

**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 September 30, 2009

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-31458

**Newcastle Investment Corp.**

(Exact name of registrant as specified in its charter)

**Maryland**

(State or other jurisdiction of  
incorporation or organization)

**1345 Avenue of the Americas, New York, NY**  
(Address of principal executive offices)

**81-0559116**  
(I.R.S. Employer  
Identification No.)

**10105**  
(Zip Code)

**(212) 798-6100**

(Registrant's telephone number, including area code)

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

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulations S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).  Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  (Do not check if a smaller reporting company)  
Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the last practicable date.

**Common stock, \$0.01 par value per share: 52,905,335 shares outstanding as of November 4, 2009.**

## CAUTIONARY NOTE REGARDING FORWARD LOOKING STATEMENTS

This report contains certain “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements relate to, among other things, the operating performance of our investments, the stability of our earnings, and our financing needs. Forward-looking statements are generally identifiable by use of forward-looking terminology such as “may,” “will,” “should,” “potential,” “intend,” “expect,” “endeavor,” “seek,” “anticipate,” “estimate,” “overestimate,” “underestimate,” “believe,” “could,” “project,” “predict,” “continue” or other similar words or expressions. Forward-looking statements are based on certain assumptions, discuss future expectations, describe future plans and strategies, contain projections of results of operations or of financial condition or state other forward-looking information. Our ability to predict results or the actual outcome of future plans or strategies is inherently uncertain. Although we believe that the expectations reflected in such forward-looking statements are based on reasonable assumptions, our actual results and performance could differ materially from those set forth in the forward-looking statements. These forward-looking statements involve risks, uncertainties and other factors that may cause our actual results in future periods to differ materially from forecasted results. Factors which could have a material adverse effect on our operations and future prospects include, but are not limited to:

- our ability to take advantage of opportunities in additional asset classes at attractive risk-adjusted prices;
- our ability to deploy capital accretively;
- the risks that default and recovery rates on our loan portfolios exceed our underwriting estimates;
- the relationship between yields on assets which are paid off and yields on assets in which such monies can be reinvested;
- the relative spreads between the yield on the assets we invest in and the cost of financing;
- changes in economic conditions generally and the real estate and bond markets specifically;
- adverse changes in the financing markets we access affecting our ability to finance our investments, or in a manner that maintains our historic net spreads;
- changing risk assessments by lenders that potentially lead to increased margin calls, not extending our repurchase agreements or other financings in accordance with their current terms or entering into new financings with us;
- changes in interest rates and/or credit spreads, as well as the success of any hedging strategy we may undertake in relation to such changes;
- the quality and size of the investment pipeline and the rate at which we can invest our cash, including cash inside our CDOs;
- impairments in the value of the collateral underlying our investments and the relation of any such impairments to our judgments as to whether changes in the market value of our securities, loans or real estate are temporary or not and whether circumstances bearing on the value of such assets warrant changes in carrying values;
- legislative/regulatory changes, including but not limited to, any modification of the terms of loans;
- reductions in cash flows received from our investments, particularly our CDOs;
- completion of pending investments;
- the availability and cost of capital for future investments;
- competition within the finance and real estate industries; and
- other risks detailed from time to time below, particularly under the heading “Risk Factors,” and in our other SEC reports.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. The factors noted above could cause our actual results to differ significantly from those contained in any forward-looking statement.

Readers are cautioned not to place undue reliance on any of these forward-looking statements, which reflect our management’s views only as of the date of this report. We are under no duty to update any of the forward-looking statements after the date of this report to conform these statements to actual results.

**SPECIAL NOTE REGARDING EXHIBITS**

In reviewing the agreements included as exhibits to this Quarterly Report on Form 10-Q, please remember they are included to provide you with information regarding their terms and are not intended to provide any other factual or disclosure information about the Company or the other parties to the agreements. The agreements contain representations and warranties by each of the parties to the applicable agreement. These representations and warranties have been made solely for the benefit of the other parties to the applicable agreement and:

- should not in all instances be treated as categorical statements of fact, but rather as a way of allocating the risk tone of the parties if those statements provide to be inaccurate;
- have been qualified by disclosures that were made to the other party in connection with the negotiation of the applicable agreement, which disclosures are not necessarily reflected in the agreement;
- may apply standards of materiality in a way that is different from what may be viewed as material to you or other investors; and
- were made only as of the date of the applicable agreement or such other date or dates as may be specified in the agreement and are subject to more recent developments.

Accordingly, these representations and warranties may not describe the actual state of affairs as of the date they were made or at any other time. Additional information about the Company may be found elsewhere in this Quarterly Report on Form 10-Q and the Company's other public filings, which are available without charge through the SEC's website at <http://www.sec.gov>.

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NEWCASTLE INVESTMENT CORP.  
FORM 10-Q

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## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

(dollars in thousands, except share data)

	September 30, 2009 (Unaudited)	December 31, 2008
<b>Assets</b>		
Real estate securities, available for sale	\$ 1,761,209	\$ 1,668,748
Real estate related loans, held for sale, net	606,504	843,212
Residential mortgage loans, held for sale, net	368,939	409,632
Subprime mortgage loans subject to call option	401,713	398,026
Investments in unconsolidated subsidiaries	173	384
Operating real estate, held for sale	10,116	11,866
Cash and cash equivalents	73,249	49,746
Restricted cash	140,728	44,282
Receivables and other assets	36,276	47,727
	<u>\$ 3,398,907</u>	<u>\$ 3,473,623</u>
<b>Liabilities and Stockholders' Equity (Deficit)</b>		
<b>Liabilities</b>		
CDO bonds payable	\$ 4,111,136	\$ 4,359,981
Other bonds payable	315,845	380,620
Repurchase agreements	78,039	276,472
Financing of subprime mortgage loans subject to call option	401,713	398,026
Junior subordinated notes payable	101,634	100,100
Derivative liabilities	242,578	333,977
Due to affiliates	1,497	1,532
Payables to brokers, dealers and clearing organizations	7,337	—
Accrued expenses and other liabilities	7,457	16,447
	<u>5,267,236</u>	<u>5,867,155</u>
<b>Stockholders' Equity (Deficit)</b>		
Preferred stock, \$0.01 par value, 100,000,000 shares authorized, 2,500,000 shares of 9.75% Series B Cumulative Redeemable Preferred Stock, 1,600,000 shares of 8.05% Series C Cumulative Redeemable Preferred Stock, and 2,000,000 shares of 8.375% Series D Cumulative Redeemable Preferred Stock, liquidation preference \$25.00 per share, issued and outstanding	152,500	152,500
Common stock, \$0.01 par value, 500,000,000 shares authorized, 52,905,335 and 52,789,050 shares issued and outstanding at September 30, 2009 and December 31, 2008, respectively	529	528
Additional paid-in capital	1,033,506	1,033,416
Accumulated deficit	(2,213,287)	(3,272,403)
Accumulated other comprehensive income (loss)	(841,577)	(307,573)
	<u>(1,868,329)</u>	<u>(2,393,532)</u>
	<u>\$ 3,398,907</u>	<u>\$ 3,473,623</u>

See notes to consolidated financial statements

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NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)

(dollars in thousands, except share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Interest income	\$ 75,222	\$ 113,549	\$ 287,033	\$ 361,461
Interest expense	52,438	73,651	167,154	236,739
Net interest income	22,784	39,898	119,879	124,722
<b>Impairment</b>				
Provision for credit losses on loan pools	—	2,077	—	6,450
Valuation allowance (reversal) on loans (held for sale in 2009)	(6,926)	39,831	83,093	76,916
Other-than-temporary impairment on securities	130,555	121,047	526,691	269,216
Portion of other-than-temporary impairment on securities recognized in other comprehensive income	(32,827)	—	(88,105)	—
Net interest income (loss) after impairment	(68,018)	(123,057)	(401,800)	(227,860)
<b>Other Income (Loss)</b>				
Gain (loss) on settlement of investments, net	(1,709)	(2,569)	7,788	3,920
Gain on extinguishment of debt	132,534	5,315	186,209	13,848
Other income (loss), net	(2,252)	(17,912)	2,193	(35,793)
Equity in earnings (losses) of unconsolidated subsidiaries	296	419	281	8,189
	128,869	(14,747)	196,471	(9,836)
<b>Expenses</b>				
Loan and security servicing expense	1,097	1,718	3,869	5,236
General and administrative expense	2,230	2,135	6,821	5,619
Management fee to affiliate	4,492	4,597	13,475	13,791
Depreciation and amortization	73	73	218	218
	7,892	8,523	24,383	24,864
Income (loss) from continuing operations	52,959	(146,327)	(229,712)	(262,560)
Income (loss) from discontinued operations	79	227	(96)	(8,724)
<b>Net Income (Loss)</b>	53,038	(146,100)	(229,808)	(271,284)
Preferred dividends	(3,375)	(3,375)	(10,126)	(10,126)
<b>Income (Loss) Applicable to Common Stockholders</b>	\$ 49,663	\$ (149,475)	\$ (239,934)	\$ (281,410)
<b>Income (Loss) Per Share of Common Stock</b>				
Basic	\$ 0.94	\$ (2.83)	\$ (4.54)	\$ (5.33)
Diluted	\$ 0.94	\$ (2.83)	\$ (4.54)	\$ (5.33)
<b>Income (loss) from continuing operations per share of common stock, after preferred dividends</b>				
Basic	\$ 0.94	\$ (2.84)	\$ (4.54)	\$ (5.17)
Diluted	\$ 0.94	\$ (2.84)	\$ (4.54)	\$ (5.17)
<b>Income (loss) from discontinued operations per share of common stock</b>				
Basic	\$ —	\$ 0.01	\$ —	\$ (0.16)
Diluted	\$ —	\$ 0.01	\$ —	\$ (0.16)
<b>Weighted Average Number of Shares of Common Stock Outstanding</b>				
Basic	52,905,335	52,788,766	52,850,034	52,784,048
Diluted	52,905,335	52,788,766	52,850,034	52,784,048
<b>Dividends Declared per Share of Common Stock</b>	\$ —	\$ 0.25	\$ —	\$ 0.75

See notes to consolidated financial statements

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NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT) (Unaudited)

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2009

(dollars in thousands)

	Preferred Stock		Common Stock		Additional Paid-in Capital	Accumulated Deficit	Accum. Other Comp. Income (Loss)	Total Stockholders' Equity (Deficit)
	Shares	Amount	Shares	Amount				
<b>Stockholders' equity (deficit) - December 31, 2008</b>	6,100,000	\$ 152,500	52,789,050	\$ 528	\$ 1,033,416	\$ (3,272,403)	\$ (307,573)	\$ (2,393,532)
Issuance of common stock to directors	—	—	116,285	1	90	—	—	91
Reclassification adjustment upon adoption of FSP 115-2 and 124-2	—	—	—	—	—	1,288,924	(1,288,924)	—
Comprehensive income:								
Net (loss)	—	—	—	—	—	(229,808)	—	(229,808)
Net unrealized gain on securities	—	—	—	—	—	—	229,077	229,077
Reclassification of net realized loss on securities into earnings	—	—	—	—	—	—	431,328	431,328
Net unrealized gain on derivatives designated as cash flow hedges	—	—	—	—	—	—	88,514	88,514
Reclassification of net realized loss on derivatives designated as cash flow hedges into earnings	—	—	—	—	—	—	6,001	6,001
Total comprehensive income (loss)								525,112
<b>Stockholders' equity (deficit) - September 30, 2009</b>	<u>6,100,000</u>	<u>\$ 152,500</u>	<u>52,905,335</u>	<u>\$ 529</u>	<u>\$ 1,033,506</u>	<u>\$ (2,213,287)</u>	<u>\$ (841,577)</u>	<u>\$ (1,868,329)</u>

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## NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

(dollars in thousands)

	<u>Nine Months Ended September 30,</u>	
	<u>2009</u>	<u>2008</u>
<b>Cash Flows From Operating Activities</b>		
Net income (loss)	\$ (229,808)	\$ (271,284)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities (inclusive of amounts related to discontinued operations):		
Depreciation and amortization	223	565
Accretion of discount and other amortization	(31,153)	(27,543)
Deferred rent	—	183
Provision for credit losses on loan pools	—	6,450
Valuation allowance on loans held for sale	83,093	76,916
Non-cash directors' compensation	91	90
(Gain) on sale of investments	(7,788)	(4,345)
Unrealized (gain) loss on non-hedge derivatives and hedge ineffectiveness	(1,946)	39,456
Other-than-temporary impairment on securities	438,586	278,267
Impairment on real estate held for sale	400	—
(Gain) loss on extinguishment of debt	(186,208)	(13,848)
Equity in (earnings) losses of unconsolidated subsidiaries	(281)	(8,189)
Distributions of earnings from unconsolidated subsidiaries	281	8,189
Change in:		
Restricted cash	897	2,374
Receivables and other assets	6,174	16,275
Due to affiliates	(35)	(6,209)
Accrued expenses and other liabilities	(982)	(5,172)
Net cash provided by (used in) operating activities	<u>71,544</u>	<u>92,175</u>
<b>Cash Flows From Investing Activities</b>		
Purchase of real estate securities	(1,800)	(67,733)
Proceeds from sale of real estate securities	135,999	1,151,012
Purchase of and advances on loans	(14,723)	—
Proceeds from settlement of loans	—	12,636
Repayments of loan and security principal	72,544	276,134
Margin received on derivative instruments	3,550	72,535
Return of margin on derivative instruments	—	(68,969)
Margin deposits on total rate of return swaps (treated as derivative instruments)	—	(27,389)
Return of margin deposits on total rate of return swaps (treated as derivative instruments)	37	36,256
Net proceeds (payments) from termination of derivative instruments	—	(37,591)
Payments on settlement of derivative instruments	(11,610)	—
Purchase and improvement of operating real estate	—	(603)
Proceeds from sale of real estate held for sale	1,350	11,226
Distributions of capital from unconsolidated subsidiaries	109	24,035
Change in restricted cash from investment in new CDOs	—	(2,397)
Net cash provided by (used in) in investing activities	<u>185,456</u>	<u>1,379,152</u>

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See notes to consolidated financial statements



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## NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

(dollars in thousands)

	Nine Months Ended September 30,	
	2009	2008
<b>Cash Flows From Financing Activities</b>		
Repayments of CDO bonds payable	(50,696)	(331,228)
Repayments of other bonds payable	(65,058)	(151,735)
Borrowings under repurchase agreements	—	85,748
Repayments of repurchase agreements	(198,488)	(1,021,585)
Return of margin deposits under repurchase agreements	7,586	91,032
Margin deposits under repurchase agreements	(7,303)	(86,864)
Dividends paid	—	(74,517)
Payment of deferred financing costs	(1,900)	(337)
Restricted cash returned from refinancing activities	82,362	128,866
Net cash provided by (used in) financing activities	(233,497)	(1,360,620)
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	23,503	110,707
<b>Cash and Cash Equivalents, Beginning of Period</b>	49,746	55,916
<b>Cash and Cash Equivalents, End of Period</b>	<u>\$ 73,249</u>	<u>\$ 166,623</u>
<b>Supplemental Disclosure of Cash Flow Information</b>		
Cash paid during the period for interest expense	\$ 124,787	\$ 209,991
Cash paid during the year for federal excise tax	\$ —	\$ 316
<b>Supplemental Schedule of Non-Cash Investing and Financing Activities</b>		
Common stock dividends declared but not paid	\$ —	\$ 13,197
Preferred stock dividends declared but not paid	\$ —	\$ 2,250

See notes to consolidated financial statements

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**NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)**

SEPTEMBER 30, 2009

(dollars in tables in thousands, except share data)

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**1. GENERAL**

Newcastle Investment Corp. (and its subsidiaries, “Newcastle”) is a Maryland corporation that was formed in 2002. Newcastle conducts its business through four primary segments: (i) investments financed with non-recourse collateralized debt obligations (“CDOs”), (ii) investments financed with other non-recourse debt, (iii) investments financed with recourse debt, including FNMA / FHLMC securities, and (iv) unlevered investments.

Newcastle is organized and conducts its operations to qualify as a real estate investment trust (“REIT”) for U.S. federal income tax purposes. As such, Newcastle will generally not be subject to U.S. federal corporate income tax on that portion of its net income that is distributed to stockholders if it distributes at least 90% of its REIT taxable income to its stockholders by prescribed dates and complies with various other requirements.

Newcastle is party to a management agreement (the “Management Agreement”) with FIG LLC (the “Manager”), an affiliate of Fortress Investment Group LLC, under which the Manager advises Newcastle on various aspects of its business and manages its day-to-day operations, subject to the supervision of Newcastle’s board of directors. For its services, the Manager receives an annual management fee and incentive compensation, both as defined in the Management Agreement.

Approximately 5.0 million shares of Newcastle’s common stock were held by the Manager, through its affiliates, and the principals of an affiliate of the Manager at September 30, 2009. In addition, the Manager, through its affiliates, held options to purchase approximately 1.7 million shares of Newcastle’s common stock at September 30, 2009.

The accompanying consolidated financial statements and related notes of Newcastle have been prepared in accordance with accounting principles generally accepted in the United States for interim financial reporting and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, certain information and footnote disclosures normally included in financial statements prepared under U.S. generally accepted accounting principles have been condensed or omitted. In the opinion of management, all adjustments considered necessary for a fair presentation of Newcastle’s financial position, results of operations and cash flows have been included and are of a normal and recurring nature. The operating results presented for interim periods are not necessarily indicative of the results that may be expected for any other interim period or for the entire year. These financial statements should be read in conjunction with Newcastle’s consolidated financial statements for the year ended December 31, 2008 and notes thereto included in Newcastle’s annual report on Form 10-K filed with the Securities and Exchange Commission. Capitalized terms used herein, and not otherwise defined, are defined in Newcastle’s consolidated financial statements for the year ended December 31, 2008.

*Change in Presentation*

Newcastle has changed the format of its consolidated statements of operations for all periods presented to be more consistent with the provisions of Article 9 of Regulation S-X. Article 9 of Regulation S-X is applicable to bank holding companies and Newcastle believes that, as a finance company, Article 9’s provisions are more closely aligned with its operations than those in Article 5, which applies to commercial and industrial companies. This change in format did not have any effect on any of the reported line items within the statements of operations, or on net income (loss) or net income (loss) per share.

**2. INFORMATION REGARDING BUSINESS SEGMENTS**

Newcastle conducts its business through four primary segments: (i) investments financed with non-recourse collateralized debt obligations (“CDOs”), (ii) investments financed with other non-recourse debt, (iii) investments financed with recourse debt, including FNMA / FHLMC securities, and (iv) unlevered investments. In the second quarter of 2008, Newcastle changed the structure of its internal organization such that the basis of the composition of its reportable segments changed from investment type to financing type. Management believes this presentation better reflects the benefits and risks of the company’s structure.

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**NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)**

SEPTEMBER 30, 2009

(dollars in tables in thousands, except share data)

Summary financial data on Newcastle's segments is given below, together with a reconciliation to the same data for Newcastle as a whole:

	CDOs (A)	Other Non-Recourse (A) (B)	Recourse	Unlevered	Unallocated	Total
<b>Nine Months Ended September 30, 2009</b>						
Interest income	\$ 221,385	\$ 58,043	\$ 6,200	\$ 1,333	\$ 72	\$ 287,033
Interest expense	107,475	50,440	3,021	—	6,218	167,154
Net interest income (expense)	113,910	7,603	3,179	1,333	(6,146)	119,879
Impairment	478,631	(7,876)	41,365	9,559	—	521,679
Other income (loss)	189,588	2,435	4,270	177	1	196,471
Depreciation and amortization	—	—	—	—	218	218
Other operating expenses	1,318	2,527	30	1	20,289	24,165
Income (loss) from continuing operations	(176,451)	15,387	(33,946)	(8,050)	(26,652)	(229,712)
Income (loss) from discontinued operations	—	—	—	(96)	—	(96)
Net income (loss)	(176,451)	15,387	(33,946)	(8,146)	(26,652)	(229,808)
Preferred dividends	—	—	—	—	(10,126)	(10,126)
Income (loss) applicable to common stockholders	<u>\$ (176,451)</u>	<u>\$ 15,387</u>	<u>\$ (33,946)</u>	<u>\$ (8,146)</u>	<u>\$ (36,778)</u>	<u>\$ (239,934)</u>
<b>Three Months Ended September 30, 2009</b>						
Interest income	\$ 54,446	\$ 19,184	\$ 1,398	\$ 165	\$ 29	\$ 75,222
Interest expense	33,908	15,523	833	—	2,174	52,438
Net interest income (expense)	20,538	3,661	565	165	(2,145)	22,784
Impairment	79,455	(1,319)	8,894	3,772	—	90,802
Other income (loss)	130,715	(2,080)	(41)	275	—	128,869
Depreciation and amortization	—	—	—	—	73	73
Other operating expenses	436	657	5	—	6,721	7,819
Income (loss) from continuing operations	71,362	2,243	(8,375)	(3,332)	(8,939)	52,959
Income (loss) from discontinued operations	—	—	—	79	—	79
Net income (loss)	71,362	2,243	(8,375)	(3,253)	(8,939)	53,038
Preferred dividends	—	—	—	—	(3,375)	(3,375)
Income (loss) applicable to common stockholders	<u>\$ 71,362</u>	<u>\$ 2,243</u>	<u>\$ (8,375)</u>	<u>\$ (3,253)</u>	<u>\$ (12,314)</u>	<u>\$ 49,663</u>
<b>September 30, 2009</b>						
Investments (C)	\$ 2,332,674	\$ 725,858	\$ 83,403	\$ 6,719	\$ —	\$ 3,148,654
Cash and restricted cash	137,813	—	3,160	458	72,546	213,977
Other assets	35,367	—	591	21	297	36,276
Debt	(4,111,136)	(717,558)	(78,039)	—	(101,634)	(5,008,367)
Derivative liabilities	(212,745)	(26,916)	(2,917)	—	—	(242,578)
Other liabilities	(9,469)	(757)	(458)	(145)	(5,462)	(16,291)
Preferred stock	—	—	—	—	(152,500)	(152,500)
GAAP book value (D)	<u>\$ (1,827,496)</u>	<u>\$ (19,373)</u>	<u>\$ 5,740</u>	<u>\$ 7,053</u>	<u>\$ (186,753)</u>	<u>\$ (2,020,829)</u>

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	CDOs (A)	Other Non-Recourse (A) (B)	Recourse	Unlevered	Unallocated	Total
<b>Nine Months Ended September 30, 2008</b>						
Interest income	\$ 232,652	\$ 67,700	\$ 39,417	\$ 19,861	\$ 1,831	\$ 361,461
Interest expense	151,917	50,775	27,733	675	5,639	236,739
Net interest income (expense)	80,735	16,925	11,684	19,186	(3,808)	124,722
Impairment	268,151	7,385	11,379	65,667	—	352,582
Other income (loss)	5,798	(2,062)	(22,966)	9,979	(585)	(9,836)
Depreciation and amortization	—	—	—	—	218	218
Other operating expenses	1,191	3,836	33	315	19,271	24,646
Income (loss) from continuing operations	(182,809)	3,642	(22,694)	(36,817)	(23,882)	(262,560)
Income (loss) from discontinued operations	—	—	—	(8,724)	—	(8,724)
Net income (loss)	(182,809)	3,642	(22,694)	(45,541)	(23,882)	(271,284)
Preferred dividends	—	—	—	—	(10,126)	(10,126)
Income (loss) applicable to common stockholders	<u>\$(182,809)</u>	<u>\$ 3,642</u>	<u>\$(22,694)</u>	<u>\$(45,541)</u>	<u>\$(34,008)</u>	<u>\$(281,410)</u>
<b>Three Months Ended September 30, 2008</b>						
Interest income	\$ 75,052	\$ 21,443	\$ 11,460	\$ 4,895	\$ 699	\$ 113,549
Interest expense	47,332	16,339	7,727	373	1,880	73,651
Net interest income (expense)	27,720	5,104	3,733	4,522	(1,181)	39,898
Impairment	122,729	1,725	8,947	29,554	—	162,955
Other income (loss)	2,761	(1,514)	(17,532)	1,536	2	(14,747)
Depreciation and amortization	—	—	—	—	73	73
Other operating expenses	371	1,233	8	211	6,627	8,450
Income (loss) from continuing operations	(92,619)	632	(22,754)	(23,707)	(7,879)	(146,327)
Income (loss) from discontinued operations	—	—	—	227	—	227
Net income (loss)	(92,619)	632	(22,754)	(23,480)	(7,879)	(146,100)
Preferred dividends	—	—	—	—	(3,375)	(3,375)
Income (loss) applicable to common stockholders	<u>\$(92,619)</u>	<u>\$ 632</u>	<u>\$(22,754)</u>	<u>\$(23,480)</u>	<u>\$(11,254)</u>	<u>\$(149,475)</u>

- (A) Assets held within CDOs and other non-recourse structures are not available to satisfy obligations outside of such financings, except to the extent Newcastle receives net cash flow distributions from such structures. Furthermore, economic losses from such structures cannot exceed Newcastle's invested equity in them. Therefore, economically their book value cannot be less than zero, except for the amounts described in note (B) below.
- (B) Includes all of the manufactured housing loan financing, of which \$13.3 million (carrying value) was recourse as of September 30, 2009.
- (C) Investments in the unlevered segment include \$2.9 million of real estate securities, \$3.6 million of a real estate related loan and \$0.2 million of interests in a joint venture at September 30, 2009. The real estate related loan was pledged as collateral for the junior subordinated notes and will be released at the end of the interest rate modification period.
- (D) Newcastle cannot economically lose more than its investment amount in any given non-recourse financing structure. Therefore, impairment recorded in excess of such investment, which results in negative GAAP book value for a given non-recourse financing structure, cannot economically be incurred and will eventually be reversed through amortization, sales at gains, or as gains at the deconsolidation or termination of such non-recourse financing structure. For non-recourse financing structures with negative GAAP book value, except as noted in (B) above, the aggregate negative GAAP book value which will eventually be recorded as income is \$1.0 billion as of September 30, 2009.

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**Unconsolidated Subsidiaries**

The following table summarizes the activity for significant subsidiaries affecting the equity held by Newcastle in unconsolidated subsidiaries:

	<b>Real Estate Loan</b>
<b>Balance at December 31, 2008</b>	<b>\$ 283</b>
Distributions from unconsolidated subsidiaries	(390)
Equity in earnings of unconsolidated subsidiaries	280
<b>Balance at September 30, 2009</b>	<b>\$ 173</b>

**Gain (Loss) on Settlement of Investments, Net and Other Income (Loss), Net**

These items are comprised of the following:

	<b>Nine Months Ended September 30,</b>	
	<b>2009</b>	<b>2008</b>
<b>Gain (loss) on settlement of investments, net</b>		
Gain on sale of real estate securities	\$ 25,774	\$ 6,459
Loss on sale of real estate securities	(18,413)	(2,245)
Loss on repayment of real estate securities	(103)	—
Gain on disposition of loans held for sale	526	1,434
Loss on disposition of loans held for sale	—	(1,303)
Realized gain (loss) on termination of derivative instruments	4	(425)
	<u>\$ 7,788</u>	<u>\$ 3,920</u>
<b>Other income (loss), net</b>		
Realized (loss) on total rate of return swaps	\$ —	\$ (7,145)
Unrealized (loss) on total rate of return swaps	—	(13,210)
Gain (loss) on non-hedge derivative instruments	11,232	(17,906)
Unrealized (loss) recognized at de-designation of hedges	(8,797)	(990)
Hedge ineffectiveness	(489)	218
Other income (loss)	247	3,240
	<u>\$ 2,193</u>	<u>\$ (35,793)</u>

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**3. REAL ESTATE SECURITIES**

The following is a summary of Newcastle's real estate securities at September 30, 2009, all of which are classified as available for sale and are therefore reported at fair value with changes in fair value recorded in other comprehensive income, except for securities that are other-than-temporarily impaired.

Asset Type	Amortized Cost Basis				Gross Unrealized			Number of Securities	Weighted Average			Maturity (Years)
	Outstanding Face Amount	Before Impairment	Other-Than-Temporary Impairment (A)	After Impairment	Gains	Losses	Carrying Value (B)		Rating (C)	Coupon	Yield	
CMBS-Conduit	\$1,673,905	\$1,491,313	\$ (621,310)	\$ 870,003	\$46,136	\$(336,183)	\$ 579,956	205	BBB-	5.77%	7.95%	3.6
CMBS- Single Borrower	609,954	593,857	(47,088)	546,769	1,007	(198,333)	349,443	67	BB-	4.24%	5.38%	2.4
CMBS-Large Loan	89,225	89,213	(2,087)	87,126	—	(49,799)	37,327	12	B+	2.03%	2.02%	1.9
CMBS- CDO	16,000	14,731	(14,731)	—	—	—	—	1	C	10.13%	0.00%	—
REIT Debt	561,270	559,784	(8,285)	551,499	12,578	(53,543)	510,534	61	BB	6.10%	6.01%	4.3
ABS-Subprime	482,817	444,991	(238,903)	206,088	5,873	(40,620)	171,341	104	B	1.40%	10.65%	3.8
ABS-Manufactured												
Housing	51,753	50,229	—	50,229	559	(7,159)	43,629	9	BBB	6.69%	7.23%	5.6
ABS-Franchise	35,626	36,053	(18,682)	17,371	54	(4,764)	12,661	17	BB+	3.86%	4.04%	3.0
FNMA/FHLMC (D)	47,848	49,482	—	49,482	2,111	—	51,593	3	AAA	5.83%	5.53%	3.9
Subtotal/Average (E)	3,568,398	3,329,653	(951,086)	2,378,567	68,318	(690,401)	1,756,484	479	BB	4.89%	6.83%	3.5
Retained Securities (F)	66,213	65,998	(63,108)	2,890	—	(918)	1,972	6	C	2.26%	12.05%	1.8
Residual Interest (F)	133	29,412	(29,279)	133	—	—	133	1	NR	0.00%	30.00%	—
Debt Security												
Total/Average	\$3,634,744	3,425,063	(1,043,473)	2,381,590	68,318	(691,319)	1,758,589	486	BB	4.84%	6.84%	3.5
Equity Securities		1,388	—	1,388	1,478	(246)	2,620	2				
Total		\$3,426,451	\$ (1,043,473)	\$2,382,978	\$69,796	\$(691,565)	\$ 1,761,209	488				

- (A) Represents the cumulative impairment against amortized cost basis recorded through earnings, net of the effect of the cumulative adjustment as a result of the adoption of FSP 115-2 and 124-2 (see below).
- (B) See Note 6 regarding the estimation of fair value, which is equal to carrying value for all securities.
- (C) Represents the weighted average of the ratings of all securities in each asset type, expressed as an S&P equivalent rating. For each security rated by multiple rating agencies, the lowest rating is used. FNMA/FHLMC securities have an implied AAA rating. Ratings provided were determined by third party rating agencies as of a particular date, may not be current and are subject to change (including the assignment of a "negative watch") at any time.
- (D) Amortized cost basis and carrying value include principal receivable of \$1.1 million.
- (E) The total outstanding face amount of fixed rate securities was \$2.6 billion, and of floating rate securities was \$1.0 billion.
- (F) Represents the retained bonds and equity from Securitization Trust 2006 and Securitization Trust 2007 (Note 4). The residuals do not have stated coupons and therefore their coupons have been treated as zero for purposes of the table.

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Unrealized losses that are considered other-than-temporary are recognized currently in income. During the nine months ended September 30, 2009, Newcastle recorded other-than-temporary impairment charges of \$526.7 million (gross of \$88.1 million of the portion of other-than-temporary impairment recognized in other comprehensive income) with respect to real estate securities. Based on management's analysis of these securities, the performance of the underlying loans and changes in market factors, Newcastle noted adverse changes in the expected cash flows on certain of these securities and concluded that they were other-than-temporarily impaired in accordance with FSP FAS 115-2 and 124-2 (see below). The remaining unrealized losses on Newcastle's securities are primarily the result of market factors. Pursuant to the FSP, these noncredit unrealized losses are recognized in accumulated other comprehensive income.

Securities in an Unrealized Loss Position	Amortized Cost Basis				Gross Unrealized		Carrying Value	Number of Securities	Weighted Average			Maturity (Years)
	Outstanding Face Amount	Before Impairment	Other-than-Temporary Impairment	After Impairment	Gains	Losses			Rating (E)	Coupon	Yield	
Less Than Twelve Months	\$ 307,923	\$ 316,454	\$(229,467)	\$ 86,987	\$—	\$ (16,015)	70,972	79	B-	3.19%	7.70%	2.9
Twelve or More Months	2,398,735	2,306,606	(493,030)	1,813,576	—	(675,550)	1,138,026	304	BB	4.97%	5.67%	3.6
<b>Total</b>	<b>\$2,706,658</b>	<b>\$2,623,060</b>	<b>\$(722,497)</b>	<b>\$1,900,563</b>	<b>\$—</b>	<b>\$(691,565)</b>	<b>\$1,208,998</b>	<b>383</b>	<b>BB</b>	<b>4.77%</b>	<b>5.77%</b>	<b>3.5</b>

In April 2009, the FASB issued FSP FAS 115-2 and 124-2 "Recognition and Presentation of Other-Than-Temporary Impairments." With the release of the FASB's Accounting Standards Codification ("ASC"), the guidance in the FSP has been incorporated primarily within the ASC 320, "Investments – Debt and Equity Securities"; ASC 310-30, "Loans and Debt Securities Acquired with Deteriorated Credit Quality" and ASC 325-40, "Beneficial Interests in Securitized Financial Assets". The FSP changes the guidance for determining, recording and disclosing other-than-temporary impairment ("OTTI"). This guidance applies to debt securities in an unrealized loss position (i.e. their fair value is less than their amortized cost basis) as follows:

Old Guidance	Current Guidance
Must express an intent and ability to hold securities until an expected recovery in value to amortized cost basis, or else record OTTI for the difference between fair value and amortized cost.	Must not have the intent to sell a security nor be in a position where a required sale is more likely than not, or else record OTTI for the difference between fair value and amortized cost.
If no recovery to amortized cost basis is expected, must record OTTI in the same amount.	Otherwise, must record OTTI relating to the portion of the unrealized loss which represents a credit loss, if any.

Newcastle performed an assessment of all of its debt securities that are in an unrealized loss position (unrealized loss position exists when a security's amortized cost basis, excluding the effect of other than temporary impairment, exceeds its fair value) in accordance with the guidance of FSP FAS 115-2 and 124-2 and determined the following:

	September 30, 2009			
	Fair Value	Amortized Cost Basis	Unrealized Losses	
			Credit (B)	Non-Credit (C)
Securities Newcastle intends to sell	\$ —	\$ —	\$ —	N/A
Securities Newcastle is more likely than not to be required to sell (A)	—	—	—	N/A
Securities Newcastle has no intent to sell and is not more likely than not to be required to sell:				
Credit impaired securities	160,513	252,654	(722,497)	(92,141)
Non credit impaired securities	1,048,455	1,647,634	—	(599,178)
<b>Total debt securities in an unrealized loss position</b>	<b>1,208,968</b>	<b>1,900,288</b>	<b>(722,497)</b>	<b>(691,319)</b>

- (A) Newcastle may, at times, be more likely than not to be required to sell certain securities for liquidity purposes. While the amount of the securities to be sold may be an estimate, and the securities to be sold have not yet been identified, this FSP requires Newcastle to make its best estimate, which is subject to significant judgment regarding future events, and may differ materially from actual future sales.
- (B) Excluding the effect of previously recorded other-than-temporary impairment, which must be reconsidered as a result of this FSP. This amount is required to be recorded as other-than-temporary impairment through the income statement. Of this amount, \$624.8 million relates to prior periods (and was recorded as part of the reclassification adjustment upon adoption, as described below) and \$97.7 million relates to the three months ended September 30, 2009. In measuring the portion of credit losses, Newcastle's management estimates the expected cash flow for each of the securities. This evaluation includes a review of the credit status and the performance of the collateral supporting those securities, including the credit of the issuer, key terms of the securities and the effect of local, industry and broader economic trends. Significant inputs in estimating the cash flows include management's expectations of prepayment speeds, default rates and loss severities. Credit losses are measured as the decline in the present value of the expected future cash flows discounted at the investment's effective interest rate.
- (C) This amount represents unrealized losses on securities that are due to non-credit factors and is required to be recorded through other comprehensive income.

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As a result of this reassessment, Newcastle has recorded a reclassification adjustment upon adoption of FSP 115-2 and 124-2 of \$1.3 billion of loss from Accumulated Deficit to Accumulated Other Comprehensive Income (Loss). The reclassification adjustment had no impact on total consolidated assets, liabilities or equity and did not impact Newcastle's liquidity. This represents a substantive reversal of a large portion of the impairment charge recorded in the fourth quarter of 2008, which was originally recorded as a result of Newcastle's inability to express the intent and ability to hold its securities until an expected recovery in value (if any).

The following table summarizes the activity related to credit losses on debt securities for the period from adoption of FSP 115-2 and 124-2 through September 30, 2009:

Beginning balance of credit losses on debt securities for which a portion of an other-than- temporary impairment was recognized in other comprehensive income	\$(363,125)
Additions for credit losses on securities for which an OTTI was not previously recognized	(121,465)
Increases to credit losses on securities for which an OTTI was previously recognized and a portion of an other-than-temporary impairment was recognized in other comprehensive income	(88,702)
Additions for credit losses on securities for which an OTTI was previously recognized without any portion of other-than-temporary impairment recognized in other comprehensive income	(273,239)
Reduction for credit losses on securities for which no other-than-temporary impairment was recognized in other comprehensive income at September 30, 2009	120,260
Reduction for securities sold during the period	3,774
Reduction for increases in cash flows expected to be collected that are recognized over the remaining life of the security	13,175
Ending balance of credit losses on debt securities for which a portion of an other-than- temporary impairment was recognized in other comprehensive income	<u>\$(709,322)</u>

In January 2009, the FASB issued FSP EITF 99-20-1, "Amendments to the Impairment Guidance of EITF Issue No. 99-20." This FSP (codified primarily in ASC 325-40, "Beneficial Interests in Securitized Financial Assets") amends previous guidance to achieve more consistent determination of whether an other-than-temporary impairment has occurred, with the same objective as ASC 320, "Investments – Debt and Equity Securities". In particular, it changed a requirement to analyze a security's estimated cash flows from a market participant's perspective to an analysis from the perspective of the holder. The adoption of EITF 99-20-1 did not have a material impact on Newcastle's impairment analysis for the nine months ended September 30, 2009 because Newcastle generally analyzes cash flows of securities in a manner consistent with market practice.

The table below summarizes the geographic distribution of the collateral securing our CMBS at September 30, 2009 (in thousands):

<u>Geographic Location</u>	<u>Outstanding Face Amount</u>	<u>Percentage</u>
Western U.S.	\$ 597,007	25.0%
Northeastern U.S.	563,625	23.6%
Southeastern U.S.	464,788	19.5%
Midwestern U.S.	313,508	13.1%
Southwestern U.S.	259,985	10.9%
Other	168,268	7.0%
Foreign	21,903	0.9%
	<u>\$ 2,389,084</u>	<u>100.0%</u>

Geographic concentrations of investments expose Newcastle to the risk of economic downturns within the relevant regions, particularly given the current unfavorable market conditions. These market conditions may make regions more vulnerable to downturns in certain market factors. Any such downturn in a region where Newcastle holds significant investments could have a material, negative impact on Newcastle.



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**4. REAL ESTATE RELATED LOANS HELD FOR SALE, RESIDENTIAL MORTGAGE LOANS HELD FOR SALE AND SUBPRIME MORTGAGE LOANS**

The following is a summary of real estate related loans held for sale, residential mortgage loans held for sale and subprime mortgage loans at September 30, 2009. The loans contain various terms, including fixed and floating rates, self-amortizing and interest only. They are generally subject to prepayment.

Loan Type	Outstanding Face Amount	Carrying Value	Loan Count	Wtd. Avg. Yield	Weighted Average Maturity (Years) (A)	Floating Rate Loans as a % of Face Amount	Delinquent Face Amount (B)
Mezzanine Loans	\$ 753,902	\$276,196	23	52.86%	1.7	86.9%	\$ 44,942
Corporate Bank Loans	340,804	198,198	10	25.90%	2.6	100.0%	49,997
B-Notes	308,085	73,599	11	44.37%	1.6	84.2%	131,592
Whole Loans	97,680	58,511	4	18.94%	1.9	97.6%	—
Total Real Estate Related Loans Held for Sale, Net	<u>\$1,500,471</u>	<u>\$606,504</u>	<u>48</u>	<u>39.75%</u>	<u>1.9</u>	<u>90.0%</u>	<u>\$ 226,531</u>
Residential Loans	\$ 71,293	\$ 44,794	246	13.65%	5.9	100.0%	\$ 7,151
Manufactured Housing Loans	427,813	324,145	12,710	13.42%	7.0	11.0%	6,454
Total Residential Mortgage Loans Held for Sale, Net (C)	<u>\$ 499,106</u>	<u>\$368,939</u>	<u>12,956</u>	<u>13.45%</u>	<u>6.8</u>	<u>23.7%</u>	<u>\$ 13,605</u>
Subprime Mortgage Loans Subject to Call Option	<u>\$ 406,217</u>	<u>\$401,713</u>					

- (A) The weighted average maturities were calculated based on constant prepayment rates (CPR) of 7% and 30% for the residential loan pools, and 4% and 6% for the manufactured housing loan pools.
- (B) Includes loans that are non-performing, in foreclosure, considered real estate owned and real estate related loans under bankruptcy filing.
- (C) Carrying value includes interest receivable of \$0.2 million for the residential housing loans and principal and interest receivable of \$8.1 million for the manufactured housing loans.

The following is a reconciliation of the related loss allowance.

	Real Estate Related Loans	Residential Mortgage Loans
Balance at December 31, 2008	\$ (827,328)	\$ (136,206)
Charge-offs	48,348	8,534
Recoveries	—	—
Valuation (allowance) reversal on loans held for sale	(85,773)	2,682
Balance at September 30, 2009	<u>\$ (864,753)</u>	<u>\$ (124,990)</u>

The charge-offs of \$48.3 million for the nine months ended September 30, 2009 represent five bank loans and one B-note which were sold or converted to equity interests during the period.

**Securitization of Subprime Mortgage Loans**

The following table presents information on the retained interests in Newcastle's securitizations of subprime mortgage loans and the sensitivity of their fair value for immediate 10% and 20% adverse changes in the assumptions utilized in calculating such fair value, at September 30, 2009:

	Subprime Portfolio	
	I	II
Total securitized loans (unpaid principal balance) (A)	\$607,665	\$817,634
Loans subject to call option (carrying value)	\$298,059	\$103,654
Retained interests (fair value) (B)	\$ 1,235	\$ 870
Weighted average life (years) of residual interest	—	0.2
Weighted average expected credit losses (C)	24.7%	46.7%
Effect on fair value of retained interests of 10% adverse change	\$ (126)	\$ (127)
Effect on fair value of retained interests of 20% adverse change	\$ (266)	\$ (223)
Weighted average constant prepayment rate (D)	9.8%	3.8%
Effect on fair value of retained interests of 10% adverse change	\$ (21)	\$ (18)
Effect on fair value of retained interests of 20% adverse change	\$ (34)	\$ (34)
Weighted average discount rate	19.6%	24.3%
Effect on fair value of retained interests of 10% adverse change	\$ (111)	\$ (9)
Effect on fair value of retained interests of 20% adverse change	\$ (201)	\$ (17)

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- (A) Average loan seasoning of 50 months and 32 months for Subprime Portfolios I and II, respectively, at September 30, 2009.
- (B) The retained interests include residual interests and retained bonds of the securitizations. Their fair value is estimated based on pricing models.
- (C) Represents the percentage of losses on the original principal balance of the loans from the date of the respective securitizations (April 2006 and July 2007) to the maturity of the loans.
- (D) Represents the weighted average voluntary prepayment rate for the loans from the date of the respective securitizations (April 2006 and July 2007) to the maturity of the loans.

The sensitivity analysis is hypothetical and should be used with caution. In particular, the results are calculated by stressing a particular economic assumption independent of changes in any other assumption; in practice, changes in one factor may result in changes in another, which might counteract or amplify the sensitivities. Also, changes in the fair value based on a 10% or 20% variation in an assumption generally may not be extrapolated because the relationship of the change in the assumption to the change in fair value may not be linear.

The following table summarizes certain characteristics of the underlying subprime mortgage loans, and related financing, in the securitizations as of September 30, 2009:

	Subprime Portfolio	
	I	II
Loan unpaid principal balance (UPB)	\$607,665	\$817,634
Weighted average coupon rate of loans	7.11%	6.96%
Delinquencies of 60 or more days (UPB) (A)	\$135,984	\$240,517
Net credit losses for the nine months ended September 30, 2009	\$ 69,646	\$ 64,524
Cumulative net credit losses	\$114,490	\$ 84,488
Cumulative net credit losses as a % of original UPB	7.62%	7.77%
Percentage of ARM loans (B)	54.3%	67.0%
Percentage of loans with loan-to-value ratio >90%	10.60%	17.30%
Percentage of interest-only loans	24.0%	4.3%
Face amount of debt (C)	\$580,277	\$759,592
Weighted average funding cost of debt (D)	1.71%	2.48%

- (A) Delinquencies include loans 60 or more days past due, in foreclosure, or real estate owned.
- (B) ARM loans are adjustable-rate mortgage loans. An option ARM is an adjustable-rate mortgage that provides the borrower with an option to choose from several payment amounts each month for a specified period of the loan term. None of the loans in the subprime portfolios are an option ARM.
- (C) Excludes face amount of \$27.4 million and \$38.8 million of retained notes for Subprime Portfolios I and II, respectively, at September 30, 2009.
- (D) Includes the effect of applicable hedges.

Newcastle received net cash inflows of \$0.7 million and \$1.1 million from the retained interests of Subprime Portfolios I and II, respectively, during the nine months ended September 30, 2009.

The weighted average yields of the retained notes of Subprime Portfolios I and II were 9.33% and 20.0%, respectively, as of September 30, 2009. The loans subject to call option and the corresponding financing recognize interest income and expense based on the expected weighted average coupons of the loans subject to call option at the call date of 9.24% and 8.68%, for Subprime Portfolios I and II, respectively.

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**5. DEBT OBLIGATIONS**

The following table presents certain information regarding Newcastle's debt obligations and related hedges at September 30, 2009:

Debt Obligation/Collateral	Month Issued	Outstanding Face Amount	Carrying Value	Unhedged Weighted Average Funding Cost (A)	Final Stated Maturity	Weighted Average Funding Cost (B)	Weighted Average Maturity (Years)	Face Amount of Floating Rate Debt	Collateral			Weighted Average Maturity (Years)	Floating Rate Face Amount (C)	Aggregate Notional Amount of Current Hedges	
									Outstanding Face Amount (C)	Amortized Cost Basis (C)	Carrying Value (C)				
<b>CDO Bonds Payable</b>															
CDO IV (D)	Mar 2004	\$ 376,883	\$ 375,386	1.19%	Mar 2039	2.96%	3.0	\$ 353,501	\$ 422,860	\$ 361,331	\$ 235,115	3.6	\$ 179,527	\$ 177,300	
CDO V	Sep 2004	454,500	452,575	0.97%	Sep 2039	2.88%	3.5	442,500	512,177	399,975	249,096	3.6	221,861	208,508	
CDO VI (D)	Apr 2005	438,772	437,105	0.75%	Apr 2040	3.29%	4.2	431,111	483,916	306,748	204,072	3.8	161,556	241,922	
CDO VII (D)	Dec 2005	413,106	410,481	0.74%	Dec 2050	4.17%	5.9	406,700	494,990	212,065	144,970	3.8	95,474	298,355	
CDO VIII	Nov 2006	729,313	728,534	0.94%	Nov 2052	1.99%	4.1	721,713	828,566	415,451	409,597	2.9	575,536	161,655	
CDO IX	May 2007	532,125	532,869	0.78%	May 2052	1.59%	5.1	532,125	821,217	389,512	391,426	1.9	636,737	91,795	
CDO X	Jul 2007	1,175,000	1,174,186	0.37%	Jul 2052	4.53%	5.3	1,175,000	1,380,524	1,023,928	850,820	3.5	329,399	945,813	
		<u>4,119,699</u>	<u>4,111,136</u>			<u>3.21%</u>	<u>4.6</u>	<u>4,062,650</u>	<u>4,944,250</u>	<u>3,109,010</u>	<u>2,485,096</u>	<u>3.2</u>	<u>2,200,090</u>	<u>2,125,348</u>	
<b>Other Bonds Payable</b>															
MH loans (E)	Jan 2006	112,465	112,465	LIBOR+0.75%	Jan 2009 (E)	5.03%	—	112,465	175,377	118,846	118,846	8.0	2,380	—	
MH loans (F)	Aug 2006	204,237	203,380	LIBOR+1.00%	Aug 2011	6.40%	1.7	204,237	252,436	205,298	205,298	6.3	44,607	—	
		<u>316,702</u>	<u>315,845</u>			<u>5.91%</u>	<u>1.1</u>	<u>316,702</u>	<u>427,813</u>	<u>324,144</u>	<u>324,144</u>	<u>7.0</u>	<u>46,987</u>	<u>—</u>	
<b>Repurchase Agreements (G)</b>															
RE securities, loans and properties	Various	36,420	36,420	LIBOR+2.26%	Various	2.50%	0.6	36,420	178,485	37,747	37,747	0.7	164,602	—	
FNMA/FHLMC securities	Rolling	41,619	41,619	LIBOR+0.16%	Oct 2009	5.03%	0.1	41,619	42,163	43,381	45,462	3.9	—	38,766	
		<u>78,039</u>	<u>78,039</u>			<u>3.85%</u>	<u>0.3</u>	<u>78,039</u>	<u>220,648</u>	<u>81,128</u>	<u>83,209</u>	<u>1.3</u>	<u>164,602</u>	<u>38,766</u>	
<b>Corporate</b>															
Junior subordinated notes payable (H)	Mar 2006	101,700	101,634	1.00%(H)	Apr 2035	7.28%	26.4	—	—	—	—	—	—	—	
		<u>101,700</u>	<u>101,634</u>			<u>7.28%</u>	<u>26.4</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	
Subtotal debt obligations		<u>4,616,140</u>	<u>4,606,654</u>			<u>3.49%</u>	<u>4.8</u>	<u>\$ 4,457,391</u>	<u>\$ 5,592,711</u>	<u>\$ 3,514,282</u>	<u>\$ 2,892,449</u>	<u>3.4</u>	<u>\$ 2,411,679</u>	<u>\$ 2,164,114</u>	
Financing on subprime mortgage loans subject to call option	(I)	406,217	401,713												
Total debt obligations		<u>\$ 5,022,357</u>	<u>\$ 5,008,367</u>												

(A) Weighted average, including floating and fixed rate classes and excluding the amortization of deferred financing costs.

(B) Including the effect of applicable hedges.

(C) Including restricted cash held for reinvestments in CDOs. The face amount and carrying value of Newcastle's unlevered investments (real estate loans and securities) were \$181.3 million and \$6.7 million, respectively, as of September 30, 2009.

(D) CDOs IV, VI and VII were not in compliance with their applicable over collateralization tests as of September 30, 2009. Newcastle is not receiving cash flows from these CDOs (other than senior management fees) and expects these CDOs to remain out of compliance for the foreseeable future.

(E) See further description below.

(F) Of which \$13.4 million face amount is recourse financing.

(G) The counterparties on these repurchase agreements include: Goldman Sachs (\$41.6 million of FNMA/FHLMC financing), Deutsche Bank (\$16.4 million) and Citigroup (\$20.0 million). The non-FNMA/FHLMC financings are subject to scheduled repayments, with the final payment to be made in June 2010.

(H) In April 2009, Newcastle entered into an exchange agreement with the holder of the trust preferred securities under which Newcastle will effectively be accruing interest at a rate of 1.0% per annum beginning February 1, 2009 for a maximum of six quarters, after which the rate reverts to 7.574% through April 2016 and to LIBOR + 2.25% after April 2016. Pursuant to the exchange, a real estate loan, which was valued at \$3.6 million on September 30, 2009, was pledged as collateral for the junior subordinated notes and will be released at the end of the interest rate modification period. For details, see Note 9 below.

(I) Issued in April 2006 and July 2007. See Note 4 regarding the securitizations of Subprime Portfolios I and II.

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In the first quarter of 2009, Newcastle repurchased \$30.3 million face amount of three classes of CDO bonds for \$3.2 million. As a result, Newcastle extinguished \$30.3 million face amount of CDO debt and recorded a gain on extinguishment of debt of \$26.9 million in the first quarter of 2009.

In January 2009, the debt for one of Newcastle's manufactured housing loan portfolios (\$112.5 million outstanding at September 30, 2009) became callable at the option of the lender. The principal and interest payments from the underlying loans, net of expenses and payments related to interest rate swap contracts, are used to repay the outstanding debt on a monthly basis.

In February 2009, Newcastle renegotiated the terms of a recourse loan agreement financing one of its manufactured housing loan portfolios. Under the amended terms of the agreement, certain debt covenants relating to equity requirements were removed.

In February 2009, Newcastle renegotiated the terms of a repurchase agreement financing its investment in a real estate related loan. Under the amended terms of the repurchase agreement, certain debt covenants relating to a concentration limit and equity requirements, as well as the mark-to-market (margin posting) requirement were removed.

In March 2009, Newcastle renegotiated the terms of a repurchase agreement financing its investment in a real estate related loan. Under the amended terms of the repurchase agreement, the mark-to-market (margin posting) provisions and certain financial covenants relating to net worth and leverage ratio were removed. Newcastle also agreed not to enter into any new debt financings subject to margin calls other than to finance FNMA/FHLMC securities.

In April 2009, Newcastle repurchased \$29.5 million face amount of two classes of CDO bonds for \$2.4 million. As a result, Newcastle extinguished \$29.5 million face amount of CDO debt and recorded a gain on extinguishment of debt of \$26.8 million in the second quarter of 2009.

On April 30, 2009, Newcastle entered into an exchange agreement with several collateralized debt obligations managed by a third party pursuant to which Newcastle agreed to exchange newly issued junior subordinated notes due in 2035 with an initial aggregate principal amount of \$101.7 million (the "Notes") for \$100 million in aggregate liquidation amount of trust preferred securities that were previously issued by a subsidiary of Newcastle (the "TRUPs") and were owned by the third party. The Notes accrue interest at a rate of 1.0% per year for a maximum of six quarters, beginning on February 1, 2009 and the aggregate principal amount of the Notes will increase to \$104.9 million by July 30, 2010. Subsequent to that period, the rate reverts to that which Newcastle was required to pay on the TRUPs (7.574% through April 2016 and at a floating rate of 3-month LIBOR plus 2.25% thereafter). In conjunction with the exchange, the TRUPs were cancelled and Newcastle pledged 100% of its equity interests in NIC TP LLC, a special purpose subsidiary that holds Newcastle's participation in a loan and related deposit account, which were valued at \$3.6 million on September 30, 2009, as collateral. The pledged collateral will be released at the end of the interest rate modification period. Under the provisions of ASC 470-60, "Troubled Debt Restructurings by Debtors", this exchange is considered a troubled debt restructuring which requires Newcastle to account for the effect of the interest modification prospectively and to record the expenses related to the modification immediately through earnings.

In September 2009, Newcastle repurchased \$150.1 million face amount of six classes of CDO bonds for \$16.7 million. As a result, Newcastle extinguished \$150.1 million face amount of CDO debt and recorded a gain on extinguishment of debt of \$132.5 million in the third quarter of 2009.

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**6. FAIR VALUE OF FINANCIAL INSTRUMENTS**

*Fair Value Summary Table*

Newcastle held the following financial instruments at September 30, 2009:

	Principal Balance or Notional Amount	Carrying Value	Fair Value	Fair Value Method (A)	Weighted Average Yield/Funding Cost	Weighted Average Maturity (Years)
<b>Assets:</b>						
Real estate securities, available for sale*	\$3,634,744	\$1,761,209	\$1,761,209	Broker quotations, counterparty quotations, pricing services, pricing models	6.84%	3.5
Real estate related loans held for sale*	1,500,471	606,504	606,504	Broker quotations, counterparty quotations, pricing services, pricing models	39.75%	1.9
Residential mortgage loans held for sale*	499,106	368,939	368,939	Pricing models	13.45%	6.8
Subprime mortgage loans subject to call option (B)	406,217	401,713	401,713	(B)	9.09%	(B)
<b>Liabilities:</b>						
CDO bonds payable	\$4,119,699	\$4,111,136	\$821,284	Counterparty quotations, pricing models	3.21%	4.6
Other bonds payable	316,702	315,845	243,595	Pricing models	5.91%	1.1
Repurchase agreements	78,039	78,039	78,039	Market comparables	3.85%	0.3
Financing of subprime mortgage loans subject to call option (B)	406,217	401,713	401,713	(B)	9.09%	(B)
Junior subordinated notes payable	101,700	101,634	28,956	Pricing models	7.28%	26.4
Interest rate swaps, treated as hedges (C)(E)*	2,164,114	215,662	215,662	Counterparty quotations	N/A	(C)
Non-hedge derivatives (D)(E)*	256,765	26,916	26,916	Counterparty quotations	N/A	(D)

\* Measured at fair value on a recurring basis.

(A) Methods are listed in order of priority. In the case of real estate securities and real estate related loans, broker quotations are obtained if available and practicable, otherwise counterparty quotations or pricing service valuations are obtained or, finally, internal pricing models are used. Internal pricing models are only used for (i) securities and loans which are not traded in an active market, and therefore have little or no price transparency, and for which significant unobservable inputs must be used in estimating fair value, or (ii) loans or debt obligations which are private and untraded.

(B) These two items results from an option, not an obligation, to repurchase loans from Newcastle's subprime mortgage loan securitizations (Note 4), are noneconomic until such option is exercised, and are equal and offsetting.

(C) Represents current swap agreements as follows:

<u>Maturing In</u>	<u>Weighted Average Month of Maturity</u>	<u>Aggregate Notional Amount</u>	<u>Weighted Average Fixed Pay Rate</u>	<u>Aggregate Fair Value</u>
<b>Agreements which receive 1-Month LIBOR:</b>				
2011	December	\$ 110,566	5.003%	\$ (8,498)
2012	July	19,995	5.388%	(1,666)
2014	October	16,567	5.092%	(1,882)
2015	September	1,276,989	5.254%	(129,761)
2016	May	180,155	5.043%	(20,955)
2017	August	174,034	5.235%	(25,735)
<b>Agreements which receive 3-Month LIBOR:</b>				
2011	February	32,000	5.078%	(1,870)
2014	June	353,808	4.196%	(25,295)
		<u>\$ 2,164,114</u>		<u>\$(215,662)</u>

(D) These include three interest rate swaps with a total notional balance of \$256.8 million. The maturity dates of the \$97.9 million, \$1.8 million and \$157.1 million interest rate swaps are January 2016, January 2016 and June 2016, respectively. Newcastle entered into these swap agreements to reduce its exposure to interest rate changes on the floating rate financings of its manufactured housing loan portfolios. These swaps were redesignated as hedges for hedge accounting purposes.

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- (E) Newcastle's derivatives fall into two categories. Derivatives held within Newcastle's nonrecourse debt structures (primarily CDOs) with an aggregate notional balance of \$2.4 billion, all of which were liabilities at period end, are not subject to Newcastle's credit risk as they are senior to all the debt obligations of the related structure. Derivatives held outside Newcastle's nonrecourse debt structures with an aggregate notional balance of \$70.8 million are primarily 100% collateralized by margin (based on their current fair value) and therefore are not subject to Newcastle's or its counterparty's credit risk. As a result, no adjustments have been made to the fair value quotations received related to credit risk. Newcastle's significant derivative counterparties include Bank of America, Deutsche Bank, Wachovia and Credit Suisse.

**Securities Valuation**

As of September 30, 2009, Newcastle's securities valuation methodology and results are further detailed as follows:

Asset Type	Outstanding Face Amount (A)	Amortized Cost Basis (B)	Fair Value			Total
			Multiple Quotes (C)	Single Quote (D)	Internal Pricing Models (E)	
CMBS	\$ 2,389,084	\$ 1,503,898	\$ 713,499	\$ 126,438	\$ 126,789	\$ 966,726
ABS – subprime	482,817	206,088	67,625	16,481	87,235	171,341
Subprime retained	66,213	2,890	—	—	1,972	1,972
Subprime residuals	133	133	—	—	133	133
ABS – other real estate	87,379	67,600	19,694	25,718	10,878	56,290
FNMA / FHLMC	47,848	49,482	—	51,593	—	51,593
REIT debt	561,270	551,499	468,377	42,157	—	510,534
Debt security total	<u>\$ 3,634,744</u>	<u>2,381,590</u>	<u>1,269,195</u>	<u>262,387</u>	<u>227,007</u>	<u>1,758,589</u>
Equity securities		1,388	—	—	2,620	2,620
Total		<u>\$ 2,382,978</u>	<u>\$ 1,269,195</u>	<u>\$ 262,387</u>	<u>\$ 229,627</u>	<u>1,761,209</u>

- (A) Net of incurred losses.  
 (B) Net of discounts (or gross premiums) and after other-than-temporary impairment, including impairment taken during the period ended September 30, 2009.  
 (C) Management generally obtained broker quotations from two sources, one of which was generally the seller (the party that sold us the security). Management selected one of the quotes received as being most representative of fair value and did not use an average of the quotes. Newcastle's methodology is to not use quotes from selling brokers, unless those quotes are the only marks available, or unless the quotes provided by other (non-selling) brokers are, in management's judgment, not representative of fair value. Even if Newcastle receives two or more quotes on a particular security that come from non-selling brokers, it does not use an average because management believes using an actual quote more closely represents a transactable price for the security than an average level. Furthermore, in some cases there is a wide disparity between the quotes Newcastle receives. Management believes using an average of the quotes in these cases would generally not represent the fair value of the asset. Based on Newcastle's own fair value analysis using internal models, management selects one of the quotes which is believed to more accurately reflect fair value. Newcastle never adjusts quotes received.  
 (D) Management was unable to obtain quotations from more than one source on these securities. The one source was generally the seller (the party that sold us the security).  
 (E) Securities whose fair value was estimated based on internal pricing models are further detailed as follows:

	Amortized Cost		Impairment Recorded In Current Year	Unrealized Gains (Losses) in Accumulated OCI	Assumption Ranges			
	Basis	Fair Value			Discount Rate	Prepayment Speed (F)	Cumulative Default Rate	Loss Severity
CMBS – Conduit	\$ 152,878	\$ 99,821	\$ 216,138	\$ (53,057)	20%	N/A	15% - 45%	35% - 48%
CMBS – Large loan / Single borrower	79,707	26,968	51,635	(52,739)	20% - 75%	N/A	0% - 100%	0% - 100%
ABS – subprime	118,136	87,235	62,302	(30,901)	20%	1% - 13%	22% - 91%	50% - 90%
Subprime retained	2,890	1,972	3,203	(918)	20%	3%	61% - 74%	70%
Subprime residuals	133	133	716	—	30%	3%	74%	70%
ABS – other RE	13,856	10,878	4,029	(2,978)	20%	2%	58%	70%
Debt security total	<u>\$ 367,600</u>	<u>\$ 227,007</u>	<u>\$ 338,023</u>	<u>\$ (140,593)</u>				
Equity securities	1,388	2,620		1,232				
Total	<u>\$ 368,988</u>	<u>\$ 229,627</u>	<u>\$ 338,023</u>	<u>\$ (139,361)</u>				

All of the assumptions listed have some degree of market observability, based on Newcastle's knowledge of the market, relationships with market participants, and use of common market data sources. Collateral prepayment, default and loss severity projections are in the form of "curves" or "vectors" that vary for each monthly collateral cash flow projection. Methods used to develop these projections vary by asset class (e.g., CMBS projections are developed differently than Home Equity ABS projections) but conform to industry conventions. We use assumptions that generate our best estimate of future cash flows of each respective security.

The prepayment vector specifies the percentage of the collateral balance that is expected to voluntarily pay off at each point in the future. The prepayment vector is based on projections from the a widely published investment bank model which considers factors such as collateral FICO score,

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loan-to-value ratio, debt-to-income ratio, and vintage on a loan level basis. This vector is scaled up or down to match recent collateral-specific prepayment experience, as obtained from remittance reports and market data services.

Loss severities are based on recent collateral-specific experience with additional consideration given to collateral characteristics. Collateral age is taken into consideration because severities tend to initially increase with collateral age before eventually stabilizing. We typically use projected severities that are higher than the historic experience for collateral that is relatively new (e.g., 2007 vintage origination) to account for this effect. Collateral characteristics such as loan size, lien position, and location (state) also effect loss severity. We consider whether a collateral pool has experienced a significant change in its composition with respect to these factors when assigning severity projections.

Default vectors are determined from the current "pipeline" of loans that are more than 90 days delinquent, in foreclosure, or are real estate owned (REO). These significantly delinquent loans determine the first 24 months of the default vector. Beyond month 24, the default vector transitions to a steady-state value that is generally equal to or greater than that given by the widely published investment bank model.

The discount rates we use are derived from a range of observable pricing on securities backed by similar collateral and offered in a live market. As the markets in which we transact have become less liquid, we have had to rely on fewer data points in this analysis.

(F) Lifetime average constant prepayment rate.

**Valuation Hierarchy**

Pursuant to ASC 820, "Fair Value Measurements and Disclosures", the methodologies used for valuing such instruments have been categorized into three broad levels which form a hierarchy. Newcastle follows this hierarchy for its financial instruments measured at fair value on a recurring basis. The classifications are based on the lowest level of input that is significant to the fair value measurement.

The following table summarizes such financial assets and liabilities at September 30, 2009:

	Principal Balance or Notional Amount	Carrying Value	Fair Value			Total
			Level 2	Level 3A	Level 3B	
<b>Assets:</b>						
Real estate securities, available for sale:						
CMBS	\$ 2,389,084	\$ 966,726	\$ —	\$ 839,937	\$ 126,789	\$ 966,726
ABS – subprime	482,817	171,341	—	84,106	87,235	171,341
Subprime retained	66,213	1,972	—	—	1,972	1,972
Subprime residuals	133	133	—	—	133	133
ABS – other real estate	87,379	56,290	—	45,412	10,878	56,290
FNMA / FHLMC	47,848	51,593	51,593	—	—	51,593
REIT debt	561,270	510,534	—	510,534	—	510,534
Debt security total	<u>3,634,744</u>	<u>1,758,589</u>	<u>51,593</u>	<u>1,479,989</u>	<u>227,007</u>	<u>1,758,589</u>
Equity securities		2,620	—	—	2,620	2,620
Total		<u>\$ 1,761,209</u>	<u>\$ 51,593</u>	<u>\$ 1,479,989</u>	<u>\$ 229,627</u>	<u>\$ 1,761,209</u>
<b>Liabilities:</b>						
Interest rate swaps, treated as hedges	2,164,114	215,662	215,662	—	—	215,662
Non-hedge derivatives	256,765	26,916	26,916	—	—	26,916

Newcastle's investments in instruments measured at fair value using Level 3 inputs changed during the nine months ended September 30, 2009 as follows:

	<u>Level 3A</u>	<u>Level 3B</u>	<u>Total</u>
<b>Assets</b>			
Balance at December 31, 2008	\$1,304,776	\$ 179,763	\$1,484,539
Total gains (losses)			
Included in net income (loss) (A)	(127,689)	(307,827)	(435,516)
Reclassification related to the adoption of FSP 115-2 (codified in ASC 320, 310-30 and 325-40) included in Other Comprehensive income (loss)	979,089	309,835	1,288,924
Included in other comprehensive income (loss)	(557,010)	(70,936)	(627,946)
Amortization included in interest income	49,010	23,668	72,678
Purchases, sales and repayments	(16,323)	(56,740)	(73,063)
Transfers between Level 3A and Level 3B	(151,864)	151,864	—
Transfers into Level 3 (B)	—	—	—
Transfers out of Level 3 (B)	—	—	—
Balance at September 30, 2009	<u>\$1,479,989</u>	<u>\$ 229,627</u>	<u>\$1,709,616</u>



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(A) These gains (losses) are recorded in the following line items in the consolidated statement of operations:

	<b>Nine Months Ended September 30, 2009</b>
Gain (loss) on settlement of investments, net	\$ 3,070
Other income (loss), net	—
Other-than-temporary impairment	(438,586)
Total	<u>\$ (435,516)</u>

Other-than-temporary impairment recorded in earnings during the nine months ended September 30, 2009 is attributable to the change in unrealized losses relating to Level 3 assets still held at September 30, 2009.

	<b>Nine Months Ended September 30, 2009</b>
Gain (loss) on settlement of investments, net, from investments transferred into Level 3 during the period	\$ —

(B) Transfers are assumed to occur at the beginning of the quarter.

During the nine months ended September 30, 2009, Newcastle recorded \$85.8 million and (\$2.7) million of valuation allowance (reversal) on real estate related loans and residential mortgage loans (Note 4), respectively. These loans were written down to fair value at the time of the impairment, based on broker quotations, pricing service quotations or internal pricing models. All the loans were within Level 3 of the fair value hierarchy. For real estate related loans, the most significant inputs used in the valuations are the amount and timing of expected future cash flows, market yields and the estimated collateral value of such loan investments. For residential mortgage loans, significant inputs include management's expectations of prepayment speeds, default rates, loss severities and discount rates that market participants would use in determining the fair values of similar pools of residential mortgage loans.

**Derivatives**

ASC 815, "Derivatives and Hedging" establishes the accounting and disclosures for derivative instruments. The disclosure below provides information relating to Newcastle's uses and reporting of derivative instruments, as well as enhanced qualitative and quantitative disclosures pursuant to these accounting standards.

Newcastle is exposed to certain risks relating to its ongoing business operations. The primary risk managed by Newcastle using derivative instruments is interest rate risk. Newcastle enters into interest rate swap agreements to reduce the impact of fluctuating interest rates on its earnings. Pursuant to ASC 815, Newcastle designates certain interest rate swap agreements as cash flow hedges of its floating rate financings. For derivative instruments that are designated and qualify as a cash flow hedge (i.e. hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), the effective portion of the gain or loss, and net payments received or made, on the derivative instrument are reported as a component of other comprehensive income and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. The remaining gain or loss on the derivative instrument in excess of the cumulative change in the present value of future cash flows of the hedged item, if any, is recognized in current earnings during the period of change.

Newcastle's derivatives are recorded on its balance sheet as follows:

		<b>Fair Value</b>	
	<b>Balance sheet location</b>	<b>September 30, 2009</b>	<b>December 31, 2008</b>
Interest rate swaps, designated as hedging instruments under ASC 815	Derivative liabilities	\$ 215,662	\$ 317,757
Interest rate swaps, not designated as hedging instruments under ASC 815	Derivative liabilities	26,916	16,220
		<u>\$ 242,578</u>	<u>\$ 333,977</u>

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### NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2009

(dollars in tables in thousands, except share data)

The following table summarizes information related to derivatives:

	September 30, 2009	December 31, 2008
<b>Cash flow hedges</b>		
Notional amount of interest rate swap agreements	\$ 2,164,114	\$2,376,420
Amount of (loss) recognized in OCI on effective portion	(211,094)	(312,431)
Deferred hedge gain (loss) related to anticipated financings, which have subsequently occurred, net of amortization	857	932
Deferred hedge gain (loss) related to dedesignation, net of amortization	(9,571)	(2,825)
Expected reclassification of deferred hedges from AOCI into earnings over the next 12 months	(4,536)	1,149
Expected reclassification of current hedges from AOCI into earnings over the next 12 months	(95,832)	(19,570)
<b>Non-hedge Derivatives</b>		
Notional amount of interest rate swap agreements	256,765	182,867

The following table summarizes gains (losses) recorded in relation to derivatives (excluding total rate of return swaps, which are reported separately):

	Income statement location	Nine Months Ended September 30,	
		2009	2008
<b>Cash flow hedges</b>			
Gain (loss) on the ineffective portion	Other income (loss)	\$ (489)	\$ 218
Gain (loss) immediately recognized at dedesignation	Other income (loss)	(8,797)	(990)
Amount of gain (loss) reclassified from AOCI into income, related to effective portion	Interest expense	(74,180)	(45,233)
Deferred hedge gain reclassified from AOCI into income, related to anticipated financings	Interest expense	75	69
Deferred hedge gain (loss) reclassified from AOCI into income, related to effective portion of dedesignated hedges	Interest expense	(8,021)	(1,316)
<b>Non-hedge derivatives gain (loss)</b>	Other income (loss)	11,232	(38,261)

#### 7. EARNINGS PER SHARE

Newcastle is required to present both basic and diluted earnings per share ("EPS"). Basic EPS is calculated by dividing net income available for common stockholders by the weighted average number of shares of common stock outstanding during each period. Diluted EPS is calculated by dividing net income available for common stockholders by the weighted average number of shares of common stock outstanding plus the additional dilutive effect of common stock equivalents during each period. Newcastle's common stock equivalents are its outstanding stock options. During the three and nine months ended September 30, 2009 and 2008, Newcastle had no dilutive common stock equivalents. Net loss applicable to common stockholders is equal to net loss less preferred dividends.

As of September 30, 2009, Newcastle's outstanding options were summarized as follows:

Held by the Manager	1,686,447
Issued to the Manager and subsequently transferred to certain of the Manager's employees	798,162
Held by the independent directors and former directors	14,000
Total	<u>2,498,609</u>

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**NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)**

SEPTEMBER 30, 2009

(dollars in tables in thousands, except share data)

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**8. COMMITMENTS AND CONTINGENCIES**

**Loan Commitment** — With respect to a commercial construction loan, Newcastle entered into an agreement effective June 30, 2009 with the other parties to the loan. As a result, as of September 30, 2009, Newcastle and its CDOs do not have any future funding commitment with respect to this loan.

**Litigation** — Newcastle is, from time to time, a defendant in legal actions from transactions conducted in the ordinary course of business. Management, after consultation with legal counsel, believes the ultimate liability arising from such actions which existed at September 30, 2009, if any, will not materially affect Newcastle's consolidated results of operations or financial position.

**Preferred Dividends in Arrears** — As of September 30, 2009, \$12.4 million of dividends on Newcastle's cumulative preferred stock were unpaid and in arrears.

**Contingent Gain in CDOs** — As of September 30, 2009, Newcastle has recorded \$1.0 billion of losses in its CDOs in excess of its economic exposure which must eventually be reversed through amortization, sales at gains, or as gains at the deconsolidation or termination of the CDOs.

**9. RECENT ACTIVITIES**

These financial statements include a discussion of material events which have occurred subsequent to September 30, 2009 (referred to as "subsequent events") through the issuance of these consolidated financial statements on November 9, 2009. Events subsequent to that date have not been considered in these financial statements.

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

The following should be read in conjunction with the unaudited consolidated financial statements and notes included herein.

**GENERAL**

Newcastle Investment Corp. is a real estate investment and finance company. We invest in, and actively manage, a portfolio of real estate securities, loans and other real estate related assets. Our objective is to maximize the difference between the yield on our investments and the cost of financing these investments while hedging our interest rate risk. We emphasize portfolio management, asset quality, diversification, match funded financing and credit risk management.

We currently own a diversified portfolio of credit sensitive real estate debt investments, including securities and loans. Our portfolio of real estate securities includes commercial mortgage backed securities (CMBS), senior unsecured debt issued by property REITs, real estate related asset backed securities (ABS), and FNMA/FHLMC securities. Mortgage backed securities are interests in or obligations secured by pools of mortgage loans. We generally target investments rated A through BB, except for our FNMA/FHLMC securities which have an implied AAA rating. We also own, directly and indirectly, interests in loans and pools of loans, including real estate related loans, commercial mortgage loans, residential mortgage loans, manufactured housing loans, and subprime mortgage loans.

We employ leverage as part of our investment strategy. We do not have a predetermined target debt to equity ratio as we believe the appropriate leverage for the particular assets we are financing depends on the credit quality of those assets. As a result of our negative GAAP equity, our GAAP debt to equity ratio is not a meaningful measure as of September 30, 2009. Our general investment guidelines adopted by our board of directors limit total leverage (as defined under the governing documents) to a maximum 9.0 to 1 debt to equity ratio. As of September 30, 2009, our debt to equity ratio, as computed under this method, was approximately 4.3 to 1.0.

We strive to maintain access to a broad array of capital resources in an effort to insulate our business from potential fluctuations in the availability of capital. We utilize multiple forms of financing including collateralized debt obligations (CDOs), other securitizations, term loans, and trust preferred securities, as well as short term financing in the form of loans and repurchase agreements. As we discuss in more detail under "Market Considerations" below, the ongoing credit and liquidity crisis has limited the array of capital resources available to us and made the terms of capital resources we are able to obtain generally less favorable to us relative to the terms we were able to obtain prior to the crisis. For example, we are currently contractually restricted from entering into new debt financings subject to margin calls other than to finance up to a specified amount of FNMA/FHLMC securities.

We seek to match fund our investments with respect to interest rates and maturities in order to reduce the impact of interest rate fluctuations on earnings and reduce the risk of refinancing our liabilities prior to the maturity of the investments. We seek to finance a substantial portion of our real estate securities and loans through the issuance of term debt, which generally represents obligations issued in multiple classes secured by an underlying portfolio of assets. Specifically, our CDO financings offer us the structural flexibility to buy and sell certain investments to manage risk and, subject to certain limitations, to optimize returns.

We conduct our business through four primary segments: (i) investments financed with non-recourse collateralized debt obligations (CDOs), (ii) investments financed with other non-recourse debt, (iii) investments financed with recourse debt, including FNMA / FHLMC securities, and (iv) unlevered investments. In the second quarter of 2008, Newcastle changed the structure of its internal organization such that the basis of the composition of its reportable segments changed from investment type to financing type. Revenues attributable to each segment are disclosed below (in thousands).

<u>For the Nine Months Ended September 30,</u>	<u>Other</u>					<u>Total</u>
	<u>CDOs</u>	<u>Non-Recourse</u>	<u>Recourse</u>	<u>Unlevered</u>	<u>Unallocated</u>	
2009	\$221,385	\$ 58,043	\$ 6,200	\$ 1,333	\$ 72	\$287,033
2008	\$232,652	\$ 67,700	\$39,417	\$ 19,861	\$ 1,831	\$361,461

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### **Market Considerations**

#### *Financial Institutions*

Many market participants remain uncertain about the health of a number of financial institutions and the financial system in general. Continuing write-downs and capital related issues affecting financial market participants have contributed to the recent wave of significant events affecting financial institutions, including the insolvency of Lehman Brothers, the government's placing Fannie Mae, Freddie Mac and AIG under its supervision, the announced distressed sales of all or portions of Bear Stearns, Merrill Lynch, Wachovia and Washington Mutual and the government's increasing its equity investment in Citigroup. Although the United States and other governments have taken a number of significant steps to improve market conditions and the strength of major financial institutions, such efforts to date have not brought stability or liquidity to the capital markets, and we cannot predict the future conditions of these markets or the impact of such condition on our business.

The consolidation or elimination of Lehman Brothers, Bear Stearns and several other counterparties has increased our concentration of counterparty risk, decreased the universe of potential counterparties and reduced our ability to obtain competitive financing rates and terms. For a more detailed discussion of our counterparty default and concentration risk, see Part I, Item 1A, "Risk Factors – Risks Related to the Financial Services Industry and Financial Markets – We are subject to counterparty default and concentration risk."

#### *Financial Markets in which We Operate*

Our ability to generate income is dependent on our ability to invest our capital on a timely basis at attractive levels. The two primary market factors that affect this ability are (1) credit spreads and (2) the availability of financing on favorable terms.

Generally speaking, widening credit spreads reduce any unrealized gains on our current investments (or cause or increase unrealized losses) and increase our costs for new financings, but increase the yields available on potential new investments, while tightening credit spreads increase the unrealized gains (or reduce unrealized losses) on our current investments and reduce our costs for new financings, but reduce the yields available on potential new investments. By reducing unrealized gains (or causing unrealized losses), widening credit spreads also impact our ability to realize gains on existing investments if we were to sell such assets.

During the first nine months of 2009, credit spreads widened initially and then tightened substantially in the third quarter of 2009. This net tightening of credit spreads caused the net unrealized losses on our securities to decrease. One of the key drivers of the widening of credit spreads has been the continued disruption and liquidity concerns throughout the credit markets. The severity and scope of the disruption intensified meaningfully during the fourth quarter of 2008 and the first portion of 2009 and caused credit spreads to widen further during this period. In the third quarter 2009, credit spreads tightened substantially. Despite signs of moderate improvement, market conditions remain significantly challenging, and we do not know how recent changes in market conditions will affect our business.

#### *Liquidity*

The ongoing credit and liquidity crisis has adversely affected us and the market in which we operate in a number of other ways. For example, it has reduced the market trading activity for many real estate securities and loans, resulting in less liquid markets for those securities and loans. As the securities held by us and many other companies in our industry are marked to market at the end of each quarter, the decreased liquidity and concern over market conditions have resulted in significant reductions in mark to market valuations of many real estate securities and loans and the collateral underlying them. These lower valuations, and decreased expectations of future cash flows, have affected us by, among other things:

- decreasing our net book value;
- contributing to our decision to record significant impairment charges;
- prompting us to negotiate the removal of certain financial covenants from our non-CDO financings;
- reducing the amount, which we refer to as cushion, by which we satisfy the over collateralization and interest coverage tests of our CDOs (sometimes referred to as CDO "triggers") or contributing to several of our CDOs failing their over collateralization tests (see "– Liquidity and Capital Resources" and "– Debt Obligations" below); and
- requiring us to pay additional amounts under certain financing arrangements.

In some cases, we have sold, and may continue to sell, assets at prices below what we believed to be their value in order to meet liquidity requirements under certain financing arrangements. Failed CDO triggers, impairments resulting from incurred losses, and asset sales at prices significantly below face amount, while the related debt is being repaid at its full face amount, further contribute to reductions in future earnings, cash flow and liquidity. As a result, we expect that our future cash flow from operations will be significantly reduced relative to previous periods.

In order to maintain liquidity, we have elected to retain the majority of our investment proceeds (including those from asset sales) in lieu of using those proceeds to make new investments, or to buy back stock or debt, and elected not to declare any common or preferred dividends during the fourth quarter of 2008 or the first three quarters of 2009. This approach has

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increased our liquidity while reducing our operating earnings. We may elect to adjust or not to pay any future dividend payments to reflect our current and expected cash from operations or to satisfy future liquidity needs.

### *Extent of Market Disruption*

We do not currently know the full extent to which this market disruption will affect us or the markets in which we operate, and we are unable to predict its length or ultimate severity. If the disruption continues, particularly with respect to commercial real estate, we will likely experience additional impairment charges, potential reductions in cash flows from our investments and additional challenges in raising capital and obtaining investment financing on attractive terms. Moreover, we will likely need to continue to place a high priority on managing our liquidity. If we raised capital or issued unsecured debt in the current market, it could be significantly dilutive to our current shareholders.

Future cash flows and our liquidity may be materially impacted if conditions do not continue to improve. Should the current conditions worsen, or persist for an extended period of time, our available capital could be reduced upon the expiration or termination of our capital resources.

Certain aspects of these effects are more fully described in Part I, Item 2, “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Interest Rate, Credit and Spread Risk” and “– Liquidity and Capital Resources” as well as in Part I, Item 3, “Quantitative and Qualitative Disclosures About Market Risk.”

## **APPLICATION OF CRITICAL ACCOUNTING POLICIES**

Management’s discussion and analysis of financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”). The preparation of financial statements in conformity with GAAP requires the use of estimates and assumptions that could affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities and the reported amounts of revenue and expenses. Actual results could differ from these estimates. Management believes that the estimates and assumptions utilized in the preparation of the consolidated financial statements are prudent and reasonable. Actual results have been in line with management’s estimates and judgments used in applying each of the accounting policies described below, as modified periodically to reflect current market conditions. The following is a summary of our accounting policies that are most effected by judgments, estimates and assumptions.

### *Variable Interest Entities*

Financial Accounting Standards Board Accounting Standards Codification (“ASC”) Topic 810 “Consolidation” clarified the methodology for determining whether an entity is a variable interest entity (“VIE”) and the methodology for assessing who is the primary beneficiary of a VIE. VIEs are defined as entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. A VIE is required to be consolidated by its primary beneficiary, and only by its primary beneficiary, which is defined as the party who will absorb a majority of the VIE’s expected losses or receive a majority of the expected residual returns as a result of holding variable interests.

The VIEs in which we have a significant interest include (i) our subprime securitizations, which are held in qualifying special purpose entities under ASC 860-40, “Transfers to Qualifying Special Purpose Entities”, and are therefore exempt from consolidation as VIEs, and (ii) our CDOs, in which we have been determined to be the primary beneficiary and therefore consolidate them, since we would absorb a majority of their expected losses and receive a majority of their expended residual returns, as determined on the date of formation and on any applicable reconsideration dates. Our CDOs are held in special purpose entities whose debt is treated as a non-recourse secured borrowing of Newcastle.

We will continue to analyze future investments, as well as reconsideration events in existing entities, pursuant to the requirements of ASC 810. These analyses require considerable judgment in determining the primary beneficiary of a VIE since they involve estimated probability weighting of subjectively determined possible cash flow scenarios. The result could be the consolidation of an entity that would otherwise not have been consolidated or the non-consolidation of an entity that would otherwise have been consolidated.

### *Valuation and Impairment of Securities*

We have classified all our real estate securities as available for sale. As such, they are carried at fair value with net unrealized gains or losses reported as a component of accumulated other comprehensive income, to the extent impairment losses are considered temporary as described below. Fair value may be based upon broker quotations, counterparty quotations or pricing services quotations, which provide valuation estimates based upon reasonable market order indications or a good faith estimate thereof and are subject to significant variability based on market conditions, such as interest rates, credit spreads and market liquidity. A significant portion of our securities are currently not traded in active markets and therefore have little or no price transparency. For a further discussion of this trend, see “– Market Considerations” above. As a result, we have estimated the fair value of these illiquid securities based on internal pricing models rather than broker quotations. The determination of estimated cash flows used in pricing models is inherently subjective and imprecise. Changes in market conditions, as well as

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changes in the assumptions or methodology used to determine fair value, could result in a significant and immediate increase or decrease in our GAAP equity. For securities valued with pricing models, these inputs include the discount rate, assumptions relating to prepayments, default rates and loss severities, as well as other variables.

See Note 6 to our consolidated financial statements in Part I, Item 1, “Financial Statements and Supplementary Data” for information regarding the fair value of our investments, and its estimation methodology, as of September 30, 2009.

Our estimation of the fair value of level 3B assets (as described below) involves significant judgment. Changes in market conditions, as well as changes in the assumptions or methodology used to determine fair value, could result in a significant increase or decrease in our GAAP equity. For securities valued using pricing models, the inputs include the discount rate, assumptions relating to prepayments, default rates and loss severities, as well as other variables. We validated the inputs and outputs of our models by comparing them to available independent third party market parameters and models for reasonableness. We believe the assumptions we used are within the range that a market participant would use and factor in the relative illiquidity currently in the markets. In comparison to the prior year end, we have used slower prepayment speeds, higher default rates and higher severity assumptions as inputs to our pricing models in order to reflect current market conditions. In the first three quarters of 2009, Newcastle generally lowered the prepayment assumptions based on observed reductions in actual prepayment speeds and slower expected future prepayments consistent with market projections. The slower prepayments were the result of increasing difficulties for borrowers to refinance, caused by a tightening of underwriting standards, decline in home prices, contraction of available lenders due to bank failures and a distressed securitization market. Default assumptions were increased due to higher levels of delinquent underlying loans. Loss severity assumptions were increased based on observed increases in recent loss severities that have been driven by falling home prices and the increasing number of foreclosures or distressed home sales in the residential sector and higher losses as a result of the increasing number of foreclosures and bankruptcies of borrowers experienced in the commercial sector.

For debt securities valued with internal models, which have an aggregate fair value of \$227.0 million as of September 30, 2009, a 10% unfavorable change in our assumptions would result in the following decreases in such aggregate fair value:

	CMBS	ABS
Outstanding face amount	\$969,323	\$462,687
Fair value	\$126,789	\$100,218
Effect on fair value with 10% unfavorable change in:		
Discount rate	\$ (2,503)	\$ (4,531)
Prepayment rate	N/A	\$ (1,528)
Default rate	\$ (20,233)	\$ (7,831)
Loss severity	\$ (15,338)	\$ (14,506)

The sensitivity analysis is hypothetical and should be used with caution. In particular, the results are calculated by stressing a particular economic assumption independent of changes in any other assumption; in practice, changes in one factor may result in changes in another, which might counteract or amplify the sensitivities. Also, changes in the fair value based on a 10% variation in an assumption generally may not be extrapolated because the relationship of the change in the assumption to the change in fair value may not be linear.

Pursuant to ASC 820 “Fair Value Measurements and Disclosures”, our securities must be categorized by the “level” of inputs used in estimating their fair values. Level 1 would be assets valued based on quoted prices for identical instruments in active markets; we have no level 1 assets. Level 2 would be assets valued based on quoted prices in active markets for similar instruments, on quoted prices in less active or inactive markets, or on other “observable” market inputs. Level 3 would be assets valued based significantly on “unobservable” market inputs. We have further broken level 3 into level 3A, third party indications, and level 3B, internal models. Fair value under ASC 820 represents an exit price in the normal course of business, not a forced liquidation price. If we were forced to sell assets in a short period to meet liquidity needs, the prices we receive could be substantially less than the recorded fair values.

We generally classify the broker quotations we receive as level 3A inputs, except for certain liquid securities. They are quoted prices in generally inactive and illiquid markets for identical or similar securities. These quotations are generally received via email and contain disclaimers which state that they are “indicative” and not “actionable” – meaning that the party giving the quotation is not bound to actually purchase the security at the quoted price. These quotations are generally based on models prepared by the brokers and we have little visibility into the inputs they use. Based on procedures we have performed with respect to prior quotations received from these brokers in comparison to the outputs generated from our internal pricing models and transactions we have completed with respect to these securities, as well as on our knowledge and experience of these markets, we have generally determined that these quotes represent a reasonable estimate of fair value. In addition, management performs its own quarterly analysis of fair value, based on internal pricing models, to confirm that each of the quotations received represented a reasonable estimate of fair value as defined under ASC 820. For securities valued using quotations, a 100 basis point change in credit spreads would impact estimated fair value at period and by approximately \$49.1 million.

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We must also assess whether unrealized losses on securities, if any, reflect a decline in value which is other-than-temporary and, if so, write the impaired security down to its fair value through earnings. A decline in value is deemed to be other-than-temporary if (i) it is probable that we will be unable to collect all amounts due according to the contractual terms of a security which was not impaired at acquisition (there is an expected credit loss), or (ii) if we have the intent to sell a security in an unrealized loss position or it is more likely than not we will be required to sell a security in an unrealized loss position prior to its anticipated recovery (if any). For the purposes of performing this analysis, we assume the anticipated recovery period is until the respective security's expected maturity. Also, for those securities within the scope of ASC 325-40, "Beneficial Interests in Securitized Financial Assets", whenever there is a probable adverse change in the timing or amounts of estimated cash flows of a security from the cash flows previously projected, an other-than-temporary impairment is considered to have occurred. Securities within the scope of ASC 325-40 are also analyzed for other-than-temporary impairment under the guidelines applicable to all securities as described herein. We note that primarily all of our securities, except our FNMA/FHLMC securities, fall within the scope of ASC 325-40.

Temporary declines in value generally result from changes in market factors, such as market interest rates and credit spreads, or from certain macroeconomic events, including market disruptions and supply changes, which do not directly impact our ability to collect amounts contractually due. We continually evaluate the credit status of each of our securities and the collateral supporting our securities. This evaluation includes a review of the credit of the issuer of the security (if applicable), the credit rating of the security, the key terms of the security (including credit support), debt service coverage and loan to value ratios, the performance of the pool of underlying loans and the estimated value of the collateral supporting such loans, including the effect of local, industry and broader economic trends and factors. These factors include loan default expectations and loss severities, which are analyzed in connection with a particular security's credit support, as well as prepayment rates. These factors are also analyzed in relation to the amount of the unrealized loss and the period elapsed since it was incurred. The result of this evaluation is considered when determining management's estimate of cash flows, particularly with respect to developing the necessary inputs and assumptions. Each security is impacted by different factors and in different ways; generally the more negative factors which are identified with respect to a given security, the more likely we are to determine that we do not expect to receive all contractual payments when due with respect to that security. Significant judgment is required in this analysis.

During the nine months ended September 30, 2009, we had 209, or \$514.7 million carrying amount of, securities that were downgraded and recorded a net other-than-temporary impairment charge of \$292.5 million on these securities in 2009. However, we do not depend on credit ratings in underwriting our securities, either at acquisition or on an ongoing basis. As mentioned above, a credit rating downgrade is one factor that we monitor and consider in our analysis regarding other-than-temporary impairment, however it is not determinative. Our securities generally benefit from the support of one or more subordinate classes of securities or equity or other forms of credit support. Therefore, credit rating downgrades, even to the extent they relate to an expectation that a securitization we have invested in, on an overall basis, has credit issues, may not ultimately impact cash flow estimates for the class of securities in which we are invested.

Furthermore, the analysis of whether it is more likely than not that we will be required to sell securities in an unrealized loss position prior to an expected recovery in value (if any), the amount of such expected required sales, and the projected identification of which securities would be sold is also subject to significant judgment, particularly in times of market illiquidity such as we are currently experiencing.

### *Revenue Recognition on Securities*

Income on these securities is recognized using a level yield methodology based upon a number of cash flow assumptions that are subject to uncertainties and contingencies. Such assumptions include the rate and timing of principal and interest receipts (which may be subject to prepayments and defaults). These assumptions are updated on at least a quarterly basis to reflect changes related to a particular security, actual historical data, and market changes. These uncertainties and contingencies are difficult to predict and are subject to future events, and economic and market conditions, which may alter the assumptions. For securities acquired at a discount for credit losses, the net income recognized is based on a "loss adjusted yield" whereby a gross interest yield is recorded to Interest Income, offset by a provision for probable, incurred credit losses which is accrued on a periodic basis to Provision for Credit Losses. The provision is determined based on an evaluation of the credit status of securities, as described in connection with the analysis of impairment above.

### *Valuation of Derivatives*

Similarly, our derivative instruments are carried at fair value pursuant to ASC 815 "Derivatives and Hedging," as amended. Fair value is based on counterparty quotations. Newcastle reports the fair value of derivative instruments gross of cash paid or received pursuant to credit support agreements and is reflected on a net by counterparty basis when Newcastle believes a legal right of setoff exists under an enforceable netting agreement. To the extent they qualify as cash flow hedges under ASC 815, net unrealized gains or losses are reported as a component of accumulated other comprehensive income; otherwise, they are reported currently in income. To the extent they qualify as fair value hedges, net unrealized gains or losses on both the derivative and the related portion of the hedged item are reported currently in income. Fair values of such derivatives are subject to significant variability based on many of the same factors as the securities discussed above, including counterparty risk. The results of such variability could be a significant increase or decrease in our GAAP equity and/or earnings.



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### *Impairment of Loans*

We purchase, directly and indirectly, real estate related, commercial mortgage and residential mortgage loans, including manufactured housing loans and subprime mortgage loans. We must periodically evaluate each of these loans or loan pools for possible impairment. Impairment is indicated when it is deemed probable that we will be unable to collect all amounts due according to the contractual terms of the loan, or, for loans acquired at a discount for credit losses, when it is deemed probable that we will be unable to collect as anticipated. Upon determination of impairment, we would establish a specific valuation allowance with a corresponding charge to earnings. We continually evaluate our loans receivable for impairment. Our residential mortgage loans, including manufactured housing loans, are aggregated into pools for evaluation based on like characteristics, such as loan type and acquisition date. Individual loans are evaluated based on an analysis of the borrower's performance, the credit rating of the borrower, debt service coverage and loan to value ratios, the estimated value of the underlying collateral, the key terms of the loan, and the effect of local, industry and broader economic trends and factors. Pools of loans are also evaluated based on similar criteria, including historical and anticipated trends in defaults and loss severities for the type and seasoning of loans being evaluated. This information is used to estimate specific impairment charges on individual loans as well as provisions for estimated unidentified incurred losses on pools of loans. Significant judgment is required both in determining impairment and in estimating the resulting loss allowance. Furthermore, we must assess our intent and ability to hold our loan investments on a periodic basis. If we do not have the intent to hold a loan for the foreseeable future or until its expected payoff, the loan must be classified as "held for sale" and recorded at the lower of cost or estimated fair value. As of September 30, 2009, we determined that we could not express the intent and ability to hold all of our loans which are in an unrealized loss position for the foreseeable future or until their expected pay off.

### *Revenue Recognition on Loans Held for Investment*

Income on these loans is recognized similarly to that on our securities and is subject to similar uncertainties and contingencies, which are also analyzed on at least a quarterly basis. For loan pools acquired at a discount for credit losses, the net income recognized is based on a "loss adjusted yield" whereby a gross interest yield is recorded to Interest Income, offset by a provision for probable, incurred credit losses which is accrued on a periodic basis to Provision for Credit Losses. The provision is determined based on an evaluation of the loans as described under "Impairment of Loans" above. A rollforward of the provision is included in Note 4 to our consolidated financial statements included herein.

### *Revenue Recognition on Loans Held for Sale*

Real estate related, commercial mortgage and residential mortgage loans that are considered held for sale are carried at the lower of amortized cost or market value determined on either an individual method basis, or in the aggregate for pools of similar loans. Interest income is recognized to the extent cash is received whereas a change in the market value of loans, to the extent that the value is not above the cost basis, is recorded in Valuation Allowance.

## **Recent Accounting Pronouncements**

In February 2008, the FASB issued FASB Staff Position No. FAS 140-3 ("FSP FAS 140-3"), "Accounting for Transfers of Financial Assets and Repurchase Financing Transactions." FSP FAS 140-3, codified in ASC 860-10, provides guidance on accounting for a transfer of a financial asset and a repurchase financing. It presumes that an initial transfer of a financial asset and a repurchase financing are considered part of the same arrangement (a linked transaction) unless certain criteria are met. If the criteria are not met, the linked transaction would be recorded as a net investment, likely as a derivative, instead of recording the purchased financial asset on a gross basis along with a repurchase financing. FSP FAS 140-3 applies to reporting periods beginning after November 15, 2008 and is only applied prospectively to transactions that occur on or after the adoption date. The adoption of FSP FAS 140-3 did not have a material impact on our financial condition, liquidity or results of operations as we have not entered into any such transactions since January 2009.

In March 2008, the FASB issued SFAS 161, "Disclosures about Derivative Instruments and Hedging Activities." SFAS 161, codified in ASC 815-10-65 applies to reporting periods beginning after November 15, 2008. ASC 815-10-65 requires enhanced disclosures about an entity's derivative and hedging activities. It does not change the accounting for such activities. As a result, while the adoption of ASC 815-10-65 has changed our disclosures, it did not have a material impact on our financial condition, liquidity or results of operations.

In January 2009, the FASB issued FSP EITF 99-20-1, "Amendments to the Impairment Guidance of EITF Issue No. 99-20." This FSP, codified in ASC 325-40-65 "Beneficial Interests in Securitized Financial Assets", amends previous guidance to achieve more consistent determination of whether an other-than-temporary impairment has occurred, with the same objective as ASC 320. In particular, it changed a requirement to analyze a security's estimated cash flows from a market participant's perspective to an analysis from the perspective of the holder. It is effective for periods ending after December 15, 2008 and is applied prospectively. Due to the prospective nature of its adoption, the adoption of ASC 325-40-65 did not have a material impact on our financial condition, liquidity or results of operations. It did not have a material impact on our impairment analyses subsequent to adoption because we generally analyze cash flows of securities in a manner consistent with market practice.

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In April 2009, the FASB issued three FSPs related to fair value and impairment, FSP FAS 107-1 and APB 28-1 “Interim Disclosures about Fair Value of Financial Instruments (codified in ASC 825-10-65),” FSP FAS 115-2 and FAS 124-2 “Recognition and Presentation of Other-Than-Temporary Impairments (codified in ASC 320-10-65),” and FSP FAS 157-4 “Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (codified in ASC 820-10-65).” These FSPs (i) require disclosures about the fair value of financial instruments on an interim basis, (ii) change the guidance for determining, recording and disclosing other-than-temporary impairment, and (iii) provide additional guidance for estimating fair value when the volume or level of activity for an asset or liability have significantly decreased. These FSPs were effective for Newcastle as of April 1, 2009. They had a significant impact on our disclosures, but no material impact on our financial condition, liquidity, or results of operations upon adoption. A reclassification adjustment of \$1.3 billion of loss from Accumulated Deficit to Accumulated Other Comprehensive Income (Loss) was recorded at adoption of FSP FAS 115-2 and 124-2 (as codified in ASC 320-10-65) but had no net effect on equity. Post-adoption impairment determinations, including the analysis performed at September 30, 2009, are performed using this new guidance and may result in materially different conclusions than would have been reached under prior guidance.

In June 2009, the FASB issued SFAS No. 166 “Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140.” As of the date of this filing, FASB ASC did not integrate SFAS 166 into the codification. SFAS 166 eliminates the concept of qualified special purpose entities (QSPEs), changes the requirements for reporting a transfer of a portion of financial assets as a sale, clarifies other sale accounting criteria and changes the initial measurement of a transferor’s interest in transferred financial assets. Furthermore, it requires additional disclosures. SFAS 166 is effective for fiscal year beginning after November 15, 2009. We are currently evaluating the potential impact of SFAS 166 will have on us. At this time, we do not expect that the adoption of SFAS 166 will have a material impact on our financial position, liquidity or results of operations.

In June 2009, the FASB issued SFAS No. 167 “Amendment to FASB Interpretation No. 46(R).” As of the date of this filing, FASB ASC did not integrate SFAS 167 into the codification. SFAS 167 changes the definition of a variable interest entity (“VIE”) and changes the methodology to determine who is the primary beneficiary of, or in other words who consolidates, a VIE. Furthermore, it eliminates the scope exception for qualified special purpose entities (QSPEs), which are now subject to the VIE consolidation rules. SFAS 167 is effective for fiscal year beginning after November 15, 2009. Generally, the changes are expected to cause more entities to be defined as VIE’s and to require consolidation by the entity that exercises day-to-day control over a VIE, such as servicers and collateral managers. We are currently evaluating the potential impact of SFAS 167 on us. If the adoption of this standard caused us to deconsolidate any of our CDOs or other non-recourse financing structures, we would record a gain to the extent that we have taken impairments on assets within a given VIE in excess of our investment in such VIE. This gain could be material. To the extent the adoption resulted in the consolidation of VIEs that are currently not consolidated, the impact could be material to our gross assets, liabilities, revenues and expenses but would not be material to the net income or equity applicable to our common stockholders.

## RESULTS OF OPERATIONS

The following table summarizes the changes in our results of operations from the three and nine months ended September 30, 2008 to the three and nine months ended September 30, 2009 (dollars in thousands):

	Three Months		Nine Months		Explanations of Material Changes
	Amount Change	Percent Change	Amount Change	Percent Change	
Interest income	\$ (38,327)	(33.8)%	\$ (74,428)	(20.6)%	(1)
Interest expense	(21,213)	(28.8)%	(69,585)	(29.4)%	(1)
Provision for credit losses on loan pools	(2,077)	(100.0)%	(6,450)	(100.0)%	(2)
Valuation allowance on loans (held for sale in 2009)	(46,757)	N.M.	6,177	N.M.	(2)
Other-than-temporary impairment on securities, net	(23,319)	N.M.	169,370	N.M.	(3)
Gain (loss) on settlement of investments, net	860	N.M.	3,868	98.7%	(4)
Gain (loss) on extinguishment of debt	127,219	N.M.	172,361	N.M.	(5)
Other income (loss), net	15,660	N.M.	37,986	N.M.	(6)
Equity in earnings of unconsolidated subsidiaries	(123)	(29.4)%	(7,908)	(96.6)%	(7)
Loan and security servicing expense	(621)	(36.1)%	(1,367)	(26.1)%	(1)
General and administrative expense	95	4.4%	1,202	21.4%	(8)
Management fee to affiliate	(105)	(2.3)%	(316)	(2.3)%	(9)
Depreciation and amortization	—	0.0%	—	0.0%	N/A
Income (loss) from continuing operations	<u>\$ 199,286</u>	<u>136.2%</u>	<u>\$ 32,848</u>	<u>(12.5)%</u>	

N.M.—Not meaningful

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- (1) Changes in interest income and expense are primarily related to our acquisition and disposition during these periods of interest bearing assets and related financings, as follows:

	Three Months		Nine Months	
	Period to Period Increase (Decrease)		Period to Period Increase (Decrease)	
	Interest Income	Interest Expense	Interest Income	Interest Expense
Disposition of securities and loans	\$ (8,426)	\$ (4,729)	\$ (28,231)	\$ (17,061)
Prepayment penalty income	704	—	8,158	—
Repayment of debt obligations and related dispositions	—	(1,392)	(4,004)	(7,785)
Paydowns	(5,579)	(2,987)	(18,171)	(10,459)
Amortization of deferred hedge loss	—	1,710	—	6,699
Other (see below)	(25,026)	(13,815)	(32,180)	(40,979)
	<u>\$ (38,327)</u>	<u>\$ (21,213)</u>	<u>\$ (74,428)</u>	<u>\$ (69,585)</u>

Changes in Other are primarily due to changes in interest rates and partially offset by the increased interest income recorded in 2009 as a result of the accretion of discounts on the impaired securities.

Changes in loan and security servicing expense are primarily due to dispositions and paydowns.

- (2) This change is primarily the result of the classification of loans as held for sale in the fourth quarter of 2008 as we could no longer express the intent and ability to hold our loan investments through maturity. For the nine months ended September 30, 2009, the actual losses incurred in our pools of residential mortgage loans were recorded against the Valuation Allowance on Loans Held for Sale whereas the change in fair value was recorded to Valuation Allowance on Loans Held for Sale. The change for the three months ended September 30, 2009 is a result of a net increase in the valuation of the loans.
- (3) This change is due to the impairment charges recorded as a result of the continued credit market turmoil, which led us to record write downs to a significant portion of our securities portfolio. The change for the three months ended September 30, 2009 is a result of a tightening of credit spreads.
- (4) This change is predominantly the result of the gains recorded on paydown at par of loans and securities previously written down, partially offset by the loss on sales of certain securities and loans.
- (5) This change is primarily due to increased gains on the repurchase of our own debt.
- (6) This change is primarily due to an increase in the fair value of our interest rate swaps not designated as accounting hedges in the three and nine months ended September 30, 2009 which we mark to market through the statement of operations, and the unrealized loss recorded on the total rate of return swaps held in 2008.
- (7) This change is primarily due to the sale of our interests in the operating real estate joint venture in 2008.
- (8) This change is primarily due to increases in insurance expense, legal and professional fees, partially offset by a refund of excise tax paid in 2008.
- (9) Management fees have remained relatively stable as we did not raise capital through common or preferred stock offerings during these periods. As a result of impairment charges, we will not incur incentive compensation to our manager for an indefinite period of time.

## LIQUIDITY AND CAPITAL RESOURCES

### Overview

Liquidity is a measurement of our ability to meet potential cash requirements, including ongoing commitments to repay borrowings, fund and maintain investments, and other general business needs. Additionally, to maintain our status as a REIT under the Code, we must distribute annually at least 90% of our REIT taxable income. We note that up to 90% of this requirement may be met in future years through stock dividends, rather than cash, subject to limitations based on the value of our stock. Our primary sources of funds for liquidity consist of net cash provided by operating activities, sales or repayments of investments, potential refinancing of existing debt and the issuance of equity securities, when available. Our debt obligations are generally secured directly by our investment assets.

### Sources of Liquidity and Uses of Capital

As of the date of this filing, we currently have sufficient cash on hand to satisfy all of our non-agency recourse liabilities (excluding our trust preferred securities, which are long-term obligations). With respect to the next twelve months, we expect that our cash on hand combined with our cash flow provided by operations will be sufficient to satisfy our anticipated liquidity needs with respect to our current investment portfolio, including related financings, hedges, potential margin calls and operating expenses. While it is inherently more difficult to forecast beyond the next twelve months, we currently expect to meet our long term liquidity requirements, specifically the repayment of our debt obligations, through our cash on hand and, if needed, additional borrowings, proceeds received from repurchase agreements and similar financings, and the liquidation or refinancing of our assets.

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These short-term and long-term expectations are forward-looking and subject to a number of uncertainties and assumptions, which are described below under “–Factors That Could Impact Our Liquidity” as well as Part II, Item 1A, “Risk Factors.” If our assumptions about our liquidity prove to be incorrect, we could be subject to a shortfall in liquidity in the future, and this short-fall may occur rapidly and with little or no notice, which would limit our ability to address the shortfall on a timely basis.

Cash flow provided by operations constitutes a critical component of our liquidity. Essentially, our cash flow provided by operations is equal to (i) the net cash flow from our CDOs that have not failed their over collateralization and interest coverage tests, plus (ii) the net cash flow from our non-CDO investments that are not subject to mandatory debt repayment, including principal and sales proceeds, less (iii) operating expenses (primarily management fees, professional fees and insurance), and less (iv) interest on the junior subordinated notes payable.

Our cash flow provided by operations differs from our net income (loss) due to these primary factors: (i) accretion of discount or premium on our real estate securities and loans (including the accrual of interest and fees payable at maturity), discount on our debt obligations, deferred financing costs and interest rate cap premiums, and deferred hedge gains and losses, (ii) gains and losses from sales of assets financed with CDOs, (iii) the provision for credit losses and valuation allowance recorded in connection with our loan assets, as well as other-than-temporary impairment on our securities, (iv) unrealized gains or losses on our non-hedge derivatives, (v) the non-cash charges associated with our early extinguishment of debt, and (vi) net income (loss) generated within CDOs that have failed their over collateralization tests and one of the manufactured housing loan portfolios that became callable in January 2009 and therefore do not remit cash to us. Proceeds from the sale of assets which serve as collateral for our CDO financings, including gains thereon, are required to be retained in the CDO structure until the related bonds are retired and are therefore not available to fund current cash needs outside of these structures.

### Update on Liquidity, Capital Resources and Capital Obligations

Certain details regarding our liquidity, current financings and capital obligations as of November 4, 2009 are set forth below:

- *Cash* – We had unrestricted cash of \$74.0 million. In addition, we had \$126.7 million of restricted cash for reinvestments in our CDOs;
- *Margin Exposure* – We have no financings subject to margin calls, other than one repurchase agreement with a face amount of \$41.4 million which finances our FNMA/FHLMC investments and four interest rate swap agreements with an aggregate notional amount of \$70.1 million;
- *Construction Loan Funding Commitment* – In June 2009, we entered into an agreement with the other lender parties to the commercial construction loan to terminate all future funding commitments. As a result, as of September 30, 2009, we no longer have any future funding commitments with respect to this loan; and
- *Recourse Financings* – Substantially all of our assets, other than our FNMA/FHLMC investments, are currently financed with term debt subject to amortization payments. The following table compares the face amount of our recourse financings, excluding the trust preferred securities:

	November 4, 2009	September 30, 2009	December 31, 2008
Recourse Financings			
Real Estate Securities, Loans and Properties	\$ 36,171	\$ 36,420	\$ 102,977
Manufactured Housing Loans	12,346	13,425	51,118
FNMA/FHLMC Securities	41,438	41,619	173,495
Total Recourse Financings	<u>\$ 89,955</u>	<u>\$ 91,464</u>	<u>\$ 327,590</u>

The following table summarizes the scheduled repayments of our recourse financings as of November 4, 2009:

November 4, 2009 to December 31, 2009 (A)	\$ 47,438
1st Quarter 2010	15,171
2nd Quarter 2010	23,000
3rd Quarter 2010	3,000
4th Quarter 2010	1,346
Total Recourse Financings	<u>\$ 89,955</u>

(A) Includes \$41.4 million of financing on FNMA/FHLMC securities, which is expected to be “rolled” (refinanced at similar terms) upon maturity.

It is important for readers to understand that our liquidity, available capital resources and capital obligations could change rapidly due to a variety of factors, many of which are beyond our control. Set forth below is a discussion of some of the factors that could impact our liquidity, available capital resources and capital obligations.

### Factors That Could Impact Our Liquidity, Capital Resources and Capital Obligations

We refer readers to our discussions in other sections of this report for the following information:

- For a further discussion of recent trends and events affecting our liquidity, see “– Market Considerations” above;

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- As described below, under “– Interest Rate, Credit and Spread Risk,” we are subject to margin calls in connection with our derivatives related to the non-recourse financing structures;
- Our match funded investments are financed long term, and their credit status is continuously monitored, which is described under “Quantitative and Qualitative Disclosures About Market Risk — Interest Rate Exposure” below. Our remaining investments, generally financed with short term debt or short term repurchase agreements, are also subject to refinancing risk upon the maturity of the related debt. See “Debt Obligations” below; and
- For a further discussion of a number of risks that could affect our liquidity, access to capital resources and our capital obligations, see Part II, Item 1A, “Risk Factors”.

In addition to the information referenced above, the following factors could also affect our liquidity, access to capital resources and our capital obligations. As such, if their outcomes do not fall within our expectations, changes in these factors could negatively affect our liquidity.

- *Access to Financing from Counterparties* – Decisions by investors, counterparties and lenders to enter into transactions with us will depend upon a number of factors, such as our historical and projected financial performance, compliance with the terms of our current credit and derivative arrangements, industry and market trends, the availability of capital and our investors’, counterparties’ and lenders’ policies and rates applicable thereto, and the relative attractiveness of alternative investment or lending opportunities. As we discuss in more detail under “–Market Considerations” below, the ongoing credit and liquidity crisis has limited the array of capital resources available to us and made the terms of capital resources we are able to obtain generally less favorable to us relative to the terms we were able to obtain prior to the crisis. For example, we are currently contractually restricted from entering into new debt financings subject to margin calls other than to finance up to a specified amount of FNMA/FHLMC securities. Our core business strategy is dependent upon our ability to finance our real estate securities, loans and other real estate related assets with match funded debt at rates that provide a positive net spread. Currently, spreads for such liabilities have widened and demand for such liabilities has become extremely limited, therefore restricting our ability to execute future financings. This restriction can be exacerbated by the requirement to post margin on existing obligations.
- *Impact of Rating Downgrades on CDO Cash Flows* – Ratings downgrades of assets in our CDOs can negatively impact compliance with the CDOs’ over collateralization tests. Generally, the over collateralization test measures the principal balance of the specified pool of assets in a CDO against the corresponding liabilities issued by the CDO. However, based on ratings downgrades, the principal balance of an asset or of a specified percentage of assets in a CDO may be deemed to be reduced below their current balance to levels set forth in the related CDO documents for purposes of calculating the over collateralization test. As a result, ratings downgrades can reduce the assumed principal balance of the assets used in the over collateralization test relative to the corresponding liabilities in the test, thereby reducing the over collateralization percentage. In addition, actual defaults of assets would also negatively impact compliance with the over collateralization tests. Failure to satisfy an over collateralization test could result in the redirection of cashflows, or, in certain cases, in the potential removal of Newcastle as collateral manager of the affected CDO. See “Debt Obligations” below for a summary of assets on negative watch for possible downgrade in our CDOs.
- *Impact of Expected Repayment or Forecasted Sale on Cash Flows* – The timing of and proceeds from the repayment or sale of certain investments may be different than expected or may not occur as expected. Proceeds from sales of assets in the current illiquid market environment are unpredictable and may vary materially from their estimated fair value and their carrying value.

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### Investment Portfolio

The following summarizes our investment portfolio at September 30, 2009 (dollars in millions).

	Outstanding Face Amount	Amortized Cost Basis (1)	Percentage of Amortized Cost Basis	Number of Investments	Credit (2)	Weighted Average Life (years) (3)
<b>Investment (5)</b>						
<b>Commercial</b>						
CMBS	\$ 2,389	\$ 1,504	44.9%	285	BB+	3.2
Mezzanine Loans	754	276	8.3%	23	68%	1.7
B-Notes	308	74	2.2%	11	60%	1.6
Whole Loans	98	58	1.7%	4	37%	1.9
Total Commercial Assets	3,549	1,912	57.1%			2.7
<b>Residential</b>						
Manufactured Housing and Residential Mortgage Loans	499	361	10.8%	12,956	697	6.0
Subprime Securities	483	206	6.2%	104	B	3.8
Subprime Retained Securities and Residuals	66	3	0.1%	7	C/649	1.8
Real Estate ABS	87	68	2.0%	26	BBB-	4.5
	1,135	638	19.1%			4.7
FNMA/FHLMC securities	48	48	1.4%	3	AAA	3.9
Total Residential Assets	1,183	686	20.5%			4.6
<b>Corporate</b>						
REIT Debt	561	552	16.5%	61	BB	4.3
Corporate Bank Loans	341	198	5.9%	10	CCC-	2.6
Total Corporate Assets	902	750	22.4%			3.7
<b>TOTAL / WA</b>	<b>\$ 5,634</b>	<b>\$ 3,348</b>	<b>100.0%</b>			<b>3.3</b>
Reconciliation to GAAP total assets:						
Net unrealized loss recorded in accumulated other comprehensive income		(622)				
Other assets						
Subprime mortgage loans subject to call option (4)		402				
Real estate held for sale		10				
Cash and restricted cash		214				
Other		47				
GAAP total assets		<u>\$ 3,399</u>				

WA – Weighted average, in all tables.

- (1) Net of impairments.
- (2) Credit represents weighted average of minimum rating for rated assets, LTV (based on the appraised value at the time of purchase) for non-rated commercial assets, FICO score for non-rated residential assets and an implied AAA rating for FNMA/FHLMC securities. Ratings provided above were determined by third party rating agencies as of a particular date, may not be current and are subject to change (including the assignment of a “negative watch”) at any time.
- (3) Weighted average life represents the timing of expected principal payments on the asset. For an asset with an expected loss, weighted average life represents the timing of all remaining expected cash flows, both principal and interest payments.
- (4) Our subprime mortgage loans subject to call option are excluded from the statistics because they result from an option, not an obligation, to repurchase such loans, are noneconomic until such option is exercised, and are offset by an equal liability on the consolidated balance sheet.
- (5) The following tables summarize certain supplemental data relating to our investments (dollars in thousands):

### CMBS

Deal Vintage (A)	Average Minimum Rating (B)	Number	Outstanding Face Amount	Amortized Cost Basis	Percentage of Amortized Cost Basis	Delinquency 60+/FC/REO (C)	Principal Subordination (D)	Weighted Average Life (years)
Pre 2004	BBB+	81	\$ 429,115	\$ 413,444	27.5%	3.6%	11.8%	3.3
2004	BB+	61	434,747	338,967	22.5%	3.1%	5.7%	4.2
2005	BB	53	601,136	251,409	16.7%	2.0%	5.8%	3.1
2006	BB+	50	473,568	324,715	21.6%	1.3%	10.3%	2.9
2007	B+	40	450,518	175,363	11.7%	3.0%	10.8%	2.4
Total / WA	BB+	285	\$2,389,084	\$1,503,898	100.0%	2.5%	8.7%	3.2

- (A) The year in which the securities were issued.

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- (B) Ratings provided above were determined by third party rating agencies as of a particular date, may not be current and are subject to change (including the assignment of a “negative watch”) at any time.
- (C) The percentage of underlying loans that are 60+ days delinquent, or in foreclosure or considered real estate owned (REO).
- (D) The percentage of the outstanding face amount of securities that is subordinate to our investments.

### Mezzanine Loans, B-Notes and Whole Loans

	Mezzanine Loans	B-Notes	Whole Loans	Total / WA
Outstanding Face Amount	\$ 753,902	\$308,085	\$ 97,680	\$1,159,667
Amortized Cost Basis	\$ 276,196	\$ 73,599	\$ 58,496	\$ 408,291
Number	23	11	4	38
Weighted Average First \$ Loan to Value (A)	55.3%	47.9%	0.0%	48.7%
Weighted Average Last \$ Loan to Value (A)	68.1%	59.8%	37.3%	63.3%
Delinquency (B)	6.0%	42.7%	0.0%	15.2%

- (A) Loan to value is based on the appraised value at the time of purchase.
- (B) The percentage of underlying loans that are non-performing, in foreclosure, under bankruptcy filing or considered real estate owned.

### Manufactured Housing and Residential Loans

Deal	Outstanding Face Amount	Amortized Cost Basis	Percentage of Amortized Cost Basis	Average Loan Age (months)	Original Balance	Delinquency 90+/FC/REO (A)	Cumulative Loss to Date
Manufactured Housing Loans Portfolio I	\$ 175,377	\$116,359	32.3%	96	\$ 327,855	1.5%	5.1%
Manufactured Housing Loans Portfolio II	252,436	199,641	55.3%	126	434,743	1.2%	3.2%
Residential Loans Portfolio I	67,498	41,438	11.5%	77	646,357	9.1%	0.2%
Residential Loans Portfolio II	3,795	3,180	0.9%	60	83,950	0.0%	0.0%
Total / WA	\$ 499,106	\$360,618	100.0%	108	\$1,492,905	2.3%	3.5%

- (A) The percentage of loans that are 90+ days delinquent, or in foreclosure or considered real estate owned (REO).

### Subprime Securities (A)

Vintage (B)	Security Characteristics						
	Average Minimum Rating (C)	Number of Securities	Outstanding Face Amount	Amortized Cost Basis	Percentage of Amortized Cost Basis	Principal Subordination (D)	Excess Spread (E)
2003	BB	15	\$ 23,085	\$ 15,481	7.5%	20.9%	4.2%
2004	B+	31	99,222	41,420	20.1%	12.9%	4.2%
2005	B	39	169,272	46,915	22.8%	23.3%	5.1%
2006	CCC	12	105,166	45,187	21.9%	18.7%	4.9%
2007	BB+	7	86,072	57,085	27.7%	30.7%	4.6%
Total / WA	B	104	\$ 482,817	\$206,088	100.0%	21.4%	4.8%

Vintage (B)	Collateral Characteristics				
	Average Loan Age (months)	Collateral Factor (F)	3 month CPR (G)	Delinquency (H)	Cumulative Losses to Date
2003	78	0.11	13.1%	15.0%	2.6%
2004	65	0.15	11.7%	18.8%	2.6%
2005	52	0.25	17.2%	32.8%	7.3%
2006	38	0.58	14.9%	38.6%	9.2%
2007	36	0.69	20.7%	32.4%	8.3%
Total / WA	50	0.37	16.0%	30.3%	6.7%

- (A) Excludes subprime retained securities and residual interests.
- (B) The year in which the securities were issued.
- (C) Ratings provided above were determined by third party rating agencies as of a particular date, may not be current and are subject to change (including the assignment of a “negative watch”) at any time.
- (D) The percentage of the outstanding face amount of securities and residual interests that is subordinate to our investments.
- (E) The annualized amount of interest received on the underlying loans in excess of the interest paid on the securities, as a percentage of the outstanding collateral balance.
- (F) The ratio of original unpaid principal balance of loans still outstanding.
- (G) Three month average constant prepayment rate.
- (H) The percentage of underlying loans that are 90+ days delinquent, or in foreclosure or considered real estate owned (REO).

### Subprime Retained Securities and Residual Interests

Represents \$2.0 million and \$0.1 million of amortized cost basis of retained bonds and residual interests, respectively, in the securitizations of Subprime Portfolios I and II. For further information on these securitizations, see Note 4 to our consolidated financial statements included herein.

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[REIT Debt](#)

<u>Industry</u>	<u>Average Minimum Rating (A)</u>	<u>Number</u>	<u>Outstanding Face Amount</u>	<u>Amortized Cost Basis</u>	<u>Percentage of Amortized Cost Basis</u>
Retail	BB+	18	\$ 164,460	\$152,365	27.6%
Diversified	B-	13	133,141	133,511	24.2%
Office	BBB	12	130,219	132,441	24.0%
Multifamily	BBB	4	18,765	17,513	3.2%
Hotel	BBB-	4	37,220	37,777	6.9%
Healthcare	BBB-	6	51,600	51,374	9.3%
Storage	A-	1	5,000	5,078	0.9%
Industrial	BB-	3	20,865	21,440	3.9%
<b>Total / WA</b>	<b>BB</b>	<b>61</b>	<b>\$ 561,270</b>	<b>\$551,499</b>	<b>100.0%</b>

[Corporate Bank Loans](#)

<u>Industry</u>	<u>Average Minimum Rating (A)</u>	<u>Number</u>	<u>Outstanding Face Amount</u>	<u>Amortized Cost Basis</u>	<u>Percentage of Amortized Cost Basis</u>
Real Estate	C	3	\$ 104,549	\$ 62,974	31.8%
Media	CC	2	112,000	35,840	18.1%
Resorts	BB-	1	76,406	59,215	29.9%
Restaurant	B	2	19,388	14,458	7.3%
Transportation	NR	1	27,000	24,300	12.2%
Theatres	B-	1	1,461	1,411	0.7%
<b>Total / WA</b>	<b>CCC-</b>	<b>10</b>	<b>\$ 340,804</b>	<b>\$198,198</b>	<b>100.0%</b>

(A) Ratings provided above were determined by third party rating agencies as of a particular date, may not be current and are subject to change (including the assignment of a “negative watch”) at any time.

*Debt Obligations*

Our debt obligations, as summarized in Note 5 to our consolidated financial statements included herein, existing at September 30, 2009 (gross of \$13.9 million of discounts) had contractual maturities as follows (in thousands):

	<u>Nonrecourse</u>	<u>Recourse</u>	<u>Total</u>
Period from October 1, 2009 through December 31, 2009	\$ 112,465	\$ 48,619	\$ 161,084
2010	—	42,845	42,845
2011	190,812	—	190,812
2012	—	—	—
2013	—	—	—
2014	—	—	—
Thereafter	4,525,916	101,700	4,627,616
<b>Total</b>	<b>\$4,829,193</b>	<b>\$ 193,164</b>	<b>\$ 5,022,357</b>

Certain of the debt obligations included above are obligations of our consolidated subsidiaries which own the related collateral. In some cases, including the CDO and Other Bonds Payable, such collateral is not available to other creditors of ours.

Our non-CDO debt obligations contain various customary loan covenants. We were in compliance with all the covenants in our non-CDO financings as of September 30, 2009.

Our Other Bonds Payable are collateralized by two portfolios of manufactured housing loans. In January 2009, the debt for one of the portfolios of manufactured housing loans (\$112.5 million outstanding at September 30, 2009) became callable at the option of the lender, and is reflected as due on October 1, 2009 in the table above. The principal and interest payments from the underlying loans, net of expenses and payments related to interest rate swap contracts, are used to repay the outstanding debt on a monthly basis.

In the first quarter of 2009, we repurchased \$30.3 million face amount of three classes of CDO bonds for \$3.2 million. As a result, we extinguished \$30.3 million face amount of CDO debt and recorded a gain on extinguishment of debt of \$26.9 million.

In February 2009, we renegotiated the terms of a recourse loan agreement financing one of our manufactured housing loan portfolios. Under the amended terms of the agreement, certain debt covenants relating to equity requirements were removed.



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In February 2009, we renegotiated the terms of a repurchase agreement financing our investment in a real estate related loan. Under the amended terms of the repurchase agreement, certain debt covenants relating to a concentration limit and equity requirements, as well as the mark-to-market (margin posting) requirement were removed.

In March 2009, we renegotiated the terms of a repurchase agreement financing our investment in a real estate related loan. Under the amended terms of the repurchase agreement, the mark-to-market (margin posting) provisions and certain financial covenants relating to net worth and leverage ratio were removed. Newcastle also agreed not to enter into any new debt financings subject to margin calls other than to finance FNMA/FHLMC securities.

In April 2009, we repurchased \$29.5 million face amount of two classes of CDO bonds for \$2.4 million. As a result, we extinguished \$29.5 million face amount of CDO debt and recorded a gain on extinguishment of debt of \$26.8 million in the second quarter of 2009.

On April 30, 2009, we entered into an exchange agreement with several collateralized debt obligations managed by a third party pursuant to which we agreed to exchange newly issued junior subordinated notes due in 2035 with an initial aggregate principal amount of \$101.7 million (the "Notes") for \$100 million in aggregate liquidation amount of trust preferred securities that were previously issued by a subsidiary of us (the "TRUPs") and were owned by the third party. The Notes accrue interest at a rate of 1.0% per year for a maximum of six quarters, beginning on February 1, 2009 and the aggregate principal amount of the Notes will increase to \$104.9 million by July 31, 2010. Subsequent to that period, the rate reverts to that which we were required to pay on the TRUPs (7.574% through April 2016 and at a floating rate of 3-month LIBOR plus 2.25% thereafter). In conjunction with the exchange, the TRUPs were cancelled and we pledged 100% of our equity interests in NIC TP LLC, a special purpose subsidiary that holds our participation in a loan and related deposit account, which were valued at \$3.6 million on September 30, 2009, as collateral. The pledged collateral will be released at the end of the interest rate modification period. This exchange is considered a troubled debt restructuring under GAAP which requires us to account for the effect of the interest modification prospectively and to record expenses related to the modification immediately through earnings.

In September 2009, we repurchased \$150.1 million face amount of six classes of CDO bonds for \$16.7 million. As a result, we extinguished \$150.1 million face amount of CDO debt and recorded a gain on extinguishment of debt of \$132.5 million in the third quarter of 2009.

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The following table summarizes our CDO financings as of September 30, 2009 (dollars in thousands). The amounts reflect data at the CDO level which is unconsolidated and thus is different from the GAAP balance sheet due to intercompany amounts eliminated in consolidation.

	CDO IV		CDO V		CDO VI		CDO VII		CDO VIII		CDO IX		CDO X		Total / Weighted Average
<b>Balance Sheet:</b>															
Asset Face Amount	\$422,860		\$512,177		\$483,916		\$494,990		\$918,816		\$835,467		\$1,422,344		\$ 5,090,570
Asset Amortized Cost Basis	\$361,331		\$399,826		\$306,747		\$212,066		\$492,976		\$403,762		\$1,052,031		\$ 3,228,739
Debt Carrying Value	380,608		452,575		437,105		452,301		728,534		582,869		1,223,394		4,257,386
Invested Equity (1)	\$ —		\$ —		\$ —		\$ —		\$ —		\$ —		\$ —		\$ —
Quarterly Net Cash Receipts (2)	\$ 145		\$ 1,764		\$ 147		\$ 147		\$ 5,021		\$ 5,373		\$ 4,590		\$ 17,187
Collateral on Negative Watch (3)	\$136,374		\$129,026		\$193,436		\$232,748		\$197,743		\$ 47,250		\$ 381,878		\$ 1,318,455
<b>Collateral Composition (4):</b>															
CMBS	59.7%	BB	65.2%	BB+	64.3%	BB+	67.4%	BB	20.0%	BB-	11.5%	BB+	59.3%	BBB-	46.3%
REIT Debt	22.4%	BBB-	15.5%	BB+	14.6%	BBB-	13.6%	BBB	3.3%	D	0.0%	—	15.4%	BB-	11.0%
ABS	13.5%	BBB	19.3%	BB	16.6%	BB-	16.8%	CCC+	7.2%	BB-	0.0%	—	15.2%	BB+	11.8%
Bank Loans	2.1%	CCC-	0.0%	—	4.2%	CCC+	2.2%	C	11.8%	CCC	18.8%	CCC-	2.5%	CC	6.7%
Mezzanine Loans / B-Notes / Whole Loans	2.3%	BB+	0.0%	—	0.0%	—	0.0%	—	42.1%	CCC+	67.2%	B-	0.0%	—	18.8%
CDO	0.0%	—	0.0%	—	0.0%	—	0.0%	—	9.8%	B	1.7%	BB-	2.9%	C	2.9%
Restricted Cash for Reinvestments	0.0%	—	0.0%	—	0.3%	—	0.0%	—	5.8%	—	0.8%	—	4.7%	—	2.5%
Total	100.0%	BB+	100.0%	BB+	100.0%	BB	100.0%	BB-	100.0%	B-	100.0%	B-	100.0%	BB+	100.0%
<b>CDO Overview:</b>															
Effective Date	Sep-04		Feb-05		Aug-05		Jan-06		Mar-07		Jul-07		Dec-07		
Reinvestment Period Ends (5)	Mar-09		Sep-09		Apr-10		Dec-10		Nov-11		May-12		Jul-12		
Optional Call Date (6)	Jun-07		Dec-07		May-08		Jan-09		Dec-09		Jun-10		Aug-10		
Auction Call Date (7)	Mar-14		Sep-14		Apr-15		Dec-15		Nov-16		May-17		Jul-17		
Avg Debt Spread (bps) (8)	53		45		38		47		46		60		36		45
Asset Weighted Average Life	3.6		3.6		3.8		3.8		3.3		2.0		3.6		3.3
Debt Weighted Average Life	3.1		3.5		4.2		6.0		4.2		5.4		5.5		4.8
<b>CDO Cashflow Triggers (9):</b>															
<b>Over Collateralization (10) (11)</b>															
On the Effective Date	109.4%		110.0%		111.9%		113.4%		113.2%		116.1%		109.8%		
Current	99.4%		110.2%		93.9%		84.7%		111.4%		114.1%		103.1%		
Trigger	105.9%		107.5%		109.3%		110.9%		108.7%		108.0%		101.5%		
<b>Interest Coverage</b>															
Current	214.2%		223.1%		203.4%		176.2%		369.8%		369.7%		374.4%		
Trigger	106.0%		106.0%		106.0%		106.0%		106.0%		103.0%		107.0%		

See notes next page.

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- (1) Given the non-recourse nature of our CDO liabilities, invested equity cannot be less than zero. As of period end, our GAAP equity in our CDOs was \$1.0 billion in the aggregate lower than our invested equity due to impairment recorded in excess of our maximum possible economic loss.
- (2) Represents net cash received from each CDO based on all of our interests in such CDO (including senior management fees). Cash receipts for the quarter-ended September 30, 2009 included \$1.5 million of non-recurring prepayment fees and may not be indicative of cash receipts for subsequent periods. See Cautionary Note Regarding Forward Looking Statements for risk and uncertainties that could cause our receipts for subsequent periods to differ materially from these amounts.
- (3) Represents the face amount of collateral on negative watch for possible downgrade by at least one rating agency (Moody's, S&P or Fitch) as of September 30, 2009 in the respective CDOs. The amounts include CDO bonds of \$146.3 million issued by Newcastle, which are eliminated in consolidation and not reflected in our investment portfolio segments.
- (4) Collateral composition is calculated as a percentage of the face amount of collateral and includes CDO bonds of \$146.3 million and other bonds of \$65.01 million issued by Newcastle, which are eliminated in consolidation. Also reflected are weighted average credit ratings, which were determined by third party rating agencies as of a particular date, may not be current and are subject to change (including the assignment of a "negative watch") at any time.
- (5) Our CDO financings typically have a 5 year reinvestment period. Generally, after such period ends, principal payments on the collateral are used to paydown the most senior debt outstanding. Prior to the end of the reinvestment period, principal payments received on the collateral are reinvested.
- (6) At the option call date, Newcastle, as the equity holder, has the right to payoff the CDO bonds at their related redemption price.
- (7) At the auction call date, there is a mandatory auction of the assets. If the prices are sufficient to pay off the outstanding CDO bonds, the assets will be sold and the CDO bonds will be redeemed.
- (8) Debt spread represents the spread above the benchmark interest rate (LIBOR or U.S. Treasuries) that Newcastle pays on its debt.
- (9) Each of our CDO financings contains tests that measure the amount of over collateralization and excess interest in the transaction. Failure to satisfy these tests would cause the principal and/or interest cashflow that would otherwise be distributed to more junior classes of securities (including those held by Newcastle) to be redirected to pay down the most senior class of securities outstanding until the tests are satisfied. As a result, our cash flow and liquidity are negatively impacted upon such a failure, and the impact could be material. Each CDO contains tests at various over collateralization and interest coverage percentage levels. The trigger percentages identified above represent the first threshold at which cashflows would be redirected as described in this footnote. The data presented is as of the most recent remittance date on or before September 30, 2009 and may change or have changed subsequent to that date. In addition, our CDOs may also contain specific over collateralization tests that, if failed, can result in the occurrence of an event of default or our being removed as collateral manager of the CDO. Failure of the over collateralization tests can also cause a "phantom income" issue if cash that constitutes income is diverted to pay down debt instead of distributed to us. As of November 4, 2009, CDOs IV, VI and VII were not in compliance with their applicable over collateralization tests and, consequently, we are not receiving cash flows from these CDOs (other than senior management fees). Based upon our current calculations, we expect these portfolios to remain out of compliance for the foreseeable future. Moreover, given current market conditions, it is possible that all of our CDOs could be out of compliance with their over collateralization tests as of one or more measurement dates within the next twelve months. Our ability to rebalance will depend upon the availability of suitable securities, market prices, whether the reinvestment period of the applicable CDO has ended, and other factors that are beyond our control, such rebalancing efforts may be extremely difficult given current market conditions and we cannot assure you that we will be successful in our rebalancing efforts. If the liabilities of our CDOs are downgraded by Moody's to certain predetermined levels, our discretion to rebalance the applicable CDO portfolios may be negatively impacted. Moreover, if we bring these coverage tests into compliance, we cannot assure you that they will not fall out of compliance in the future or that we will be able to correct any noncompliance.
- (10) Ratings downgrades of assets in our CDOs can negatively impact compliance with the over collateralization tests. Generally, the over collateralization test measures the principal balance of the specified pool of assets in a CDO against the corresponding liabilities issued by the CDO. However, based on ratings downgrades, the principal balance of an asset or of a specified percentage of assets in a CDO may be deemed reduced below their current balance to levels set forth in the related CDO documents for purposes of calculating the over collateralization test. As a result, ratings downgrades can reduce the principal balance of the assets used in the over collateralization test relative to the corresponding liabilities in the test, thereby reducing the over collateralization percentage. In addition, actual defaults of an asset would also negatively impact compliance with the over collateralization tests. Failure to satisfy an over collateralization test could result in the redirection of cashflows as described in footnote 9 above or, in certain instances, our removal as manager of the applicable portfolio.
- (11) The over collateralization excess percentages as of the October remittance reports were as follows: CDO VI -15.3%, CDO VII -28.0 %, CDO VIII 8.3%, CDO IX 15.7% and CDO X 7.0 %. CDOs IV and V only report actual over collateralization excess percentages on a quarterly basis. The excess percentages for a number of our CDOs decreased between June 2009 and September 2009, and this trend could continue in the future for one or more of our CDOs.

## Stockholders' Equity

### Common Stock

The following table presents information on shares of our common stock issued during the nine months ended September 30, 2009:

Shares Issued	Range of Issue Prices (1)	Net Proceeds (millions)	Option Granted to Manager
116,285	N/A (2)	\$0.0	N/A

- (1) Excludes prices of shares issued pursuant to the exercise of options and of shares issued to our independent directors.
- (2) The only shares issued during this period were to our independent directors.

At September 30, 2009, we had 52,905,335 shares of common stock outstanding.

As of September 30, 2009, our outstanding options had a weighted average strike price of \$26.64 and were summarized as follows:

Held by the Manager	1,686,447
Issued to the Manager and subsequently transferred to certain of the Manager's employees	798,162
Held by the independent directors and former directors	14,000
Total	2,498,609

As of September 30, 2009, approximately 5.0 million shares of our common stock were held by our manager, through affiliates, and its principals.

No dividends were declared with respect to our common stock related to the nine months ended September 30, 2009.

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### Preferred Stock

As of September 30, 2009, \$12.4 million of dividends on Newcastle's cumulative preferred stock were unpaid and in arrears.

### Accumulated Other Comprehensive Income (Loss)

During the nine months ended September 30, 2009, our accumulated other comprehensive income (loss) changed due to the following factors (in thousands):

	<u>Gains (Losses) on Cash Flow Hedges</u>	<u>Unrealized Gains (Losses) on Securities</u>	<u>Total Accumulated Other Comprehensive Income (Loss)</u>
Accumulated other comprehensive income (loss), December, 31, 2008	\$ (314,323)	\$ 6,750	\$ (307,573)
Net unrealized gain (loss) on securities	—	229,077	229,077
Reclassification of net realized (gain) loss on securities into earnings	—	431,328	431,328
Net unrealized gain (loss) on derivatives designated as cash flow hedges	88,514	—	88,514
Reclassification of net realized (gain) loss on derivatives designated as cash flow hedges into earnings	6,001	—	6,001
Reclassification adjustment upon adoption of FSP 115-2 and 124-2 (discussed above)	—	(1,288,924)	(1,288,924)
Accumulated other comprehensive income (loss), September 30, 2009	<u>\$ (219,808)</u>	<u>\$ (621,769)</u>	<u>\$ (841,577)</u>

Our GAAP equity changes as our real estate securities portfolio and derivatives are marked to market each quarter, among other factors. The primary causes of mark to market changes are changes in interest rates and credit spreads. During the nine months ended September 30, 2009, a recharacterization of unrealized non-credit losses upon the adoption of FSP 115-2 and 124-2 coupled with a net tightening of credit spreads have caused a net increase in unrealized losses recorded in accumulative other comprehensive income on our real estate securities. Net unrealized losses on derivatives designated as cash flow hedges decreased for the nine months ended September 30, 2009 primarily as a result of increases in the long-term interest rates.

See “- Market Considerations” above for a further discussion of recent trends and events affecting our unrealized gains and losses as well as our liquidity.

### Cash Flow

#### Operating Activities

Net cash flow provided by operating activities decreased to \$71.5 million for the nine months ended September 30, 2009 from \$92.2 million for the nine months ended September 30, 2008. This change primarily resulted from the acquisition and settlement of our investments as described above, and the performance thereof.

#### Operating Activities – Direct Method Comparison

Cash interest received for investments in securities and loans decreased approximately \$101.9 million as a result of lower average interest earning securities and loans balance of \$5.5 billion for the nine months ended September 30, 2009 compared to \$6.5 billion for the nine months ended September 30, 2008 and a decrease in the weighted average interest rate to 5.09% from 6.08% for the nine months ended September 30, 2009 and September 30, 2008, respectively. The lower asset balance is primarily the result of paydowns and a higher volume of asset sales.

Cash received from interest earned on cash balances decreased approximately \$3.8 million as a result of lower cash balances.

Cash received from our investment in an operating real estate joint venture decreased by \$8 million due to the sale of our interest in the second quarter of 2008.

Cash interest paid decreased approximately \$85.2 million due to a lower average debt balance of \$4.9 billion for the nine months ended September 30, 2009 compared to \$5.7 billion for the nine months ended September 30, 2008 and a decrease in the weighted average funding cost, including the effect of hedges to 3.49% from 5.10% for the nine months ended September 30, 2009 and September 30, 2008, respectively.

Incentive compensation payment decreased by \$6.2 million for the nine months ended September 30, 2009, as a result of the payment of 2007 incentive compensation in September 2008. We did not make a similar payment in 2009 as we have not incurred any incentive compensation.

#### Investing Activities

Investing activities provided \$185.5 million and \$1,379.2 million during the nine months ended September 30, 2009 and 2008, respectively. Investing activities consisted primarily of investments made in certain real estate securities, loans and other real estate related assets, offset by proceeds from the sale or settlement of investments.

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### Financing Activities

Financing activities provided (used) (\$233.5) million and (\$1,360.6) million during the nine months ended September 30, 2009 and 2008, respectively. The return of restricted cash from refinancing activities and return of margin deposits served as the primary sources of cash flow from financing activities. Offsetting uses included the repayment of debt as described above and the payment of related deferred financing costs.

See the consolidated statements of cash flows included in our consolidated financial statements for a reconciliation of our cash position for the periods described.

### **INTEREST RATE, CREDIT AND SPREAD RISK**

We are subject to interest rate, credit and spread risk with respect to our investments. These risks are further described in “Quantitative and Qualitative Disclosures About Market Risk.”

### **OFF-BALANCE SHEET ARRANGEMENTS**

As of September 30, 2009, we had two material off-balance sheet arrangements. We believe that these off-balance sheet structures presented the most efficient and least expensive form of financing for these assets at the time they were entered, and represented the most common market-accepted method for financing such assets.

- In April 2006, we securitized our Subprime Portfolio I. The loans were sold to a securitization trust, of which 80% were treated as a sale, which is an off-balance sheet financing.
- In July 2007, we securitized our Subprime Portfolio II. The loans were sold to a securitization trust, of which 90% were treated as a sale, which is an off-balance sheet financing.

We have no obligation to repurchase any loans from either of our subprime securitizations. Therefore, it is expected that our exposure to loss is limited to the carrying amount of our retained interests in the securitization entities, as described above. A subsidiary of ours gave limited representations and warranties with respect to the second securitization; however, it has no assets and does not have recourse to the general credit of Newcastle.

We also had the following arrangements which do not meet the definition of off-balance sheet arrangements, but do have some of the characteristics of off-balance sheet arrangements.

- We have made investments in three unconsolidated subsidiaries, two of which are dormant at September 30, 2009.

In each case, our exposure to loss is limited to the carrying (fair) value of our investment.

### **CONTRACTUAL OBLIGATIONS**

During the first nine months of 2009, we had all of the material contractual obligations referred to in our annual report on Form 10-K for the year ended December 31, 2008, excluding the debt which was repaid or repurchased and the related hedges which were terminated, as described in “– Liquidity and Capital Resources,” as well as the following:

<u>Contract Category</u>	<u>Change</u>
Repurchase agreements	As described above, we modified the terms of several debt agreements.
Junior subordinated notes	As described above, we modified the terms of the junior subordinated notes issued by us.
Loan commitment	As described above, Newcastle’s and its CDOs’ future funding commitments with respect to the commercial construction loan were terminated.

The terms of these contracts are described under “Quantitative and Qualitative Disclosures About Market Risk” below.

### **INFLATION**

We believe that our risk of increases in the market interest rates on our floating rate debt as a result of inflation is largely offset by our use of match funding and hedging instruments as described above. See “Quantitative and Qualitative Disclosure About Market Risk — Interest Rate Exposure” below.

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**ADJUSTED FUNDS FROM OPERATIONS**

We believe Adjusted Funds From Operations (“AFFO”) is one appropriate measure of the operating performance of real estate companies. We also believe that AFFO is an appropriate supplemental disclosure of operating performance for a REIT. Furthermore, AFFO is used to compute our incentive compensation to the Manager. AFFO, for our purposes, represents net income available for common stockholders (computed in accordance with GAAP), excluding extraordinary items, plus depreciation of operating real estate, and after adjustments for unconsolidated subsidiaries, if any. We consider gains and losses on resolution of our investments to be a normal part of our recurring operations and therefore do not exclude such gains and losses when arriving at AFFO. This is the one difference between our definition of AFFO and the National Association of Real Estate Investment Trusts (“NAREIT”) definition of FFO, which excludes gains and losses. Adjustments for unconsolidated subsidiaries, if any, are calculated to reflect AFFO on the same basis. AFFO does not represent cash generated from operating activities in accordance with GAAP and therefore should not be considered an alternative to net income as an indicator of our operating performance or as an alternative to cash flow as a measure of liquidity and is not necessarily indicative of cash available to fund cash needs. Our calculation of AFFO may be different from the calculation used by other companies and, therefore, comparability may be limited.

AFFO is calculated as follows (in thousands):

	For the Nine Months Ended September 30,	
	2009	2008
Income (loss) applicable to common stockholders	\$(239,934)	\$(281,410)
Operating real estate depreciation	(124)	(5,223)
Adjusted Funds from Operations (AFFO)	<u>\$(240,058)</u>	<u>\$(286,633)</u>

Adjusted Funds from Operations was derived from our segments as follows (in thousands):

	Book Equity at	AFFO for the Nine	AFFO for the
	September 30, 2009	Months Ended September 30, 2009	Three Months Ended September 30, 2009
CDOs	\$ (998,216)	\$ (176,451)	\$ 71,362
Other nonrecourse	(6,474)	15,387	2,243
Recourse	6,928	(33,946)	(8,375)
Unlevered	6,989	(8,270)	(3,253)
Unallocated (1)	<u>(187,611)</u>	<u>(36,778)</u>	<u>(12,314)</u>
Total (2)	(1,178,384)	<u>\$ (240,058)</u>	<u>\$ 49,663</u>
Preferred stock	152,500		
Accumulated depreciation	(868)		
Accumulated other comprehensive income (loss)	<u>(841,577)</u>		
Net GAAP equity	<u>\$ (1,868,329)</u>		

- (1) Unallocated AFFO represents (\$10,126) of preferred dividends, (\$6,218) of interest expense on our junior subordinated notes payable, and (\$20,434) of corporate general and administrative expenses and management fees for the nine months ended September 30, 2009.
- (2) Invested common equity is equal to GAAP equity excluding preferred stock, accumulated depreciation and accumulated other comprehensive income (loss).

As a result of the effect of the other-than-temporary impairment on our AFFO, we expect that there will be no incentive compensation payable to the Manager for an indeterminate amount of time.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Market risk is the exposure to loss resulting from changes in interest rates, credit spreads, foreign currency exchange rates, commodity prices and equity prices. The primary market risks that we are exposed to are interest rate risk and credit spread risk. These risks are highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond our control. All of our market risk sensitive assets, liabilities and related derivative positions are for non-trading purposes only. For a further understanding of how market risk may affect our financial position or results of operations, please refer to “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Application of Critical Accounting Policies.”

**Interest Rate Exposure**

Changes in interest rates, including changes in expected interest rates or “yield curves,” affect our investments in two distinct ways, each of which is discussed below.

First, changes in interest rates affect our net interest income, which is the difference between the interest income earned on assets and the interest expense incurred in connection with our debt obligations and hedges.

Our general financing strategy focuses on the use of match funded structures, when appropriate and available. This means that we seek to match the maturities of our debt obligations with the maturities of our assets to minimize the risk that we have to refinance our liabilities prior to the maturities of our assets, and to reduce the impact of changing interest rates on our earnings. In addition, we generally match fund interest rates on our assets with like-kind debt (i.e., fixed rate assets are financed with fixed rate debt and floating rate assets are financed with floating rate debt), directly or through the use of interest rate swaps, caps or other financial instruments (see below), or through a combination of these strategies, which also allows us to reduce the impact of changing interest rates on our earnings.

However, increases in interest rates can nonetheless reduce our net interest income to the extent that we are not completely match funded. Furthermore, a period of rising interest rates can negatively impact our return on certain floating rate investments. Although these investments may be financed with floating rate debt, the interest rate on the debt may reset prior to, and in some cases more frequently than, the interest rate on the assets, causing a decrease in return on equity during a period of rising interest rates.

As of September 30, 2009, a 100 basis point increase in short term interest rates would increase our earnings by approximately \$2.6 million per annum, assuming a static portfolio of current investments and financings.

Second, changes in the level of interest rates also affect the yields required by the marketplace on debt. Increasing interest rates would decrease the value of the fixed rate assets we hold at the time because higher required yields result in lower prices on existing fixed rate assets in order to adjust their yield upward to meet the market.

Changes in unrealized gains or losses resulting from changes in market interest rates do not directly affect our cash flows, or our ability to pay a dividend, to the extent the related assets are expected to be held, as their fair value is not relevant to their underlying cash flows. Our assets are largely financed to maturity through long term CDO financings that are not redeemable as a result of book value changes. As long as these fixed rate assets continue to perform as expected, our cash flows from these assets would not be affected by increasing interest rates. Changes in unrealized gains or losses would impact our ability to realize gains on existing investments if they were sold. Furthermore, with respect to changes in unrealized gains or losses on investments which are carried at fair value, changes in unrealized gains or losses would impact our net book value and, in the cases of impaired assets and non-hedge derivatives, our net income (loss).

Changes in the value of our assets could affect our ability to borrow and access capital. Also, if the value of our assets subject to short term financing were to decline, it could cause us to fund margin and affect our ability to refinance such assets upon the maturity of the related financings, adversely impacting our rate of return on such securities.

As of September 30, 2009, a 100 basis point change in short term interest rates would impact our net book value by approximately \$56.9 million, assuming a static portfolio of current investments and financings.

Interest rate swaps are agreements in which a series of interest rate flows are exchanged with a third party (counterparty) over a prescribed period. The notional amount on which swaps are based is not exchanged. In general, our swaps are “pay fixed” swaps involving the exchange of floating rate interest payments from the counterparty for fixed interest payments from us. This can effectively convert a floating rate debt obligation into a fixed rate debt obligation. Interest rate swaps may be subject to margin calls.

Similarly, an interest rate cap or floor agreement is a contract in which we purchase a cap or floor contract on a notional face amount. We will make an up-front payment to the counterparty for which the counterparty agrees to make future payments to us should the reference rate (typically LIBOR) rise above (cap agreements) or fall below (floor agreements) the “strike” rate specified in the contract. Payments on an annualized basis will equal the contractual notional face amount multiplied by the difference between the actual reference rate and the contracted strike rate.

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While a REIT may utilize these types of derivative instruments to hedge interest rate risk on its liabilities or for other purposes, such derivative instruments could generate income that is not qualified income for purposes of maintaining REIT status. As a consequence, we may only engage in such instruments to hedge such risks within the constraints of maintaining our standing as a REIT. We do not enter into derivative contracts for speculative purposes nor as a hedge against changes in credit risk.

Our hedging transactions using derivative instruments also involve certain additional risks such as counterparty credit risk, the enforceability of hedging contracts and the risk that unanticipated and significant changes in interest rates will cause a significant loss of basis in the contract. The counterparties to our derivative arrangements are major financial institutions with which we and our affiliates may also have other financial relationships. As a result, we do not anticipate that any of these counterparties will fail to meet their obligations. There can be no assurance that we will be able to adequately protect against the foregoing risks and will ultimately realize an economic benefit that exceeds the related amounts incurred in connection with engaging in such hedging strategies.

### **Credit Spread Exposure**

Credit spreads measure the yield demanded on loans and securities by the market based on their credit relative to U.S. Treasuries, for fixed rate credit, or LIBOR, for floating rate credit. Our fixed rate loans and securities are valued based on a market credit spread over the rate payable on fixed rate U.S. Treasuries of like maturity. Our floating rate loans and securities are valued based on a market credit spread over LIBOR. Excessive supply of such loans and securities combined with reduced demand will generally cause the market to require a higher yield on such loans and securities, resulting in the use of a higher (or "wider") spread over the benchmark rate to value them.

Widening credit spreads would result in higher yields being required by the marketplace on loans and securities. This widening would reduce the value of the loans and securities we hold at the time because higher required yields result in lower prices on existing securities in order to adjust their yield upward to meet the market. The effects of such a decrease in values on our financial position, results of operations and liquidity are discussed above under "- Interest Rate Exposure."

As of September 30, 2009, a 25 basis point movement in credit spreads would impact our net book value by approximately \$19.6 million, assuming a static portfolio of current investments and financings, but would not directly affect our earnings or cash flow.

Our financing strategy is dependent on our ability to place the match funded debt we use to finance our investments at rates that provide a positive net spread. Currently, spreads for such liabilities have widened and demand for such liabilities has become extremely limited, therefore restricting our ability to execute future financings.

In an environment where spreads are tightening, if spreads tighten on the assets we purchase to a greater degree than they tighten the liabilities we issue, our net spread will be reduced.

### **Credit Risk**

In addition to the above described market risks, Newcastle is subject to credit risk.

Credit risk refers to the ability of each individual borrower under our loans and securities to make required interest and principal payments on the scheduled due dates. The commercial mortgage and asset backed securities we invest in are generally junior in right of payment of interest and principal to one or more senior classes, but benefit from the support of one or more subordinate classes of securities or other form of credit support (which absorbs losses before the securities in which we invest) within a securitization transaction. The senior unsecured REIT debt securities we invest in reflect comparable credit risk. As a result of the current economic crisis and illiquidity in the markets, the value of the subordinated securities has generally been reduced or, in some cases, eliminated, which could leave our securities economically in a first loss position. We also invest in loans and securities which represent "first loss" pieces; in other words, they do not benefit from credit support although we believe they predominantly benefit from underlying collateral value in excess of their carrying amounts.

We seek to reduce credit risk by actively monitoring our asset portfolio and the underlying credit quality of our holdings and, where appropriate and achievable, repositioning our investments to upgrade their credit quality. In the event of a significant rising interest rate environment and/or economic downturn, loan and collateral defaults may increase and result in credit losses that would adversely affect our liquidity and operating results. As described above in "- Market Considerations" and elsewhere in this quarterly report, adverse market and credit conditions have resulted in our recording of other-than-temporary impairment in certain securities and loans.

### **Margin**

Certain of our derivatives are subject to margin calls based on the value of such instruments. We seek to maintain adequate cash reserves and other sources of available liquidity to meet any margin calls resulting from decreases in value related to a reasonably possible (in the opinion of management) change in interest rates.



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**Interest Rate and Credit Spread Risk Sensitive Instruments and Fair Value**

Our holdings of such financial instruments, and their fair values and the estimation methodology thereof, are detailed in Note 6 to our consolidated financial statements included herein. For information regarding the impact of prepayment, reinvestment, and expected loss factors on the timing of realization of our investments, please refer to the consolidated financial statements included herein and in our Annual Report on Form 10-K for the year ended December 31, 2008. For information regarding the impact of changes in these factors on the value of securities valued with internal models, see Part I, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies."

We note that the values of our investments in real estate securities, loans and derivative instruments are sensitive to changes in market interest rates, credit spreads and other market factors. The value of these investments can vary, and has varied, materially from period to period.

**Trends**

See "- Market Considerations" above for a further discussion of recent trends and events affecting our liquidity, unrealized gains and losses.

**ITEM 4. CONTROLS AND PROCEDURES**

- (a) Disclosure Controls and Procedures. The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. The Company's disclosure controls and procedures are designed to provide reasonable assurance that information is recorded, processed, summarized and reported accurately and on a timely basis. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective.
- (b) Internal Control Over Financial Reporting. There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

From time to time, we are or may be involved in various disputes and litigation matters that arise in the ordinary course of business. The Company is not party to any material legal proceedings as of the date on which this report is filed.

### Item 1A. Risk Factors

Risks relating to our management, business and company include, specifically:

#### *Risks Related to the Financial Services Industry and Financial Markets*

**We do not know what impact the U.S. government's plans to purchase large amounts of illiquid, mortgage-backed and other securities, or its plans to modify the terms of outstanding loans, will have on the financial markets or our business.**

In response to the financial crises affecting the banking system and financial markets and going concern threats to investment banks and other financial institutions, the U.S. government enacted the Emergency Economic Stabilization Act of 2008, or EESA, on October 3, 2008. Pursuant to the EESA, the U.S. Treasury has the authority to, among other things, purchase up to \$700 billion of mortgage-backed and other securities from financial institutions for the purpose of stabilizing the financial markets. As part of this plan, the U.S. government also recently made preferred equity investments in a number of the largest financial institutions. More recently, the U.S. government has approved an additional financial stimulus package, and President Obama and members of Congress have proposed modifying the terms of certain loans, including real estate mortgages and asset-backed securities. It is not clear what impact these initiatives will have on the financial markets, including the illiquidity in the global credit markets and the downward trends and extreme levels of volatility in the global equity markets. Moreover, while the details of some of these initiatives are not yet finalized, it appears that these initiatives will not directly benefit us, and it is possible that any modifications to the terms of loans for which we are the lender could have a significantly negative impact on our business, results of operations and financial condition. Moreover, if any of our competitors are able to benefit from one or more of these initiatives, they may gain a significant competitive advantage over us.

#### *Risks Relating to Our Management*

**We are dependent on our manager and may not find a suitable replacement if our manager terminates the management agreement.**

We have no employees. Our officers and other individuals who perform services for us are employees of our manager. We are completely reliant on our manager, which has significant discretion as to the implementation of our operating policies and strategies, to conduct our business. We are subject to the risk that our manager will terminate the management agreement and that we will not be able to find a suitable replacement for our manager in a timely manner, at a reasonable cost or at all. Furthermore, we are dependent on the services of certain key employees of our manager whose compensation is partially or entirely dependent upon the amount of incentive or management compensation earned by our manager and whose continued service is not guaranteed and the loss of such services could adversely affect our operations.

**There are conflicts of interest in our relationship with our manager.**

Our chairman serves as an officer of our manager. Our management agreement with our manager was not negotiated at arm's-length and its terms, including fees payable, may not be as favorable to us as if it had been negotiated with an unaffiliated third party.

There are conflicts of interest inherent in our relationship with our manager insofar as our manager and its affiliates — including investment funds, private investment funds, or businesses managed by our manager — invest in real estate securities, real estate related loans and operating real estate and whose investment objectives overlap with our investment objectives. Certain investments appropriate for Newcastle may also be appropriate for one or more of these other investment vehicles. Members of our board of directors and employees of our manager who are our officers may serve as officers and/or directors of these other entities. In addition, our manager or its affiliates may have investments in and/or earn fees from such other investment vehicles which are larger than their economic interests in Newcastle and which may therefore create an incentive to allocate investments to such other investment vehicles. Our manager or its affiliates may determine, in their discretion, to make a particular investment through another investment vehicle rather than through Newcastle and have no obligation to offer to Newcastle the opportunity to participate in any particular investment opportunity. Accordingly, it is possible that we may not be given the opportunity to participate at all in certain investments made by our affiliates that meet our investment objectives.

Our management agreement with our manager generally does not limit or restrict our manager or its affiliates from engaging in any business or managing other pooled investment vehicles that invest in investments that meet our investment objectives, except that under our management agreement neither our manager nor any entity controlled by or under common control with our manager is permitted to raise or sponsor any new pooled investment vehicle whose investment policies, guidelines or plan targets as its primary investment category investment in United States dollar-denominated credit sensitive real estate related

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securities reflecting primarily United States loans or assets. Our manager intends to engage in additional real estate related management and investment opportunities in the future which may compete with us for investments.

The ability of our manager and its officers and employees to engage in other business activities, subject to the terms of our management agreement with our manager, may reduce the time our manager spends managing Newcastle. In addition, we may engage in material transactions with our manager or another entity managed by our manager or one of its affiliates, including certain financing arrangements and co-investments which present an actual, potential or perceived conflict of interest, subject to our investment guidelines. It is possible that actual, potential or perceived conflicts could give rise to investor dissatisfaction, litigation or regulatory enforcement actions. Appropriately dealing with conflicts of interest is complex and difficult, and our reputation could be damaged if we fail, or appear to fail, to deal appropriately with one or more potential, actual or perceived conflicts of interest. Regulatory scrutiny of, or litigation in connection with, conflicts of interest could have a material adverse effect on our reputation which could materially adversely affect our business in a number of ways, including causing an inability to raise additional funds, a reluctance of counterparties to do business with us, a decrease in the prices of our common and preferred securities and a resulting increased risk of litigation and regulatory enforcement actions.

The management compensation structure that we have agreed to with our manager may incentivize our manager to invest in high risk investments. In addition to its management fee, our manager is entitled to receive incentive compensation based in part upon our achievement of targeted levels of funds from operations. In evaluating investments and other management strategies, the opportunity to earn incentive compensation based on funds from operations may lead our manager to place undue emphasis on the maximization of funds from operations at the expense of other criteria, such as preservation of capital, in order to achieve higher incentive compensation, particularly in light of the fact that our manager has not received any incentive compensation and likely will not receive any incentive compensation in the future unless it meaningfully increases Newcastle's investment returns. Investments with higher yield potential are generally riskier or more speculative than lower-yielding investments. Moreover, because our manager receives compensation in the form of options in connection with the completion of our common equity offerings, our manager may be incentivized to cause us to issue additional common stock, which could be dilutive to existing shareholders.

### **It would be difficult and costly to terminate our management agreement with our manager.**

Termination of the management agreement with our manager would be difficult and costly. The management agreement may only be terminated annually upon the affirmative vote of at least two-thirds of our independent directors, or by a vote of the holders of a majority of the outstanding shares of our common stock, based upon (1) unsatisfactory performance by our manager that is materially detrimental to us or (2) a determination that the management fee payable to our manager is not fair, subject to our manager's right to prevent such a compensation termination by accepting a mutually acceptable reduction of fees. Our manager will be provided 60 days' prior notice of any termination and will be paid a termination fee equal to the amount of the management fee earned by the manager during the twelve-month period preceding such termination. In addition, following any termination of the management agreement, the manager may require us to purchase its right to receive incentive compensation at a price determined as if our assets were sold for their fair market value (as determined by an appraisal, taking into account, among other things, the expected future value of the underlying investments) or otherwise we may continue to pay the incentive compensation to our manager. These provisions may increase the effective cost to us of terminating the management agreement, thereby adversely affecting our ability to terminate our manager without cause.

### **Our directors have approved very broad investment guidelines for our manager and do not approve each investment decision made by our manager.**

Our manager is authorized to follow very broad investment guidelines. Consequently, our manager has great latitude in determining the types of assets it may decide are proper investments for us. Our directors periodically review our investment guidelines and our investment portfolio. However, our board does not review or pre-approve each proposed investment or our related financing arrangements. In addition, in conducting periodic reviews, the directors rely primarily on information provided to them by our manager. Furthermore, transactions entered into by our manager may be difficult or impossible to unwind by the time they are reviewed by the directors even if the transactions contravene the terms of the management agreement.

### **We may change our investment strategy without stockholder consent, which may result in our making investments that entail more risk than our current investments.**

Our investment strategy may evolve, in light of existing market conditions and investment opportunities, and this evolution may involve additional risks depending upon the nature of such assets and our ability to finance such assets on a short or long term basis. Investment opportunities that present unattractive risk-return profiles relative to other available investment opportunities under particular market conditions may become relatively attractive under changed market conditions and changes in market conditions may therefore result in changes in the investments we target. Decisions to make investments in new asset categories present risks that may be difficult for us to adequately assess and could therefore reduce the stability of our dividends or have adverse effects on our financial condition. A change in our investment strategy may also increase our exposure to interest rate, foreign currency, real estate market or credit market fluctuations. Our failure to accurately assess the risks inherent in new asset categories or the financing risks associated with such assets could adversely affect our results of operations and our financial condition.

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### *Risks Relating to Our Business*

#### **Challenging market conditions will likely continue to negatively impact our business, results of operations and financial condition.**

The market in which we operate is affected by a number of factors that are largely beyond our control but can nonetheless have a potentially significant, negative impact on us. These factors include, among other things:

- Interest rates and credit spreads;
- The availability of credit, including the price, terms and conditions under which it can be obtained;
- The quality, pricing and availability of suitable investments and credit losses with respect to our investments;
- The ability to obtain accurate market-based valuations;
- Loan values relative to the value of the underlying real estate assets;
- Default rates on both commercial and residential mortgages and the amount of the related losses;
- The actual and perceived state of the real estate markets, market for dividend-paying stocks and public capital markets generally;
- Unemployment rates; and
- The attractiveness of other types of investments relative to investments in real estate or REITs generally.

Changes in these factors are difficult to predict, and a change in one factor can affect other factors. For example, during 2007, increased default rates in the subprime mortgage market played a role in causing credit spreads to widen, reducing availability of credit on favorable terms, reducing liquidity and price transparency of real estate related assets, resulting in difficulty in obtaining accurate mark-to-market valuations, and causing a negative perception of the state of the real estate markets and of REITs generally. These conditions worsened during 2008 as a result of the ongoing global credit and liquidity crisis and continue to have a significantly negative impact on our results of operations and financial condition. We do not currently know the full extent to which this market disruption will affect us or the markets in which we operate, and we are unable to predict its length or ultimate severity. If the challenging conditions continue, we may experience additional impairment charges as well as additional challenges in raising capital and obtaining investment or other financing on attractive terms.

#### **A prolonged economic slowdown, a lengthy or severe recession, or declining real estate values could harm our operations.**

We believe the risks associated with our business are more severe during periods similar to those we are currently experiencing in which an economic slowdown or recession is accompanied by declining real estate values. Declining real estate values generally reduce the level of new mortgage loan originations, since borrowers often use increases in the value of their existing properties to support the purchase of, or investment in, additional properties. Borrowers may also be less able to pay principal and interest on our loans, and the loans underlying our securities, if the real estate economy weakens. Further, declining real estate values significantly increase the likelihood that we will incur losses on our loans and securities in the event of default because the value of our collateral may be insufficient to cover our basis. Any sustained period of increased payment delinquencies, foreclosures or losses could adversely affect both our net interest income from loans and securities in our portfolio as well as our ability to originate, sell and securitize loans, which would significantly harm our revenues, results of operations, financial condition, liquidity, business prospects and our ability to make distributions to our shareholders. For more information on the impact of the ongoing global credit and liquidity crisis on our business and results of operations see Part I, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations – Market Considerations."

#### **We have limited liquidity. We are party to agreements that require cash payments at periodic intervals, including during the next twelve months. Failure to make such required payments have a material adverse affect on our business, financial condition and results of operations.**

We are currently party to non-FNMA/FHLMC recourse financing agreements that require us to make cash payments at periodic intervals. During the period from November 5, 2009 through September 30, 2010, we are required to make principal payments under these financing agreements of approximately \$47.2 million. Events could occur or circumstances could arise, which we may not be able to foresee, that may cause us to be unable to make these cash payments when they become due. Failure to make the payments required under our financing documents would give the lenders the right to require us to repay all amounts owed to them under the applicable financing immediately. If the lender exercises this right, we likely would not have sufficient cash on hand to repay such amounts, which would cause a rapid deterioration in our financial condition and could necessitate a filing for protection under the United States Bankruptcy Code.

#### **The use of CDO financings with coverage tests may have a negative impact on our operating results and cash flows.**

We have retained, and may in the future retain, subordinate classes of bonds issued by certain of our subsidiaries in our CDO financings. Each of our CDO financings contains tests that measure the amount of over collateralization and excess interest in the transaction. Failure to satisfy these tests would result in principal and/or interest cash flow that would otherwise be distributed to more junior classes of securities (including those held by Newcastle) to be redirected to pay down the most senior class of securities outstanding until the tests are satisfied. As a result, failure to satisfy the coverage tests could adversely affect

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our operating results and cash flows by temporarily or permanently directing funds that would otherwise come to us to holders of the senior classes of bonds. In addition, the redirected funds would be used to pay down financing which currently bears an attractive rate, thereby reducing our future earnings from the affected CDO. The ratings assigned to the assets in each CDO affect the results of the tests governing whether a CDO can distribute cash to the various classes of securities in the CDO. As a result, ratings downgrades of the assets in a CDO can result in a CDO failing its tests and thereby cause us not to receive cash flows from the affected CDO. We note that we have approximately \$1.3 billion of assets in our CDOs as of September 30, 2009 that are under negative watch for possible downgrade by at least one of the rating agencies. One or more of the rating agencies could downgrade some or all of these assets at any time, and any such downgrade could affect – and possibly materially affect – our future cash flows. As of November 4, 2009, CDOs IV, VI and VII were not in compliance with their applicable over collateralization tests and, consequently, we are not receiving cash flows from these CDOs (other than senior management fees). Based upon our current calculations, we expect these to remain out of compliance for the foreseeable future. Moreover, given current market conditions, it is possible that all of our CDOs could be out of compliance with their over collateralization tests as of one or more measurement dates within the next twelve months. Our ability to rebalance will depend upon the availability of suitable securities, market prices, whether the reinvestment period of the applicable CDO has ended, and other factors that are beyond our control, such rebalancing efforts may be extremely difficult given current market conditions and we cannot assure you that we will be successful in our rebalancing efforts. If the liabilities of our CDOs are downgraded by Moody's to certain predetermined levels, our discretion to rebalance the applicable CDO portfolios may be negatively impacted. Moreover, if we bring these coverage tests into compliance, we cannot assure you that they will not fall out of compliance in the future or that we will be able to correct any noncompliance. Failure of the over collateralization tests can also cause a “phantom income” issue if cash that constitutes income is diverted to pay down debt instead of distributed to us. For more information regarding noncompliance with the terms of certain of our CDO financings in the near future, please see “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources” and “– Debt Obligations.”

### **We may experience an event of default or the removal of us as collateral manager under one or more of our CDOs, which would negatively affect us in a number of ways.**

The documentation governing our CDOs specify certain events of default, which, if they occur, would negatively affect us. Events of default include, among other things, failure to pay interest on senior classes of securities within the CDO, breaches of covenants, representations or warranties, bankruptcy, and failure to satisfy specific over collateralization and interest coverage tests. If an event of default occurs under any of our CDOs, it would negatively affect our cash flows, business, results of operations and financial condition.

In addition, we can be removed as manager of a CDO if certain events occur, including the failure to satisfy specific over collateralization and interest coverage tests, failure to satisfy certain “key man” requirements or an event of default occurring for the failure to pay interest on the related senior classes of securities of the CDO. If we are removed as collateral manager, we would no longer receive management fees from — and no longer be able to manage the assets of — the applicable CDO, which would negatively affect our cash flows, business, results of operations and financial condition.

### **Our investments have previously been — and in the future may be — subject to significant impairment charges, which adversely affect our results of operations.**

We are required to periodically evaluate our investments for impairment indicators. The value of an investment is impaired when our analysis indicates that, with respect to a loan, it is probable that we will not be able to collect the full amount we intended to collect from the loan or, with respect to a security, it is probable that the value of security is other than temporarily impaired. The judgment regarding the existence of impairment indicators is based on a variety of factors depending upon the nature of the investment and the manner in which the income related to such investment calculated for purposes of our financial statements. If we determine that an impairment has occurred, we are required to make an adjustment to the net carrying value of the investment, which could adversely affect our results of operations and funds from operations in the applicable period and thereby adversely affect our ability to pay dividends to our stockholders.

As has been widely publicized, the recent and ongoing credit and liquidity crisis has resulted in a number of financial institutions recording an unprecedented amount of impairment charges, and we have also been affected by these conditions. The liquidity crisis has reduced the market trading activity for many real estate securities, resulting in less liquid markets for those securities. These lower valuations have affected us by, among other things, decreasing our net book value and contributing to our decision to record impairment charges.

### **The lenders under any repurchase agreements that we may enter into from time to time may elect not to extend financing to us, which could quickly and seriously impair our liquidity.**

We have historically financed a meaningful portion of our investments not held in CDOs with repurchase agreements, which are short-term financing arrangements. Under the terms of these agreements, and we may enter into additional repurchase agreements in the future, we sell a security to a counterparty for a specified price and concurrently agree to repurchase the same security from our counterparty at a later date for a higher specified price. During the term of the repurchase agreement – generally 30 days – the counterparty makes funds available to us and holds the security as collateral. Our counterparties can also require us to post additional margin as collateral at any time during the term of the agreement. When the term of a

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repurchase agreement ends, we are required to repurchase the security for the specified repurchase price, with the difference between the sale and repurchase prices serving as the equivalent of paying interest to the counterparty in return for extending financing to us. If we want to continue to finance the security with a repurchase agreement, we ask the counterparty to extend – or “roll” – the repurchase agreement for another term.

Our counterparties are not required to roll our repurchase agreements upon the expiration of the stated terms, which subjects us to a number of risks. As we have experienced recently and may experience in the future, counterparties electing to roll our repurchase agreements may charge higher spread and impose more onerous terms upon us, including the requirement that we post additional margin as collateral. More significantly, if a repurchase agreement counterparty elects not to extend our financing, we would be required to pay the counterparty the full repurchase price on the maturity date and find an alternate source of financing. Alternate sources of financing may be more expensive, contain more onerous terms or simply may not be available. If we were unable to pay the repurchase price for any security financed with a repurchase agreement, the counterparty has the right to sell the underlying security being held as collateral and require us to compensate them for any shortfall between the value of our obligation to the counterparty and the amount for which the collateral was sold (which may be sold at a significantly discounted price). As of September 30, 2009, we had \$41.6 million in repurchase agreement obligations relating to FNMA/FHLMC securities. Moreover, all of our FNMA/FHLMC securities are financed under a repurchase agreement with one counterparty. If this counterparty elected not to roll this repurchase agreement, it is likely that we would not be able to find a replacement counterparty in a timely manner. If one or more of our repurchase agreement counterparties elected not to roll our existing repurchase agreements, such nonrenewal could increase our cost of financing, significantly reduce our liquidity and force us to sell assets at a loss.

### **Our determination of how much leverage to apply to our investments may adversely affect our return on our investments and may reduce cash available for distribution.**

We leverage our portfolio through borrowings, generally through the use of credit facilities, warehouse facilities, repurchase agreements, mortgage loans on real estate, securitizations, including the issuance of CDOs, private or public offerings of debt by subsidiaries, loans to entities in which we hold, directly or indirectly, interests in pools of properties or loans, and other borrowings. Our investment policies do not limit the amount of leverage we may incur with respect to any specific asset or pool of assets, subject to an overall limit on our use of leverage to 90% (as defined in our governing documents) of the value of our assets on an aggregate basis. As a result of the ongoing global credit and liquidity crisis, the return we are able to earn on our investments and cash available for distribution to our stockholders has been significantly reduced due to changes in market conditions causing the cost of our financing to increase relative to the income that can be derived from our assets.

### **We are subject to counterparty default and concentration risks.**

In the ordinary course of our business, we enter into various types of financing arrangements with counterparties. Currently, the majority of our financing arrangements take the form of repurchase agreements, securitization vehicles, loans, hedge contracts, swaps and other derivative and non-derivative contracts. The terms of these contracts are often customized and complex, and many of these arrangements occur in markets or relate to products that are not subject to regulatory oversight.

We are subject to the risk that the counterparty to one or more of these contracts defaults, either voluntarily or involuntarily, on its performance under the contract. Any such default may occur rapidly and without notice to us. Moreover, if a counterparty defaults, we may be unable to take action to cover our exposure, either because we lack the contractual ability or because market conditions make it difficult to take effective action. This inability could occur in times of market stress consistent with the conditions we are currently experiencing, which are precisely the times when defaults may be most likely to occur.

In addition, our risk-management processes may not accurately anticipate the impact of market stress or counterparty financial condition, and as a result, we may not take sufficient action to reduce our risks effectively. Although we monitor our credit exposures, default risk may arise from events or circumstances that are difficult to detect, foresee or evaluate. In addition, concerns about, or a default by, one large participant could lead to significant liquidity problems for other participants, which may in turn expose us to significant losses.

In the event of a counterparty default, particularly a default by a major investment bank, we could incur material losses rapidly, and the resulting market impact of a major counterparty default could seriously harm our business, results of operations and financial condition. In the event that one of our counterparties becomes insolvent or files for bankruptcy, our ability to eventually recover any losses suffered as a result of that counterparty's default may be limited by the liquidity of the counterparty or the applicable legal regime governing the bankruptcy proceeding.

In addition, with respect to our CDOs, certain of our derivative counterparties are required to maintain certain ratings to avoid having to post collateral or transfer the derivative to another counterparty. If the counterparty was downgraded below these levels they may not be able to satisfy their obligations under the derivative, which could have a material negative effect on the applicable CDO.

The counterparty risks that we face have increased in complexity and magnitude as a result of the deterioration of conditions in the financial markets and weakening or insolvency of a number of major financial institutions (such as Bear Stearns, Lehman Brothers, Merrill Lynch, Citigroup and AIG). For example, the consolidation and elimination of counterparties has increased our concentration of counterparty risk and decreased the universe of potential counterparties. We currently finance all of our FNMA/FHLMC securities under a repurchase agreement with one counterparty. If this counterparty elected not to roll this

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repurchase agreement, it is likely that we would not be able to find a replacement counterparty, which could negatively impact us in a number of ways, including forcing us to sell these securities at distressed prices and use cash on hand to make up for any additional amounts needed to repay the counterparty. Moreover, because we currently hold our FNMA/FHLMC securities mainly to maintain our exemption under the Investment Company Act, the sale of these securities may, if we are unable to return to compliance, require us to register as an investment company or cause us to lose our REIT status, either of which would negatively impact us in a number of ways described below. In addition, counterparties have generally reacted to the ongoing market volatility by tightening their underwriting standards and increasing their margin requirements for all categories of financing, which has negatively impacted us in several ways, including, decreasing the number of counterparties willing to provide financing to us, decreasing the overall amount of leverage available to us, and increasing the costs of borrowing. As a result, we currently finance all of our assets not held in CDOs with a very concentrated number of counterparties. If one or more of these counterparties elected not to continue to provide financing to us, we would likely not be able to find substitute financing in a timely manner or on economical terms, which could, in turn, significantly harm our ability to conduct our business, our financial condition and results of operations.

We are not restricted from dealing with any particular counterparty or from concentrating any or all of our transactions with one counterparty. Any loss suffered by us as a result of a counterparty defaulting, refusing to conduct business with us or imposing more onerous terms on us would also negatively affect our business, results of operations and financial condition.

**Although we seek to match fund our investments to limit refinance risk and lock in net spreads, we do not currently match fund our investments not held in our CDOs, which increases the risks related to refinancing these investments.**

A key to our investment strategy is to finance our investments using match funded financing structures, which match assets and liabilities with respect to maturities and interest rates. This strategy limits our refinance risk, including the risk of being able to refinance an investment on favorable terms or at all. We generally use match funded financing structures, such as CDOs, to finance our investments in real estate securities and loans. However, our manager may elect for us to bear a level of refinancing risk on a short term or longer term basis, such as is the case with investments financed with repurchase agreements, when, based on its analysis, our manager determines that bearing such risk is deemed advisable or unavoidable (this is generally the case with respect to the residential mortgage loans and FNMA/FHLMC in which we invest). In addition, we may be unable, as a result of conditions in the credit markets, to match fund investments. For example, non-recourse term financing not subject to margin requirements has generally not been available or economical for the past year, and may not be available for an indeterminate period of time, which impairs our ability to match fund our investments. The decision not, or the inability, to match fund certain investments exposes us to additional refinancing risks that may not apply to our other investments.

Furthermore, we anticipate that, in most cases, for any period during which our floating rate assets are not match funded with respect to maturity, the income from such assets may respond more slowly to interest rate fluctuations than the cost of our borrowings. Because of this dynamic, interest income from such investments may rise more slowly than the related interest expense, with a consequent decrease in our net income. Interest rate fluctuations resulting in our interest expense exceeding interest income would result in operating losses for us from these investments.

Accordingly, if we do not or are unable to match fund our investments with respect to maturities and interest rates, we will be exposed to the risk that we may not be able to finance or refinance our investments on economically favorable terms or may have to liquidate assets at a loss.

**We may not be able to finance our investments on a long term basis on attractive terms, including by means of securitization, which may require us to seek more costly financing for our investments or to liquidate assets.**

When we acquire securities and loans that we finance on a short term basis with a view to securitization or other long term financing, we bear the risk of being unable to securitize the assets or otherwise finance them on a long term basis at attractive prices or in a timely matter, or at all. If it is not possible or economical for us to securitize or otherwise finance such assets on a long term basis, we may be unable to pay down our short term credit facilities, or be required to liquidate the assets at a loss in order to do so. For example, as a result of the continued deterioration in the credit markets beginning in 2007, financing investments with securitizations or other long-term non-recourse financing not subject to margin requirements has not been available or economical for the past year, and we do not expect it to be possible or economical for the foreseeable future. These conditions make it highly likely that we will have to use less efficient forms of financing for any new investments, which will likely require a larger portion of our cash flows to be put toward making the initial investment and thereby reduce the amount of cash available for distribution to our stockholders and funds available for operations and investments, and which will also likely require us to assume higher levels of risk when financing our investments.

**The loans we invest in, and the loans underlying the securities and total rate of return swaps we invest in, are subject to delinquency, foreclosure and loss, which could result in losses to us.**

Commercial mortgage loans are secured by multifamily or commercial property and are subject to risks of delinquency and foreclosure, and risks of loss. The ability of a borrower to repay a loan secured by an income-producing property typically is dependent primarily upon the successful operation of such property rather than upon the existence of independent income or assets of the borrower. If the net operating income of the property is reduced, the borrower's ability to repay the loan may be impaired. Net operating income of an income-producing property can be affected by, among other things: tenant mix, success of tenant businesses, property management decisions, property location and condition, competition from comparable types of properties, changes in laws that increase operating expense or limit rents that may be charged, any need to address



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environmental contamination at the property, the occurrence of any uninsured casualty at the property, changes in national, regional or local economic conditions and/or specific industry segments, declines in regional or local real estate values, declines in regional or local rental or occupancy rates, increases in interest rates, changes in the availability of credit on favorable terms, real estate tax rates and other operating expenses, changes in governmental rules, regulations and fiscal policies, including environmental legislation, acts of God, terrorism, social unrest and civil disturbances.

Residential mortgage loans, manufactured housing loans and subprime mortgage loans are secured by single-family residential property and are also subject to risks of delinquency and foreclosure, and risks of loss. The ability of a borrower to repay a loan secured by a residential property is dependent upon the income or assets of the borrower. A number of factors may impair borrowers' abilities to repay their loans, including, among other things, changes in the borrower's employment status, changes in national, regional or local economic conditions, changes in interest rates or the availability of credit on favorable terms, changes in regional or local real estate values, changes in regional or local rental rates and changes in real estate taxes.

In the event of any default under a loan held directly by us, we will bear a risk of loss of principal to the extent of any deficiency between the value of the collateral and the outstanding principal and accrued but unpaid interest of the loan, which could adversely affect our cash flow from operations. Foreclosure of a loan, particularly a commercial loan, can be an expensive and lengthy process, which would negatively affect our anticipated return on the foreclosed loan.

Mortgage and asset backed securities are bonds or notes backed by loans and/or other financial assets and include commercial mortgage back securities (CMBS), FNMA/FHLMC securities, and real estate related asset backed securities (ABS). The ability of a borrower to repay these loans or other financial assets is dependent upon the income or assets of these borrowers. If a borrower has insufficient income or assets to repay these loans, it will default on its loan. While we intend to focus on real estate related asset backed securities, there can be no assurance that we will not invest in other types of asset backed securities.

Our investments in mortgage and asset backed securities will be adversely affected by defaults under the loans underlying such securities. To the extent losses are realized on the loans underlying the securities in which we invest, the Company may not recover the amount invested in, or, in extreme cases, any of our investment in, such securities.

We have recently experienced increased default rates on our commercial and residential mortgage loans.

### **We face a heightened risk of delinquency and loss from our investment in subprime mortgage loans.**

We face a heightened risk of delinquency and loss from our investment in subprime mortgage loans. Subprime mortgage loans are generally loans to credit impaired borrowers and borrowers that are ineligible to qualify for loans from conventional mortgage sources due to loan size, lower credit characteristics or documentation standards. As of September 30, 2009, our subprime mortgage holdings totaled \$173.4 million, or 5.1% of our assets. Loans to lower credit grade borrowers generally experience higher-than-average default and loss rates than do loans to borrowers with better credit characteristics. Material differences in the defaults, loss severities and/or prepayments on the subprime mortgage loans we acquire (or on the manufactured housing loans we acquire) from what we estimate in connection with our underwriting of the acquisition of such loans would cause reductions in our income and adversely affect our operating results, both with respect to unsecured loans and loans that we have securitized or otherwise financed on a long term match funded basis. We cannot assure you that our underwriting criteria will afford adequate protection against the higher risks associated with loans made to lower credit grade borrowers. If we underestimate the extent of losses that our loans will incur, then our business, financial condition, liquidity and results of operations will be adversely impacted. We have recently experienced increased default rates on our subprime mortgage loans.

### **Our investments in debt securities are subject to specific risks relating to the particular issuer of the securities and to the general risks of investing in subordinated real estate securities.**

Our investments in debt securities involve special risks. REITs generally are required to invest substantially in real estate or real estate-related assets and are subject to the inherent risks associated with real estate-related investments discussed in this report. Our investments in debt are subject to the risks described above with respect to mortgage loans and MBS and similar risks, including:

- risks of delinquency and foreclosure, and risks of loss in the event thereof;
- the dependence upon the successful operation of and net income from real property;
- risks generally incident to interests in real property; and
- risks that may be presented by the type and use of a particular property.

Debt securities may be unsecured and may also be subordinated to other obligations of the issuer. We may also invest in debt securities that are rated below investment grade. As a result, investments in debt securities are also subject to risks of:

- limited liquidity in the secondary trading market;
- substantial market price volatility resulting from changes in prevailing interest rates or credit spreads;
- subordination to the prior claims of senior lenders to the issuer;
- the possibility that earnings of the debt security issuer may be insufficient to meet its debt service; and

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- the declining creditworthiness and potential for insolvency of the issuer of such debt securities during periods of rising interest rates and economic downturn.

These risks may adversely affect the value of outstanding debt securities and the ability of the issuers thereof to repay principal and interest.

### **We are subject to significant competition and we may not compete successfully.**

We are subject to significant competition in seeking investments. We compete with other companies, including other REITs, insurance companies and other investors, including funds and companies affiliated with our manager. Some of our competitors have greater resources than we possess or have greater access to capital or various types of financing structures than are available to us, and we may not be able to compete successfully for investments or provide attractive investment returns relative to our competitors. Furthermore, competition for investments of the type to be made by us may lead to the returns available from such investments decreasing, which may further limit our ability to generate our desired returns. We cannot assure you that other companies will not be formed that compete with us for investments or otherwise pursue investment strategies similar to ours or that we will be able to compete successfully against any such companies.

### **Both during the ramp up phase of a potential CDO financing and following the closing of a CDO financing when we have locked in the liability costs for a CDO during the reinvestment period, the rate at which we are able to acquire eligible investments and changes in market conditions may adversely affect our anticipated returns.**

We seek to acquire real estate securities and loans and finance them on a long term basis, typically through the issuance of collateralized debt obligations. We use short term warehouse lines of credit or other arrangements to finance the acquisition of real estate securities and loans until a sufficient quantity of assets are accumulated, at which time we may refinance these lines through a securitization, such as a CDO financing, or other long term financing. As a result, we are subject to the risk that we will not be able to acquire, during the period that any warehouse facility or short-term financing is available, a sufficient amount of eligible assets to maximize the efficiency of a collateralized debt obligation financing. In addition, conditions in the capital markets may make the issuance of a collateralized debt obligation impossible or economically unattractive to us when we do have a sufficient pool of collateral. If we are unable to issue a collateralized debt obligation to finance these assets, we may be required to seek other forms of less attractive financing or otherwise to liquidate the assets.

In addition, following each CDO financing we must invest both the net cash raised in the financing as well as cash proceeds of any prepayment or assets which we determine to sell. Until we are able to acquire sufficient assets, our returns will reflect income earned on uninvested cash and, having locked in the cost of liabilities for the particular CDO, the particular CDO's returns will be at risk of declining to the extent that yields on the assets to be acquired decline.

In general, our ability to acquire appropriate investments depends upon the supply in the market of investments we deem suitable, and changes in various economic factors may affect our determination of what constitutes a suitable investment.

### **Our returns will be adversely affected when investments held in CDOs are prepaid or sold subsequent to the reinvestment period.**

Real estate securities and loans are subject to prepayment risk. In addition, we may sell, and realize gains (or losses) on, investments. To the extent such assets were held in CDOs subsequent to the end of the reinvestment period, the proceeds are fully utilized to pay down the related CDOs debt. This causes the leverage on the CDO to decrease, thereby lowering our returns on equity.

### **Our investments in senior unsecured REIT securities are subject to specific risks relating to the particular REIT issuer and to the general risks of investing in subordinated real estate securities, which may result in losses to us.**

Our investments in REIT securities involve special risks relating to the particular REIT issuer of the securities, including the financial condition and business outlook of the issuer. REITs generally are required to substantially invest in operating real estate or real estate related assets and are subject to the inherent risks associated with real estate related investments discussed in this report.

Our investments in REIT securities are also subject to the risks described above with respect to mortgage loans and mortgage backed securities and similar risks, including (i) risks of delinquency and foreclosure, and risks of loss in the event thereof, (ii) the dependence upon the successful operation of and net income from real property, (iii) risks generally incident to interests in real property, and (iv) risks that may be presented by the type and use of a particular commercial property.

REIT securities are generally unsecured and may also be subordinated to other obligations of the issuer. We may also invest in REIT securities that are rated below investment grade. As a result, investments in REIT securities are also subject to risks of: (i) limited liquidity in the secondary trading market, (ii) substantial market price volatility resulting from changes in prevailing interest rates, (iii) subordination to the prior claims of banks and other senior lenders to the issuer, (iv) the operation of mandatory sinking fund or call/redemption provisions during periods of declining interest rates that could cause the issuer to reinvest premature redemption proceeds in lower yielding assets, (v) the possibility that earnings of the REIT issuer may be insufficient to meet its debt service and dividend obligations and (vi) the declining creditworthiness and potential for insolvency of the issuer of such REIT securities during periods of rising interest rates and economic downturn. These risks may adversely affect the value of outstanding REIT securities and the ability of the issuers thereof to repay principal and interest or make dividend payments.

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### **The real estate related loans and other direct and indirect interests in pools of real estate properties or other loans that we invest in may be subject to additional risks relating to the structure and terms of these transactions, which may result in losses to us.**

We invest in real estate related loans and other direct and indirect interests in pools of real estate properties or loans such as mezzanine loans and “B Note” mortgage loans. We invest in mezzanine loans that take the form of subordinated loans secured by second mortgages on the underlying real property or other business assets or revenue streams or loans secured by a pledge of the ownership interests of the entity owning real property or other business assets or revenue streams (or the ownership interest of the parent of such entity). These types of investments involve a higher degree of risk than long term senior lending secured by business assets or income producing real property because the investment may become unsecured as a result of foreclosure by a senior lender. In the event of a bankruptcy of the entity providing the pledge of its ownership interests as security, we may not have full recourse to the assets of such entity, or the assets of the entity may not be sufficient to repay our mezzanine loan. If a borrower defaults on our mezzanine loan or debt senior to our loan, or in the event of a borrower bankruptcy, our mezzanine loan will be satisfied only after the senior debt is repaid in full. As a result, we may not recover some or all of our investment. In addition, mezzanine loans may have higher loan to value ratios than conventional mortgage loans, resulting in less equity in the property and increasing the risk of loss of principal.

We also invest in mortgage loans (“B Notes”) that while secured by a first mortgage on a single large commercial property or group of related properties are subordinated to an “A Note” secured by the same first mortgage on the same collateral. As a result, if an issuer defaults, there may not be sufficient funds remaining for B Note holders. B Notes reflect similar credit risks to comparably rated commercial mortgage backed securities. In addition, we invest, directly or indirectly, in pools of real estate properties or loans. However, since each transaction is privately negotiated, these investments can vary in their structural characteristics and risks. For example, the rights of holders of B Notes to control the process following a borrower default may vary from transaction to transaction, while investments in pools of real estate properties or loans may be subject to varying contractual arrangements with third party co-investors in such pools. Further, B Notes typically are secured by a single property, and so reflect the risks associated with significant concentration. These investments also are less liquid than commercial mortgage backed securities.

### **We may not be able to extend any total return swaps that we enter into in the event that the maturity of the underlying asset is extended, which could adversely impact our leveraging strategy.**

Subject to maintaining our qualification as a REIT, from time to time we leverage certain of our investments through the use of total return swaps. While we are not currently party to any total return swaps, we may enter into one or more total return swaps in the future. We may wish to renew many of such swaps, which are for specified terms, as they mature, particularly in the event that the maturity of the underlying asset is extended. However, there is a limited number of providers of such swaps, and there is no assurance the initial swap providers will choose to renew the swaps, and — if they do not renew — that we would be able to obtain suitable replacement providers. Providers may choose not to renew our total return swaps for a number of reasons, including:

- increases in the provider’s cost of funding;
- insufficient volume of business with a particular provider;
- a desire by our company to invest in a type of swap that the provider does not view as economically attractive due to changes in interest rates or other market factors; or
- the inability of our company and a provider to agree on terms.

Furthermore, our ability to invest in total return swaps, other than through a taxable REIT subsidiary, or TRS, may be severely limited by the REIT qualification requirements because total return swaps are not qualifying assets and do not produce qualifying income for purposes of the REIT asset and income tests.

### **Investment in non-investment grade loans may involve increased risk of loss.**

We acquire and may continue to acquire in the future certain loans that do not conform to conventional loan criteria applied by traditional lenders and are not rated or are rated as non-investment grade (for example, for investments rated by Moody’s Investors Service, ratings lower than Baa3, and for Standard & Poor’s, BBB- or below). The non-investment grade ratings for these loans typically result from the overall leverage of the loans, the lack of a strong operating history for the properties underlying the loans, the borrowers’ credit history, the properties’ underlying cash flow or other factors. As a result, these loans have a higher risk of default and loss than conventional loans. Any loss we incur may reduce distributions to our stockholders. There are no limits on the percentage of unrated or non-investment grade assets we may hold in our portfolio.

### **Insurance on real estate in which we have interests (including the real estate serving as collateral for our real estate securities and loans) may not cover all losses.**

There are certain types of losses, generally of a catastrophic nature, such as earthquakes, floods, hurricanes, terrorism or acts of war, that may be uninsurable or not economically insurable. Inflation, changes in building codes and ordinances, environmental considerations, and other factors, including terrorism or acts of war, also might make the insurance proceeds insufficient to repair or replace a property if it is damaged or destroyed. Under such circumstances, the insurance proceeds received might not be adequate to restore our economic position with respect to the affected real property. As a result of the events of September 11,

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2001, insurance companies are limiting and/or excluding coverage for acts of terrorism in insurance policies. As a result, we may suffer losses from acts of terrorism that are not covered by insurance.

In addition, the mortgage loans that are secured by certain of the properties in which we have interests contain customary covenants, including covenants that require property insurance to be maintained in an amount equal to the replacement cost of the properties. There can be no assurance that the lenders under these mortgage loans will not take the position that exclusions from coverage for losses due to terrorist acts is a breach of a covenant which, if uncured, could allow the lenders to declare an event of default and accelerate repayment of the mortgage loans.

**Many of our investments are illiquid, and this lack of liquidity could significantly impede our ability to vary our portfolio in response to changes in economic and other conditions or to realize the value at which such investments are carried if we are required to dispose of them.**

The real estate properties that we own and operate and our other direct and indirect investments in real estate and real estate related assets are generally illiquid. Our investments in unconsolidated subsidiaries are also illiquid. In addition, the real estate securities that we purchase in connection with privately negotiated transactions are not registered under the relevant securities laws, resulting in a prohibition against their transfer, sale, pledge or other disposition except in a transaction that is exempt from the registration requirements of, or is otherwise in accordance with, those laws. In addition, there are no established trading markets for a majority of our investments. As a result, our ability to vary our portfolio in response to changes in economic and other conditions may be limited.

Our securities have historically been valued based primarily on third party quotations, which are subject to significant variability based on the liquidity and price transparency created by market trading activity. The ongoing dislocation in the trading markets has continued to reduce the trading for many real estate securities, resulting in less transparent prices for those securities. Consequently, it is currently more difficult for us to sell many of our assets now that it has been historically because, if we were to sell such assets, we will likely not have access to readily ascertainable market prices when establishing valuations of them. Moreover, currently there is a relatively low market demand for the vast majority of the types of assets that we hold, which may make it extremely difficult to sell assets. If we are required to liquidate all or a portion of our illiquid investments quickly, we may realize significantly less than the amount at which we have previously valued these investments.

**Interest rate fluctuations and shifts in the yield curve may cause losses.**

Our primary interest rate exposures relate to our real estate securities, loans, floating rate debt obligations and interest rate swaps. Changes in interest rates, including changes in expected interest rates or “yield curves,” affect our business in a number of ways. Changes in the general level of interest rates can affect our net interest income, which is the difference between the interest income earned on our interest-earning assets and the interest expense incurred in connection with our interest-bearing liabilities and hedges. Changes in the level of interest rates also can affect, among other things, our ability to acquire real estate securities and loans at attractive prices, the value of our real estate securities, loans and derivatives and our ability to realize gains from the sale of such assets.

In the event of a significant rising interest rate environment and/or economic downturn, loan and collateral defaults may increase and result in credit losses that would adversely affect our liquidity and operating results. Interest rates are highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political conditions, and other factors beyond our control.

Our ability to execute our business strategy, particularly the growth of our investment portfolio, depends to a significant degree on our ability to obtain additional capital. Our financing strategy is dependent on our ability to place the match funded debt we use to finance our investments at rates that provide a positive net spread. If spreads for such liabilities widen or if demand for such liabilities ceases to exist, then our ability to execute future financings will be severely restricted.

Interest rate changes may also impact our net book value as our real estate securities, real estate related loans and hedge derivatives are marked to market each quarter. Debt obligations are not marked to market. Generally, as interest rates increase, the value of our fixed rate securities decreases, which will decrease the book value of our equity.

Furthermore, shifts in the U.S. Treasury yield curve reflecting an increase in interest rates would also affect the yield required on our real estate securities and therefore their value. For example, increasing interest rates would reduce the value of the fixed rate assets we hold at the time because the higher yields required by increased interest rates result in lower market prices on existing fixed rate assets in order to adjust the yield upward to meet the market, and vice versa. This would have similar effects on our real estate securities portfolio and our financial position and operations to a change in interest rates generally.

**Our investments in real estate securities and loans are subject to changes in credit spreads, which could adversely affect our ability to realize gains on the sale of such investments.**

Real estate securities and loans are subject to changes in credit spreads. Credit spreads measure the yield demanded on securities and loans by the market based on their credit relative to a specific benchmark.

Fixed rate securities and loans are valued based on a market credit spread over the rate payable on fixed rate U.S. Treasuries of like maturity. Floating rate securities and loans are valued based on a market credit spread over LIBOR and are affected similarly by changes in LIBOR spreads. Excessive supply of these securities combined with reduced demand will generally

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cause the market to require a higher yield on these securities and loans, resulting in the use of a higher, or “wider,” spread over the benchmark rate to value such securities. Under such conditions, the value of our real estate securities and loan portfolios would tend to decline. Conversely, if the spread used to value such securities were to decrease, or “tighten,” the value of our real estate securities portfolio would tend to increase. Such changes in the market value of our real estate securities and loan portfolios may affect our net equity, net income or cash flow directly through their impact on unrealized gains or losses on available for sale securities, and therefore our ability to realize gains on such securities, or indirectly through their impact on our ability to borrow and access capital. During 2008 through the first half of 2009, credit spreads widened substantially. This widening of credit spreads caused the net unrealized gains on our securities, loans and derivatives, recorded in accumulated other comprehensive income or retained earnings, and therefore our book value per share, to decrease and resulted in net losses.

In addition, if the value of our loans subject to financing agreements were to decline, it could affect our ability to refinance such loans upon the maturity of the related repurchase agreements. Any credit or spread related losses incurred with respect to our loans would affect us in the same way as similar losses on our real estate securities portfolio as described above.

In addition, widening credit spreads will generally result in a decrease in the mark to market value of certain investments which are treated as derivatives on our balance sheet, such as total rate of return swaps. Since changes in the value of such assets are reflected in our income statement, this would result in a decrease in our net income. To the extent that we choose to make investments in real estate related assets by means of entering into total rate of return swaps, our net income will be susceptible to decreases stemming from credit spread changes.

### **Any hedging transactions that we enter into may limit our gains or result in losses.**

We use derivatives to hedge a portion of our interest rate exposure, and this approach has certain risks, including the risk that losses on a hedge position will reduce the cash available for distribution to stockholders and that such losses may exceed the amount invested in such instruments. We have adopted a general policy with respect to the use of derivatives, which generally allows us to use derivatives where appropriate, but does not set forth specific policies and procedures or require that we hedge any specific amount of risk. From time to time, we use derivative instruments, including forwards, futures, swaps and options, in our risk management strategy to limit the effects of changes in interest rates on our operations. A hedge may not be effective in eliminating all of the risks inherent in any particular position. Our profitability may be adversely affected during any period as a result of the use of derivatives.

There are limits to the ability of hedging strategy to protect us completely against interest rate risks. When rates change, we expect the gain or loss on derivatives to be offset by a related but inverse change in the value of the items, generally our liabilities, which we hedge. We cannot assure you, however, that our use of derivatives will offset the risks related to changes in interest rates. We cannot assure you that our hedging strategy and the derivatives that we use will adequately offset the risk of interest rate volatility or that our hedging transactions will not result in losses. In addition, our hedging strategy may limit our flexibility by causing us to refrain from taking certain actions that would be potentially profitable but would cause adverse consequences under the terms of our hedging arrangements.

In managing our hedge instruments, we consider the effect of the expected hedging income on the REIT qualification tests that limit the amount of gross income that a REIT may receive from hedging. The REIT provisions of the Internal Revenue Code limit our ability to hedge. We need to carefully monitor, and may have to limit, our hedging strategy to assure that we do not realize hedging income, or hold hedges having a value, in excess of the amounts which would cause us to fail the REIT gross income and asset tests.

Accounting for derivatives under GAAP is extremely complicated. Any failure by us to account for our derivatives properly in accordance with GAAP in our financial statements could adversely affect our earnings.

### **Under certain conditions, increases in prepayment rates can adversely affect yields on certain investments, including our residential mortgage loans.**

The value of our assets may be affected by prepayment rates on our residential mortgage loans and other floating rate assets. Prepayment rates are influenced by changes in current interest rates and a variety of economic, geographic and other factors beyond our control, and consequently, such prepayment rates cannot be predicted with certainty. In periods of declining mortgage interest rates, prepayments on loans generally increase. If general interest rates decline as well, the proceeds of such prepayments received during such periods are likely to be reinvested by us in assets yielding less than the yields on the assets that were prepaid. In addition, the market value of floating rate assets may, because of the risk of prepayment, benefit less than fixed rate assets from declining interest rates. Conversely, in periods of rising interest rates, prepayments on loans generally decrease, in which case we would not have the prepayment proceeds available to invest in assets with higher yields. Under certain interest rate and prepayment scenarios we may fail to recoup fully our cost of acquisition of certain investments.

In addition, when market conditions lead us to increase the portion of our CDO investments that are comprised of floating rate securities, the risk of assets inside our CDOs prepaying increases. Since our CDO financing costs are locked in, reinvestment of such prepayment proceeds at lower yields than the initial investments, as a result of changes in the interest rate or credit spread environment, will result in a decrease of the return on our equity and therefore our net income.

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### **Changes in accounting rules could occur at any time and could impact us in significantly negative ways that we are unable to predict or protect against.**

As has been widely publicized, the SEC and other regulatory bodies that establish the accounting rules applicable to us have recently proposed or enacted a wide array of changes to current accounting rules. Moreover, these regulators may propose additional changes in the future of which we are not currently aware. Changes to accounting rules that apply to us could significantly impact our business or our reported financial performance in negative ways that we cannot predict or prepare against. We cannot predict whether any changes to current accounting rules will occur or what impact any codified changes will have on our business, results of operation or financial condition.

### **Environmental compliance costs and liabilities with respect to our real estate in which we have interests may adversely affect our results of operations.**

Our operating costs may be affected by our obligation to pay for the cost of complying with existing environmental laws, ordinances and regulations, as well as the cost of complying with future legislation with respect to the assets, or loans secured by assets, with environmental problems that materially impair the value of the assets. Under various federal, state and local environmental laws, ordinances and regulations, a current or previous owner or operator of real property may be liable for the costs of removal or remediation of hazardous or toxic substances on, under, or in such property. Such laws often impose liability whether or not the owner or operator knew of, or was responsible for, the presence of such hazardous or toxic substances. In addition, the presence of hazardous or toxic substances, or the failure to remediate properly, may adversely affect the owner's ability to borrow by using such real property as collateral. Certain environmental laws and common law principles could be used to impose liability for releases of hazardous materials, including asbestos-containing materials, into the environment, and third parties may seek recovery from owners or operators of real properties for personal injury associated with exposure to released asbestos-containing materials or other hazardous materials. Environmental laws may also impose restrictions on the manner in which a property may be used or transferred or in which businesses it may be operated, and these restrictions may require expenditures. In connection with the direct or indirect ownership and operation of properties, we may be potentially liable for any such costs. The cost of defending against claims of liability or remediating contaminated property and the cost of complying with environmental laws could adversely affect our results of operations and financial condition.

### ***Risks Relating to Our REIT Status and Other Matters***

#### **Our failure to qualify as a REIT would result in higher taxes and reduced cash available for distribution to our stockholders.**

We operate in a manner intended to qualify as a REIT for federal income tax purposes. Our ability to satisfy the asset tests depends upon our analysis of the fair market values of our assets, some of which are not susceptible to a precise determination, and for which we will not obtain independent appraisals. Our compliance with the REIT income and quarterly asset requirements also depends upon our ability to successfully manage the composition of our income and assets on an ongoing basis. Moreover, the proper classification of an instrument as debt or equity for federal income tax purposes, and the tax treatment of participation interests that we hold in mortgage loans and mezzanine loans, may be uncertain in some circumstances, which could affect the application of the REIT qualification requirements. Accordingly, there can be no assurance that the IRS will not contend that our interests in subsidiaries or other issuers will not cause a violation of the REIT requirements.

If we were to fail to qualify as a REIT in any taxable year, we would be subject to federal income tax, including any applicable alternative minimum tax, on our taxable income at regular corporate rates, and distributions to stockholders would not be deductible by us in computing our taxable income. Any such corporate tax liability could be substantial and would reduce the amount of cash available for distribution to our stockholders, which in turn could have an adverse impact on the value of, and trading prices for, our stock. Unless entitled to relief under certain Internal Revenue Code provisions, we also would be disqualified from taxation as a REIT for the four taxable years following the year during which we ceased to qualify as a REIT.

#### **Our failure to qualify as a REIT would constitute an event of default under a significant number of our financings and other agreements and would cause our common and preferred stock to be delisted from the NYSE.**

Our failure to qualify as a REIT would constitute an event of default under a significant number of our financing and other agreements, which would, in turn, result in either the acceleration of the amounts we owe to the applicable counterparty or otherwise give our counterparty the right to terminate the applicable agreement. Either scenario would likely have a material adverse effect on our financial condition and ability to conduct our business, which would likely, in turn, require the Company to restructure or file for protection under the U.S. Bankruptcy Code.

In addition, the New York Stock Exchange requires, as a condition to the continued listing of our common and preferred shares, that we maintain our REIT status. Consequently, if we fail to maintain our REIT status, our common and preferred shares would promptly be delisted from the NYSE, which would decrease the trading activity of such shares. This could make it difficult to sell shares and could cause the market volume of the shares trading to decline.

If Newcastle was delisted as a result of losing its REIT status and desired to relist its shares on the NYSE, the Company would have to reapply to the NYSE to be listed as a domestic corporation. As the NYSE's listing standards for REITs are less onerous than its standards for domestic corporations, it would be more difficult for the Company to become a listed company



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under these heightened standards. Given current conditions, Newcastle would not be able to satisfy the NYSE's listing standards for a domestic corporation. As a result, if it were delisted from the NYSE, it likely would not be able to relist as a domestic corporation, and thus the Company's common and preferred shares could not trade on the NYSE.

### **Dividends payable by REITs do not qualify for the reduced tax rates.**

Tax law changes in 2003 reduced the maximum tax rate for dividends payable to individuals from 35% to 15% (through 2010). Dividends payable by REITs, however, are generally not eligible for the reduced rates. Although this legislation does not adversely affect the taxation of REITs or dividends paid by REITs, the more favorable rates applicable to regular corporate dividends could cause investors who are individuals, trusts and estates to perceive investments in REITs to be relatively less attractive than investments in the stocks of non-REIT corporations that pay dividends, which could adversely affect the value of the stock of REITs, including our common stock. In addition, the relative attractiveness of real estate in general may be adversely affected by the newly favorable tax treatment given to corporate dividends, which could affect the value of our real estate assets negatively.

### **REIT distribution requirements could adversely affect our liquidity and our ability to execute our business plan.**

We generally must distribute annually at least 90% of our net taxable income, excluding any net capital gain, in order for corporate income tax not to apply to earnings that we distribute. We intend to make distributions to our stockholders to comply with the requirements of the Internal Revenue Code. However, differences in timing between the recognition of taxable income and the actual receipt of cash could require us to sell assets or borrow funds on a short-term or long-term basis to meet the 90% distribution requirement of the Internal Revenue Code. Certain of our assets may generate substantial mismatches between taxable income and available cash. As a result, the requirement to distribute a substantial portion of our net taxable income could cause us to: (i) sell assets in adverse market conditions, (ii) borrow on unfavorable terms or (iii) distribute amounts that would otherwise be invested in future acquisitions, capital expenditures or repayment of debt, in order to comply with REIT requirements. Further, amounts distributed will not be available to fund investment activities. If we fail to obtain debt or equity capital in the future, it could limit our ability to satisfy our liquidity needs, which could adversely affect the value of our common stock.

### **The IRS tax rules regarding recognizing capital losses and ordinary income for our non-recourse financings, coupled with current REIT distribution requirements, could result in our recognizing significant ordinary income without receiving an equivalent amount of cash proceeds. This disconnect could have a serious, negative affect on us.**

We may experience issues regarding the characterization of income for tax purposes. For example, we may recognize significant capital losses, which we would not be able to use to reduce ordinary income, and which could increase the amount of income we would be required to distribute to shareholders in order to maintain our REIT status. This could occur in the case of one or more of our non-recourse financing structures, including off balance sheet structures such as our subprime securitizations, where we incur capital losses on the related assets, and ordinary income from the cancellation of the related non-recourse financing if the ultimate proceeds from the assets are insufficient to repay such debt. If we experienced any of these disconnects, we may not have sufficient cashflow to make the distributions necessary to satisfy our REIT distribution requirements, which would cause us to lose our REIT status and thereby materially negatively impact our business, financial condition and potentially impair our ability to continue operating in the future. Under current market conditions, this type of disconnect would likely occur at some point in the future if the current regulations that create the disconnect are not revised, but we cannot predict at this time when such a disconnect may occur.

### **We may be unable to generate sufficient revenue from operations to pay our operating expenses and to pay distributions to our stockholders.**

As a REIT, we are generally required to distribute at least 90% of our REIT taxable income (determined without regard to the dividends paid deduction and not including net capital losses) each year to our stockholders. To qualify for the tax benefits accorded to REITs, we intend to make distributions to our stockholders in amounts such that we distribute all or substantially all our net taxable income each year, subject to certain adjustments. However, our ability to make distributions may be adversely affected by the risk factors described in this Quarterly Report on Form 10-Q, particularly in light of current market conditions. In the event of a continued downturn in our operating results and financial performance or continued declines in the value of our asset portfolio, we may be unable to declare or pay quarterly distributions or make distributions to our stockholders, and we may elect to comply with our REIT distribution requirements by, after completing various procedural steps, distributing, under certain circumstances, up to 90% of the required amount in the form of common shares in lieu of cash. The timing and amount of distributions are in the sole discretion of our board of directors, which considers, among other factors, our earnings, financial condition, debt service obligations and applicable debt covenants, REIT qualification requirements and other tax considerations and capital expenditure requirements as our board may deem relevant from time to time.

### **The stock ownership limit imposed by the Internal Revenue Code for REITs and our charter may inhibit market activity in our stock and restrict our business combination opportunities.**

In order for us to maintain our qualification as a REIT under the Internal Revenue Code, not more than 50% in value of our outstanding stock may be owned, directly or indirectly, by five or fewer individuals (as defined in the Internal Revenue Code to include certain entities) at any time during the last half of each taxable year after our first year. Our charter, with certain

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exceptions, authorizes our board of directors to take the actions that are necessary and desirable to preserve our qualification as a REIT. Unless exempted by our board of directors, no person may own more than 8% of the aggregate value of our outstanding capital stock, treating classes and series of our stock in the aggregate, or more than 25% of the outstanding shares of our Series B Preferred Stock, Series C Preferred Stock or our Series D Preferred Stock. Our board may grant an exemption in its sole discretion, subject to such conditions, representations and undertakings as it may determine in its sole discretion. These ownership limits could delay or prevent a transaction or a change in our control that might involve a premium price for our common stock or otherwise be in the best interest of our stockholders. Our board has granted limited exemptions to an affiliate of our manager, a third party group of funds managed by Cohen & Steers, and certain affiliates of these entities.

### **Even if we remain qualified as a REIT, we may face other tax liabilities that reduce our cash flow.**

Even if we remain qualified for taxation as a REIT, we may be subject to certain federal, state and local taxes on our income and assets, including taxes on any undistributed income, tax on income from some activities conducted as a result of a foreclosure, and state or local income, property and transfer taxes, such as mortgage recording taxes. Moreover, if a REIT distributes less than 85% of its taxable income to its stockholders during any calendar year (including any distributions declared by the last day of the calendar year but paid in the subsequent year), then it is required to pay an excise tax on 4% of any shortfall between the required 85% and the amount that was actually distributed. Any of these taxes would decrease cash available for distribution to our stockholders. In addition, in order to meet the REIT qualification requirements, or to avert the imposition of a 100% tax that applies to certain gains derived by a REIT from dealer property or inventory, we may hold some of our assets through taxable REIT subsidiaries. Such subsidiaries will be subject to corporate level income tax at regular rates.

### **Complying with REIT requirements may cause us to forego otherwise attractive opportunities.**

To qualify as a REIT for federal income tax purposes, we must continually satisfy tests concerning, among other things, the sources of our income, the nature and diversification of our assets, the amounts we distribute to our stockholders and the ownership of our stock. We also may be required to make distributions to stockholders at disadvantageous times or when we do not have funds readily available for distribution. Thus, compliance with the REIT requirements may hinder our ability to make certain attractive investments.

### **Complying with REIT requirements may limit our ability to hedge effectively.**

The existing REIT provisions of the Internal Revenue Code may substantially limit our ability to hedge our operations because a significant amount of the income from those hedging transactions is likely to be treated as non-qualifying income for purposes of both of satisfying REIT gross income tests. In addition, we must limit our aggregate income from non-qualified hedging transactions, from our provision of services and from other non-qualifying sources, to less than 5% of our annual gross income (determined without regard to gross income from qualified hedging transactions). As a result, we may have to limit our use of certain hedging techniques or implement those hedges through total return swaps. This could result in greater risks associated with changes in interest rates than we would otherwise want to incur or could increase the cost of our hedging activities. If we fail to comply with these limitations, we could lose our REIT qualification for U.S. federal income tax purposes, unless our failure was due to reasonable cause and not due to willful neglect, and we meet certain other technical requirements. Even if our failure was due to reasonable cause, we might incur a penalty tax.

### **The “taxable mortgage pool” rules may increase the taxes that we or our stockholders may incur, and may limit the manner in which we effect future securitizations.**

Certain of our securitizations have resulted in the creation of taxable mortgage pools for federal income tax purposes. As a REIT, so long as we own 100% of the equity interests in a taxable mortgage pool, we would generally not be adversely affected by the characterization of the securitization as a taxable mortgage pool. Certain categories of stockholders, however, such as foreign stockholders eligible for treaty or other benefits, stockholders with net operating losses, and certain tax-exempt stockholders that are subject to unrelated business income tax, could be subject to increased taxes on a portion of their dividend income from us that is attributable to the taxable mortgage pool. In addition, to the extent that our stock is owned by tax-exempt “disqualified organizations,” such as certain government-related entities and charitable remainder trusts that are not subject to tax on unrelated business income, we may incur a corporate level tax on a portion of our income from the taxable mortgage pool. In that case, we may reduce the amount of our distributions to any disqualified organization whose stock ownership gave rise to the tax.

### **Maintenance of our Investment Company Act exemption imposes limits on our operations.**

We conduct our operations so as not to become regulated as an investment company under the Investment Company Act of 1940, as amended. We believe that there are a number of exemptions under the Investment Company Act that may be applicable to us. The assets that we may acquire, therefore, are limited by the provisions of the Investment Company Act and the rules and regulations promulgated under the Investment Company Act. In addition, we could, among other things, be required either (a) to change the manner in which we conduct our operations to avoid being required to register as an investment company or (b) to register as an investment company, either of which could adversely affect us and the market price for our stock.



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### **ERISA may restrict investments by plans in our common stock.**

A plan fiduciary considering an investment in our common stock should consider, among other things, whether such an investment is consistent with the fiduciary obligations under ERISA, including whether such investment might constitute or give rise to a prohibited transaction under ERISA, the Internal Revenue Code or any substantially similar federal, state or local law and, if so, whether an exemption from such prohibited transaction rules is available.

### **Maryland takeover statutes may prevent a change of our control. This could depress our stock price.**

Under Maryland law, “business combinations” between a Maryland corporation and an interested stockholder or an affiliate of an interested stockholder are prohibited for five years after the most recent date on which the interested stockholder becomes an interested stockholder. These business combinations include certain mergers, consolidations, share exchanges, or, in circumstances specified in the statute, an asset transfer or issuance or reclassification of equity securities or a liquidation or dissolution. An interested stockholder is defined as:

- any person who beneficially owns 10% or more of the voting power of the corporation’s outstanding shares; or
- an affiliate or associate of a corporation who, at any time within the two-year period prior to the date in question, was the beneficial owner of 10% or more of the voting power of the then outstanding stock of the corporation.

A person is not an interested stockholder under the statute if the board of directors approved in advance the transaction by which he or she otherwise would have become an interested stockholder.

After the five-year prohibition, any business combination between the Maryland corporation and an interested stockholder generally must be recommended by the board of directors of the corporation and approved by the affirmative vote of at least:

- 80% of the votes entitled to be cast by holders of outstanding shares of voting stock of the corporation voting together as a single group; and
- two-thirds of the votes entitled to be cast by holders of voting stock of the corporation other than shares held by the interested stockholder with whom or with whose affiliate the business combination is to be effected or held by an affiliate or associate of the interested stockholder voting together as a single voting group.

The business combination statute may discourage others from trying to acquire control of us and increase the difficulty of consummating any offer, including potential acquisitions that might involve a premium price for our common stock or otherwise be in the best interest of our stockholders.

### **Our authorized, but unissued common and preferred stock may prevent a change in our control.**

Our charter authorizes us to issue additional authorized but unissued shares of our common stock or preferred stock. In addition, our board of directors may classify or reclassify any unissued shares of common stock or preferred stock and may set the preferences, rights and other terms of the classified or reclassified shares. As a result, our board may establish a series of preferred stock that could delay or prevent a transaction or a change in control that might involve a premium price for our common stock or otherwise be in the best interest of our stockholders.

### **Our stockholder rights plan could inhibit a change in our control.**

We have adopted a stockholder rights agreement. Under the terms of the rights agreement, in general, if a person or group acquires more than 15% of the outstanding shares of our common stock, all of our other common stockholders will have the right to purchase securities from us at a discount to such securities’ fair market value, thus causing substantial dilution to the acquiring person. The rights agreement may have the effect of inhibiting or impeding a change in control not approved by our board of directors and, therefore, could adversely affect our stockholders’ ability to realize a premium over the then-prevailing market price for our common stock in connection with such a transaction. In addition, since our board of directors can prevent the rights agreement from operating, in the event our board approves of an acquiring person, the rights agreement gives our board of directors significant discretion over whether a potential acquirer’s efforts to acquire a large interest in us will be successful. Because the rights agreement contains provisions that are designed to assure that the executive officers, our manager and its affiliates will never, alone, be considered a group that is an acquiring person, the rights agreement provides the executive officers, our manager and its affiliates with certain advantages under the rights agreement that are not available to other stockholders.

### **Our staggered board and other provisions of our charter and bylaws may prevent a change in our control.**

Our board of directors is divided into three classes of directors. Directors of each class are chosen for three-year terms upon the expiration of their current terms, and each year one class of directors is elected by the stockholders. The staggered terms of our directors may reduce the possibility of a tender offer or an attempt at a change in control, even though a tender offer or change in control might be in the best interest of our stockholders. In addition, our charter and bylaws also contain other provisions that may delay or prevent a transaction or a change in control that might involve a premium price for our common stock or otherwise be in the best interest of our stockholders.

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### *Risks Related to Our Common Shares*

**Our share price has fluctuated significantly, particularly on a percentage basis, and may fluctuate significantly in the future. Accordingly, you may not be able to resell your shares at or above the price at which you purchased them.**

The trading price of our common shares has recently been highly volatile. Moreover, future share price fluctuations could likely be subject to similarly wide price fluctuations in the future in response to various factors, including:

- market conditions in the broader stock market in general, or in the REIT or real estate industry in particular;
- market perception of our current and projected financial condition, potential growth, future earnings and future cash dividends;
- actual or anticipated fluctuations in our quarterly financial and operating results;
- market perception or media coverage of our manager or its affiliates;
- actions by rating agencies;
- short sales of our common stock;
- issuance of new or changed securities analysts' reports or recommendations;
- media coverage of us, other REITS or the outlook of the real estate industry;
- major reductions in trading volumes on the exchanges on which we operate;
- credit deterioration within our portfolio;
- legislative or regulatory developments, including changes in the status of our regulatory approvals or licenses; and
- litigation and governmental investigations.

These and other factors may cause the market price and demand for our common shares to fluctuate substantially, which may negatively affect the price or liquidity of our common shares. Moreover, the recent market conditions have negatively impacted our share price and may do so in the future. When the market price of a stock has been volatile or has decreased significantly in the past, holders of that stock have, at times, instituted securities class action litigation against the company that issued the stock. If any of our shareholders brought a lawsuit against us, we could incur substantial costs defending, settling or paying any resulting judgments related to the lawsuit. Such a lawsuit could also divert the time and attention of our management from our business and hurt our share price.

**We may be unable – or elect not – to pay dividends on our common or preferred shares in the future, which would negatively impact our business in a number of ways and decrease the price of our common and preferred shares.**

We did not pay dividends on our common stock for the fourth fiscal quarter of 2008 or the first three fiscal quarters of 2009. While we are required to make distributions in order to maintain our REIT status (as described above under “–We may be unable to generate sufficient revenue from operations to pay our operating expenses and to pay distributions to our stockholders”), we may elect not to maintain our REIT status, in which case we would no longer be required to make such distributions. Moreover, even if we do elect to maintain our REIT status, we may elect to comply with the applicable requirements by, after completing various procedural steps, distributing, under certain circumstances, up to 90% of the required amount in the form of common shares in lieu of cash. If we elect not to maintain our REIT status or to satisfy any required distributions in common shares in lieu of cash, such action could negatively affect our business and financial condition as well as the price of both our common and preferred shares. No assurance can be given that we will pay any dividends on our common shares in the future.

In addition, in the fourth fiscal quarter of 2008 and the first three fiscal quarters of 2009, our board of directors elected not to declare any of the specified dividends on our three series of preferred stock. Until we pay all accrued dividends on our preferred shares, we cannot pay any dividends on our common shares, pay any consideration to repurchase or otherwise acquire shares of our common stock or redeem any shares of any series of our preferred stock without redeeming all of our outstanding preferred shares in accordance with the governing documentation. Moreover, if we do not pay dividends on any series of preferred stock for six or more periods, then holders of each affected series obtain the right to call a special meeting and elect two members to our board of directors. Consequently, failure to pay dividends on our preferred shares restricts the actions that we may take with respect to our common and preferred shares and could affect the composition of our board and, thus, the management of our business. No assurance can be given that we will pay any dividends on any series of our preferred shares in the future.

**Shares eligible for future sale may adversely affect our common stock price.**

Sales of our common stock or other securities in the public or private market, or the perception that these sales may occur, could cause the market price of our common stock to decline. This could also impair our ability to raise additional capital through the sale of our equity securities. Under our certificate of incorporation, we are authorized to issue up to 500,000,000 shares of common stock, of which 52,905,335 shares of common stock were outstanding as of November 4, 2009. We cannot

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predict the size of future issuances of our common stock or other securities or the effect, if any, that future sales and issuances would have on the market price of our common stock.

### **An increase in market interest rates may have an adverse effect on the market price of our common stock.**

One of the factors that investors may consider in deciding whether to buy or sell shares of our common stock is our distribution rate as a percentage of our share price relative to market interest rates. If the market price of our common stock is based primarily on the earnings and return that we derive from our investments and income with respect to our investments and our related distributions to stockholders, and not from the market value of the investments themselves, then interest rate fluctuations and capital market conditions will likely affect the market price of our common stock. For instance, if market interest rates rise without an increase in our distribution rate, the market price of our common stock could decrease as potential investors may require a higher distribution yield on our common stock or seek other securities paying higher distributions or interest. In addition, rising interest rates would result in increased interest expense on our variable rate debt, thereby adversely affecting cash flow and our ability to service our indebtedness and pay distributions.

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**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

**Item 3. Defaults upon Senior Securities**

None.

**Item 4. Submission of Matters to a Vote of Security Holders**

None.

**Item 5. Other Information**

None.

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### **Item 6. Exhibits**

- 3.1 Articles of Amendment and Restatement (incorporated by reference to the Registrant's Registration Statement on Form S-11 (File No. 333-90578), Exhibit 3.1).
- 3.2 Articles Supplementary Relating to the Series B Preferred Stock (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q for the period ended March 31, 2003, Exhibit 3.3).
- 3.3 Articles Supplementary Relating to the Series C Preferred Stock (incorporated by reference to the Registrant's Report on Form 8-K, Exhibit 3.3, filed on October 25, 2005).
- 3.4 Articles Supplementary Relating to the Series D Preferred Stock (incorporated by reference to the Registrant's Report on Form 8-A, Exhibit 3.1, filed on March 14, 2007).
- 3.5 Amended and Restated By-laws (incorporated by reference to the Registrant's Registration Statement on Form 8-K, Exhibit 3.1, filed on May 5, 2006).
- 4.1 Rights Agreement between the Registrant and American Stock Transfer and Trust Company, as Rights Agent, dated October 16, 2002 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q for the period ended September 30, 2002, Exhibit 4.1).
- 4.2 Junior Subordinated Indenture between Newcastle Investment Corp. and The Bank of New York Mellon Trust Company, National Association, dated April 30, 2009 (incorporated by reference to the Registrant's Report on Form 8-K, Exhibit 4.1, filed on May 4, 2009).
- 4.3 Pledge and Security Agreement between Newcastle Investment Corp. and The Bank of New York Mellon Trust Company, National Association, as trustee, dated April 30, 2009 (incorporated by reference to the Registrant's Report on Form 8-K, Exhibit 4.2, filed on May 4, 2009).
- 4.4 Pledge, Security Agreement and Account Control Agreement among Newcastle Investment Corp., NIC TP LLC, as pledgor, and The Bank of New York Mellon Trust Company, National Association, as bank and trustee, dated April 30, 2009 (incorporated by reference to the Registrant's Report on Form 8-K, Exhibit 4.3, filed on May 4, 2009).
- 10.1 Amended and Restated Management and Advisory Agreement by and among the Registrant and Fortress Investment Group LLC, dated June 23, 2003 (incorporated by reference to the Registrant's Registration Statement on Form S-11 (File No. 333-106135), Exhibit 10.1).
- 10.2 Newcastle Investment Corp. Nonqualified Stock Option and Incentive Award Plan Amended and Restated Effective as of February 11, 2004 (incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2005, Exhibit 10.2).
- 10.3 Exchange Agreement between Newcastle Investment Corp. and Taberna Preferred Funding IV, Ltd., Taberna Preferred Funding V, Ltd., Taberna Preferred Funding VI, Ltd. and Taberna Preferred Funding VII, Ltd., dated April 30, 2009 (incorporated by reference to the Registrant's Report on Form 8-K, Exhibit 10.1, filed on May 4, 2009).
- 21.1 Subsidiaries of the Registrant (incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2008, Exhibit 21.1)
- 31.1 Certification of Chief Executive Officer as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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SIGNATURES

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

NEWCASTLE INVESTMENT CORP.

November 9, 2009

By: /s/ Kenneth M. Riis  
Kenneth M. Riis  
Chief Executive Officer and President

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

By: /s/ Kenneth M. Riis  
Kenneth M. Riis  
Chief Executive Officer and President

November 9, 2009

By: /s/ Brian C. Sigman  
Brian C. Sigman  
Chief Financial Officer

November 9, 2009

EXHIBIT 31.1

CERTIFICATION OF CHIEF EXECUTIVE OFFICER

I, Kenneth M. Riis, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Newcastle Investment Corp.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

November 9, 2009  
(Date)

/s/ Kenneth M. Riis  
Kenneth M. Riis  
Chief Executive Officer

EXHIBIT 31.2

CERTIFICATION OF CHIEF FINANCIAL OFFICER

I, Brian C. Sigman, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Newcastle Investment Corp.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

November 9, 2009  
(Date)

/s/ Brian C. Sigman  
Brian C. Sigman  
Chief Financial Officer



**EXHIBIT 32.1**

**CERTIFICATION OF CEO PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report on Form 10-Q of Newcastle Investment Corp. (the "Company") for the quarterly period ended September 30, 2009 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Kenneth M. Riis, as Chief Executive Officer of the Company, hereby certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of his knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Kenneth M. Riis

Kenneth M. Riis  
Chief Executive Officer  
November 9, 2009

This certification accompanies the Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by the Sarbanes-Oxley Act of 2002, be deemed filed by the Company for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

A signed original of this written statement required by Section 906 of the Sarbanes-Oxley Act of 2002 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

**EXHIBIT 32.2**

**CERTIFICATION OF CFO PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report on Form 10-Q of Newcastle Investment Corp. (the "Company") for the quarterly period ended September 30, 2009 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Brian C. Sigman, as Chief Financial Officer of the Company, hereby certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of his knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Brian C. Sigman

Brian C. Sigman  
Chief Financial Officer  
November 9, 2009

This certification accompanies the Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by the Sarbanes-Oxley Act of 2002, be deemed filed by the Company for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

A signed original of this written statement required by Section 906 of the Sarbanes-Oxley Act of 2002 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

**End of Filing**