation*, which also supersedes APB 25, Accounting for Stock Issued to Employees. The revised standard eliminates the alternative to use Opinion 25 s intrinsic value method of accounting and eliminates the disclosure only provisions of SFAS No. 123. The compliance date for the revised standard was extended by the Securities and Exchange Commission (the SEC) in April 2005. The revised standard applies to all stock options and awards granted after December 31, 2005 and requires the recognition of compensation expense in the financial statements for all share-based payment transactions subsequent to that date. The revised standard also requires the prospective recognition of compensation expense in the financial statements for all unvested options after January 1, 2006. Adoption of this standard on January 1, 2006 will have a negative impact on our earnings based on our current pro forma earnings as presented in Note 1 to the consolidated financial statements.

Risk Factors That May Affect Future Results

You should carefully consider the following risks, together with other matters described in this Form 10-Q in evaluating our business and prospects. If any of the events referred to below actually occur, our business, financial condition, liquidity and results of operations could suffer. In that case, the trading price of our common stock could decline. The risks described below are not the only ones we face. Additional risks not presently known to us or that we currently deem immaterial may also impair our business operations. Certain statements in this Form 10-Q (including certain of the following risk factors) constitute forward-looking statements. Please refer to the section entitled Forward-Looking Statements on page 3 of this Form 10-Q.

Risks Related to Our Business

We finance borrowers with lower credit ratings. The non-prime loans we originate generally have higher delinquency and default rates than prime mortgage loans, which could result in losses on loans that we hold or that we are required to repurchase, the loss of our servicing rights and damage to our reputation as a loan servicer.

We are in the business of originating, selling, securitizing and servicing non-prime mortgage loans. Non-prime mortgage loans generally have higher delinquency and default rates than prime mortgage loans. Delinquency interrupts the flow of projected interest income from a mortgage loan and default can ultimately lead to a loss if the net realizable value of the real property securing the mortgage loan is insufficient to cover the principal and interest due on the loan. Also, our cost of financing and servicing a delinquent or defaulted loan is generally higher than for a performing loan. We bear the risk of delinquency and default on loans beginning when we originate them until we sell them and we continue to bear the risk of delinquency and default after we securitize loans or sell loans with a retained interest. Loans that become delinquent prior to sale or securitization may become unsaleable or saleable only at a discount, and the longer we hold loans prior to sale or securitization, the greater

the chance we will bear the costs associated with the loans delinquency. Factors that may increase the time held prior to sale or securitization include the time required to accumulate loans for securitizations or sales of large pools of loans, the amount and timing of third-party due diligence in connection with sales or securitizations, and defects in the loans.

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We also reacquire the risks of delinquency and default for loans that we are obligated to repurchase. Repurchase obligations are typically triggered in loan sale transactions if an early payment default occurs on the loan after sale, or in any sale or securitization if the loan materially violates our representations or warranties. At June 30, 2005, mortgage loans held for sale included $17.2 million of loans repurchased. Our total provision for losses for the six months ended June 30, 2005 was $17.9 million and for the year ended December 31, 2004 was $56.9 million. If we experience higher-than-expected levels of delinquency or default in pools of loans that we service, we may lose our servicing rights, which would result in a loss of future servicing income and may damage our reputation as a loan servicer.

We attempt to manage these risks with risk-based mortgage loan pricing and appropriate underwriting policies and loan collection methods. However, if such policies and methods are insufficient to control our delinquency and default risks and do not result in appropriate loan pricing, our business, financial condition, liquidity and results of operations could be significantly harmed. Our total delinquency rate, including loans in foreclosure and converted into real estate owned, for our servicing portfolio was 1.7% at June 30, 2005. Historically, our delinquency rate has increased, and may increase in the future, as the mortgage loans in our portfolio age.

We face intense competition that could adversely impact our market share and our revenues.

We face intense competition from finance and mortgage banking companies, Internet-based lending companies where entry barriers are relatively low, and from traditional bank and thrift lenders that have entered the non-prime mortgage industry. As we seek to expand our business further, we will face a significant number of additional competitors, many of whom will be well established in the markets we seek to penetrate. Some of our competitors are much larger, have better name recognition, and have far greater financial and other resources than us.

The government-sponsored entities Fannie Mae and Freddie Mac are also expanding their participation in the non-prime mortgage industry. These government-sponsored entities have a size and cost-of-funds advantage that allows them to purchase loans with lower rates or fees than we are willing to offer. While the government- sponsored entities presently do not have the legal authority to originate mortgage loans, including non-prime loans, they do have the authority to buy loans. A material expansion of their involvement in the market to purchase non-prime loans could change the dynamics of the industry by virtue of their sheer size, pricing power and the inherent advantages of a government charter. In addition, if as a result of their purchasing practices, these government-sponsored entities experience significantly higher-than-expected losses, such experience could adversely affect the overall investor perception of the non-prime mortgage industry.

The intense competition in the non-prime mortgage industry has also led to rapid technological developments, evolving industry standards and frequent releases of new products and enhancements. As mortgage products are offered more widely through alternative distribution channels, such as the Internet, we may be required to make significant changes to our current retail and wholesale structure and information and technology systems to compete effectively. Our inability to continue enhancing our current Internet capabilities, or to adapt to other technological changes in the industry, could significantly harm our business, financial condition, liquidity and results of operations. In addition, we rely on software and other technology-based programs to gather and analyze competitive and other data from the marketplace. Problems with our technology or inability to implement technological changes may, therefore, result in delayed detection of market trends and conditions.

Competition in the industry can take many forms, including interest rates and costs of a loan, less stringent underwriting standards, offering of loan products which we do not offer, convenience in obtaining a loan, customer service, amount and term of a loan and marketing and distribution channels. The need to maintain mortgage loan volume in this competitive environment creates a risk of price competition in the non-prime mortgage industry. Price competition could prevent us from raising rates in response to a rising cost of funds or cause us to lower the interest rates that we charge borrowers, which could adversely impact our profitability and lower the value of our loans. If our competitors adopt less stringent underwriting standards, we will be pressured to do so as well, which would result in greater loan risk without compensating pricing. If we do not relax

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underwriting standards in response to our competitors, we may lose market share. Any increase in these pricing and underwriting pressures could reduce the volume of our loan originations and sales and significantly harm our business, financial condition, liquidity and results of operations.

Any substantial economic slowdown could increase delinquencies, defaults and foreclosures and reduce our ability to originate loans.

Periods of economic slowdown or recession may be accompanied by decreased demand for consumer credit, decreased real estate values, and increased rates of delinquencies, defaults and foreclosures. Any material decline in real estate values would increase the loan-to-value ratios (LTVs) on loans that we hold pending sale and loans in which we have a residual or retained interest, weaken our collateral coverage and increase the possibility and severity of a loss if a borrower defaults. We originate loans to borrowers who make little or no down payment, resulting in higher LTVs. A lack of equity in the home may reduce the incentive a borrower has to meet his payment obligations during periods of financial hardship, which might result in higher delinquencies, defaults and foreclosures. These factors would reduce our ability to originate loans and increase our losses on loans in which we have a residual or retained interest. In addition, loans we originate during an economic slowdown may not be as valuable to us because potential purchasers of our loans might reduce the premiums they pay for the loans to compensate for any increased risks arising during such periods. Any sustained increase in delinquencies, defaults or foreclosures is likely to significantly harm the pricing of our future loan sales and securitizations and also our ability to finance our loan originations.

An increase in interest rates could result in a reduction in our loan origination volumes, an increase in delinquency, default and foreclosure rates and a reduction in the value of, and income from, our loans.

The following are some of the risks we face related to an increase in interest rates:

- A substantial and sustained increase in interest rates could harm our ability to originate loans because refinancing an existing loan would be less attractive and qualifying for a purchase loan may be more difficult.

- Existing borrowers with adjustable-rate mortgages may incur higher monthly payments as the interest rate increases, which may lead to higher delinquency and default rates.

- If prevailing interest rates increase after we fund a loan, the value that we receive upon the sale or securitization of the loan decreases.

- The cost of financing our mortgage loans prior to sale or securitization is based primarily upon the London Inter-Bank Offered Rate (LIBOR). The interest rates we charge on our mortgage loans are based, in part, upon prevailing interest rates at the time of origination, and the interest rates on all of our mortgage loans are fixed for at least the first six months, or two, three or five years. If LIBOR increases after the time of loan origination, our net interest income which represents the difference between the interest rates we receive on our mortgage loans pending sale or securitization and our LIBOR-based cost of financing such loans will be reduced. The weighted average cost of financing our mortgage loans, prior to sale or securitization, was 4.0% during the six months ended June 30, 2005.

- When we securitize loans or sell loans with retained interests, the value of and the income we receive from the loans held for investment subject to portfolio-based accounting and the mortgage-related securities we retain are also based on LIBOR to the extent the underlying loans have an adjustable interest rate. This is because the income we receive from these mortgage loans and mortgage-related securities is based on the difference between the fixed rates payable on the loans for the first two or three years, and

an adjustable LIBOR-based yield payable to the senior security holders or loan purchasers. We also have interest rate risk when the loans become adjustable after their two or three year fixed rate period. This is due to the loan rates resetting every six months, subject to various caps and floors, versus the monthly reset on the rate passed through to the investors in the mortgage-related securities and holders of the securitization bonds.

Accordingly, our business, financial condition, liquidity and results of operations may be significantly harmed as a result of increased interest rates.

Our business may be significantly harmed by a slowdown in the economy or a natural disaster in the states of California or Florida, where we conduct a significant amount of business.

A significant portion of the mortgage loans we have originated, purchased or serviced has been secured by properties in California and Florida. During the six months ended June 30, 2005, 21% and 11% of the principal balance of the loans we originated were collateralized by properties located in California and Florida, respectively. At June 30, 2005, 25% and 10% of the unpaid principal balance of loans we serviced were collateralized by properties located in California and Florida, respectively. An overall decline in the economy or the residential real estate market, or the occurrence of a natural disaster that is not covered by standard homeowners insurance policies, such as an earthquake, hurricane or wildfire, could decrease the value of mortgaged properties in these states. This, in turn, would increase the risk of delinquency, default or foreclosure on mortgage loans in our portfolio or that we have sold to others. This could restrict our ability to originate, sell, or securitize mortgage loans, and significantly harm our business, financial condition, liquidity and results of operations.

Our hedging strategies may not be successful in mitigating our risks associated with interest rates.

We use various derivative financial instruments to provide a level of protection against interest rate risks, but no hedging strategy can protect us completely. When rates change, we expect to record a gain or loss on derivatives which would be offset by an inverse change in the value of loans held for sale and mortgage-related securities, as reflected in the Interest Rate Simulation Sensitivity Analysis in the section entitled Market Risk in ITEM 2. Management s Discussion and Analysis of Financial Condition and Results of Operations. We cannot assure you, however, that our use of derivatives will offset the risks related to changes in interest rates. There have been periods, and it is likely that there will be periods in the future, during which we will not have offsetting gains or losses in loan values after accounting for our derivative financial instruments. The derivative financial instruments we select may not have the effect of reducing our interest rate risk. In addition, the nature and timing of hedging transactions may influence the effectiveness of these strategies. Poorly designed strategies, improperly executed transactions, or inaccurate assumptions could actually increase our risk and losses. In addition, hedging strategies involve transaction and other costs. We cannot assure you that our hedging strategy and the derivatives that we use will adequately offset the risk of interest rate volatility or that our hedging transactions will not result in losses. See discussion under Market Risk in ITEM 2. Management s Discussion and Analysis of Financial Condition and Results of Operations.

Our business requires a significant amount of cash and if it is not available our business will be significantly harmed.

Our primary sources of cash are our warehouse credit facilities and the proceeds from the sales and securitizations of our loans. We require substantial cash to fund our loan originations, to pay our loan origination expenses and to hold our loans pending sale or securitization. Also, as a servicer of loans, we are required to advance delinquent principal and interest payments, unpaid property taxes, hazard insurance premiums, and foreclosure and foreclosure-related costs. Our warehouse credit facilities also require us to observe certain financial covenants, including the maintenance of certain levels of cash and general liquidity in our company.

As of June 30, 2005, we financed substantially all of our loans through eight separate warehouse lenders. Each of these facilities is cancelable by the lender for cause at any time and at least one is cancelable at any time without cause. These facilities generally have a renewable, one-year term. Because these are short-term commitments of capital, the lenders may respond to market conditions, which may favor an alternative investment strategy for them, making it more difficult for us to secure continued financing. If we are not able to renew any of these warehouse

credit facilities or arrange for new financing on terms acceptable to us, or if we

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default on our covenants or are otherwise unable to access funds under any of these facilities, or if the lenders do not honor their commitments for any reason, we will have to curtail our loan origination activities. This would result in decreased revenues and profits from loan sales.

The timing of our loan dispositions (which are periodic) is not always matched to the timing of our expenses (which are continuous). This requires us to maintain significant levels of cash to maintain acceptable levels of liquidity. When we securitize our loans or sell our loans with a retained interest, we may not receive any amounts in excess of the principal amount of the loan for up to 12 months or longer. Further, any decrease in demand in the whole loan market such that we are unable to timely and profitably sell our loans could inhibit our ability to meet our liquidity demands.

Our warehouse credit facilities contain covenants that restrict our operations and may inhibit our ability to grow our business and increase revenues.

Our warehouse credit facilities contain extensive restrictions and covenants that, among other things, require us to satisfy specified financial, asset quality and loan performance tests and may prohibit inter-company dividends in certain circumstances. If we fail to meet or satisfy any of these covenants, we would be in default under these agreements and our lenders could elect to declare all amounts outstanding under the agreements to be immediately due and payable, enforce their interests against collateral pledged under such agreements and restrict our ability to make additional borrowings. These agreements also contain cross-default provisions, so that if a default occurs under any one agreement, the lenders under our other agreements could also declare a default.

The covenants and restrictions in our warehouse credit facilities may restrict our ability to, among other things:

- incur additional debt;
- make certain investments or acquisitions;
- repurchase or redeem capital stock;
- engage in mergers or consolidations;
- finance loans with certain attributes;
- reduce liquidity below certain levels; and
- hold loans for longer than established time periods.

These restrictions may interfere with our ability to obtain financing or to engage in other business activities, which may significantly harm our business, financial condition, liquidity and results of operations.

Our rights to cash flow from our loans held for investment subject to portfolio-based accounting are subordinate to senior interests and may fail to generate any revenues for us if the revenue stream only generates enough revenues to pay the senior interest holders.

As part of the credit enhancement for our securitizations, the net cash flow that we receive from the loans held for investment generally represents the excess of amounts, if any, generated by the underlying mortgage loans over the amounts required to be paid to the senior security holders or loan purchasers. This excess amount is also calculated after deduction of servicing fees and any other specified expenses related to the sale or securitization. These excess amounts are derived from, and are affected by, the interplay of several factors, including:

- the extent to which the interest rates of the mortgage loans exceed the interest rates payable to the senior security holders or loan purchasers;
- the level of losses and delinquencies experienced on the underlying loans; and
- the extent to which the underlying loans are prepaid by borrowers in advance of scheduled maturities.

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Any combination of the factors listed above may reduce the income we receive from and the value of our loans held for investment.

If we do not manage our growth effectively, our financial performance could be harmed.

In recent years, we have experienced rapid growth that has placed, and will continue to place, certain pressures on our management, administrative, operational and financial infrastructure. As of December 31, 2002, we had 1,294 employees and by June 30, 2005, we had 2,503 employees. Many of these employees have very limited experience with us and a limited understanding of our systems and controls. The increase in the size of our operations may make it more difficult for us to ensure that we originate quality loans and that we service them effectively. We will need to attract and hire additional sales, servicing and management personnel in an intensely competitive hiring environment in order to preserve and increase our market share. At the same time, we will need to continue to upgrade and expand our financial, operational and managerial systems and controls. We also intend to continue to grow our business in the future, which could require capital, systems development and human resources beyond what we currently have. We cannot assure you that we will be able to:

- meet our capital needs;
- expand our systems effectively;
- allocate our human resources optimally;
- identify and hire qualified employees;
- satisfactorily perform our servicing obligations; or
- effectively integrate the components of any businesses that we may acquire in our effort to achieve growth.

The failure to manage growth effectively would significantly harm our business, financial condition, liquidity and results of operations.

Our inability to attract and retain qualified employees could significantly harm our business.

We depend upon our wholesale account executives and retail loan officers to attract borrowers by, among other things, developing relationships with financial institutions, other mortgage companies and brokers, real estate agents, borrowers and others. We believe that these relationships lead to repeat and referral business. The market for skilled executive officers, account executives and loan officers is highly competitive and historically has experienced a high rate of turnover. Because of the difficulty in retaining qualified management personnel, we currently recruit college graduates to participate in our management trainee program. If we are unable to retain those trainees for a sufficient period following their training, we may be unable to recapture our costs of training and recruitment. In addition, if a manager leaves our company there is an increased likelihood that other members of his or her team will follow. Competition for qualified account executives and loan officers may lead to increased hiring and retention costs. If we are unable to attract or retain a sufficient number of skilled account executives at manageable costs, we will be unable to continue to originate quality mortgage loans that we are able to sell for a profit, which will reduce our revenues.

We may not be able to continue to sell and securitize our mortgage loans on terms and conditions that are profitable to us.

A substantial portion of our revenues comes from the gains on sale generated by sales of pools of our mortgage loans as whole loans. We make whole loan sales to a limited number of institutional purchasers, some of which may be frequent, repeat purchasers, and others of which may make only one or a few purchases from us. We cannot assure you that we will continue to have purchasers for our loans on terms and conditions that will be profitable to us. Also, even though our mortgage loans are generally marketable to multiple purchasers, certain loans may be marketable to only one or a few purchasers, thereby increasing the risk that we may be unable to sell such loans at a profit.

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We also rely on our ability to securitize our mortgage loans to realize a greater percentage of the full economic value of the loans. We cannot assure you, however, that we will continue to be successful in securitizing mortgage loans. Our ability to complete securitizations of our loans will depend upon a number of factors, many of which are beyond our control, including conditions in the credit and securities markets generally, conditions in the asset-backed securities market specifically, the availability of credit enhancements such as financial guarantee insurance, a senior subordinated structure or other means, and the performance of our loans previously held for investment.

An interruption in, or breach of, our information systems may result in lost business.

We rely heavily upon communications and information systems to conduct our business. As we implement our growth strategy and increase our volume of loan production, that reliance will increase. Any failure, interruption or breach in the security of our information systems or the third-party information systems on which we rely could cause underwriting or other delays and could result in fewer loan applications being received, slower processing of applications and reduced efficiency in loan servicing. We cannot assure you that such failures or interruptions will not occur, or if they do occur that they will be adequately addressed by us or the third parties on which we rely. The occurrence of any failures or interruptions could significantly harm our business.

The success and growth of our business will depend upon our ability to adapt to and implement technological changes.

Our mortgage loan origination business is currently dependent upon our ability to effectively interface with our brokers, borrowers and other third parties and to efficiently process loan applications and closings. The origination process is becoming more dependent upon technological advancement, such as the ability to process applications over the Internet, accept electronic signatures, provide status updates instantly and other customer-expected conveniences that are cost-efficient to our business. In addition, competition and increasing regulation may increase our reliance on technology as a means to improve efficiency. Implementing this new technology and becoming proficient with it may also require significant capital expenditures. As these requirements increase in the future, we will have to fully develop these technological capabilities to remain competitive or our business will be significantly harmed.

If we are unable to maintain and expand our network of independent brokers, our loan origination business will decrease.

A significant majority of our originations of mortgage loans comes from independent brokers. During 2004, 90% of our loan originations were originated through our broker network. Our brokers are not contractually obligated to do business with us. Further, our competitors also have relationships with our brokers and actively compete with us in our efforts to expand our broker networks. Accordingly, we cannot assure you that we will be successful in maintaining our existing relationships or expanding our broker networks, the failure of which could significantly harm our business, financial condition, liquidity and results of operations.

Our financial results fluctuate as a result of seasonality and other timing factors, which makes it difficult to predict our future performance and may affect the price of our common stock.

Our business is generally subject to seasonal trends. These trends reflect the general pattern of housing sales, which typically peak during the spring and summer seasons. Our quarterly operating results have fluctuated in the past and are expected to fluctuate in the future, reflecting the seasonality of the industry. Further, if the closing of a sale of loans is postponed, the recognition of gain from the sale is also postponed. If such a delay causes us to recognize income in the next quarter, our results of operations for the previous quarter could be significantly depressed.

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We are subject to losses due to fraudulent and negligent acts on the part of loan applicants, mortgage brokers, other vendors and our employees.

When we originate mortgage loans, we rely heavily upon information supplied by third parties including the information contained in the loan application, property appraisal, title information and employment and income documentation. If any of this information is intentionally or negligently misrepresented and such misrepresentation is not detected prior to loan funding, the value of the loan may be significantly lower than expected. Whether a misrepresentation is made by the loan applicant, the mortgage broker, another third party or one of our own employees, we generally bear the risk of loss associated with the misrepresentation. A loan subject to a material misrepresentation is typically unsaleable or subject to repurchase if it is sold prior to detection of the misrepresentation. Even though we may have rights against persons and entities who made or knew about the misrepresentation, such persons and entities are often difficult to locate and it is often difficult to collect any monetary losses that we have suffered as a result of their actions.

We have controls and processes designed to help us identify misrepresented information in our loan origination operations. We cannot assure you, however, that we have detected or will detect all misrepresented information in our loan originations.

We are subject to losses due to fraudulent and negligent acts in other parts of our operations. If we experience a significant number of such fraudulent or negligent acts, our business, financial condition, liquidity and results of operations would be significantly harmed.

Defective loans may harm our business.

In connection with the sale and securitization of our loans, we are required to make a variety of customary representations and warranties regarding our company and the loans. We are subject to these representations and warranties for the life of the loan and they relate to, among other things:

- compliance with laws;
- regulations and underwriting standards;
- the accuracy of information in the loan documents and loan file; and
- the characteristics and enforceability of the loan.

A loan that does not comply with these representations and warranties may take longer to sell, impact our ability to obtain third party financing, and be unsaleable or saleable only at a discount. If such a loan is sold before we detect a non-compliance, we may be obligated to repurchase the loan and bear any associated loss directly, or we may be obligated to indemnify the purchaser against any such losses, either of which could reduce our cash available for operations and liquidity. We believe that we have qualified personnel at all levels and have established controls to ensure that all loans are originated to the market s requirements, but we cannot assure you that we will not make mistakes, or that certain employees will not deliberately violate our lending policies. We seek to minimize losses from defective loans by correcting flaws if possible and selling or re-selling such loans. We also create allowances to provide for defective loans in our financial statements. We cannot assure you,

however, that losses associated with defective loans will not harm our results of operations or financial condition.

If the prepayment rates for our mortgage loans are higher than expected, our results of operations may be significantly harmed.

When a borrower pays off a mortgage loan prior to the loan s scheduled maturity, the impact on us depends upon when such payoff or prepayment occurs. Our prepayment losses generally occur after we sell or securitize our loans and the extent of our losses depends on when the prepayment occurs. If the prepayment occurs:

- within 12 to 18 months following a whole loan sale, we may have to reimburse the purchaser for all or a portion of the premium paid by the purchaser for the loan, again resulting in a loss of our profit on the loan; or

after we have securitized the loan or sold the loan in a sale with a retained interest, we lose the future income from that loan, and if we recorded a gain at the time of such securitization or sale, we may be required to record a charge against our earnings if actual prepayment rates for the related pool of loans are higher than the prepayment rates assumed in recording the gain at the time of sale or securitization.

Prepayment rates on mortgage loans vary from time to time and tend to increase during periods of declining interest rates. Of the securitized loans we serviced during the three months ended June 30, 2005, 29.6%, on an annualized basis, were prepaid. We seek to minimize our prepayment risk through a variety of means, including originating a significant portion of loans with prepayment penalties with terms of two to five years. No strategy, however, can completely insulate us from prepayment risks, whether arising from the effects of interest rate changes or otherwise. See Statutory and Regulatory Risks below for a discussion of statutes related to prepayment penalties.

We are exposed to environmental liabilities, with respect to properties that we take title to upon foreclosure, that could increase our costs of doing business and harm our results of operations.

In the course of our servicing activities, we may foreclose and take title to residential properties and become subject to environmental liabilities with respect to those properties. We may be held liable to a governmental entity or to third parties for property damage, personal injury, investigation and clean-up costs incurred by these parties in connection with environmental contamination, or may be required to investigate or clean up hazardous or toxic substances or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. Moreover, as the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based upon damages and costs resulting from environmental contamination emanating from the property. If we ever become subject to significant environmental liabilities, our business, financial condition, liquidity and results of operations would be significantly harmed.

Statutory and Regulatory Risks

The scope of our operations exposes us to risks of noncompliance with an increasing and inconsistent body of complex laws and regulations at the federal, state and local levels.

Because we originate mortgage loans in all 50 states, in the District of Columbia and Canada, we must comply with the laws and regulations, as well as judicial and administrative decisions, of all of these jurisdictions, as well as an extensive body of federal and international laws and regulations. The volume of new or modified laws and regulations has increased in recent years, and, in addition, individual cities and counties have begun to enact laws that restrict non-prime loan origination activities in those cities and counties. The laws and regulations of each of these jurisdictions are different, complex and, in some cases, in direct conflict with each other. As our operations continue to grow, it may be more difficult to comprehensively identify, to accurately interpret and to properly program our technology systems and effectively train our personnel with respect to all of these laws and regulations, thereby potentially increasing our exposure to the risks of noncompliance with these laws and regulations.

For example, certain provisions of Illinois law, known as the Illinois Interest Act, limit the charging of certain fees on mortgage loans with interest rates that exceed a specified threshold. On March 31, 2004, an Illinois appellate court held, in U.S. Bank, National Association, et al., v. Clark, et al., that the Illinois Interest Act was not preempted by federal law. Before this decision, prior case law and published positions of the Illinois Attorney General and the Illinois Office of Banks and Real Estate supported federal preemption of the Illinois Interest Act with respect to first priority mortgage loans. In reliance on that prior authority, some of the first priority mortgage loans we made in Illinois prior to the Clark decision had fees which may have exceeded the limit of the Illinois Interest Act. Damages for violation of the Illinois Interest Act include actual economic damage and an amount equal to twice the total of all interest, discount and charges determined by the loan contract or paid by the

obligor, whichever is greater. The Clark decision is currently on appeal to the Supreme Court of Illinois. If the Clark decision is not reversed on appeal, or if legislation overriding the holding of the Clark decision is not enacted, we could be materially and adversely affected by the potential liability from mortgage loans we made prior to the Clark decision which may be found to have been in violation of the Illinois Interest Act.

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In addition, recently enacted and changed laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new Securities and Exchange Commission regulations and stock exchange rules, are creating uncertainties for companies like ours. These new or changed laws, regulations and standards are subject to varying interpretations due, in many cases, to their lack of specificity. As their applications evolve over time and new guidance is provided by regulatory and governing bodies, we may incur higher costs of compliance resulting from ongoing revisions to our disclosure and governance practices.

Our failure to comply with these laws can lead to:

- civil and criminal liability;
- loss of approved status;
- demands for indemnification or loan repurchases from purchasers of our loans;
- class action lawsuits; and
- administrative enforcement actions.

Stockholder refusal to comply with regulatory requirements may interfere with our ability to do business in certain states.

Some states in which we operate may impose regulatory requirements on our officers and directors and persons holding certain amounts, usually 10% or more, of our common stock. If any person holding such an amount of our stock fails to meet or refuses to comply with a state s applicable regulatory requirements for mortgage lending, we could lose our authority to conduct business in that state.

We may be subject to fines or other penalties based upon the conduct of our independent brokers.

The mortgage brokers from which we obtain loans are subject to legal obligations which are parallel to, but separate from, the legal obligations that we are subject to as a lender. While these laws may not explicitly hold the originating lenders responsible for the legal violations of mortgage brokers, federal and state agencies have increasingly sought to impose such assignee liability.

For example, the United States Federal Trade Commission (FTC) entered into a settlement agreement with a mortgage lender in which the FTC characterized a broker that had placed all of its loan production with a single lender as the agent of the lender. The FTC imposed a fine on the lender in part because, as principal, the lender was legally responsible for the mortgage broker s unfair and deceptive acts and practices. Also, the United States Justice Department in the past has sought to hold a non-prime mortgage lender responsible for the pricing practices of its mortgage brokers, alleging that the mortgage lender was directly responsible for the total fees and charges paid by the borrower under the Fair Housing Act even if the lender neither dictated what the mortgage broker could charge nor kept the money for its own account. Accordingly, we may be subject to fines or other penalties based upon the conduct of our independent mortgage brokers.

We are no longer able to rely on the Alternative Mortgage Transactions Parity Act to preempt certain state law restrictions on prepayment penalties, and we may be unable to compete effectively with financial institutions that are exempt from such restrictions.

The value of a mortgage loan depends, in part, upon the expected period of time that the mortgage loan will be outstanding. If a borrower pays off a mortgage loan in advance of this expected period, the holder of the mortgage loan does not realize the full value expected to be received from the loan. However, a prepayment penalty payable by a borrower who repays a loan earlier than expected helps offset the reduction in value resulting from the early payoff. Consequently, the value of a mortgage loan is enhanced to the extent the loan includes a prepayment penalty, and a mortgage lender can offer a lower interest rate and/or lower loan fees on a loan which has a prepayment penalty. Prepayment penalties are an important feature to obtain value on the loans we originate.

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Certain state laws restrict or prohibit prepayment penalties on mortgage loans, and we have relied on the federal Alternative Mortgage Transactions Parity Act (the Parity Act) and related rules issued in the past by the Office of Thrift Supervision (the OTS) to preempt state limitations on prepayment penalties. The Parity Act was enacted to extend to financial institutions, other than federally chartered depository institutions, the federal preemption which federally chartered depository institutions enjoy. However, on September 25, 2002, the OTS released a new rule that reduced the scope of the Parity Act preemption as of July 1, 2003, preventing us from relying on the Parity Act to preempt state restrictions on prepayment penalties. The elimination of this federal preemption requires us to comply with state restrictions on prepayment penalties. This may place us at a competitive disadvantage relative to financial institutions that will continue to enjoy federal preemption of such state restrictions because such institutions will be able to charge prepayment penalties without regard to state restrictions and thereby may be able to offer loans with interest rate and loan fee structures that are more attractive than we are able to offer.

The increasing number of federal, state and local anti-predatory lending laws may restrict our ability to originate, or increase our risk of liability with respect to, certain mortgage loans and could increase our cost of doing business.

In recent years, several federal, state and local laws, rules and regulations have been adopted, or are under consideration, that are intended to eliminate so-called predatory lending practices. These laws, rules and regulations impose certain restrictions on loans on which certain points and fees or the annual percentage rate (APR) exceeds specified thresholds, commonly referred to as high cost loans. Some of these restrictions expose a lender to risks of litigation and regulatory sanction no matter how carefully a loan is underwritten. In addition, an increasing number of these laws, rules and regulations seek to impose liability for violations on purchasers of loans, regardless of whether a purchaser knew of or participated in the violation.

We have generally avoided and will continue to avoid originating high cost loans because the rating agencies generally will not rate securities backed by such loans, and the companies that buy our loans and/or provide financing for our loan origination operations generally do not want to buy or finance such loans. The continued enactment or adoption of these laws, rules and regulations may prevent us from making certain loans that we would otherwise make, may cause us to cease operations in certain jurisdictions altogether and may cause us to reduce the APR or the points and fees on loans that we do make. In addition, the difficulty of managing the risks presented by these laws, rules and regulations may decrease the availability of warehouse financing and the overall demand for non-prime loans, making it difficult to fund, sell or securitize any of our loans. If we decide to relax our restrictions on loans subject to these laws, rules and regulations, we will be subject to greater risks for actual or perceived non-compliance with such laws, rules and regulations, including demands for indemnification or loan repurchases from our lenders and loan purchasers, class action lawsuits, increased defenses to foreclosure of individual loans in default, individual claims for significant monetary damages, and administrative enforcement actions. If nothing else, the growing number of these laws, rules and regulations will increase our cost of doing business, as we are required to develop systems and procedures to ensure that we do not violate any aspect of these new requirements. Any of the foregoing could significantly harm our business, financial condition, liquidity and results of operations.

Risks Related to Our Capital Structure

Our guarantee of the Series A preferred shares of the REIT is senior to claims of our common stockholders.

Our guarantee of dividend and principal payments on the Series A preferred shares of the REIT is subordinate to all of our existing and future indebtedness but is senior to our common stock. As a result, upon any distribution to our creditors in a bankruptcy, liquidation or reorganization or similar proceeding, the holders of the Series A preferred shares will be entitled to be paid in full under the guarantee before any payment may be made to holders of our common stock.

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We are a holding company and our assets consist primarily of investments in our subsidiaries. Substantially all of our consolidated liabilities have been incurred by our subsidiaries. Therefore, our right to participate in the distribution of assets of any subsidiary upon the latter s liquidation or reorganization will be subject to prior claims of the subsidiary s creditors, including trade creditors, except to the extent that we may be a creditor with recognized claims against the subsidiary, in which case our claims would still be subject to the prior claims of any secured creditor of such subsidiary and of any holder of indebtedness of such subsidiary that is senior to that held by us.

If the REIT fails to maintain its status as a real estate investment trust, the REIT will be subject to federal and state income tax on taxable income at regular corporate rates, and the value of our common stock may be adversely impacted as a result.

The REIT was organized to qualify for taxation as a real estate investment trust under the Internal Revenue Code of 1986, as amended (the Code). The REIT has conducted, and intends to continue to conduct, its operations so as to qualify as a real estate investment trust. Qualification as a real estate investment trust involves the satisfaction of numerous requirements, some on an annual and some on a quarterly basis, established under highly technical and complex provisions of the Code for which there are only limited judicial and administrative interpretations and involves the determination of various factual matters and circumstances not entirely within the REIT s control. For instance, in order to qualify as a real estate investment trust, no more than 50% of the value of the outstanding shares of beneficial interest of the REIT may be beneficially owned, directly or indirectly, by five or fewer individuals (as defined in the Code to include certain entities) (the Ownership Test). Furthermore, each year the REIT must distribute to its shareholders at least 90% of the REIT s taxable income (the Annual Distribution Requirements). We cannot assure you that the REIT will at all times satisfy these rules and tests.

If the REIT were to fail to timely meet the Annual Distribution Requirements, satisfy the Ownership Test or otherwise qualify as a real estate investment trust in any taxable year, the REIT would be subject to federal and state income tax, including any applicable alternative minimum tax, on its taxable income at regular corporate rates. Moreover, unless entitled to relief under certain statutory provisions, the REIT would also be disqualified from treatment as a real estate investment trust for the four taxable years following the year during which the qualification is lost. This treatment would reduce the REIT s net earnings and cash flow available for distribution to shareholders, including to us as holder of the REIT s common shares, because of its additional tax liability for the years involved. Additionally, distributions to shareholders would no longer be required to be made by the REIT. Accordingly, the REIT s failure to qualify as a real estate investment trust could have a material adverse impact on our financial results and the value of the common stock held by our stockholders.

Moreover, in order to satisfy the Ownership Test, the REIT s Declaration of Trust establishes certain ownership restrictions on its shares of beneficial interest. For example, no individual (as described above) may beneficially own more than 9.8% of the value of the REIT. Even with this restriction, depending on the concentration of ownership of our stock and the relative value in the REIT s common and preferred shares, it is possible that our ownership of the REIT s common shares would cause the REIT to fail to satisfy the Ownership Test. In such a situation, the Declaration of Trust would require that the number of the REIT common shares held by us which causes the REIT to fail to satisfy the Ownership Test be transferred to a charitable trust at a price no greater than the fair market value of the REIT common shares as of such date, and we would have no future beneficial interest in such REIT common shares (including the right to vote or receive dividends on such REIT common shares).

The market price of our common stock could be volatile.

The market price for our common stock may fluctuate substantially due to a number of factors, including:

- the issuance of new equity securities pursuant to a future offering;

changes in interest rates;

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- competitive developments, including announcements by us or our competitors of new products or services or significant contracts, acquisitions, strategic partnerships, joint ventures or capital commitments;

- variations in quarterly operating results;

- changes in financial estimates and forecasts published by securities analysts;

- the depth and liquidity of the market for our common stock;

- investor perceptions of our company and the mortgage industry generally (including the non-prime and nonconforming mortgage industry); and

- general economic and other national conditions.

Some provisions of our certificate of incorporation and bylaws may deter takeover attempts, which may limit the opportunity of our stockholders to sell their shares at a favorable price.

Some of the provisions of our certificate of incorporation and bylaws could make it more difficult for a third party to acquire us, even if doing so might be beneficial to our stockholders by providing them with the opportunity to sell their shares possibly at a premium over the then market price.

For example, our board of directors is divided into three classes. At each annual meeting of stockholders, the terms of approximately one-third of the directors will expire, and new directors will be elected to serve for three years. The term of the first class expires at the 2007 annual meeting of stockholders, the term of the second class expires in 2005, and the term of the third class expires in 2006. Thus, it will take at least two annual meetings to effect a change in control of our board of directors because a majority of the directors cannot be elected at a single meeting, which may delay, discourage, prevent or make it more difficult or costly to acquire or effect a change in control, even if such a change in control would be favorable to our stockholders.

In addition, our certificate of incorporation authorizes the board of directors to issue up to 5,000,000 shares of preferred stock. The preferred stock may be issued in one or more series, the terms of which may be determined at the time of issuance by our board of directors without further action by the stockholders. These terms may include voting rights including the right to vote as a series on particular matters, preferences as to dividends and liquidation, conversion rights, redemption rights and sinking fund provisions. No shares of preferred stock are presently outstanding. The issuance of any preferred stock in the future could diminish the rights of holders of our common stock, and therefore could reduce the value of our common stock. In addition, specific rights granted to future holders of preferred stock could be used to restrict our ability to merge with, or sell assets to, a third party. The ability of our board of directors to issue preferred stock could delay, discourage, prevent or make it more difficult or costly to acquire or effect a change in control, even if such a change in control would be favorable to our stockholders.

Our bylaws contain provisions that require stockholders to act only at a duly-called meeting and make it difficult for any person other than management to introduce business at a duly-called meeting by requiring such other person to follow certain notice procedures.

Finally, we are also subject to Section 203 of the Delaware General Corporation Law which, subject to certain exceptions, prohibits a Delaware corporation from engaging in any business combination with any interested stockholder for a period of three years following the date that the stockholder became an interested stockholder. The preceding provisions of our certificate of incorporation and bylaws, as well as Section 203 of the Delaware General Corporation Law, could discourage potential acquisition proposals, or delay or prevent a change of control and prevent changes in our management, even if such things would be in the best interests of our stockholders.

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ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

See discussion under Market Risk in ITEM 2. Management s Discussion and Analysis of Financial Condition and Results of Operations.

ITEM 4. Controls and Procedures

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures. Accredited maintains controls and procedures designed to ensure that it is able to collect the information it is required to disclose in the reports it files with the SEC, and to process, summarize and disclose this information within the time periods specified in the rules and regulations of the SEC. As described in our Annual Report on Form 10-K for the year ended December 31, 2004, in connection with the audit of our financial statements for the year ended December 31, 2004, our management identified a material weakness in internal controls related to Accredited s accounting for cash flows from mortgage origination activities in its financial statements. In response to the identification of the material weakness, an adjustment to the financial statements was made by Accredited to properly classify on our statement of cash flows, cash used for origination of mortgage loans from cash flows from investing activities to cash flows from operating activities for the year ended December 31, 2004. As a result, our Chief Executive Officer and Chief Financial Officer believe that our cash flows as reported in our audited financial statements for the year ended December 31, 2004 and contained in our Annual Report on Form 10-K were in accordance with United States generally accepted accounting principals, or GAAP, and that the identified material weakness has been remediated. Based on an evaluation of Accredited s disclosure controls and procedures as of the end of the period covered by this report conducted by Accredited s management, Accredited s Chief Executive Officer and Chief Financial Officer believe that Accredited s disclosure controls and procedures were effective to ensure that Accredited is able to collect, process and disclose the information it is required to disclose in the reports it files with the SEC within the required time periods.

(b) Changes in Internal Controls. There were no changes in our internal control over financial reporting that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II

ITEM 1. Legal Proceedings

In December 2002, we were served with a complaint and motion for class certification in a class action lawsuit, *Wratchford et al. v. Accredited Home Lenders, Inc.,* brought in Madison County, Illinois under the Illinois Consumer Fraud and Deceptive Business Practices Act, the consumer protection statutes of the other states in which we do business and the common law of unjust enrichment. The complaint alleges that we have a practice of misrepresenting and inflating the amount of fees we pay to third parties in connection with the residential mortgage loans that we fund. The plaintiffs claim to represent a nationwide class consisting of others similarly situated, that is, those who paid us to pay, or reimburse our payments of, third-party fees in connection with residential mortgage loans and never received a refund for the difference between what they paid and what was actually paid to the third party. The plaintiffs are seeking to recover damages on behalf of themselves and the class, in addition to pre-judgment interest, post-judgment interest, and any other relief the court may grant. On January 28, 2005, the court issued an order conditionally certifying (1) a class of Illinois residents with respect to the alleged violation of the Illinois Consumer Fraud and Deceptive Business Practices Act who, since November 19, 1997, paid money to us for third-party fees in connection with residential mortgage loans and never received a refund of the difference between the amount they paid us and the amount we paid the third party and (2) a nationwide class of claimants with respect to an unjust enrichment cause of action included in the original complaint who, since November 19, 1997 paid money to us for third-party fees in connection with residential mortgage loans and never received a refund of the difference between the amount they paid us and the amount we paid the third party. The court conditioned its order limiting the statutory consumer fraud act claims to claimants in the State of Illinois on the outcome of a case pending before the Illinois Supreme Court in which one of the issues is the propriety of certifying a nationwide class based on the Illinois Consumer Fraud and Deceptive Business Practices Act. Our petition to have the court certify an interlocutory appeal of the class certification decision has been denied, but we continue to believe the court erred in certifying any class in this matter, and we intend to petition the Illinois Supreme Court for a supervisory order reversing the lower court s class certification decision. There has not yet been a ruling on that petition or the merits of either the plaintiffs individual claims or the claims of the class, and the ultimate outcome of this matter and the amount of liability, if any, that may result is not presently determinable. Accordingly, no amounts have been accrued in our financial statements with respect to this matter. We intend to continue to vigorously defend this matter and we do not believe it will have a material adverse effect on our business.

In January 2004, we were served with a complaint, *Yturralde v. Accredited Home Lenders, Inc.,* brought in Sacramento County, California. The named plaintiff is a former commissioned loan officer of ours, and the complaint alleges that we violated California and federal law by misclassifying the plaintiff and other non-exempt employees as exempt employees, failing to pay the plaintiff on an hourly basis and for overtime worked, and failing to properly and accurately record and maintain payroll information. The plaintiff seeks to recover, on behalf of himself and all of our other similarly situated current and former employees, lost wages and benefits, general damages, multiple statutory penalties and interest, attorneys fees and costs of suit, and also seeks to enjoin further violations of wage and overtime laws and retaliation against employees who complain about such violations. We have been served with eleven substantially similar complaints on behalf of certain other former and current employees, which have been consolidated with the *Yturralde* action. We have appealed the court s denial of our motion to compel arbitration of the consolidated cases, and a resolution of that appeal is not expected before early 2006. In the meantime, discussions are ongoing between the parties regarding potential settlement or mediation of the claims, and we have pursued and effected settlements directly with many current and former employees covered by the allegations of the complaints. A motion to certify a class has not yet been filed, and there has been no ruling on the merits of either the plaintiffs individual claims or the claims of the putative class. We do not believe these matters will have a material adverse effect on our business, but, at the present time, the ultimate outcome of the litigation and the total amount of liability is not determinable. As a result, we have not accrued any amounts in our financial statements with respect to the litigation, except for accrued amounts relating to settlements effected with current and former employees.

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In June 2005, we were served with a complaint, *Williams et al. v. Accredited Home Lenders, Inc.,* brought in United States District Court for the Northern District of Georgia. The two named plaintiffs are former commissioned loan officers of ours, and the complaint alleges that we violated federal law by requiring the plaintiffs to work overtime without compensation. The plaintiffs seek to recover, on behalf of themselves and other similarly situated employees, the allegedly unpaid overtime, liquidated damages, attorneys fees and costs of suit. A motion to certify a collective class has not yet been filed, and there has been no ruling on the merits of either the plaintiffs individual claims or the claims of the putative class, and the ultimate outcome of this matter and the amount of liability, if any, which may result is not presently determinable. Accordingly, no amounts have been accrued in our financial statements with respect to this matter. We intend to vigorously defend this matter and do not believe it will have a material adverse effect on our business.

In addition, because the nature of our business involves the collection of numerous accounts, the validity of liens and compliance with various state and federal lending laws, we are subject to various legal proceedings in the ordinary course of business related to foreclosures, bankruptcies, condemnation and quiet title actions, and alleged statutory and regulatory violations. We are also subject to legal proceedings in the ordinary course of business related to employment matters. We do not believe that the resolution of these lawsuits will have a material adverse effect on our financial position or results of operations.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

ITEM 3. Defaults Upon Senior Securities

None.

ITEM 4. Submission of Matters to a Vote of Security Holders

On May 26, 2005, the Company held its Annual Meeting of Stockholders. At this meeting, Ray W. McKewon, James H. Berglund and Joseph J. Lydon were elected to the Board of Directors as Class II Directors, receiving 15,980,627 votes in favor of Mr. McKewon, 17,438,098 votes in favor of James H. Berglund and 17,274,702 votes in favor of Joseph J. Lydon. There were no votes against Mr. McKewon, Mr. Berglund or Mr. Lydon and the abstentions were 1,575,612, 118,141 and 281,537 respectively. In accordance with his previously announced plans, Mr. McKewon retired as a director and officer of the Company effective July 15, 2005.

Also at the meeting, Deloitte & Touche LLP (Deloitte) was ratified as the Company s independent auditors. There were 15,763,138 votes cast for the ratification of Deloitte, 1,789,487 votes were cast against, with 3,614 abstentions. Following the meeting, on June 14, 2005, the Company dismissed Deloitte and engaged Grant Thornton LLP to serve as the Company s independent registered public accounting firm for the 2005 fiscal year. The decision to change accounting firms was approved by the Audit Committee of the Company s Board of Directors.

ITEM 5. Other Information

None.

ITEM 6. Exhibits

For a list of exhibits filed with this Quarterly Report on Form 10-Q, refer to the Exhibit Index beginning on page 79.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: August 9, 2005

ACCREDITED HOME LENDERS HOLDING CO.

BY: /s/ JAMES A. KONRATH

James A. Konrath

Chairman of the Board and Chief Executive Officer

(Principal Executive Officer)

BY: /s/ JOHN S. BUCHANAN

John S. Buchanan

Chief Financial Officer

(Principal Financial and Accounting Officer)

EXHIBIT INDEX

2.1[1]	Agreement and Plan of Merger.
3.1[2]	Amended and Restated Certificate of Incorporation of the Registrant.
3.2[2]	Bylaws of the Registrant.
4.1[2]	Specimen Common Stock Certificate.
4.2[3]	Second Amended and Restated Investors Rights Agreement.
4.3[4]	Articles Supplementary to Declaration of Trust of Accredited Mortgage Loan REIT Trust Dated August 11, 2004.
4.4[5]	Articles Supplementary to Declaration of Trust of Accredited Mortgage Loan REIT Trust Dated October 4, 2004.
4.5[4]	Guarantee Agreement of Accredited Home Lenders Holding Co., dated as of August 12, 2004.
4.6[5]	Guarantee Agreement of Accredited Home Lenders Holding Co., dated as of October 6, 2004.
10.1[6]	Office Lease between Kilroy Realty, L.P. and Accredited Home Lenders, Inc., dated as of June 6, 2005.
10.2	Executive Employment Agreement between Accredited Home Lenders, Inc. and Stuart Marvin effective as of April 11, 2005.
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1[7]	Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350).
32.2[7]	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350).

(1) Filed with Form 10-K for the fiscal year ended December 31, 2002.
(2) Filed with amendment number 3 to Registration Statement on Form S-1 (File No. 333-91644) dated November 12, 2002.
(3) Filed with amendment number 1 to Registration Statement on Form S-1 (File No. 333-91644) dated August 20, 2002.
(4) Filed with Current Report on Form 8-K (File No. 000-50179) dated August 9, 2004.
(5) Filed with Current Report on Form 8-K (File No. 001-32275) dated October 1, 2004.
(6) Filed with Current Report on Form 8-K (File No. 000-50179) dated June 9, 2005.
(7) The information contained in these certifications is furnished to the Securities and Exchange Commission pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not be incorporated by reference into any filing with the Securities and Exchange Commission made by the Company whether before or after the date hereof, regardless of any general incorporation language in such filing.