

IMPAC MORTGAGE HOLDINGS INC  
Form 10-Q  
September 15, 2008  
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## UNITED STATES

## SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## FORM 10-Q

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

For the quarterly period ended June 30, 2008 or

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

For the transition period from                    to                    .

Commission File Number: 1-14100

## IMPAC MORTGAGE HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

Maryland

33-0675505

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(State or other jurisdiction of  
incorporation or organization)

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

**19500 Jamboree Road, Irvine, California 92612**

**(Address of principal executive offices)**

**(949) 475-3600**

**(Registrant's telephone number, including area code)**

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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

There were 76,096,392 shares of common stock outstanding as of September 12, 2008.

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**IMPAC MORTGAGE HOLDINGS, INC.**

**FORM 10-Q QUARTERLY REPORT**

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(in thousands, except share data)

	June 30, 2008 (Unaudited)	December 31, 2007
<b>ASSETS</b>		
Cash and cash equivalents	\$ 25,971	\$ 24,387
Trust assets		
Investment securities available-for-sale	8,644	15,248
Securitized mortgage collateral (at fair value at June 30, 2008)	11,055,382	16,532,633
Derivative assets	109	7,497
Real estate owned (REO) at net realizable value	621,433	400,863
Total trust assets	11,685,568	16,956,241
Assets of discontinued operations	203,320	353,250
Other assets	48,684	57,194
Total assets	\$ 11,963,543	\$ 17,391,072
<b>LIABILITIES</b>		
Trust liabilities		
Securitized mortgage borrowings (at fair value at June 30, 2008)	\$ 11,497,132	\$ 17,780,060
Derivative liabilities	136,580	127,757
Total trust liabilities	11,633,712	17,907,817
Trust preferred securities (at fair value at June 30, 2008)	46,266	98,398
Liabilities of discontinued operations	253,334	405,341
Other liabilities	5,723	57,244
Total liabilities	11,939,035	18,468,800
Commitments and contingencies		
<b>STOCKHOLDERS EQUITY</b>		
Series-A junior participating preferred stock, \$0.01 par value; 2,500,000 shares authorized; none issued and outstanding		
Series-B 9.375% cumulative redeemable preferred stock, \$0.01 par value; liquidation value \$50,000; 2,000,000 shares authorized, issued and outstanding	20	20
Series-C 9.125% cumulative redeemable preferred stock, \$0.01 par value; liquidation value \$111,765; 5,500,000 shares authorized; 4,470,600 shares issued and outstanding as of June 30, 2008 and December 31, 2007	45	45

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Common stock, \$0.01 par value; 200,000,000 shares authorized; 76,096,392 shares issued and outstanding as of June 30, 2008 and December 31, 2007	761	761
Additional paid-in capital	1,175,125	1,173,562
Accumulated other comprehensive income		1,028
Net accumulated deficit:		
Cumulative dividends declared	(811,355)	(803,912)
Retained deficit	(340,088)	(1,449,232)
Net accumulated deficit	(1,151,443)	(2,253,144)
Total stockholders' equity (deficit)	24,508	(1,077,728)
Total liabilities and stockholders' equity	\$ 11,963,543	\$ 17,391,072

See accompanying notes to consolidated financial statements.

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## IMPAC MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF OPERATIONS

## AND COMPREHENSIVE EARNINGS (LOSS)

(in thousands, except per share data)

(Unaudited)

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2008	2007	2008	2007
<b>INTEREST INCOME:</b>				
Total interest income	\$ 407,855	\$ 316,443	\$ 679,811	\$ 621,191
<b>INTEREST EXPENSE:</b>				
Total interest expense	403,599	308,569	668,206	605,374
Net interest income	4,256	7,874	11,605	15,817
Provision for loan losses		161,163		190,295
Net interest income (expense) after provision for loan losses	4,256	(153,289)	11,605	(174,478)
<b>NON-INTEREST INCOME:</b>				
Change in fair value of derivative instruments		91,670		73,672
Change in fair value of net trust assets, excluding REO	(11,161)		(7,633)	
Change in fair value of trust preferred securities	(997)		(5,020)	
Losses from real estate owned	(4,830)	(19,328)	(9,086)	(29,220)
Real estate advisory fees	4,696		8,540	
Other	1,544	(1,538)	3,442	3,749
Total non-interest (expense) income	(10,748)	70,804	(9,757)	48,201
<b>NON-INTEREST EXPENSE:</b>				
General and administrative	4,925	4,451	8,912	9,960
Personnel expense	2,820	1,620	5,150	2,464
Total non-interest expense	7,745	6,071	14,062	12,424
Net loss from continuing operations	(14,237)	(88,556)	(12,214)	(138,701)
Income tax expense from continuing operations	2,202	4,969	8,728	8,956
Net loss from continuing operations	(16,439)	(93,525)	(20,942)	(147,657)
Net loss from discontinued operations, net of tax	(11,048)	(59,022)	(10,360)	(126,558)
Net loss	(27,487)	(152,547)	(31,302)	(274,215)
Cash dividends on cumulative redeemable preferred stock	(3,722)	(3,722)	(7,443)	(7,443)
Net loss available to common stockholders	\$ (31,209)	\$ (156,269)	\$ (38,745)	\$ (281,658)

See accompanying notes to consolidated financial statements.

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	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2008	2007	2008	2007
Net loss	\$ (27,487)	\$ (152,547)	\$ (31,302)	\$ (274,215)
Net unrealized losses on securities:				
Unrealized holding losses arising during year		(1,656)		(2,718)
Reclassification of losses included in net earnings		1,596		1,596
Net unrealized losses		(60)		(1,122)
Comprehensive loss	\$ (27,487)	\$ (152,607)	\$ (31,302)	\$ (275,337)
Net loss per common share - Basic:				
Loss from continuing operations	\$ (0.26)	\$ (1.28)	\$ (0.37)	\$ (2.04)
Loss from discontinued operations	(0.15)	(0.78)	(0.14)	(1.66)
Net loss per share	\$ (0.41)	\$ (2.05)	\$ (0.51)	\$ (3.70)
Net loss per common share - Diluted:				
Loss from continuing operations	\$ (0.26)	\$ (1.28)	\$ (0.37)	\$ (2.04)
Loss from discontinued operations	(0.15)	(0.78)	(0.14)	(1.66)
Net loss per share	\$ (0.41)	\$ (2.05)	\$ (0.51)	\$ (3.70)
Dividends declared per common share	\$	\$	\$	\$ 0.10

See accompanying notes to consolidated financial statements.



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## IMPAC MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	For the Six Months Ended June 30,	
	2008	2007
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net loss from continuing operations	\$ (20,942)	\$ (147,657)
Provision for loan losses		190,295
Provision for REO losses	14,323	28,074
Loss (gain) on sale of REO	(5,237)	1,145
Amortization of deferred charge, net	8,728	9,069
Amortization of debt issuance costs and mortgage servicing rights	948	807
Amortization of premiums and securitization costs		84,863
Change in fair value of derivative instruments	12,144	1,354
Change in fair value of net trust assets, excluding REO and derivatives	(75,878)	
Change in fair value of trust preferred securities	5,020	
Accretion of interest income and expense	(25,191)	
Stock-based compensation	653	812
Net change in accrued interest receivable		(547)
Net cash provided by (used in) operating activities of discontinued operations	91,219	(3,157,915)
Net change in other assets and liabilities	(41,444)	(8,968)
<b>Net cash used in operating activities</b>	<b>(35,657)</b>	<b>(2,998,668)</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Securitized mortgage collateral	1,342,015	3,468,817
Mortgages held-for-investment	22	(3,229)
Purchase of premises and equipment	386	(873)
Principal change on investment securities available-for-sale	1,196	6,404
Proceeds from the sale of real estate owned	197,796	76,532
Net cash provided by (used in) investing activities of discontinued operations	11,805	191,664
<b>Net cash provided by investing activities</b>	<b>1,553,220</b>	<b>3,739,315</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Cash disbursements under reverse repurchase agreements		(90,642)
Cash receipts from reverse repurchase agreements		92,392
Proceeds from securitized mortgage borrowings		3,858,143
Repayment of securitized mortgage borrowings	(1,393,987)	(4,323,044)
Common stock dividends paid		(30,326)
Preferred stock dividends paid	(7,443)	(7,443)
Proceeds from sale of cumulative redeemable preferred stock		608
Net cash (used in) provided by investing activities of discontinued operations	(116,465)	(306,831)
<b>Net cash used in financing activities</b>	<b>(1,517,895)</b>	<b>(807,143)</b>
Net change in cash and cash equivalents	(332)	(66,496)
Cash and cash equivalents at beginning of period	26,462	179,677
Cash and cash equivalents at end of period - Continuing Operations	25,971	107,083

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Cash and cash equivalents at end of period - Discontinued Operations		159		6,098
Cash and cash equivalents at end of period	\$	26,130	\$	113,181

See accompanying notes to consolidated financial statements.

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	For the Six Months Ended June 30,	
	2008	2007
<b>SUPPLEMENTARY INFORMATION (Continuing and Discontinued Operations):</b>		
Interest paid	\$ 315,545	\$ 651,736
Taxes paid		116
<b>NON-CASH TRANSACTIONS (Continuing and Discontinued Operations):</b>		
Accumulated other comprehensive loss	\$	\$ (1,122)
Transfer of loans held-for-sale and held-for-investment to real estate owned		20,872
Transfer of securitized mortgage collateral to real estate owned	435,038	255,051
Transfer of loans held-for-sale to securitized mortgage collateral		3,245,500
Transfer of securitized mortgage collateral to loans held-for-sale		27,040

See accompanying notes to consolidated financial statements.

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**IMPAC MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

(dollars in thousands, except per share data or as otherwise indicated)

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

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

***Business Summary***

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

During late 2007, the Company's board of directors elected to discontinue the non-conforming mortgage operations conducted by IFC, commercial operations conducted by ICCC, retail mortgage operations conducted by IHL, and warehouse lending operations conducted by IWLG.

The Company consists of the continuing operations which includes the long-term mortgage portfolio (residual interests in securitizations) conducted by IMH and IMH Assets, master servicing portfolio conducted by IFC and real estate advisory fees from IMH's advisory services agreement with a real estate marketing company.

The information contained throughout this document is presented on a continuing basis, unless otherwise stated.

***Financial Statement Presentation***

The accompanying unaudited consolidated financial statements of IMH and its subsidiaries (as defined above) have been prepared in accordance with Accounting Principles Generally Accepted in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring adjustments considered necessary for a fair presentation, have been included. Operating results for the three-month and six month periods ended June 30, 2008 are not

necessarily indicative of the results that may be expected for the year ending December 31, 2008.

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

Management has made a number of estimates and assumptions relating to the reporting of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period to prepare these consolidated financial statements in conformity with GAAP. The items affected by management's estimates and assumptions include the valuation of trust assets and liabilities (including investment securities available-for-sale), the valuation of repurchase liabilities related to sold loans, the valuation of trust preferred securities, and the valuation of loans held-for-sale. Actual results could differ from those estimates.

***Market Conditions, Status of Operations, Liquidity and Capital Resources***

In 2007 and 2008, management has been seriously challenged by the unprecedented turmoil in the mortgage market, including the following: significant increases in delinquencies and foreclosures; significant increases in credit-related losses; decline in originations; tightening of warehouse credit and the virtual elimination of the market for loan securitizations. As a result, the Company discontinued certain operations, resolved and terminated all but one of the Company's reverse repurchase facilities and settled a portion of its outstanding repurchase claims, while also reducing its operating costs and liabilities. In the first quarter of 2008, the Company also entered into an agreement with a real estate marketing company to generate advisory fees.

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As describes in Note L, in September 2008, the Company executed definitive agreements, which require scheduled principal paydowns and remove any and all technical defaults that existed under the previous reverse repurchase facility.

In order to reduce dividend payments on its preferred stock, the Company is considering exchanging the preferred stock for common stock. In July 2008, the Company's stockholders approved the potential issuance of common shares in excess of 20 percent of the existing common shares.

The Company earns advisory fees from a real estate marketing company specializing in the marketing and disposition of foreclosed properties. During the three and six months ended June 30, 2008, the Company earned \$4.7 million and \$8.5 million, respectively, from this relationship. The amount of real estate advisory fees the Company receives from this relationship are based on numerous factors, including real estate market conditions, the level of foreclosure activity, the ability of the marketing company to attract new business, and the Company retaining its CEO and avoiding liquidation. The agreement terminates in 2010 with the Company having an option to extend the agreement for an additional three years.

In July 2008, the Company executed a letter of intent, subject to execution of definitive agreements, to acquire a special servicing platform, whereby the seller will contribute specified balances of loans (mostly distressed) to the platform in order to provide sufficient cash flows to maintain the business during its initial operations.

There can be no assurance that the Company will be successful in executing the agreements outlined above. Also, there can be no assurance that the restructuring of the trust preferred securities or the preferred stock will occur. In this event, the Company intends to reduce operating expenses to a level that is supportable by the revenues from the existing long-term mortgage portfolio (residual interests in securitizations), master servicing portfolio and real estate advisory fees. Nevertheless, if the Company is not successful in completing the objectives outlined above, it may not be able to meet its contractual obligations for the next year, including repayment of the reverse repurchase line, interest payments on trust preferred securities and preferred stock dividends.

## **2. Adoption of New Accounting Standards**

### **Adoption of SFAS 157 Fair Value Measurements**

The Company prospectively adopted the provisions of Financial Accounting Standards Board (FASB) Statement No. 157 Fair Value Measurements (SFAS 157), as of January 1, 2008. SFAS 157 defines fair value, expands disclosure requirements around fair value and specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's market assumptions. These two types of inputs create the following fair value hierarchy:

- Level 1 Quoted prices for identical instruments in active markets.

- Level 2 Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets.
- Level 3 Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

This hierarchy requires the Company to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value.

For some products or in certain market conditions, observable inputs may not always be available. Through the second quarter of 2008, certain markets remained illiquid, and some key observable inputs used in valuing certain exposures were unavailable. When and if these markets are liquid, the Company will use the related observable inputs available at that time from these markets.

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Under fair value accounting, the Company is required to take into account its own credit risk when measuring the fair value of assets and liabilities.

**Adoption of SFAS 159 - Fair Value Option**

The adoption of Statement No. 159 The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159) has also resulted in new valuation techniques used by the Company when determining fair value, most notably to value its securitized mortgage collateral and borrowings and trust preferred securities, which had not previously been carried at fair value. The Company prospectively adopted SFAS 159 as of January 1, 2008. SFAS 159 provides an option on an instrument-by-instrument basis for most financial assets and liabilities to be reported at fair value with changes in fair value reported in earnings. After the initial adoption, the election is made at the acquisition of a financial asset, financial liability, or a firm commitment and it may not be revoked. Management believes that the adoption of SFAS 159 provides an opportunity to mitigate volatility in reported earnings and provides a better representation of the economics of the trust assets and liabilities.

Under the SFAS 159 transition provisions, the Company elected to apply fair value accounting to certain financial instruments (certain trust assets, trust liabilities and trust preferred securities) held at January 1, 2008. Differences between the December 31, 2007 carrying values and the January 1, 2008 fair values were recognized as an adjustment to retained deficit. The adoption of SFAS 159 resulted in a \$1.1 billion decrease to retained deficit on January 1, 2008 from \$(1.4) billion at December 31, 2007 to \$(308.8) million at January 1, 2008.

As a result of deterioration in the real estate market since the second half of 2007, the Company significantly added to its allowance for loan losses during the third and fourth quarters of 2007. Principally, because of the increase in the allowance for loan losses, the Company reported a stockholders' deficit as of December 31, 2007. This stockholders' deficit was created primarily because the Company was required under GAAP to record an allowance for loan losses that reduced securitized mortgage collateral in its consolidated trusts below the balance of the related securitized mortgage borrowings, resulting in a negative investment in certain consolidated trusts, even though the related trust agreements are nonrecourse to the Company. However, with the adoption of SFAS 159, the Company's net investment position is unable to go below zero since the related trust liabilities are also recorded at fair value. Therefore the difference between the fair value of the trust assets and trust liabilities represents the net investment interests (residual interests in securitizations) in the trust at fair value.

The following table summarizes the initial retained earnings charge related to the prospective adoption SFAS 159 as of January 1, 2008 and the related fair value balances as of January 1, 2008.

	Ending Balance as of December 31, 2007 (Prior to Adoption)	Adoption Net Gain/(Loss)	Fair Value Balance as of January 1, 2008 (After Adoption) (5)
Impact of electing the fair value option under SFAS 159:			
Investment securities available-for-sale	\$ 15,248	\$ 1,028(1)	\$ 15,248
Securitized mortgage collateral (2)	16,532,633	(821,311)	15,711,322
Securitized mortgage borrowings (3)	(17,780,060)	1,903,283	(15,876,777)
Trust preferred securities	(98,398)	57,446	(40,952)
Cumulative-effect adjustment (pre-tax)		1,140,446	
Tax impact (4)			
Cumulative-effect adjustment to reduce retained deficit		<b>\$ 1,140,446</b>	



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Total retained deficit as of December 31, 2007		(1,449,232)
Cumulative-effect adjustment to reduce retained deficit	\$	1,140,446
Total retained deficit as of January 1, 2008 (6)	\$	<b>(308,786)</b>

- 
- (1) Investment securities available-for-sale are recorded at fair value at December 31, 2007, with a corresponding \$1,028 thousand unrealized gain included in accumulated other comprehensive income. Included in the cumulative-effect adjustment was \$1,028 thousand in unrealized holding gains that were reclassified from accumulated other comprehensive income to retained deficit. Due to the effect of reclassifying the \$1,028 thousand from accumulated other comprehensive income to retained deficit, the investment securities available-for-sale balances do not add across.

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- (2) Components of securitized mortgage collateral at December 31, 2007 include the allowance for loan loss of \$1.2 billion, accrued interest of \$99.7 million and premiums of \$183.1 million, which were part of its fair value for the adoption of SFAS 159. At June 30, 2008 and December 31, 2007, securitized mortgage collateral included \$10.1 million and \$9.1 million, respectively in master servicing rights, recorded at the lower of cost or market, related to consolidated securitizations and recorded at the lower of cost or market.
- (3) Components of securitized mortgage borrowings at December 31, 2007 include accrued interest of \$17.1 million and securitization costs of \$37.5 million, which were part of its fair value for the adoption of SFAS 159.
- (4) There was no tax effect of the adoption of SFAS 159 as the Company qualifies as a REIT for federal income tax purposes and its tax liabilities are only related to its deferred charges associated with previous inter-company loan sales.
- (5) The securitized mortgage collateral and securitized mortgage borrowings include the mortgage insurance and bond insurance proceeds to be received from third parties.
- (6) As of January 1, 2008, after adoption of SFAS 159, total stockholder's equity was \$61.7 million

**Changes in Significant Accounting Policies**

*Investment Securities Available-for-Sale*

The Company elected to continue to account for all of its existing investment securities available-for-sale at fair value. Interest income is recorded based on the effective yield for the period based on the valuation of the previous quarter. Net gains and losses resulting from changes in fair value of investment securities available-for-sale are recorded within change in fair value of net trust assets in the Company's consolidated statement of operations.

The Company's election to account for its investment securities available-for-sale at fair value was based on the Company's overall objective of moving toward fair value accounting for significant financial assets and liabilities. The election of SFAS 159 for these investment securities results in increased volatility within net earnings as a result of the recognition of fair value changes with no offsetting amounts that would result if these assets were economically hedged. However, management believes that electing fair value accounting for its investment securities results in a stronger reflection of the value, while furthering its objective of migrating toward fair value accounting.

*Securitized Mortgage Collateral and Borrowings*

The Company elected to account for certain of its securitized assets at fair value. Interest income on securitized mortgage collateral and interest expense on securitized mortgage borrowings, respectively, is recorded based on the effective yield for the period based on the previous quarter's valuation resulting in interest income and expense accretion. Net gains (losses) resulting from the changes in fair value of these items, are included in non-interest income in the Company's consolidated statement of operations. Electing the fair value option allows the Company to avoid the burden of recording losses on collateral for which the Company will not ultimately bare the loss. In addition, recording the collateral and borrowings at fair value will help to reflect the true economics of the transactions within the consolidated statement of operations. Upon the adoption of SFAS 159, all deferred costs associated with securitized mortgage collateral and borrowings have been recognized as a cumulative effect of a change in accounting principle within retained deficit as of January 1, 2008.

*Trust Preferred Securities*

The Company elected to account for all of its trust preferred securities at fair value. Interest expense on these items is recorded based on the effective yield for the period. Gains and losses resulting from the changes in fair value of these items are recorded within change in fair value of trust preferred securities in the Company's consolidated statement of operations.

The Company's election to account for its trust preferred securities at fair value was based on the Company's overall objective of moving toward fair value accounting for significant financial assets and liabilities. The election of SFAS 159 for these liabilities results in increased volatility within net earnings as a result of the recognition of fair value changes with no offsetting amounts that would result if these liabilities were economically hedged. However, management believes that electing fair value accounting for its trust preferred securities results in a stronger reflection of the value, while furthering its objective to migrate toward fair value accounting.

### **3. Recent Accounting Pronouncements**

In March 2008, the FASB issued Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (SFAS 161), an amendment of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133), to expand disclosure requirements for an entity's derivative and hedging activities. Under SFAS 161, entities are required to provide enhanced disclosures about how and why an entity uses derivative instruments, how derivative

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instruments and related hedged items are accounted for under SFAS 133 and its related interpretations, and how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. In order to meet these requirements, entities shall include qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008 with early adoption encouraged. The Company plans to adopt this Statement on January 1, 2009, and there should be no impact on the consolidated financial statements as this Statement only addresses disclosures.

In April 2008, the FASB voted to eliminate qualifying special purpose entities (QSPEs) from the guidance in FASB Statement No. 140 Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities (SFAS 140). While the revised standard has not been finalized and the FASB's proposals will be subject to a public comment period, this change may have a significant impact on the Company's consolidated financial statements as it may lose sales treatment for assets previously sold to a QSPE, as well as for future sales. An effective date for any proposed revisions has not been determined by the FASB. As of June 30, 2008, the current principal balance of QSPEs to which the Company, acting as principal, has transferred assets and received sales treatment were \$727.1 million. The Company's investment in these QSPEs consists of residual interests accounted for as investment securities available-for-sale in its consolidated balance sheets.

In connection with the proposed changes to SFAS 140, the FASB also is proposing three key changes to the consolidation model in FASB Interpretation No. 46(R), Consolidation of Variable Interest Entities (revised December 2003) an interpretation of ARB No. 51 (FIN 46(R)). First, the FASB will now include former QSPEs in the scope of FIN 46(R). In addition, the FASB supports amending FIN 46(R) to change the method of analyzing which party to a variable interest entity (VIE) should consolidate the VIE to a primarily qualitative determination of control instead of today's risks and rewards model. Finally, the proposed amendment is expected to require all VIEs and their primary beneficiaries to be reevaluated quarterly. The previous rules required reconsideration only when specified reconsideration events occurred. As of June 30, 2008, the current principal balance of significant unconsolidated VIEs with which the Company is involved were approximately \$727.1 million.

The Company will be evaluating the impact of these changes on the Company's consolidated financial statements once the standard is approved and issued.

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

The Company is party to litigation and claims which are normal in the course of its operations. While the results of such litigation and claims cannot be predicted with certainty, the Company believes the final outcome of such matters will not have a material adverse effect on the Company's financial condition or results of operations.

On November 9, 2007, and separately on August 25, 2008, two matters were filed against IFC in Orange County in the Superior Court of California, as case nos. 07CC11612 and 00110553, respectively, by Citimortgage, Inc., alleging claims for breach of contract and damages based upon representations and warranties made in conjunction with whole loan sales. These actions seek combined damages in excess of \$4.2 million.

On June 28, 2008 a matter was filed against IFC in the Circuit Court of the Eighteenth Judicial District, Dupage County in Illinois, as case no. 2008L000721, by TR Mid America Plaza Corp., seeking damages for breach of contract (a lease agreement) in excess of \$0.6 million plus such

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amount as determined through the date of judgment and payment of attorneys fees and costs.

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

Please refer to IMH s report on Form 10-K for the year ended December 31, 2007 for a description of other litigation and claims.

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**5. Income Taxes and Deferred Charge**

In accordance with Accounting Research Bulletin No. 51, Consolidated Financial Statements, the Company records a deferred charge representing the deferral of income tax expense on inter-company profits that resulted from the sale of mortgages from taxable subsidiaries to IMH in prior years. The deferred charge is included in other assets in the accompanying consolidated balance sheets and is amortized as a component of income tax expense in the accompanying consolidated statements of operations over the estimated life of the mortgages retained in the securitized mortgage collateral. The Company recorded a tax provision of \$2.2 million and \$8.7 million for the three and six months ending June 30, 2008 and \$5.0 million and \$9.0 million for the three and six months ending June 30, 2007, respectively. The net provision is predominately the result of the amount of the deferred charge amortized and/or impaired resulting from credit losses, which does not result in any tax liability required to be paid.

**Note B Fair Value of Financial Instruments**

The Company's consolidated financial statements include financial assets and liabilities that are measured based on their estimated fair values. The use of fair value to measure the Company's financial instruments is fundamental to its consolidated financial statements and is a critical accounting estimate because a substantial portion of its assets and liabilities are recorded at estimated fair value.

The application of fair value estimates may be on a recurring or nonrecurring basis depending on the accounting principles applicable to the specific asset or liability or whether management has elected to carry the item at its estimated fair value as discussed previously.

Effective January 1, 2008, the Company adopted two pronouncements affecting its fair value measurements and accounting: SFAS 157 and SFAS 159.

SFAS 157 defines fair value as the price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS 157 establishes a three-tiered fair value hierarchy that prioritizes the inputs used to estimate fair value into three broad levels, considering the relative reliability of the inputs:

- **Level 1** Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include debt and equity securities and derivative contracts that are traded in an active exchange market, as well as certain U.S. treasury, other U.S. Government and agency mortgage-backed debt securities that are highly liquid and are actively traded in over-the-counter markets.

- **Level 2** Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable

market data for substantially the full term of the assets or liabilities. Level 2 assets and liabilities include securities with quoted prices that are traded less frequently than exchange-traded instruments, securities and derivative contracts and financial liabilities whose value is determined using a pricing model with inputs that are observable in the market or can be derived principally from or corroborated by observable market data. This category generally includes trust assets or liabilities where more than a significant percentage of the fair values were derived using a pricing process that was based upon observable inputs.

- Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. This category includes those assets and liabilities that were not included in Level 1 or Level 2.

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The following table presents for each of these hierarchy levels, the Company's assets and liabilities that are measured at fair value on a recurring basis, including financial instruments for which the Company has elected the fair value option at June 30, 2008.

	Recurring Fair Value Measurements At June 30, 2008			
	Level 1	Level 2	Level 3	Total
<b>Assets</b>				
Investment securities available-for-sale	\$	\$	\$ 8,644	\$ 8,644
Securitized mortgage collateral (1)		10,747,133	298,189	11,045,322
<b>Total Assets at Fair Value</b>	<b>\$</b>	<b>\$ 10,747,133</b>	<b>\$ 306,833</b>	<b>\$ 11,053,966</b>
<b>Liabilities</b>				
Securitized mortgage borrowings	\$	\$ 11,180,164	\$ 316,968	\$ 11,497,132
Derivative liabilities, net (2)		136,471		136,471
Trust preferred securities			46,266	46,266
<b>Total Liabilities at Fair Value</b>	<b>\$</b>	<b>\$ 11,316,635</b>	<b>\$ 363,234</b>	<b>\$ 11,679,869</b>

- (1) Excluded from securitized mortgage collateral above is \$10.1 million in master servicing rights related to consolidated securitizations and recorded at the lower of cost or market.
- (2) Derivative liabilities, net includes \$109 thousand in derivative assets and \$136.6 million in derivative liabilities, included within trust assets and trust liabilities, respectively.

Level 3 assets and liabilities were 2.6 percent and 3.0 percent of total assets at fair value and total liabilities at fair value, respectively.

The following tables present a reconciliation for all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three and six months ended June 30, 2008:

	Level 3 Recurring Fair Value Measurements Three Months Ended June 30, 2008					
	Fair Value - March 31, 2008	Total Gains (Losses) Included in Earnings	Transfers in and/or out of Level 3	Purchases, issuances and settlements	Fair Value - June 30, 2008	Unrealized gains (losses) still held (1)
Investment securities available-for-sale	\$ 10,621	\$ (1,318)	\$	\$ (659)	\$ 8,644	\$ (1,977)
Securitized mortgage collateral	966,958	12,581	(645,986)	(35,364)	298,189	(22,783)
Securitized mortgage borrowings	(998,395)	(12,388)	661,157	32,658	(316,968)	20,270
Trust preferred securities	(45,129)	(1,137)			(46,266)	(1,137)

	Level 3 Recurring Fair Value Measurements Six Months Ended June 30, 2008					
	Fair Value - January 1, 2008	Total Gains (Losses) Included in	Transfers in and/or out of Level 3	Purchases, issuances and settlements	Fair Value - June 30, 2008	Unrealized gains (losses) still held (1)



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Earnings												
Investment securities available-for-sale	\$	15,248	\$	(5,408)	\$	(1,196)	\$	8,644	\$	(5,006)		
Securitized mortgage collateral		782,574		(236,490)		(119,516)		(128,379)		298,189		(189,290)
Securitized mortgage borrowings		(767,704)		265,815		98,688		86,233		(316,968)		183,216
Trust preferred securities		(40,952)		(5,314)						(46,266)		(5,020)

(1) Represents the amount of total gains or losses for the period, included in earnings, attributable to the change in unrealized gains (losses) relating to assets and liabilities classified as Level 3 that are still held at June 30, 2008.

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The tables below summarize gains and losses due to changes in fair value, including both realized and unrealized gains and losses, recorded in earnings for Level 3 assets and liabilities for the three and six months ended June 30, 2008.

	Recurring Fair Value Measurements Level 3 - Total Gains (Losses) Included in Net Loss Three Months Ended June 30, 2008			
	Investment Securities Available-for-Sale	Securitized Mortgage Collateral	Securitized Mortgage Borrowings	Trust Preferred Securities
Interest income	\$ 199	\$ 10,306	\$	\$
Interest expense			(6,275)	(140)
Change in fair value of net trust assets, excluding REO	(1,517)	2,275	(6,113)	
Change in fair value of trust preferred securities				(997)
<b>Total</b>	<b>\$ (1,318)</b>	<b>\$ 12,581</b>	<b>\$ (12,388)</b>	<b>\$ (1,137)</b>

	Recurring Fair Value Measurements Level 3 - Total Gains (Losses) Included in Net Loss Six Months Ended June 30, 2008			
	Investment Securities Available-for-Sale	Securitized Mortgage Collateral	Securitized Mortgage Borrowings	Trust Preferred Securities
Interest income	\$ 399	\$ 10,217	\$	\$
Interest expense			(15,176)	(294)
Change in fair value of net trust assets, excluding REO	(5,807)	(246,707)	280,991	
Change in fair value of trust preferred securities				(5,020)
<b>Total</b>	<b>\$ (5,408)</b>	<b>\$ (236,490)</b>	<b>\$ 265,815</b>	<b>\$ (5,314)</b>

SFAS 159 permits fair value accounting to be elected for certain assets and liabilities on an individual contract basis at the time of acquisition or under certain other circumstances referred to as remeasurement event dates. For those items for which fair value accounting is elected, changes in fair value will be recognized in earnings, and fees and costs associated with the origination or acquisition of such items will be recognized as incurred rather than deferred. In addition, SFAS 159 allows application of the Statement's provisions to eligible items existing at the effective date and management has elected to apply SFAS 159 to certain of those items as discussed below.

The following is a description of the measurement techniques for items recorded at fair value on a recurring basis and a non-recurring basis.

**Recurring basis**

*Investment Securities Available-for-Sale.* Pursuant to the Company's adoption of SFAS 159, the Company elected to carry all of its investment securities available-for-sale at fair value. These investment securities are recorded at fair value and consist primarily of non-investment grade mortgage-backed securities. The fair value of the investment securities are measured based upon the Company's expectation of inputs that other market participants would use. Such assumptions include judgments about the underlying collateral, prepayment speeds, credit losses, and certain other factors. Given

the market disruption and lack of observable market data as of June 30, 2008, the fair value of the investment securities available-for-sale were measured using significant internal expectations of market participants' assumptions. At June 30, 2008, investment securities available-for-sale were classified as Level 3 fair value measurements.

*Securitized Mortgage Collateral* Pursuant to the Company's adoption of SFAS 159, the Company elected to carry all of its securitized mortgage collateral at fair value. These assets consist primarily of Alt-A mortgage loans securitized between 2002 and 2007. Fair value measurements are based on the Company's estimated cash flow models, which incorporate assumptions, inputs of other market participants and quoted prices for the underlying bonds. The Company's assumptions include its expectations of inputs that other market participants would use. These assumptions include judgments about the underlying collateral, prepayment speeds, credit losses, and certain other factors. At June 30, 2008, securitized mortgage collateral was classified as Level 2 or Level 3 measurements depending on the observability of significant inputs to the model. As of June 30, 2008, the unpaid principal balance and fair values of loans 90 days or more past due was \$2.7 billion and estimated at \$1.6 billion, respectively. The aggregate unpaid principal balances exceed the fair value by \$1.1 billion at June 30, 2008.

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*Securitized Mortgage Borrowings* - Pursuant to the Company's adoption of SFAS 159, the Company elected to carry all of its securitized mortgage borrowings at fair value. These borrowings consist of individual tranches of bonds issued by securitization trusts and are primarily backed by Alt-A mortgage loans. Fair value measurements include the Company's judgments about the underlying collateral assumptions such as prepayment speeds, credit losses, and certain other factors and are based upon quoted prices for the individual tranches of bonds, if available. At June 30, 2008, securitized mortgage borrowings were classified as Level 2 or Level 3 measurements depending on the observability of significant inputs to the model. As of June 30, 2008, the unpaid principal balance and fair value of securitized mortgage borrowings was \$16.5 billion and estimated at \$11.5 billion, respectively. The aggregate unpaid principal balance exceeds the fair value by \$5 billion at June 30, 2008.

*Trust Preferred Securities* - Pursuant to the Company's adoption of SFAS 159, the Company elected to carry all of its trust preferred securities at fair value. These securities were measured based upon using other preferred stock issued by the Company adjusted for differences between the securities. The fair value of the trust preferred securities resulted in adjustments to reduce the par value for the following factors:

- Stated interest rate adjustments to account for the stated yield difference between the trust preferred securities and the preferred stock issued by the Company,
- Liquidity adjustments to reflect the presence of a lack of an actively traded market for these securities.
- Preference adjustments to reflect the rights of the trust preferred securities as compared to the preferred securities.

At June 30, 2008 trust preferred securities were classified as Level 3 measurements. As of June 30, 2008, the unpaid principal balance and fair value of trust preferred securities was \$99.2 million and \$46.3 million, respectively. The aggregate unpaid principal balance exceeds the fair value by \$52.9 million at June 30, 2008.

*Derivative Assets and Liabilities.* For non-exchange traded contracts, fair value is based on the amounts that would be required to settle the positions with the related counterparties as of the valuation date. Valuations of derivative assets and liabilities reflect the value of the instruments, including the values associated with counterparty risk. With the issuance of SFAS 157, these values must also take into account the Company's own credit standing, to the extent applicable, thus included in the valuation of the derivative instrument is the value of the net credit differential between the counterparties to the derivative contract. At June 30, 2008, derivative assets and liabilities were classified as Level 2 measurements.

*Non-recurring basis*

The Company is required to measure certain assets at fair value from time-to-time. These fair value measurements typically result from the application of specific accounting pronouncements under GAAP. The fair value measurements are considered non-recurring fair value measurements under SFAS 157.

*Loans Held-for-Sale* - Loans held-for-sale for which the fair value option was not elected are carried at lower of cost or market (LOCOM). When available, such measurements are based upon what secondary markets offer for portfolios with similar characteristics, and are considered Level 2 measurements. If market pricing is not available, such measurements are significantly impacted by the Company's expectations of other market participants' assumptions, and are considered Level 3 measurements. The Company utilizes internal pricing processes to estimate the fair value of loans held-for-sale, which is based on recent loan sales and estimates of the fair value of the underlying collateral. Loans held-for-sale, which are primarily included in assets of discontinued operations, are considered Level 3 measurements at June 30, 2008.

*Mortgage Servicing Rights* - Mortgage servicing rights (MSRs) for which the fair value option was not elected are carried at LOCOM. MSRs are not traded in an active market with observable prices. The Company utilizes internal pricing processes to estimate the fair value of MSRs, which are based on assumptions the Company believes would be used by market participants, including market discount rates, float, prepayment speeds and master servicing fees. MSRs, which are included in other assets, are considered Level 3 measurements at June 30, 2008.

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The following table presents the fair values of those financial assets measured at fair value on a non-recurring basis at June 30, 2008.

	Non-recurring Fair Value Measurements As of June 30, 2008				Total Gains (Losses) For the Periods Ended June 30, 2008	
	Level 1	Level 2	Level 3	Total	Three Months	Six Months
Loans held-for-sale (1)	\$	\$	\$ 167,420	\$ 167,420	\$ (7,885)	\$ (16,249)
Mortgage servicing rights	\$	\$	\$ 1,677	\$ 1,677	\$ (301)	\$ (948)

(1) Includes \$1.8 million and \$165.6 million of loans held-for-sale within continuing and discontinued operations, respectively at June 30, 2008.

The following table represents changes in fair value of recurring fair value measurements for the three and six months ended June 30, 2008.

	Recurring Fair Value Measurements Changes in Fair Value Included in Net Loss Three Months Ended June 30, 2008				
	Interest Income	Interest Expense	Net Trust Assets	Trust Preferred Securities	Total
Investment securities available-for-sale	\$ 687	\$	\$ (1,517)	\$	\$ (830)
Securitized mortgage collateral	406,988		(19,062)		387,926
Securitized mortgage borrowings		(401,431)	(88,886)		(490,317)
Trust preferred securities		(2,168)		(997)	(3,165)
Derivative instruments			98,304		98,304
<b>Total</b>	<b>\$ 407,675</b>	<b>\$ (403,599)</b>	<b>\$ (11,161)</b>	<b>\$ (997)</b>	<b>\$ (8,082)</b>

	Recurring Fair Value Measurements Changes in Fair Value Included in Net Loss Six Months Ended June 30, 2008				
	Interest Income	Interest Expense	Net Trust Assets	Trust Preferred Securities	Total
Investment securities available-for-sale	\$ 1,420	\$	\$ (5,807)(1)	\$	\$ (4,387)
Securitized mortgage collateral	676,886		(3,248,563)(1)		(2,571,677)
Securitized mortgage borrowings		(663,248)	3,330,248(1)		2,667,000
Trust preferred securities		(4,350)		(5,020)	(9,370)
Derivative instruments			(83,511)(2)		(83,511)
<b>Total</b>	<b>\$ 678,306(3)</b>	<b>\$ (667,598)(3)</b>	<b>\$ (7,633)</b>	<b>\$ (5,020)</b>	<b>\$ (1,945)</b>

(1)

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The \$75.9 million total change in fair value of these financial instruments is included as change in fair value of trust assets, excluding REO and derivatives, in the accompanying statement of cash flows for the six months ended June 30, 2008.

- (2) Included in this amount is \$(12.1) million in non-cash changes in the fair value of derivative instruments, which are included in the accompanying statement of cash flows for the six months ended June 30, 2008, and \$(71.4) million in cash settlements paid.
- (3) The totals include \$(370.1) million and \$344.9 million of accretion of interest income and expense, respectively.

The change in fair value of the asset and liabilities above, excluding derivative instruments, are primarily due to the changes in credit risk. The change in fair value for derivative instruments is primarily due to the change in the forward LIBOR curve for the quarter.

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

	Six Months Ended June 30,	
	2008	2007
Risk-free interest rate	1.88% to 2.13%	
Expected lives (in years)	3.25	
Expected volatility (1)	87.3% - 89.9%	
Expected dividend yield (2)	0.00%	
Grant date fair value of share options	\$ 0.71 - 0.78	

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

(2) Expected dividend yield is zero because a dividend on the common stock is currently not probable over the expected life of the options granted during the six months ended June 30, 2008.

There were no stock options granted during the six months ended June 30, 2007.

The following table summarizes activity, pricing and other information for the Company's stock options for the six-month period ended June 30, 2008:

	Number of Shares	Weighted- Average Exercise Price (\$)
Options outstanding at January 1, 2008	5,939,914	\$ 9.75
Options granted	7,810,000	1.28
Options exercised		
Options forfeited / cancelled	(1,131,164)	4.69
Options outstanding at June 30, 2008	12,618,750	\$ 4.91
Options exercisable at June 30, 2008	2,661,559	\$ 12.94

As of June 30, 2008, there was approximately \$5.6 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the plan. That cost is expected to be recognized over a weighted average period of 1.2 years.



**Note D Reconciliation of Earnings Per Share**

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

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	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2008	2007	2008	2007
<b>Numerator for basic earnings per share:</b>				
Net loss from continuing operations	\$ (16,439)	\$ (93,525)	\$ (20,942)	\$ (147,657)
Net (loss) earnings from discontinued operations	(11,048)	(59,022)	(10,360)	(126,558)
Less: Cash dividends on cumulative redeemable preferred stock	(3,722)	(3,722)	(7,443)	(7,443)
Net loss available to common stockholders	\$ (31,209)	\$ (156,269)	\$ (38,745)	\$ (281,658)
<b>Denominator for basic earnings per share:</b>				
Basic weighted average number of common shares outstanding during the period	76,096	76,081	76,096	76,081
<b>Denominator for diluted earnings per share:</b>				
Diluted weighted average number of common shares outstanding during the period	76,096	76,081	76,096	76,081
Net effect of dilutive stock options				
Diluted weighted average common shares	76,096	76,081	76,096	76,081
<b>Net loss per common share - Basic:</b>				
Loss from continuing operations	\$ (0.26)	\$ (1.28)	\$ (0.37)	\$ (2.04)
Loss from discontinued operations	(0.15)	(0.78)	(0.14)	(1.66)
Net loss per share	\$ (0.41)	\$ (2.05)	\$ (0.51)	\$ (3.70)
<b>Net loss per common share - Diluted:</b>				
Loss from continuing operations	\$ (0.26)	\$ (1.28)	\$ (0.37)	\$ (2.04)
Loss from discontinued operations	(0.15)	(0.78)	(0.14)	(1.66)
Net loss per share	\$ (0.41)	\$ (2.05)	\$ (0.51)	\$ (3.70)

For the three and six month periods ended June 30, 2008, stock options to purchase 12.6 million shares were outstanding but not included in the above weighted average calculations because they were anti-dilutive.

For the three and six month periods ended June 30, 2007, stock options to purchase 6.7 million shares were outstanding but not included in the above weighted average calculations because they were anti-dilutive.

**Note E Segment Reporting**

The Company has two reporting segments, the continuing operations and discontinued operations. The following tables present the selected financial data and operating results by reporting segments for the periods indicated:

	Continuing Operations	Discontinued Operations	Consolidated
<b>Balance Sheet Items as of June 30, 2008:</b>			
Securitized mortgage collateral	\$ 11,055,382	\$	\$ 11,055,382
Loans held-for-sale	1,785	165,635	167,420

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Total assets		11,760,223		203,320		11,963,543
Total liabilities		11,685,701		253,334		11,939,035
Total stockholders equity (deficit)	\$	74,522	\$	(50,014)	\$	24,508

**Balance Sheet Items as of December 31, 2007:**

Securitized mortgage collateral	\$	16,532,633	\$		\$	16,532,633
Loans held-for-sale		1,684		279,659		281,343
Finance receivables		336		12,458		12,794
Total assets		17,037,822		353,250		17,391,072
Total liabilities		18,063,459		405,341		18,468,800
Total stockholders deficit	\$	(1,025,637)	\$	(52,091)	\$	(1,077,728)

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	Continuing Operations	Discontinued Operations	Consolidated
<b>Statement of Operations Items for the three months ended June 30, 2008:</b>			
Net interest income	\$ 4,256	\$ 1,543	\$ 5,799
Change in fair value of derivatives, net		258	258
Change in fair value of net trust assets	(11,161)		(11,161)
Other non-interest income (expense)	413	(8,612)	(8,199)
Non-interest expense and income taxes	(9,947)	(4,237)	(14,184)
Net loss	\$ (16,439)	\$ (11,048)	\$ (27,487)

<b>Statement of Operations Items for the six months ended June 30, 2008:</b>			
Net interest income	\$ 11,605	\$ 3,213	\$ 14,818
Change in fair value of derivatives, net		112	112
Change in fair value of net trust assets	(7,633)		(7,633)
Other non-interest income (expense)	(2,124)	867	(1,257)
Non-interest expense and income taxes	(22,790)	(14,552)	(37,342)
Net loss	\$ (20,942)	\$ (10,360)	\$ (31,302)

	Continuing Operations	Discontinued Operations	Consolidated
<b>Statement of Operations Items for the three months ended June 30, 2007:</b>			
Net interest income	\$ 7,874	\$ 5,109	\$ 12,983
Provision for loan losses	(161,163)	(1,818)	(162,981)
Change in fair value of derivatives, net	91,670	3,870	95,540
Other non-interest income (expense)	(20,866)	(38,159)	(59,025)
Non-interest expense and income taxes	(11,040)	(28,024)	(39,064)
Net loss	\$ (93,525)	\$ (59,022)	\$ (152,547)

<b>Statement of Operations Items for the six months ended June 30, 2007:</b>			
Net interest income	\$ 15,817	\$ 10,622	\$ 26,439
Provision for loan losses	(190,295)	(2,061)	(192,356)
Change in fair value of derivatives, net	73,672	567	74,239
Other non-interest income (expense)	(25,471)	(82,814)	(108,285)
Non-interest expense and income taxes	(21,380)	(52,872)	(74,252)
Net loss	\$ (147,657)	\$ (126,558)	\$ (274,215)

Table of Contents**Note G Other Assets**

Other assets for the periods indicated consisted of the following:

	At June 30, 2008	At December 31, 2007
Deferred charge	\$ 28,684	\$ 37,412
Other receivables	4,618	
Premises and equipment	2,947	3,904
Real estate owned outside trust	2,269	4,571
Prepaid expenses	2,423	3,505
Investment in capital trusts	2,271	2,394
Mortgage servicing rights	1,677	2,083
Other assets	3,795	3,325
	\$ 48,684	\$ 57,194

**Note H Real Estate Owned (REO)**

Real estate owned, which consists of residential real estate acquired in satisfaction of loans, is carried at the net realizable value less estimated selling and holding costs, offset by expected mortgage insurance proceeds to be received. Historically, adjustments to the loan carrying value required at the time of foreclosure are charged off against the allowance for loan losses. Historically, the Company would writedown REO for changes in the value of the real estate due to declining home prices during the holding period and recognize that amount as a provision for REO losses. The gains and losses related to REO are included in the cash flows of the securitized mortgage collateral. Losses or gains from the ultimate disposition of real estate owned are recorded as gain (loss) on sale of other real estate owned in the consolidated statements of operations. REO is recorded at its estimated net realizable value at June 30, 2008 and December 31, 2007.

Activity for the Company's REO consisted of the following:

	Six Months Ended June 30, 2008	Year Ended December 31, 2007
Beginning balance	\$ 405,434	\$ 137,331
Foreclosures	388,907	487,314
Liquidations	(170,639)	(219,211)
REO	\$ 623,702	\$ 405,434
REO inside trusts	\$ 621,433	\$ 400,863
REO outside trust (1)	2,269	4,571
REO	\$ 623,702	\$ 405,434

(1) Amount represents REO related to a former on-balance sheet securitization, which was collapsed as the result of the Company exercising its clean-up call option. This REO is included in other assets within continuing operations.



Table of Contents**Note I Securitized Mortgage Borrowings**

The following is selected information on securitized mortgage borrowings for the periods indicated (dollars in millions):

Year of Issuance	Original Issuance Amount	Securitized mortgage borrowings outstanding as of		Fixed Interest Rates	Range of Percentages:	
		June 30, 2008	December 31, 2007		Interest Rate Margins over One-Month LIBOR (1)	Interest Rate Margins after Adjustment Date (2)
2002	\$ 3,876.1	\$ 38.9	\$ 42.1	5.25 - 12.00	0.27 - 2.75	0.54 - 3.68
2003	5,966.1	363.5	409.4	4.34 - 12.75	0.27 - 3.00	0.54 - 4.50
2004	17,710.7	2,430.8	2,751.8	3.58 - 5.56	0.25 - 2.50	0.50 - 3.75
2005	13,387.7	5,380.6	5,961.6		0.24 - 2.90	0.48 - 4.35
2006	5,971.4	4,761.7	5,015.7	6.25	0.10 - 2.75	0.20 - 4.125
2007	3,860.5	3,480.2	3,619.9		0.06 - 2.00	0.12 - 3.00
Subtotal securitized mortgage borrowings		16,455.7	17,800.5			
Accrued interest expense			17.1			
Unamortized securitization costs			(37.5)			
Fair value adjustment		(4,958.6)				
Total securitized mortgage borrowings	\$	\$ 11,497.1	\$ 17,780.1			

(1) One-month London Interbank Offered Rate (LIBOR) was 2.46 percent as of June 30, 2008.

(2) Interest rate margins are generally adjusted when the unpaid principal balance of the securitized mortgage borrowings is reduced to less than 10% - 20% of the original issuance amount.

**Note J Repurchase Liabilities (Discontinued Operations)***Reverse Repurchase Facilities*

The Company's reverse repurchase agreements, included in discontinued operations, are secured by the Company's loans held-for-sale, restricted cash and certain REOs. The following table presents the outstanding balance of the Company's reverse repurchase facilities as of the dates indicated:

	Discontinued Operations	
	as of June 30, 2008	as of December 31, 2007
Reverse repurchase line (1)	\$ 220,225	\$ 318,669

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Warehouse line (2)				18,021
Total	\$	220,225	\$	336,690

- 
- (1) This line, which is guaranteed by IMH, is no longer funding loans and was in technical default of several covenants, including warehouse borrowing reduction, delivery of financial statements and financial covenants. As described in Note L, the Company has entered into an agreement to restructure this line.
  - (2) This line was paid off in full in May 2008.

### *Repurchase Reserve*

When the Company sells loans through loan sales it is required to make normal and customary representations and warranties about the loans to the purchaser. The Company's whole loan sale agreements generally require it to repurchase loans if the Company breaches a representation or warranty given to the loan purchaser. In addition, the Company may be required to repurchase loans as a result of borrower fraud or if a payment default occurs on a mortgage loan shortly after its sale. During the second quarter of 2008, the Company sold \$7.9 million of loans as compared to \$68.1 million in the first quarter of 2008. During the second quarter of 2008, we negotiated the settlement of \$4 million in repurchase claims. As of June 30, 2008 and December 31, 2007, the Company had a liability for losses on loans sold with representations and warranties totaling \$12.9 million and \$25.7 million, respectively, included in liabilities from discontinued operations.



Table of Contents**Note K Discontinued Operations**

During 2007, the Company announced plans to exit substantially all of its mortgage, commercial, retail, and warehouse lending operations. Consequently, the amounts related to these operations are presented as discontinued operations in the Company's consolidated statements of operations and its consolidated statements of cash flows, and the asset groups to be exited are reported as assets and liabilities of discontinued operations in its consolidated balance sheets for the periods presented.

The following table presents the discontinued operations condensed balance sheets at June 30, 2008 and December 31, 2007:

	<b>Discontinued Operations</b>	
	as of June 30, 2008	as of December 31, 2007
<b>Balance Sheet Items:</b>		
Loans held-for-sale	\$ 165,635	\$ 279,659
Finance receivables		12,458
Total assets	203,320	353,250
Total liabilities	253,334	405,341
Total stockholders' deficit	\$ (50,014)	\$ (52,091)

Included in total liabilities at June 30, 2008 and December 31, 2007 is a lease liability of \$9.6 million and \$10.9 million, respectively, which is guaranteed by IMH, related to office space that was previously occupied by the discontinued operations and is no longer being used by the Company. Loans held-for-sale includes a \$107.8 million and \$118.4 million fair value adjustment at June 30, 2008 and December 31, 2008, respectively.

The following tables present discontinued operations condensed statement of operations for the three and six month periods ended June 30, 2008 and 2007;

	<b>Discontinued Operations</b>	
	For the Three Months Ended June 30, 2008	2007
<b>Income Statement Items:</b>		
Net interest income	\$ 1,543	\$ 5,109
Provision for loan losses		(1,818)
Change in fair value of derivative instruments	258	3,870
Other non-interest (expense) income	(8,612)	(38,159)
Non-interest expense and income taxes	(4,237)	(28,024)
Net loss	\$ (11,048)	\$ (59,022)

	<b>Discontinued Operations</b>	
	For the Six Months Ended June 30, 2008	2007
<b>Income Statement Items:</b>		
Net interest income	\$ 3,213	\$ 10,622

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Provision for loan losses		(2,061)
Change in fair value of derivative instruments	112	567
Other non-interest income (expense)	867	(82,814)
Non-interest expense and income taxes	(14,552)	(52,872)
Net loss	\$ (10,360)	\$ (126,558)

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**Note L Subsequent Events**

In September 2008, the Company entered into an agreement to restructure its reverse repurchase line with its remaining lender. The balance of this line was \$220.2 million at June 30, 2008. The agreement removes all technical defaults from financial covenant noncompliance and any associated margin calls for the term of the agreement. The agreement calls for certain targets including a reduction of the borrowings balance to \$100 million in 18 months with an advance rate of no more than 65 percent of the unpaid principal balance and \$50 million in 24 months with an advance rate of no more than 55 percent of the unpaid principal balance. By meeting these targets, the agreement term can extend to 30 months. The agreement also calls for monthly principal paydowns of \$750,000 for one month and \$1.5 million thereafter until the earlier of the Company raising capital or the end of the agreement term. If the Company is successful in raising capital, approximately 10% of the gross proceeds will be required to be paid as an additional principal paydown and the monthly principal paydown is reduced to \$750,000. The interest rate is LIBOR plus 325 basis points, and all cash collected from the securing mortgage loans is required to be paid to the lender. Accomplishing the restructuring of this reverse repurchase line allows the Company to manage the remaining loans on the line for the eventual collection, refinance, sale or securitization without the risk of receiving margin calls.

In July 2008, the Company executed a letter of intent, subject to execution of definitive agreements, to acquire a special servicing platform, whereby the seller will contribute specified balances of loans (mostly distressed) to the platform in order to provide sufficient cash flows to maintain the business during its initial operations.

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

**(dollars in thousands, except per share data or as otherwise indicated)**

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

**Forward-Looking Statements**

This report on Form 10-Q contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements, some of which are based on various assumptions and events that are beyond our control, may be identified by reference to a future period or periods or by the use of forward-looking terminology, such as may, will, believe, expect, likely, should, could, anticipate, or similar terms or variations on those terms or the negative of those terms. Forward-looking statements are based on current management expectations. Actual results may differ materially as a result of several factors, including, but not limited to the following: the ongoing volatility in the mortgage and mortgage-backed securities industry and our ability to successfully manage through the current market environment; management's ability to successfully implement future strategies and initiatives; ability to meet liquidity needs from cash flows generated from the long-term mortgage portfolio and master servicing fees; our ability to reduce operating expenses and other outstanding liabilities, such as the trust preferred obligations; our ability to reduce dividend payments on preferred stock; ability to continue to pay dividends on outstanding preferred stock; failure to sell, or achieve expected returns upon sale of, mortgage loans, including non-performing loans, in the secondary market due to market conditions, lack of interest or ineffectual pricing; risks related to the restructuring of the existing reverse repurchase facility, such as completion of definitive agreements, which may be hindered by worsening economic conditions in the mortgage market, and potential difficulties in meeting conditions set forth in the definitive agreement; our ability to meet margin calls to the extent the reverse repurchase line is not restructured; our ability to obtain additional financing and the terms of any financing that we do obtain; our ability to raise additional capital; inability to effectively liquidate properties through auction process or otherwise thereby decreasing advisory fees; increase in loan repurchase requests and ability to adequately settle repurchase obligations; risks related to the acquisition of a special servicing platform, which will involve or require, among other things, continuing due diligence, which could reveal matters not now known that affect our decision to seek to complete the acquisition on different terms than those announced or at all, obtaining necessary approvals and consents, including regulatory approvals related to servicing, which consents and approvals may be delayed or unobtainable, difficulties and delays in obtaining regulatory approvals for the proposed transaction, potential difficulties in meeting conditions set forth in the definitive purchase agreement, and the parties' timely performance of their respective pre-closing covenants and the satisfaction of other conditions, some of which may be beyond the control of the parties or render the acquisition uneconomical; the Company's ability to successfully integrate the new servicing platform with its existing services; our ability to identify and establish or invest in, and successfully manage and grow, businesses that may be outside of the businesses in which we historically have operated; impairments on our mortgage assets; increases in default rates or losses on mortgage loans underlying our mortgage assets; inability to implement strategies effectively to increase cure rates, reduce delinquencies or mitigate losses on mortgage loans; changes in assumptions regarding estimated loan losses or fair value amounts; increase in default rates on our mortgages; changes in yield curve; the ability of our common stock and Series B and C preferred stock to continue trading in an active market; the loss of executive officers and other key management employees; our ability to maintain effective internal control over financial reporting and disclosure controls and procedures; the adoption of changes of new laws that affect our business or the business of people with whom we do business; interest rate fluctuations on our assets that differ from our liabilities; the outcome of litigation or regulatory actions pending against us or other legal contingencies; and our compliance with applicable local, state and federal laws and regulations and other general market and economic conditions.

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For a discussion of these and other risks and uncertainties that could cause actual results to differ from those contained in the forward-looking statements, see Risk Factors and Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's Annual Report on Form 10-K for the period ended December 31, 2007, the other reports we file under the Securities and Exchange Act of 1934, and the additional risk factors set forth below in this quarterly report. This document speaks only as of its date and we do not undertake, and specifically disclaim any obligation, to publicly release the results of any revisions that may be made to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

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

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

Current events, including the adoption of SFAS 159, can diminish the relevance of quarter over quarter and year-to-date over year-to-date comparisons of financial information. In such instances, the Company attempts to present financial information in its Management's Discussion and Analysis of Financial Condition and Results of Operations that is the most relevant to its financial information.

**Status of Operations, Liquidity and Capital Resources**

In 2007 and 2008, management has been seriously challenged by the unprecedented turmoil in the mortgage market, including the following: significant increases in delinquencies and foreclosures; significant increases in credit-related losses; decline in originations; tightening of warehouse credit and the virtual elimination of the market for loan securitizations. As a result, the Company discontinued certain operations, resolved and terminated all but one of our reverse repurchase facilities and settled a portion of our outstanding repurchase claims, while also reducing our operating costs and liabilities. In the first quarter of 2008, the Company also entered into an agreement with a real estate marketing company to generate advisory fees.

One of our goals has been to align the costs of our operations to the cash flows from our long-term mortgage portfolio (residual interests in securitizations), master servicing portfolio and real estate advisory fees. However, we have intentionally maintained certain personnel to allow us to explore future business opportunities should we be able to raise capital. As part of our other goals, we intend to 1) reduce or eliminate dividend payments on the Company's preferred stock, and 2) modify the Company's trust preferred securities, which may include reducing the interest rate.

In September 2008, the Company entered into an agreement to restructure its reverse repurchase line with its remaining lender. The balance of this line was \$220.2 million at June 30, 2008. The agreement removes all technical defaults from financial covenant noncompliance and any associated margin calls for the term of the agreement. The agreement calls for certain targets including a reduction the borrowings balance to \$100 million in 18 months with an advance rate of no more than 65 percent of the unpaid principal balance and \$50 million in 24 months with an advance rate of no more than 55 percent of the unpaid principal balance. By meeting these targets, the agreement term can extend to 30 months. The agreement also calls for monthly principal paydowns of \$750,000 for one month and \$1.5 million thereafter until the earlier of the Company raising capital or the end of the agreement term. If the Company is successful in raising capital, approximately 10% of the gross proceeds will be required to be paid as an additional principal paydown and the monthly principal paydown is reduced to \$750,000. The interest rate is LIBOR plus 325 basis points, and all cash collected from the securing mortgage loans is required to be paid to the lender. Accomplishing the restructuring of this reverse repurchase line allows the Company to manage the remaining loans on the line for the eventual collection, refinance, sale or securitization without the risk of receiving margin calls.

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In order to reduce dividend payments on its preferred stock, the Company is considering exchanging the preferred stock for common stock. In July 2008, our stockholders approved the potential issuance of common shares in excess of 20 percent of our existing common shares. This exchange could offer the current preferred stockholders greater liquidity as common stockholders.

We are currently exploring opportunities to raise capital so that we may accomplish several strategic initiatives, which may include strategic acquisitions, acquiring a special servicing platform and investing in distressed mortgage assets and related securities. Raising additional capital through the sale of securities could significantly dilute the current common stockholders. There can be no assurance that we will be successful in accomplishing our goal to raise the capital needed to implement our strategic initiatives.

We earn advisory fees from a real estate marketing company specializing in the marketing and disposition of foreclosed properties. During the three and six months ended June 30, 2008, we earned \$4.7 million and \$8.5 million, respectively, from this relationship. The amount of real estate advisory fees we receive from this relationship are based on numerous factors, including real estate market conditions, the level of foreclosure activity, the ability of the marketing company to attract new business, and the Company retaining our CEO and avoiding liquidation. The agreement terminates in 2010 with the Company having an option to extend the agreement for an additional three years.

In July 2008, the Company executed a letter of intent, subject to execution of definitive agreements, to acquire a special servicing platform, whereby the seller will contribute specified balances of loans (mostly distressed) to the platform in order to provide sufficient cash flows to maintain the business during its initial operations. We believe this special servicing platform, combined with our current and anticipated businesses, will create a fully integrated platform that would be utilized to take advantage of opportunities within the distressed mortgage investment market.

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There can be no assurance that we will be successful in accomplishing our objectives outlined above. In the event that we do not raise capital, we may not be able to make any of the acquisitions or implement the initiatives described above. Also, there can be no assurance that the restructuring of the trust preferred securities or the preferred stock will occur. In this event, we intend to reduce operating expenses to a level that is supportable by the revenues from the existing long-term mortgage portfolio (residual interests in securitizations), master servicing portfolio and real estate advisory fees. Nevertheless, if we are not successful in completing the objectives outlined above, we may not be able to meet our contractual obligations for the next year, including repayment of the reverse repurchase line, interest payments on trust preferred securities and preferred stock dividends.

At June 30, 2008, the Company had \$24.5 million in stockholders' equity. After reducing total stockholders' equity by the \$161.8 million in preferred stock liquidation value, our common equity deficit was \$(137.3) million or \$(1.80) per share.

To understand the financial position of the Company better, we believe it is important to understand the composition of the Company's stockholders' equity (deficit) and to which segment of the business it relates. At June 30, 2008, the equity (deficit) within our continuing and discontinued operations was comprised of the following significant assets and liabilities:

	Condensed Components of Stockholders' Equity (Deficit) by Segment As of June 30, 2008		
	Continuing Operations	Discontinued Operations	Total
Cash	\$ 25,971	\$ 159	\$ 26,130
Residual interests in securitizations (1)	41,796		41,796
Mortgage servicing rights (1)	11,737		11,737
Advisory fees receivable	4,618		4,618
Trust preferred securities (\$99,244 par)	(46,266)		(46,266)
Repurchase liabilities (2)		(55,245)	(55,245)
Lease liability (3)		(9,559)	(9,559)
Deferred charge	28,684		28,684
Net other assets	7,982	14,631	22,613
<b>Stockholders' equity (deficit)</b>	<b>\$ 74,522</b>	<b>\$ (50,014)</b>	<b>\$ 24,508</b>

(1) Included in mortgage servicing rights is \$10.1 million in master servicing rights, included in securitized mortgage collateral, associated with our consolidated securitizations.

(2) Balance includes the net amount owed to our lender, which is guaranteed by IMH, and the repurchase reserve.

(3) Guaranteed by IMH.

*Continuing operations*

We currently have three primary sources of cash earnings:



- cash flows from the long-term mortgage portfolio;
- master servicing fees from the long-term mortgage portfolio; and
- real estate advisory fees

Since our consolidated and unconsolidated securitization trusts are non-recourse, we have netted trust assets and liabilities to more simply present the Company's interest in these trusts, which are considered our residual interests in securitizations. We receive cash flows from our residual interests in securitizations to the extent they are available after required distributions to bondholders and maintaining overcollateralization levels within the trusts. The estimated fair value of the residual interests, represented by the difference in the fair value of trust assets (excluding the \$10.1 in master servicing rights included in the basis of securitized mortgage collateral) and trust liabilities, was \$41.8 million at June 30, 2008.

The Company acts as the master servicer for mortgages included in our CMO and REMIC securitizations. The master servicing fees we earn are generally 0.03 percent per annum on the declining principal balances of these mortgages plus

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interest income on cash held until remitted to investors. Master servicing rights retained in connection with consolidated securitizations are included in securitized mortgage collateral in the Company's consolidated balance sheet. Master servicing rights retained in connection with unconsolidated securitizations are included in other assets. The carrying amount of master servicing rights was \$11.7 million at June 30, 2008, including \$10.1 million included in securitized mortgage collateral.

We earn advisory fees and expect to receive significant cash flows from a real estate marketing company specializing in the marketing and disposition of foreclosed properties. During the three and six months ended June 30, 2008, we earned \$4.7 million and \$8.5 million, respectively, from this relationship. Real estate advisory fees from this relationship are based on numerous factors, including real estate market conditions, the level of foreclosure activity, the ability of this company to attract new business, retention of our CEO and avoiding liquidation. The agreement terminates in 2010 with the Company having an option to extend the agreement for an additional three years.

For the three months ended June 30, 2008 and 2007, we paid \$2.0 million and \$3.7 million in interest on trust preferred securities and preferred stock dividends, respectively. For the six months ended June 30, 2008 and 2007, we paid \$4.0 million and \$7.4 million in interest on trust preferred securities and preferred stock dividends, respectively. As of the filing date of this report, the Company is current on all dividend payments.

At June 30, 2008, we had deferred charges of \$28.7 million representing the deferral of income tax expense on inter-company profits that resulted from the sale of mortgages from taxable subsidiaries to IMH in prior years. Net other assets include \$2.9 million in premises and equipment, \$2.3 million in investment in capital trusts and \$2.4 million in prepaid expenses.

At June 30, 2008, cash within our continuing operations decreased to \$26.0 million from \$32.9 million at March 31, 2008. The decrease during the quarter is primarily related to cash flows from our residual interests in securitizations have started to decline as a result of increased credit losses and increases in interest rates.

*Discontinued operations*

The Company's most significant liabilities at June 30, 2008 relate to its repurchase liabilities and a lease liability within discontinued operations.

The repurchase liabilities consist of a repurchase reserve and the net amount owed to our lenders which is collateralized by loans held-for-sale, restricted cash balances and certain real estate owned and other assets. During the quarter ended June 30, 2008, our \$7.5 million warehouse line was fully paid off. The balance of our reverse repurchase line was approximately \$220.2 million at June 30, 2008. We are currently distributing all principal and interest received from the collateral securing the reverse repurchase line to the lender. As described above, in September 2008, the Company entered into an agreement to restructure this line.

We were required to make normal and customary representations and warranties about the loans we had previously sold to investors. Our whole loan sale agreements generally required us to repurchase loans if we breached a representation or warranty given to the loan purchaser. In addition, we also could be required to repurchase loans as a result of borrower fraud or if a payment default occurs on a mortgage loan shortly

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after its sale. During the quarter, the repurchase liability increased \$0.5 million to \$12.9 million. Determination of the repurchase liability is an estimate of losses from expected repurchases, and is based, in part, on the recent settlement of claims.

In connection with the discontinuation of our non-conforming mortgage, retail mortgage, warehouse lending and commercial operations, a significant amount of office space that was previously occupied is no longer being used by the Company. At June 30, 2008, the Company had a liability of \$9.6 million, representing the present value of the minimum lease payments over the remaining life of the lease, offset by the expected proceeds from sublet revenue related to this office space.

### **Market Conditions**

The mortgage market faced continued adversity through the filing date of this document as the continued broad repricing of mortgage credit risk continued the severe contraction in market liquidity. Furthermore, the market has continued to try to quantify the ultimate loss rates that are going to be experienced in the underlying assets in asset backed securities.

Conditions in the secondary markets (the markets in which we historically sold or securitized mortgage loans), which dramatically worsened during the third quarter of 2007, continue to be depressed as investor concerns over credit quality and

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a weakening of the United States housing market have remained high. As a result, the capital markets remain very volatile and illiquid and have effectively been unavailable to the Company. The Company believes the existing conditions in the secondary markets are unprecedented and, as such, inherently involve significant risks and uncertainty. These conditions could continue to adversely impact the performance of our long-term investment portfolio. Until bond spreads and credit performance return to more historical levels, it will be impossible for the Company to execute securitizations and loan sales. As a result, in 2007, the Company was forced to discontinue its correspondent, retail, wholesale and commercial mortgage operations as well as the warehouse lending operations, in response to the market conditions.

We believe several converging factors led to the broad repricing, including general concerns over the decline in home prices, the rapid increase in the number of delinquent loans (including Alt-A loans), the reduced willingness of investors to acquire commercial paper backed by mortgage collateral, the resulting contraction in market liquidity and availability of financing lines, the numerous rating agency downgrades of securities, and the increase in supply of securities potentially available for sale.

The downward spiral of negative pricing adjustments on assets had a compounding effect as lower prices led to increased lender margin calls for some market participants, which in turn, forced additional selling, causing yet further declines in prices. These events continued to multiply throughout this year.

Normal market trading activity through the second quarter of 2008 was unusually light as uncertainty related to future loss estimates and the lack of liquidity made it difficult for willing buyers and sellers to agree on prices. This condition was particularly acute with respect to securities backed by Alt-A loans where market participants were setting price levels based on widely varied opinions about future loan performance and loan loss severity. While the early credit performance for these securities has been clearly far worse than initial expectations, the ultimate level of realized losses will largely be influenced by events that will likely unfold over the next several years, including the severity of housing price declines and the overall strength of the economy.

The deteriorating market for residential real estate loans is illustrated in the ABX 2006-1 indices shown below in subprime securitization bonds by initial rating. This earliest ABX index shows market prices for a designated group of subprime securities by credit rating. The index does not include any IMH bonds. It is shown here as an illustration of the price volatility in the general mortgage market since the beginning of last year and does not reflect actual pricing on IMH bonds which are backed by Alt-A loans rather than subprime. There is currently no comparable index for Alt-A mortgage product, but the general direction and magnitude of price movement in the index is reflective of the price movement experienced by the Company.

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*Impact of Recent Market Activity*

As a result of the Company's inability to sell or securitize non-conforming loans, the Company discontinued funding loans. Because the Company stopped funding loans, the Company discontinued substantially all of its mortgage (including commercial) and warehouse lending operations during the second half of 2007.

In addition to the inability of the Company to sell loans, the Company's investment in securitized non-conforming loans has deteriorated in value primarily from estimated losses. As a result of continued deterioration in the real estate market through June 30, 2008, the Company increased its loan loss estimates primarily due to increased delinquencies in its long-term investment portfolio and increased loss severities related to the sale and liquidation of real estate owned properties. The decline in single-family home prices can be seen in the chart below.

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As depicted in the chart above, average home prices peaked in 2006 at 226.29 and continued their dramatic decline through June 2008. The Standard & Poor's/Case-Shiller 10-City Composite Home Price Index (the Index) for June 2008 was 180.38 (with the base of 100.00 for January 2000) and hasn't been this low since June 2004 when the Index was 179.45. Beginning in the third quarter of 2007, the Company believes there is a correlation between the borrowers' perceived equity in their homes and defaults. The original loan-to-value (defined as loan amount as a percentage of collateral value, LTV) and original combined loan-to-value (defined as first lien plus total subordinate liens to collateral value, CLTV) ratios of single-family mortgage remaining in the Company's securitized mortgage collateral as of June 30, 2008 was 73 percent and 84 percent, respectively. The LTV and CLTV ratios may have increased from origination date as a result of the deterioration of the real estate market. We believe that home prices that have declined below the borrower's original purchase price have a higher risk of default within our portfolio. Based on the Index, home prices have declined 20 percent through June 2008. Further, we believe the home prices in California and Florida, the states with the highest concentration of our mortgages, have declined even further than the Index. As a result, we have dramatically increased our loan loss estimates, which are a primary assumption used in the valuation of securitized mortgage collateral and borrowings.

**Critical Accounting Policies**

Several of the critical accounting policies important to the portrayal of our financial condition and results of operations require management to make difficult and complex judgments that rely on estimates about the effect of matters that are inherently uncertain due to the impact of changing market conditions and/or consumer behavior. We believe our most critical accounting policies relate to the valuation of: (1) assets and liabilities that are highly dependent on internal valuation models and assumptions rather than market quotations (see Fair Value of Financial Instruments discussion below); (2) derivatives and other hedging instruments; (3) loans held-for-sale, including estimates of fair value, and

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related lower of cost or market (LOCOM) valuation reserve; and (4) repurchase reserve (included in liabilities of discontinued operations). Refer to our 2007 Form 10-K for further discussion of our critical accounting policies and judgments.

Management discusses its critical accounting policies and related estimates with the Company's Audit Committee on a regular basis. We believe the judgments, estimates and assumptions used in the preparation of our consolidated financial statements are appropriate given the factual circumstances at the time. However, given the sensitivity of our consolidated financial statements to these critical accounting policies, the use of other judgments, estimates and assumptions could result in material differences in our results of operations or financial condition.

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**Fair Value of Financial Instruments**

The Company adopted SFAS 157 on January 1, 2008. SFAS 157 defines fair value, establishes a framework for measuring fair value and outlines a fair value hierarchy based on the inputs to valuation techniques used to measure fair value. SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (also referred to as an exit price). SFAS 157 categorizes fair value measurements into a three-level hierarchy based on the extent to which the measurement relies on observable market inputs in measuring fair value. Level 1, which is the highest priority in the fair value hierarchy, is based on unadjusted quoted prices in active markets for identical assets or liabilities. Level 2 is based on observable market-based inputs, other than quoted prices, in active markets for identical assets or liabilities. Level 3, which is the lowest priority in the fair value hierarchy, is based on unobservable inputs. Assets and liabilities are classified within this hierarchy in their entirety based on the lowest level of any input that is significant to the fair value measurement.

The use of fair value to measure our financial instruments is fundamental to our financial statements and is a critical accounting estimate because a substantial portion of our assets and liabilities are recorded at estimated fair value. Financial instruments classified as Level 2 in our consolidated financial statements are valued primarily utilizing inputs and assumptions that are observable in the marketplace, and which can be derived from observable market data or corroborated by observable levels at which transactions are executed in the marketplace. Because financial instruments classified as Level 3 are generally based on unobservable inputs, the process to determine fair value is generally more subjective and involves a high degree of management judgment and assumptions. These assumptions may have a significant effect on our estimates of fair value, and the use of different assumptions, as well as changes in market conditions, could have a material effect on our results of operations or financial condition.

In conjunction with the adoption of SFAS 157, the Company prospectively adopted SFAS 159 as of January 1, 2008. SFAS 159 provides an option on an instrument-by-instrument basis for most financial assets and liabilities to be reported at fair value with changes in fair value reported in earnings. After the initial adoption, the election is made at the acquisition of a financial asset, financial liability, or a firm commitment and it may not be revoked. Management believes that the adoption of SFAS 159 provides an opportunity to mitigate volatility in reported earnings and provides a better representation of the economics of the trust assets and liabilities.

Under the SFAS 159 transition provisions, the Company elected to apply fair value accounting to certain financial instruments (certain trust assets, trust liabilities and trust preferred securities) held at January 1, 2008. Differences between the December 31, 2007 carrying values and the January 1, 2008 fair values were recognized as an adjustment to retained deficit. The adoption of SFAS 159 resulted in a \$1.1 billion decrease to retained deficit on January 1, 2008 from \$(1.4) billion at December 31, 2007 to \$(308.8) million at January 1, 2008.

***Recurring basis***

*Investment Securities Available-for-Sale.* Pursuant to the Company's adoption of SFAS 159, the Company elected to carry all of its investment securities available-for-sale at fair value. These investment securities are recorded at fair value and consist primarily of non-investment grade mortgage-backed securities. The fair value of the investment securities are measured based upon our expectation of inputs that other market participants would use. Such assumptions include our judgments about the underlying collateral, prepayment speeds, credit losses, and certain other factors. Given the market disruption and lack of observable market data as of June 30, 2008, the fair value of the investment securities available-for-sale were measured using significant internal expectations of market participants' assumptions. At June 30, 2008, investment securities available-for-sale were classified as Level 3 fair value measurements.



*Securitized Mortgage Collateral* Pursuant to the Company's adoption of SFAS 159, the Company elected to carry all of its securitized mortgage collateral at fair value. These assets consist primarily of Alt-A mortgage loans securitized between 2002 and 2007. Fair value measurements are based on the Company's estimated cash flow models, which incorporate assumptions, inputs of other market participants and quoted prices for the underlying bonds. The Company's assumptions include our expectations of inputs that other market participants would use. These assumptions include our judgments about the underlying collateral, prepayment speeds, credit losses, and certain other factors. At June 30, 2008, securitized mortgage collateral was classified as Level 2 or Level 3 measurements depending on the observability of significant inputs to the model.

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*Securitized Mortgage Borrowings* - Pursuant to the Company's adoption of SFAS 159, the Company elected to carry all of its securitized mortgage borrowings at fair value. These borrowings consist of individual tranches of bonds issued by securitization trusts and are primarily backed by Alt-A mortgage loans. Fair value measurements include our judgments about the underlying collateral assumptions such as prepayment speeds, credit losses, and certain other factors and are based upon quoted prices for the individual tranches of bonds, if available. At June 30, 2008, securitized mortgage borrowings were classified as Level 2 or Level 3 measurements depending on the observability of significant inputs to the model.

*Trust Preferred Securities* - Pursuant to the Company's adoption of SFAS 159, the Company elected to carry all of its trust preferred securities at fair value. These securities were measured based upon using other preferred stock issued by the Company adjusted for differences between the securities. The fair value of the trust preferred securities resulted in adjustments to reduce the par value for the following factors:

- Stated interest rate adjustments to account for the stated yield difference between the trust preferred securities and the preferred stock issued by the Company,
- Liquidity adjustments to reflect the presence of a lack of an actively traded market for these securities.
- Preference adjustments to reflect the rights of the trust preferred securities as compared to the preferred securities.

At June 30, 2008 trust preferred securities were classified as Level 3 measurements.

*Derivative Assets and Liabilities.* For non-exchange traded contracts, fair value is based on the amounts that would be required to settle the positions with the related counterparties as of the valuation date. Valuations of derivative assets and liabilities reflect the value of the instruments including the values associated with counterparty risk. With the issuance of SFAS 157, these values must also take into account the Company's own credit standing, to the extent applicable, thus included in the valuation of the derivative instrument is the value of the net credit differential between the counterparties to the derivative contract. At June 30, 2008, derivative assets and liabilities were classified as Level 2 measurements.

*Non-recurring basis*

The Company is required to measure certain assets at fair value from time-to-time. These fair value measurements typically result from the application of specific accounting pronouncements under GAAP. The fair value measurements are considered non-recurring fair value measurements under SFAS 157.

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*Loans Held-for-Sale* - Loans held-for-sale for which the fair value option was not elected are carried at lower of cost or market (LOCOM). When available, such measurements are based upon what secondary markets offer for portfolios with similar characteristics, and are considered Level 2 measurements. If market pricing is not available, such measurements are significantly impacted by our expectations of other market participants' assumptions, and are considered Level 3 measurements. Loans held-for-sale, which are primarily included in assets of discontinued operations, are considered Level 3 measurements at June 30, 2008.

*Mortgage Servicing Rights* - Mortgage servicing rights (MSR), for which the fair value option was not elected are carried at LOCOM. MSRs are not traded in an active market with observable prices. The Company utilizes internal pricing processes to estimate the fair value of MSRs, which are based on assumptions the Company believes would be used by market participants. MSRs, which are included in other assets, are considered Level 3 measurements at June 30, 2008.

We continue to refine our valuation methodologies as markets and products develop and the pricing for certain products becomes more or less transparent. While we believe our valuation methods are appropriate and consistent with those of other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a materially different estimate of fair value as of the reporting date.

### **Interest Income and Expense**

Pursuant to the adoption of SFAS 159 on January 1, 2008, interest income and expense on the collateral and borrowings in our securitized trusts is based on effective yields. The effective yield is the rate used to derive the fair value of the securitized trusts. Interest income and expense is calculated based on the estimated effective yields in the trusts multiplied by the fair value.