

**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, 2011

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: 105,175,197 shares outstanding as of November 4, 2011.

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 that could have a material adverse effect on our operations and prospects include, but are not limited to:

- reductions in cash flows received from our investments;
- our ability to take advantage of opportunities in additional asset classes or types of assets, at attractive risk-adjusted prices;
- our ability to deploy capital accretively;
- the risks that default and recovery rates on our real estate securities and loan portfolios deteriorate compared to 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;
- 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 to the parties if those statements prove 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>.

The Company acknowledges that, notwithstanding the inclusion of the foregoing cautionary statements, it is responsible for considering whether additional specific disclosures of material information regarding material contractual provisions are required to make the statements in this report not misleading.

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP.
FORM 10-Q

INDEX

	<u>PAGE</u>
PART I. FINANCIAL INFORMATION	
Item 1. Financial Statements	
Consolidated Balance Sheets as of September 30, 2011 (unaudited) and December 31, 2010	1
Consolidated Statements of Income (unaudited) for the three and nine months ended September 30, 2011 and 2010	2
Consolidated Statements of Stockholders' Equity (Deficit) (unaudited) for the nine months ended September 30, 2011	3
Consolidated Statements of Cash Flows (unaudited) for the nine months ended September 30, 2011 and 2010	4
Notes to Consolidated Financial Statements (unaudited)	5
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	28
Item 3. Quantitative and Qualitative Disclosures About Market Risk	54
Item 4. Controls and Procedures	56
PART II. OTHER INFORMATION	
Item 1. Legal Proceedings	57
Item 1A. Risk Factors	57
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	80
Item 3. Defaults upon Senior Securities	80
Item 4. (Removed and Reserved)	80
Item 5. Other Information	80
Item 6. Exhibits	81
SIGNATURES	83

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(dollars in thousands, except share data)

	September 30, 2011 (Unaudited)	December 31, 2010
Assets		
<u>Non-Recourse VIE Financing Structures</u>		
Real estate securities, available-for-sale	\$ 1,437,893	\$ 1,859,984
Real estate related loans, held-for-sale, net	815,140	750,130
Residential mortgage loans, held-for-investment, net	340,489	124,974
Residential mortgage loans, held-for-sale, net	—	252,915
Subprime mortgage loans subject to call option	404,476	403,793
Operating real estate, held-for-sale	7,743	8,776
Other investments	18,883	18,883
Restricted cash	178,121	157,005
Derivative assets	2,383	7,067
Receivables and other assets	23,818	29,206
	<u>3,228,946</u>	<u>3,612,733</u>
<u>Recourse Financing Structures and Unlevered Assets</u>		
Real estate securities, available-for-sale	230,463	600
Real estate related loans, held-for-sale, net	6,634	32,475
Residential mortgage loans, held-for-sale, net	3,031	298
Other investments	6,024	6,024
Cash and cash equivalents	205,180	33,524
Receivables and other assets	2,775	1,457
	<u>454,107</u>	<u>74,378</u>
	<u>\$ 3,683,053</u>	<u>\$ 3,687,111</u>
Liabilities and Stockholders' Equity (Deficit)		
Liabilities		
<u>Non-Recourse VIE Financing Structures</u>		
CDO bonds payable	\$ 2,428,294	\$ 3,010,868
Other bonds and notes payable	210,033	261,165
Repurchase agreements	8,764	14,049
Financing of subprime mortgage loans subject to call option	404,476	403,793
Derivative liabilities	132,056	176,861
Payables to brokers, dealers and clearing organizations	37,341	—
Accrued expenses and other liabilities	9,107	8,445
	<u>3,230,071</u>	<u>3,875,181</u>
<u>Recourse Financing Structures and Other Liabilities</u>		
Repurchase agreements	212,164	4,683
Junior subordinated notes payable	51,250	51,253
Dividends payable	16,706	—
Due to affiliates	1,532	1,419
Accrued expenses and other liabilities	2,805	2,160
	<u>284,457</u>	<u>59,515</u>
	<u>3,514,528</u>	<u>3,934,696</u>
Stockholders' Equity (Deficit)		
Preferred stock, \$0.01 par value, 100,000,000 shares authorized, 1,347,321 shares of 9.75% Series B Cumulative Redeemable Preferred Stock, 496,000 shares of 8.05% Series C Cumulative Redeemable Preferred Stock, and 620,000 shares of 8.375% Series D Cumulative Redeemable Preferred Stock, liquidation preference \$25.00 per share, issued and outstanding as of September 30, 2011 and December 31, 2010	61,583	61,583
Common stock, \$0.01 par value, 500,000,000 shares authorized, 105,175,197 and 62,027,184 shares issued and outstanding at September 30, 2011 and December 31, 2010, respectively	1,052	620
Additional paid-in capital	1,275,765	1,065,377
Accumulated deficit	(1,076,776)	(1,328,987)
Accumulated other comprehensive income (loss)	(93,099)	(46,178)
	<u>168,525</u>	<u>(247,585)</u>
	<u>\$ 3,683,053</u>	<u>\$ 3,687,111</u>

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

(dollars in thousands, except share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Interest income	\$ 72,393	\$ 81,040	\$ 218,739	\$ 225,315
Interest expense	32,587	42,547	106,502	131,277
Net interest income	39,806	38,493	112,237	94,038
Impairment (Reversal)				
Valuation allowance (reversal) on loans	17,644	(105,360)	(38,218)	(292,668)
Other-than-temporary impairment on securities	5,537	3,616	14,433	102,397
Portion of other-than-temporary impairment on securities recognized in other comprehensive income (loss), net of the reversal of other comprehensive loss into net income (loss)	(1,531)	6,425	(838)	(15,575)
	21,650	(95,319)	(24,623)	(205,846)
Net interest income after impairment/reversal	18,156	133,812	136,860	299,884
Other Income (Loss)				
Gain (loss) on settlement of investments, net	5,636	(1,134)	75,334	17,497
Gain on extinguishment of debt	15,917	46,624	60,402	141,698
Other income (loss), net	(2,751)	(8,828)	(12,576)	(12,606)
	18,802	36,662	123,160	146,589
Expenses				
Loan and security servicing expense	1,198	1,116	3,458	3,473
General and administrative expense	1,399	1,811	4,649	6,912
Management fee to affiliate	4,569	4,258	13,313	12,993
	7,166	7,185	21,420	23,378
Income from continuing operations	29,792	163,289	238,600	423,095
Income (loss) from discontinued operations	151	213	151	186
Net Income	29,943	163,502	238,751	423,281
Preferred dividends	(1,395)	(1,395)	(4,185)	(6,058)
Excess of carrying amount of exchanged preferred stock over fair value of consideration paid	—	—	—	43,043
Income Available for Common Stockholders	<u>\$ 28,548</u>	<u>\$ 162,107</u>	<u>\$ 234,566</u>	<u>\$ 460,266</u>
Income Per Share of Common Stock				
Basic	<u>\$ 0.35</u>	<u>\$ 2.61</u>	<u>\$ 3.16</u>	<u>\$ 7.77</u>
Diluted	<u>\$ 0.35</u>	<u>\$ 2.61</u>	<u>\$ 3.16</u>	<u>\$ 7.77</u>
Income from continuing operations per share of common stock, after preferred dividends and excess of carrying amount of exchanged preferred stock over fair value of consideration paid				
Basic	<u>\$ 0.35</u>	<u>\$ 2.61</u>	<u>\$ 3.16</u>	<u>\$ 7.77</u>
Diluted	<u>\$ 0.35</u>	<u>\$ 2.61</u>	<u>\$ 3.16</u>	<u>\$ 7.77</u>
Income (loss) from discontinued operations per share of common stock				
Basic	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>
Diluted	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>
Weighted Average Number of Shares of Common Stock Outstanding				
Basic	<u>80,425,197</u>	<u>62,024,945</u>	<u>74,168,573</u>	<u>59,249,175</u>
Diluted	<u>80,441,593</u>	<u>62,024,945</u>	<u>74,177,027</u>	<u>59,249,175</u>
Dividends Declared per Share of Common Stock	<u>\$ 0.15</u>	<u>\$ —</u>	<u>\$ 0.25</u>	<u>\$ —</u>

See notes to consolidated financial statements

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

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

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2011

(dollars in thousands)

	Preferred Stock		Common Stock		Additional Paid-in Capital	Accumulated Deficit	Accum. Other Comp. Income (Loss)	Total Stock- holders' Equity (Deficit)
	Shares	Amount	Shares	Amount				
Stockholders' equity (deficit) - December 31, 2010	<u>2,463,321</u>	<u>\$61,583</u>	<u>62,027,184</u>	<u>\$ 620</u>	<u>\$1,065,377</u>	<u>\$(1,328,987)</u>	<u>\$ (46,178)</u>	<u>\$ (247,585)</u>
Dividends declared	—	—	—	—	—	(31,612)	—	(31,612)
Issuance of common stock	—	—	43,148,013	432	210,388	—	—	210,820
Deconsolidation of CDO V:								
Cumulative net loss	—	—	—	—	—	45,072	—	45,072
Deconsolidation of unrealized gain on securities	—	—	—	—	—	—	(8,026)	(8,026)
Deconsolidation of unrealized loss on derivatives designated as cash flow hedges	—	—	—	—	—	—	18,353	18,353
Comprehensive income:								
Net income	—	—	—	—	—	238,751	—	238,751
Net unrealized gain (loss) on securities	—	—	—	—	—	—	(16,579)	(16,579)
Reclassification of net realized (gain) loss on securities into earnings	—	—	—	—	—	—	(59,928)	(59,928)
Net unrealized gain on derivatives designated as cash flow hedges	—	—	—	—	—	—	6,424	6,424
Reclassification of net realized loss on derivatives designated as cash flow hedges into earnings	—	—	—	—	—	—	12,835	12,835
Total comprehensive income (loss)	—	—	—	—	—	—	—	181,503
Stockholders' equity (deficit) - September 30, 2011	<u>2,463,321</u>	<u>\$61,583</u>	<u>105,175,197</u>	<u>\$1,052</u>	<u>\$1,275,765</u>	<u>\$(1,076,776)</u>	<u>\$ (93,099)</u>	<u>\$ 168,525</u>

See notes to consolidated financial statements

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

(dollars in thousands)

	<u>Nine Months Ended September 30,</u>	
	<u>2011</u>	<u>2010</u>
Cash Flows From Operating Activities		
Net income	\$ 238,751	\$ 423,281
Adjustments to reconcile net income to net cash provided by (used in) operating activities (inclusive of amounts related to discontinued operations):		
Depreciation and amortization	225	161
Accretion of discount and other amortization	(33,214)	(11,729)
Interest income in CDOs redirected for reinvestment or CDO bonds paydown	(8,981)	(17,985)
Interest income on investments accrued to principal balance	(14,303)	(8,077)
Interest expense on debt accrued to principal balance	619	2,279
Deferred interest received	1,027	44
Non-cash directors' compensation	122	60
Reversal of valuation allowance on loans	(38,218)	(292,668)
Other-than-temporary impairment on securities	13,595	86,822
Impairment on real estate held for sale	433	60
Gain on settlement of real estate held for sale	(61)	—
Gain on settlement of investments, net	(74,402)	(17,497)
Unrealized loss on non-hedge derivatives and hedge ineffectiveness	14,483	13,356
Gain on extinguishment of debt	(60,402)	(141,698)
Change in:		
Restricted cash	1,249	(1,354)
Receivables and other assets	528	3,781
Due to affiliates	113	(78)
Accrued expenses and other liabilities	57	(1,182)
Net cash provided by (used in) operating activities	<u>41,621</u>	<u>37,576</u>
Cash Flows From Investing Activities		
Principal repayments from repurchased CDO debt	57,108	53
Principal repayments on CDO securities	9,834	—
Principal repayments on loans and non-CDO securities	65,756	55,283
Purchase of real estate securities	(303,101)	(2,291)
Proceeds from sale of real estate securities	3,885	26,022
Acquisition of servicing rights	(2,268)	—
Purchase of and advance on loans	—	(6,024)
Margin received on derivative instruments	—	5,073
Payments on settlement of derivative instruments	(14,322)	(11,394)
Proceeds from sale of real estate held for sale	650	840
Distributions of capital from equity method investees	—	161
Net cash provided by (used in) investing activities	<u>(182,458)</u>	<u>67,723</u>
Cash Flows From Financing Activities		
Repurchases of CDO bonds payable	(91,039)	(11,400)
Issuance of other bonds payable	142,736	97,650
Repayments of other bonds payable	(194,379)	(134,027)
Borrowings under repurchase agreements	291,818	—
Repayments of repurchase agreements	(89,622)	(71,309)
Issuance of common stock	211,567	—
Costs related to issuance of common stock	(468)	—
Cash consideration paid in exchange for junior subordinated notes	—	(9,715)
Cash consideration paid to redeem preferred stock	—	(16,001)
Dividends paid	(14,906)	(19,484)
Payment of deferred financing costs	(1,581)	(1,677)
Restricted cash returned from refinancing activities	58,367	50,700
Net cash provided by (used in) financing activities	<u>312,493</u>	<u>(115,263)</u>
Net Increase (Decrease) in Cash and Cash Equivalents	171,656	(9,964)
Cash and Cash Equivalents, Beginning of Period	33,524	68,300
Cash and Cash Equivalents, End of Period	<u>\$ 205,180</u>	<u>\$ 58,336</u>
Supplemental Disclosure of Cash Flow Information		
Cash paid during the period for interest expense	\$ 76,730	\$ 97,948
Supplemental Schedule of Non-Cash Investing and Financing Activities		
Common stock dividends declared but not paid	\$ 15,776	\$ —
Preferred stock dividends declared but not paid	\$ 930	\$ —
Common stock issued to redeem preferred stock	\$ —	\$ 28,457
Face amount of CDO bonds issued in exchange for previously issued junior subordinated notes of \$52,094	\$ —	\$ 37,625

See notes to consolidated financial statements

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2011

(dollars in thousands, except share data)

1. GENERAL

Newcastle Investment Corp. (and its subsidiaries, “Newcastle”) is a Maryland corporation that was formed in 2002. Newcastle conducts its business through the following segments: (i) investments financed with non-recourse collateralized debt obligations (“CDOs”), (ii) investments financed with other non-recourse debt, (iii) investments and debt repurchases financed with recourse debt, (iv) unlevered investments, and (v) corporate. With respect to the first two nonrecourse segments, subject to the passing of certain periodic coverage tests, Newcastle is generally entitled to receive the net cash flows from these structures on a periodic basis.

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”), a subsidiary of Fortress Investment Group LLC (“Fortress”), 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 is entitled to an annual management fee and incentive compensation, both as defined in, and in accordance with the terms of, the Management Agreement.

In March 2011, Newcastle issued 17,250,000 shares of its common stock in a public offering at a price to the public of \$6.00 per share for net proceeds of approximately \$98.4 million. For the purpose of compensating the Manager for its successful efforts in raising capital for Newcastle, in connection with this offering, Newcastle granted options to the Manager to purchase 1,725,000 shares of Newcastle’s common stock at the public offering price, which were valued at approximately \$7.0 million.

In September 2011, Newcastle issued 25,875,000 shares of its common stock in a public offering at a price to the public of \$4.55 per share for net proceeds of approximately \$112.3 million. Certain principals of Fortress and officers of Newcastle participated in this offering and purchased an aggregate of 1,314,780 shares at the offering price. For the purpose of compensating the Manager for its successful efforts in raising capital for Newcastle, in connection with this offering, Newcastle granted options to the Manager to purchase 2,587,500 shares of Newcastle’s common stock at the public offering price, which were valued at approximately \$5.6 million.

Approximately 4.8 million shares of Newcastle’s common stock were held by Fortress, through its affiliates, and its principals at September 30, 2011. In addition, Fortress, through its affiliates, held options to purchase approximately 6.0 million shares of Newcastle’s common stock at September 30, 2011.

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, 2010 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, 2010.

Certain prior period amounts have been reclassified to conform to the current period’s presentation.

In May 2011, the FASB issued new guidance regarding the measurement and disclosure of fair value, which will become effective for Newcastle on January 1, 2012. Newcastle has not yet completed its assessment of the potential impact of this guidance.

In June 2011, the FASB issued a new accounting standard that eliminates the current option to report other comprehensive income and its components in the statement of stockholders’ equity. Instead, an entity will be required to present items of net income and other comprehensive income in one continuous statement or in two separate, but consecutive, statements. The standard will become effective for Newcastle on January 1, 2012, with early adoption permitted.

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2011

(dollars in thousands, except share data)

The FASB has recently issued or discussed a number of proposed standards on such topics as consolidation, financial statement presentation, revenue recognition, leases, financial instruments, hedging and contingencies. Some of the proposed changes are significant and could have a material impact on Newcastle's reporting. Newcastle has not yet fully evaluated the potential impact of these proposals, but will make such an evaluation as the standards are finalized.

2. INFORMATION REGARDING BUSINESS SEGMENTS

Newcastle conducts its business through the following segments: (i) investments financed with non-recourse collateralized debt obligations ("CDOs"), (ii) investments financed with other non-recourse debt, (iii) investments and debt repurchases financed with recourse debt, (iv) unlevered investments, and (v) corporate. With respect to the first two nonrecourse segments, subject to the passing of certain periodic coverage tests, Newcastle is generally entitled to receive the net cash flows from these structures on a periodic basis.

The corporate segment consists primarily of interest income on short term investments, general and administrative expenses, interest expense on the junior subordinated notes payable and management fees pursuant to the Management Agreement.

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

	Non-Recourse (A)		Recourse (C)	Unlevered (D)	Corporate	Inter-segment Elimination (E)	Total
	CDOs	Other Non-Recourse (B)					
Nine Months Ended September 30, 2011							
Interest income	\$ 164,523	\$ 54,421	\$ 1,626	\$ 2,053	\$ 99	\$ (3,983)	\$ 218,739
Interest expense	67,173	39,660	455	—	2,859	(3,645)	106,502
Net interest income (expense)	97,350	14,761	1,171	2,053	(2,760)	(338)	112,237
Impairment (reversal)	(27,904)	7,012	—	(3,731)	—	—	(24,623)
Other income (loss)	115,425	2,561	—	5,174	—	—	123,160
Expenses	779	2,679	—	4	17,958	—	21,420
Income (loss) from continuing operations	239,900	7,631	1,171	10,954	(20,718)	(338)	238,600
Income (loss) from discontinued operations	—	(131)	—	(56)	—	338	151
Net income (loss)	239,900	7,500	1,171	10,898	(20,718)	—	238,751
Preferred dividends	—	—	—	—	(4,185)	—	(4,185)
Income (loss) applicable to common stockholders	<u>\$ 239,900</u>	<u>\$ 7,500</u>	<u>\$ 1,171</u>	<u>\$ 10,898</u>	<u>\$ (24,903)</u>	<u>\$ —</u>	<u>\$ 234,566</u>
Three Months Ended September 30, 2011							
Interest income	\$ 53,403	\$ 18,816	\$ 1,029	\$ 1,038	\$ 36	\$ (1,929)	\$ 72,393
Interest expense	19,909	13,329	213	—	953	(1,817)	32,587
Net interest income (expense)	33,494	5,487	816	1,038	(917)	(112)	39,806
Impairment (reversal)	17,550	3,919	—	181	—	—	21,650
Other income (loss)	18,262	—	—	540	—	—	18,802
Expenses	250	933	—	(111)	6,094	—	7,166
Income (loss) from continuing operations	33,956	635	816	1,508	(7,011)	(112)	29,792
Income (loss) from discontinued operations	—	54	—	(15)	—	112	151
Net income (loss)	33,956	689	816	1,493	(7,011)	—	29,943
Preferred dividends	—	—	—	—	(1,395)	—	(1,395)
Income (loss) applicable to common stockholders	<u>\$ 33,956</u>	<u>\$ 689</u>	<u>\$ 816</u>	<u>\$ 1,493</u>	<u>\$ (8,406)</u>	<u>\$ —</u>	<u>\$ 28,548</u>
September 30, 2011							
Investments	\$ 2,375,681	\$ 793,546	\$ 222,557	\$ 23,595	\$ —	\$ (144,603)	\$ 3,270,776
Cash and restricted cash	178,121	—	—	8	205,172	—	383,301
Derivative assets	2,383	—	—	—	—	—	2,383
Other assets	23,719	99	640	2,171	300	(336)	26,593
Total assets	<u>2,579,904</u>	<u>793,645</u>	<u>223,197</u>	<u>25,774</u>	<u>205,472</u>	<u>(144,939)</u>	<u>3,683,053</u>
Debt	(2,437,058)	(759,112)	(212,164)	—	(51,250)	144,603	(3,314,981)
Derivative liabilities	(132,056)	—	—	—	—	—	(132,056)
Other liabilities	(43,631)	(2,817)	(19)	(65)	(21,295)	336	(67,491)
Total liabilities	<u>(2,612,745)</u>	<u>(761,929)</u>	<u>(212,183)</u>	<u>(65)</u>	<u>(72,545)</u>	<u>144,939</u>	<u>(3,514,528)</u>
Preferred stock	—	—	—	—	(61,583)	—	(61,583)
GAAP book value	<u>\$ (32,841)</u>	<u>\$ 31,716</u>	<u>\$ 11,014</u>	<u>\$ 25,709</u>	<u>\$ 71,344</u>	<u>\$ —</u>	<u>\$ 106,942</u>

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2011

(dollars in thousands, except share data)

	Non-Recourse		Recourse	Unlevered	Corporate	Total
	CDOs (A)	Other (A)				
Nine Months Ended September 30, 2010						
Interest income	\$ 168,150	\$ 54,952	\$ 976	\$ 1,189	\$ 48	\$ 225,315
Interest expense	83,209	44,462	645	356	2,605	131,277
Net interest income (expense)	84,941	10,490	331	833	(2,557)	94,038
Impairment	(146,833)	(35,323)	(60)	(23,630)	—	(205,846)
Other income (loss)	153,919	(5,417)	(663)	(905)	(345)	146,589
Other operating expenses	1,134	2,394	4	17	19,829	23,378
Income (loss) from continuing operations	384,559	38,002	(276)	23,541	(22,731)	423,095
Income (loss) from discontinued operations	—	—	—	186	—	186
Net income (loss)	384,559	38,002	(276)	23,727	(22,731)	423,281
Preferred dividends	—	—	—	—	(6,058)	(6,058)
Excess of carrying amount of exchanged preferred stock over fair value of consideration paid	—	—	—	—	43,043	43,043
Income (loss) applicable to common stockholders	<u>\$ 384,559</u>	<u>\$ 38,002</u>	<u>\$ (276)</u>	<u>\$ 23,727</u>	<u>\$ 14,254</u>	<u>\$ 460,266</u>
Three Months Ended September 30, 2010						
Interest income	\$ 62,429	\$ 18,146	\$ —	\$ 447	\$ 18	\$ 81,040
Interest expense	27,035	14,561	—	—	951	42,547
Net interest income (expense)	35,394	3,585	—	447	(933)	38,493
Impairment	(86,525)	(1,094)	—	(7,700)	—	(95,319)
Other income (loss)	38,189	(1,636)	—	109	—	36,662
Other operating expenses	345	768	—	7	6,065	7,185
Income (loss) from continuing operations	159,763	2,275	—	8,249	(6,998)	163,289
Income (loss) from discontinued operations	—	—	—	213	—	213
Net income (loss)	159,763	2,275	—	8,462	(6,998)	163,502
Preferred dividends	—	—	—	—	(1,395)	(1,395)
Income (loss) applicable to common stockholders	<u>\$ 159,763</u>	<u>\$ 2,275</u>	<u>\$ —</u>	<u>\$ 8,462</u>	<u>\$ (8,393)</u>	<u>\$ 162,107</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, creditors or beneficial interest holders of these structures have no recourse to the general credit of Newcastle. Therefore, Newcastle's exposure to the economic losses from such structures is limited to its invested equity in them and economically their book value cannot be less than zero. Therefore, impairment recorded in excess of Newcastle's 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.
- (B) The following table summarizes the investments and debt in the other non-recourse segment:

	September 30, 2011			
	Investments		Debt	
	Outstanding Face Amount	Carrying Value	Outstanding Face Amount*	Carrying Value*
Manufactured housing loan portfolio I	\$ 139,116	\$115,357	\$ 111,052	\$101,443
Manufactured housing loan portfolio II	184,615	180,926	149,622	148,181
Residential mortgage loans	57,612	40,806	56,079	55,008
Subprime mortgage loans subject to call options	406,217	404,476	406,217	404,476
Real estate securities	69,121	44,238	48,504	44,004
Operating real estate	N/A	7,743	6,000	6,000
	<u>\$ 856,681</u>	<u>\$793,546</u>	<u>\$ 777,474</u>	<u>\$759,112</u>

- * An aggregate face amount of \$158.8 million (carrying value of \$144.6 million) of debt represents financing provided by the CDO segment (and included as investments in the CDO segment), which is eliminated upon consolidation.
- (C) The \$212.2 million of recourse debt is comprised of (i) \$209.3 million of repurchase agreement secured by \$222.6 million carrying value of FNMA/FHLMC securities and (ii) \$2.9 million of repurchase agreement secured by \$32.5 million face amount of senior notes issued by Newcastle CDO VI, which was repurchased by Newcastle in December 2010 and eliminated in consolidation.

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2011

(dollars in thousands, except share data)

(D) The following table summarizes the investments in the unlevered segment:

	September 30, 2011		
	Outstanding Face Amount	Carrying Value	Number of Investments
Real estate securities	\$ 165,669	\$ 7,906	24
Real estate related loans	69,634	6,634	4
Residential mortgage loans	6,182	3,031	193
Other investments	N/A	6,024	1
	<u>\$ 241,485</u>	<u>\$23,595</u>	<u>222</u>

(E) Represents the elimination of investments and financings and their related income and expenses between the CDO segment and other non-recourse segment as the corresponding inter-segment investments and financings are presented on a gross basis within each of these segments.

Variable Interest Entities (“VIEs”)

The VIEs in which Newcastle has a significant interest include (i) Newcastle’s CDOs, in which Newcastle has been determined to be the primary beneficiary and therefore consolidates them (with the exception of CDO V as described below), since it has the power to direct the activities that most significantly impact the CDOs’ economic performance and would absorb a significant portion of their expected losses and receive a significant portion of their expected residual returns, and (ii) the manufactured housing loan financing structures, which are similar to the CDOs in analysis. Newcastle’s CDOs and manufactured housing loan financings are held in special purpose entities whose debt is treated as non-recourse secured borrowings of Newcastle. Newcastle’s subprime securitizations are also considered VIEs, but Newcastle does not control their activities and no longer receives a significant portion of their returns. These subprime securitizations were not consolidated under the current or prior guidance.

In addition, Newcastle’s investments in CMBS, CDO securities and loans may be deemed to be variable interests in VIEs, depending on their structure. Newcastle is not obligated to provide, nor has it provided, any financial support to these VIEs. Newcastle monitors these investments and, to the extent Newcastle determines that it potentially owns a majority of the currently controlling class, it analyzes them for potential consolidation. As of September 30, 2011, Newcastle has not consolidated these potential VIEs due to the determination that, based on the nature of Newcastle’s investments and the provisions governing these structures, Newcastle does not have the power to direct the activities that most significantly impact their economic performance.

In April 2011, Newcastle sold its retained interests in Newcastle CDO VII, a non-consolidated VIE of Newcastle. As a result of the sale of Newcastle’s retained interests in CDO VII and the subsequent liquidation of the VIE, CDO VII has been removed from our non-consolidated VIE disclosure.

On June 17, 2011, Newcastle deconsolidated a non-recourse financing structure, CDO V. Newcastle determined that it does not currently have the power to direct the relevant activities of CDO V as an event of default had occurred and Newcastle may be removed as the collateral manager by a single party. The deconsolidation has reduced Newcastle’s gross assets by \$301.6 million, reduced liabilities by \$357.0 million and increased equity by \$55.4 million. The deconsolidation also reduced revenues and expenses from June 17, 2011 onwards, but its impact was not material to net income applicable to common stockholders.

Newcastle had variable interests in the following unconsolidated VIE at September 30, 2011, in addition to the subprime securitizations which are described in Note 4:

Entity	Gross Assets (A)	Debt (B)	Carrying Value of Newcastle’s Investment (C)
Newcastle CDO V	\$ 324,653	\$324,712	\$ 4,562

(A) Face amount.

(B) Includes \$41.7 million face amount of debt owned by Newcastle at September 30, 2011.

(C) This amount represents Newcastle’s maximum exposure to loss from this entity, which was the fair value at September 30, 2011 for \$6.1 million face amount of CDO V Class I notes. Newcastle repurchased these notes in the quarter ended September 30, 2011 and recorded these as investments in Real Estate Securities.

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2011

(dollars in thousands, except share data)

3. REAL ESTATE SECURITIES

The following is a summary of Newcastle's real estate securities at September 30, 2011, 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) (D)	Principal Subordination (E)
	Outstanding Face Amount	Before Impairment	Other-Than-Temporary Impairment (A)	After Impairment	Gains	Losses	Carrying Value (B)		Rating (C)	Coupon	Yield		
CMBS-Conduit	\$1,284,683	\$1,083,125	\$(204,159)	\$ 878,966	\$ 89,119	\$ (82,215)	\$ 885,870	169	BB	5.65%	10.63%	4.0	10.8%
CMBS- Single Borrower	200,385	194,802	(12,364)	182,438	3,519	(18,283)	167,674	35	BB	4.84%	5.96%	3.4	6.7%
CMBS-Large Loan	7,546	7,544	—	7,544	—	(454)	7,090	2	A	1.64%	1.84%	0.7	11.8%
REIT Debt	137,393	136,760	—	136,760	5,263	(7,672)	134,351	20	BB+	5.83%	5.69%	2.7	N/A
ABS-Subprime (F)	270,430	230,742	(86,694)	144,048	14,479	(7,623)	150,904	64	B+	1.28%	10.47%	6.5	30.8%
ABS-Manufactured Housing	31,446	30,614	—	30,614	1,541	(246)	31,909	7	BBB+	6.62%	7.52%	3.7	41.1%
ABS-Franchise	21,177	21,764	(10,895)	10,869	475	(3,243)	8,101	7	BBB-	3.15%	6.21%	10.4	24.6%
FNMA/FHLMC	210,673	221,915	—	221,915	966	(323)	222,558	26	AAA	2.76%	1.41%	4.6	N/A
CDO (G)	207,287	82,754	(14,861)	67,893	100	(10,655)	57,338	13	B-	2.90%	7.96%	1.6	N/A
Debt Security Total /Average (H)	<u>2,371,020</u>	<u>2,010,020</u>	<u>(328,973)</u>	<u>1,681,047</u>	<u>115,462</u>	<u>(130,714)</u>	<u>1,665,795</u>	<u>343</u>	<u>BB+</u>	<u>4.57%</u>	<u>8.26%</u>	<u>4.0</u>	
Equity Securities		<u>1,388</u>	<u>(276)</u>	<u>1,112</u>	<u>1,449</u>	<u>—</u>	<u>2,561</u>	<u>2</u>					
Total		<u>\$2,011,408</u>	<u>\$(329,249)</u>	<u>\$1,682,159</u>	<u>\$116,911</u>	<u>\$(130,714)</u>	<u>\$1,668,356</u>	<u>\$ 345</u>					

- (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 new accounting guidance on impairment in 2009.
- (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. Newcastle used an implied AAA rating for the FNMA/FHLMC securities. Ratings provided were determined by third party rating agencies as of a particular date, may not be current and are subject to change (including a "negative watch" assignment) at any time.
- (D) The weighted average maturity is based on the timing of expected principal reduction on the assets.
- (E) Percentage of the outstanding face amount of securities that is subordinate to Newcastle's investments.
- (F) Includes the retained bonds with a face amount of \$4.0 million and a carrying value of \$1.2 million from Securitization Trust 2006 (Note 4).
- (G) Includes two CDO bonds issued by a third party with a carrying value of \$50.1 million, four CDO bonds issued by CDO V (which has been deconsolidated) held as investments by Newcastle with a carrying value of \$4.6 million and seven CDO bonds issued by C-BASS with a carrying value of \$2.6 million.
- (H) The total outstanding face amount of fixed rate securities was \$1.6 billion, and of floating rate securities was \$0.8 billion.

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2011

(dollars in thousands, except share data)

Unrealized losses that are considered other-than-temporary are recognized currently in earnings. During the nine months ended September 30, 2011, Newcastle recorded other-than-temporary impairment charges ("OTTI") of \$14.4 million (gross of \$0.8 million 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. Any remaining unrealized losses on Newcastle's securities were primarily the result of changes in market factors, rather than issue-specific credit impairment. The following table summarizes Newcastle's securities in an unrealized loss position as of September 30, 2011.

Securities in an Unrealized Loss Position	Outstanding Face Amount	Amortized Cost Basis			Gross Unrealized		Carrying Value	Number of Securities	Weighted Average			Maturity (Years)
		Before Impairment	Other-than-Temporary Impairment	After Impairment	Gains	Losses			Rating	Coupon	Yield	
Less Than Twelve Months	\$ 785,986	\$ 683,937	\$ (29,093)	\$ 654,844	\$—	\$ (65,688)	589,156	82	BBB	4.60%	7.93%	5.4
Twelve or More Months	444,603	439,840	(7,439)	432,401	—	(65,026)	367,375	81	BB	5.04%	5.50%	2.4
Total	\$1,230,589	\$1,123,777	\$ (36,532)	\$1,087,245	\$—	\$ (130,714)	\$956,531	163	BBB-	4.76%	6.96%	4.3

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 OTTI, exceeds its fair value) and determined the following:

	September 30, 2011			
	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	29,270	33,153	(35,034)	(3,883)
Non credit impaired securities	927,261	1,054,092	—	(126,831)
Total debt securities in an unrealized loss position	\$956,531	\$1,087,245	\$(35,034)	\$ (130,714)

- (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, Newcastle must make its best estimate, which is subject to significant judgment regarding future events, and may differ materially from actual future sales.
- (B) This amount is required to be recorded as other-than-temporary impairment through earnings. 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.

[Table of Contents](#)**NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)**

SEPTEMBER 30, 2011

(dollars in thousands, except share data)

The following table summarizes the activity related to credit losses on debt securities for the nine months ended September 30, 2011:

Beginning balance of credit losses on debt securities for which a portion of an OTTI was recognized in other comprehensive income	\$(60,688)
Additions for credit losses on securities for which an OTTI was not previously recognized	(5,198)
Increases to credit losses on securities for which an OTTI was previously recognized and a portion of an OTTI was recognized in other comprehensive income	(682)
Additions for credit losses on securities for which an OTTI was previously recognized without any portion of OTTI recognized in other comprehensive income	(25,798)
Reduction for credit losses on securities for which no OTTI was recognized in other comprehensive income at the current measurement date	12,229
Reduction for securities sold during the period	37,833
Reduction for securities deconsolidated during the period	6,254
Reduction for increases in cash flows expected to be collected that are recognized over the remaining life of the security	1,016
Ending balance of credit losses on debt securities for which a portion of an OTTI was recognized in other comprehensive income	<u>\$(35,034)</u>

As of September 30, 2011, Newcastle had \$176.4 million of restricted cash held in CDO financing structures pending its reinvestment in real estate securities and loans.

The table below summarizes the geographic distribution of the collateral securing Newcastle's CMBS and ABS at September 30, 2011 (in thousands):

Geographic Location	CMBS		ABS	
	Outstanding Face Amount	Percentage	Outstanding Face Amount	Percentage
Western U.S.	\$ 570,296	38.2%	\$ 80,959	25.1%
Northeastern U.S.	267,648	17.9%	59,840	18.4%
Southeastern U.S.	275,104	18.4%	73,302	22.7%
Midwestern U.S.	171,334	11.5%	49,060	15.2%
Southwestern U.S.	132,349	8.9%	33,510	10.4%
Other	16,564	1.1%	26,382	8.2%
Foreign	59,319	4.0%	—	0.0%
	<u>\$ 1,492,614</u>	<u>100.0%</u>	<u>\$ 323,053</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.

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2011

(dollars in thousands, except share data)

4. REAL ESTATE RELATED LOANS, RESIDENTIAL MORTGAGE LOANS, SUBPRIME MORTGAGE LOANS AND SERVICING RIGHTS

The following is a summary of real estate related loans, residential mortgage loans and subprime mortgage loans at September 30, 2011. 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 (A)	Loan Count	Wtd. Avg. Yield	Weighted Average Coupon	Weighted Average Maturity (Years) (B)	Floating Rate Loans as a % of Face Amount	Delinquent Face Amount (C)
Mezzanine Loans	\$ 560,563	\$443,361	16	11.13%	7.01%	2.3	72.8%	\$ 63,615
Corporate Bank Loans	277,541	159,878	6	20.76%	9.11%	3.0	52.8%	—
B-Notes	255,085	187,865	9	15.35%	4.46%	1.8	76.4%	45,091
Whole Loans	30,670	30,670	3	4.34%	3.90%	2.1	94.9%	—
Total Real Estate Related Loans Held-for-Sale, Net	\$1,123,859	\$821,774	34	13.71%	6.87%	2.4	69.3%	\$ 108,706
Non-Securitized Manufactured Housing Loan Portfolio I	\$ 775	\$ 200	22	47.86%	8.32%	0.7	0.0%	\$ 78
Non-Securitized Manufactured Housing Loan Portfolio II	5,407	2,831	171	15.59%	10.19%	5.0	8.1%	1,826
Total Residential Mortgage Loans Held-for-Sale, Net	\$ 6,182	\$ 3,031	193	17.72%	9.96%	4.5	7.1%	\$ 1,904
Securitized Manufactured Housing Loan Portfolio I	\$ 139,116	\$115,357	3,640	9.53%	8.69%	7.5	1.0%	\$ 1,628
Securitized Manufactured Housing Loan Portfolio II	184,615	180,926	6,289	7.56%	9.66%	6.0	17.4%	2,035
Residential Loans	61,391	44,206	218	6.67%	2.34%	7.2	100.0%	7,135
Total Residential Mortgage Loans Held-for-Investment, Net (D)	\$ 385,122	\$340,489	10,147	8.11%	8.14%	6.7	24.6%	\$ 10,798
Subprime Mortgage Loans Subject to Call Option	\$ 406,217	\$404,476						

- (A) Carrying value includes interest receivable of \$0.1 million for the residential housing loans and principal and interest receivable of \$5.4 million for the manufactured housing loans.
- (B) The weighted average maturity is based on the timing of expected principal reduction on the assets.
- (C) Includes loans that are 60 or more days past due, in foreclosure, under bankruptcy, or considered real estate owned. As of September 30, 2011, \$134.6 million face amount of real estate related loans was on non-accrual status.
- (D) The following is an aging analysis of past due residential loans held-for-investment as of September 30, 2011:

	30-59 Days Past Due	60-89 Days Past Due	Over 90 Days Past Due	Reposessed	Total Past Due	Current	Total Outstanding Face Amount
Securitized Manufactured Housing Loan Portfolio I	\$ 1,465	\$ 243	\$ 705	\$ 680	\$ 3,093	\$136,023	\$ 139,116
Securitized Manufactured Housing Loan Portfolio II	\$ 1,635	\$ 487	\$ 770	\$ 778	\$ 3,670	\$180,945	\$ 184,615
Residential Loans	\$ 438	\$ —	\$ 7,135	\$ —	\$ 7,573	\$ 53,818	\$ 61,391

Newcastle's management monitors the credit qualities of the Manufactured Housing Loan Portfolios I and II primarily by using aging analyses, current trends in delinquencies and actual loss incurrence rates.

Newcastle's investments in real estate related loans and non-securitized manufactured housing loans were classified as held-for-sale as of September 30, 2011 and December 31, 2010. Loans held-for-sale are marked to the lower of carrying value or fair value.

Newcastle's investment in the securitized manufactured housing loan portfolio I was classified as held-for-investment as of September 30, 2011 and December 31, 2010. Newcastle's investment in the manufactured housing loan portfolio II was classified as held-for-sale as of December 31, 2010. However, subsequent to the refinancing of a portion of the manufactured housing loan portfolio II in May 2011, Newcastle reclassified the securitized portion of the related pool of loans from held-for-sale to held-for-investment since the longer term financing provided it the ability to hold these loans for the foreseeable future. In connection with the securitizations of the manufactured housing loan portfolios, Newcastle gave representations and warranties with respect to the manufactured housing loans sold to the securitization trusts. To the extent a breach of any such representations and warranties materially and adversely affects the value or enforceability of the related loans, Newcastle will be required to repurchase such loans from the respective securitization trusts.

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2011

(dollars in thousands, except share data)

Newcastle's investment in the residential loans was classified as held-for-sale as of December 31, 2010. In the third quarter of 2011, in light of its current capital and liquidity positions, Newcastle re-evaluated its intent and ability to hold its investment in residential loans and determined that it has the intent and ability to hold this investment to maturity and reclassified this investment as held-for-investment as of September 30, 2011.

The following is a summary of real estate related loans by maturities at September 30, 2011:

<u>Year of Maturity</u> ⁽¹⁾	<u>Outstanding Face Amount</u>	<u>Carrying Value</u>	<u>Number of Loans</u>
Delinquent ⁽²⁾	\$ 108,706	\$ 45,516	5
Period from October 1, 2011 to December 31, 2011	80,178	68,984	2
2012	123,073	57,403	4
2013	29,354	19,063	3
2014	295,273	207,338	8
2015	215,475	173,450	6
2016	254,512	234,805	5
Thereafter	17,288	15,215	1
Total	\$1,123,859	\$821,774	34

(1) Based on the final extended maturity date of each loan investment as of September 30, 2011.

(2) Includes loans that are non-performing, in foreclosure, or under bankruptcy.

Activities relating to the carrying value of our real estate loans and residential mortgage loans are as follows:

	<u>Held-for-Sale</u>		<u>Held-for-Investment</u>
	<u>Real Estate Related Loans</u>	<u>Residential Mortgage Loans</u>	<u>Residential Mortgage Loans</u>
December 31, 2010	\$ 782,605	\$ 253,213	\$ 124,974
Purchases / additional fundings	339,850	—	—
Interest accrued to principal balance	14,303	—	—
Principal paydowns	(234,418)	(8,563)	(21,128)
Sales	(125,141)	—	—
Transfer to held-for-investment	—	(238,721)	238,721
Valuation (allowance) reversal on loans	43,697	(2,900)	(2,579)
Accretion of loan discount and other amortization	—	—	1,223
Other	878	2	(722)
September 30, 2011	\$ 821,774	\$ 3,031	\$ 340,489

The following is a rollforward of the related loss allowance.

	<u>Held-For-Sale</u>		<u>Held-For-Investment</u>
	<u>Real Estate Related Loans</u>	<u>Residential Mortgage Loans</u>	<u>Residential Mortgage Loans (B)</u>
Balance at December 31, 2010	\$ (321,591)	\$ (25,193)	\$ (21,350)
Transfer to held-for-investment	—	21,364	(21,364)
Charge-offs (A)	26,853	3,553	4,035
Valuation (allowance) reversal on loans	43,697	(2,900)	(2,579)
Balance at September 30, 2011	\$ (251,041)	\$ (3,176)	\$ (41,258)

(A) The charge-offs for real estate related loans represent three loans which were written off or sold during the period.

(B) The allowance for credit losses was determined based on the guidance for loans acquired with deteriorated credit quality.

Securitization of Subprime Mortgage Loans

The following table presents information on the retained interests in Newcastle's securitizations of subprime mortgage loans at September 30, 2011:

	<u>Subprime Portfolio</u>		<u>Total</u>
	<u>I</u>	<u>II</u>	
Total securitized loans (unpaid principal balance) (A)	\$488,009	\$637,069	\$1,125,078
Loans subject to call option (carrying value)	\$299,176	\$105,300	\$ 404,476
Retained interests (fair value) (B)	\$ 1,194	\$ —	\$ 1,194

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2011

(dollars in thousands, except share data)

- (A) Average loan seasoning of 74 months and 56 months for Subprime Portfolios I and II, respectively, at September 30, 2011.
- (B) The retained interests include retained bonds of the securitizations. Their fair value is estimated based on pricing models. Newcastle's residual interests were written off in the first quarter of 2010. The weighted average yield of the retained bonds was 9.3% as of September 30, 2011.

Newcastle has no obligation to repurchase any loans from either of its subprime securitizations. Therefore, it is expected that its exposure to loss is limited to the carrying amount of its retained interests in the securitization entities, as described above. A subsidiary of Newcastle gave limited representations and warranties with respect to Subprime Portfolio II and is required to pay the difference, if any, between the repurchase price of any loan in such portfolio and the price required to be paid by a third party originator for such loan. Such subsidiary, however, has no assets and does not have recourse to the general credit of Newcastle.

The following table summarizes certain characteristics of the underlying subprime mortgage loans, and related financing, in the securitizations as of September 30, 2011:

	Subprime Portfolio	
	I	II
Loan unpaid principal balance (UPB)	\$488,009	\$637,069
Weighted average coupon rate of loans	5.47%	4.91%
Delinquencies of 60 or more days (UPB) (A)	\$109,669	\$176,129
Net credit losses for the nine months ended September 30, 2011	\$ 23,440	\$ 42,723
Cumulative net credit losses	\$186,849	\$210,359
Cumulative net credit losses as a % of original UPB	12.4%	19.3%
Percentage of ARM loans (B)	52.6%	65.3%
Percentage of loans with original loan-to-value ratio >90%	10.7%	17.2%
Percentage of interest-only loans	22.4%	4.2%
Face amount of debt (C)	\$484,009	\$637,069
Weighted average funding cost of debt (D)	1.27%	1.36%

- (A) Delinquencies include loans 60 or more days past due, in foreclosure, under bankruptcy filing 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 option ARMs.
- (C) Excludes face amount of \$4.0 million of retained notes for Subprime Portfolio I at September 30, 2011.
- (D) Includes the effect of applicable hedges.

Newcastle received negligible cash inflows from the retained interests of Subprime Portfolios I and II during the nine months ended September 30, 2011 and \$0.3 million and \$0.5 million from Subprime Portfolios I and II, respectively, during the nine months ended September 30, 2010.

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 Portfolio's I and II, respectively.

Servicing Rights

In February 2011, Newcastle, through one of its subsidiaries, purchased the management rights with respect to certain CBASS Investment Management LLC ("C-BASS") CDOs pursuant to a bankruptcy proceeding for \$2.2 million. Newcastle initially recorded the cost of acquiring the collateral management rights as a servicing asset and subsequently amortizes this asset in proportion to, and over the period of, estimated net servicing income. Servicing assets are assessed for impairment on a quarterly basis, with impairment recognized as a valuation allowance. Key economic assumptions used in measuring any potential impairment of the servicing assets include the prepayment speeds of the underlying loans, default rates, loss severities and discount rates. During the nine months ended September 30, 2011, Newcastle recorded \$0.2 million of servicing rights amortization and no servicing rights impairment. As of September 30, 2011, Newcastle's servicing asset had a carrying value of \$2.2 million recorded in Receivables and Other Assets.

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2011

(dollars in thousands, except share data)

5. DEBT OBLIGATIONS

The following table presents certain information regarding Newcastle's debt obligations and related hedges at September 30, 2011:

Debt Obligation/Collateral	Month Issued	Outstanding Face Amount	Carrying Value	Final Stated Maturity	Unhedged Weighted Average Funding Cost (A)	Weighted Average Funding Cost (B)	Weighted Average Maturity (Years)	Face Amount of Floating Rate Debt	Collateral				Aggregate Notional Amount of Current Hedges (D)	
									Outstanding Face Amount (C)	Amortized Cost Basis (C)	Carrying Value (C)	Weighted Average Maturity (Years)		Floating Rate Face Amount (C)
CDO Bonds Payable														
CDO IV (E)	Mar 2004	\$ 109,607	\$ 109,387	Mar 2039	1.65%	4.90%	2.5	\$ 98,254	\$ 212,723	\$ 200,522	\$ 183,418	2.7	\$ 67,543	\$ 98,254
CDO VI (E)	Apr 2005	91,032	91,032	Apr 2040	0.88%	5.35%	4.0	88,191	265,328	144,499	164,501	3.1	76,785	88,191
CDO VIII	Nov 2006	598,313	596,922	Nov 2052	0.82%	2.12%	2.5	590,713	749,396	533,653	544,526	3.1	443,534	161,655
CDO IX	May 2007	480,125	482,812	May 2052	0.59%	1.49%	2.6	480,125	677,030	553,492	561,183	2.8	389,370	91,401
CDO X	Jul 2007	1,150,000	1,148,141	Jul 2052	0.60%	3.71%	5.0	1,150,000	1,236,925	941,547	915,296	4.8	229,126	880,250
		<u>2,429,077</u>	<u>2,428,294</u>			<u>2.99%</u>	<u>3.8</u>	<u>2,407,283</u>	<u>3,141,402</u>	<u>2,373,713</u>	<u>2,368,924</u>	<u>3.7</u>	<u>1,206,358</u>	<u>1,319,751</u>
Other Bonds and Notes Payable (F)														
MH loans Portfolio I	Apr 2010	74,129	73,175	Jul 2035	5.41%	5.41%	3.2	—	139,116	115,357	115,357	7.5	1,391	—
MH loans Portfolio II (G)	May 2011	132,609	131,223	Dec 2033	3.81%	3.81%	3.6	—	184,615	180,926	180,926	6.0	32,067	—
Residential Mortgage Loans (H)	Aug 2006	5,635	5,635	Dec 2034	LIBOR+ 0.90%	1.14%	7.5	5,635	57,612	40,806	40,806	7.4	57,612	—
		<u>212,373</u>	<u>210,033</u>			<u>4.30%</u>	<u>3.6</u>	<u>5,635</u>	<u>381,343</u>	<u>337,089</u>	<u>337,089</u>	<u>6.8</u>	<u>91,070</u>	<u>—</u>
Repurchase Agreements														
Real estate securities, loans and properties (I)	Dec 2010	11,686	11,686	Dec 2011	LIBOR+ 1.50%	1.74%	0.2	11,686	—	—	—	—	—	—
FNMA/FHLMC securities (J)	Various	209,242	209,242	Nov 2011	0.31%	0.31%	0.2	209,242	210,673	222,557	222,557	4.6	210,673	—
		<u>220,928</u>	<u>220,928</u>			<u>0.39%</u>	<u>0.2</u>	<u>220,928</u>	<u>210,673</u>	<u>222,557</u>	<u>222,557</u>	<u>4.6</u>	<u>210,673</u>	<u>—</u>
Corporate														
Junior subordinated notes payable	Mar 2006	51,004	51,250	Apr 2035	7.57%(L)	7.41%	23.6	—	—	—	—	—	—	—
		<u>51,004</u>	<u>51,250</u>			<u>7.41%</u>	<u>23.6</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>
Subtotal debt obligations		<u>2,913,382</u>	<u>2,910,505</u>			<u>2.96%</u>	<u>3.8</u>	<u>\$ 2,633,846</u>	<u>\$ 3,733,418</u>	<u>\$ 2,933,359</u>	<u>\$ 2,928,570</u>	<u>4.2</u>	<u>\$ 1,508,101</u>	<u>\$ 1,319,751</u>
Financing on subprime mortgage loans subject to call option (K)		<u>406,217</u>	<u>404,476</u>											
Total debt obligations		<u>\$ 3,319,599</u>	<u>\$ 3,314,981</u>											

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

(B) Including the effect of applicable hedges.

(C) Including restricted cash available for reinvestment in CDOs.

(D) Including a \$36.4 million notional amount of interest rate cap agreements in CDO X and a \$98.3 million and \$88.2 million notional amount of interest rate swap agreements in CDO IV and CDO VI, respectively, which were economic hedges not designated as hedges for accounting purposes.

(E) These CDOs were not in compliance with their applicable over collateralization tests as of September 30, 2011. Newcastle is not receiving cash flows from these CDOs (other than senior management fees and cash flows on senior classes of bonds which were repurchased), since net interest is being used to repay debt, and expects these CDOs to remain out of compliance for the foreseeable future.

(F) Excluding \$36.9 million and \$17.0 million face amount of other bonds payable relating to MH loans Portfolio I and Portfolio II, respectively, and \$50.4 million face amount of notes payable relating to residential mortgage loans sold to certain Newcastle CDOs, which were eliminated in consolidation.

(G) See Note 12.

(H) Notes payable issued to CDO V, which is no longer eliminated since the deconsolidation of CDO V.

(I) The counterparty of this repurchase agreement is Bank of America. It is secured by \$32.5 million face amount of senior notes issued by Newcastle CDO VI, which is eliminated on consolidation. The maximum recourse to Newcastle is \$2.9 million.

(J) The counterparties on these repurchase agreements are Bank of America and Goldman Sachs. Interest rates on these repurchase agreements are fixed, but will be reset on a short-term basis.

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

(L) LIBOR + 2.25% after April 2016.

Each CDO financing is subject to 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

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2011

(dollars in thousands, except share data)

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. As of September 30, 2011, CDOs IV and VI were not in compliance with their applicable over collateralization tests.

In the first nine months of 2011, Newcastle repurchased \$155.1 million face amount of CDO bonds and notes payable for \$94.3 million. As a result, Newcastle extinguished \$155.1 million face amount of CDO debt and notes payable and recorded a gain on extinguishment of debt of \$60.4 million.

6. FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair Value Summary Table

Newcastle held the following financial instruments at September 30, 2011:

	Principal Balance or Notional Amount	Carrying Value	Fair Value	Fair Value Method (A)	Weighted Average Yield/Funding Cost	Weighted Average Maturity (Years)
Assets						
<u>Non-Recourse VIE Financing Structures (F)</u>						
Financial instruments:						
Real estate securities, available-for-sale*	\$1,994,678	\$1,437,893	\$1,437,893	Broker quotations, counterparty quotations, pricing services, pricing models	9.28%	4.3
Real estate related loans, held-for-sale, net	1,054,225	815,140	822,484	Broker quotations, counterparty quotations, pricing services, pricing models	13.63%	2.5
Residential mortgage loans, held-for-investment, net	385,122	340,489	341,291	Pricing models	8.11%	6.7
Subprime mortgage loans subject to call option (B)	406,217	404,476	404,476	(B)	9.09%	(B)
Restricted cash*	178,121	178,121	178,121			
Derivative assets, treated as hedges (C)(E)*	104,205	1,384	1,384	Counterparty quotations	N/A	(C)
Non-hedge derivative assets (D)(E)*	36,428	999	999	Counterparty quotations	N/A	(D)
Operating real estate, held-for-sale		7,743	7,743			
Other investments		18,883	18,883			
Receivables and other assets		23,818	23,818			
		<u>\$3,228,946</u>	<u>\$3,237,092</u>			
<u>Recourse Financing Structures and Unlevered Assets</u>						
Financial instruments:						
Real estate securities, available-for-sale*	\$ 376,342	\$ 230,463	\$ 230,463	Broker quotations, counterparty quotations, pricing services, pricing models	1.80%	2.8
Real estate related loans, held-for-sale, net	69,634	6,634	6,634	Broker quotations, counterparty quotations, pricing services, pricing models	24.30%	1.2
Residential mortgage loans, held-for-sale, net	6,182	3,031	3,031	Pricing models	17.72%	4.5
Cash and cash equivalents*	205,180	205,180	205,180			
Other investments		6,024	6,024			
Receivables and other assets		2,775	2,775			
		<u>\$ 454,107</u>	<u>\$ 454,107</u>			

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2011

(dollars in thousands, except share data)

	Principal Balance or Notional Amount	Carrying Value	Fair Value	Fair Value Method (A)	Weighted Average Yield/Funding Cost	Weighted Average Maturity (Years)
Liabilities						
<u>Non-Recourse VIE Financing Structures (F) (G)</u>						
Financial instruments:						
CDO bonds payable	\$2,429,077	\$2,428,294	\$1,528,994	Pricing models	2.99%	3.8
Other bonds and notes payable	212,373	210,033	213,454	Pricing models, broker quotation	4.30%	3.6
Repurchase agreements	8,764	8,764	8,764	Market comparables	1.74%	0.2
Financing of subprime mortgage loans subject to call option (B)	406,217	404,476	404,476	(B)	9.09%	(B)
Interest rate swaps, treated as hedges (C) (E)*	992,673	99,531	99,531	Counterparty quotations	N/A	(C)
Non-hedge derivatives (D)(E)*	316,922	32,525	32,525	Counterparty quotations	N/A	(D)
Accrued expenses and other liabilities		46,448	46,448			
		<u>\$3,230,071</u>	<u>\$2,334,192</u>			
<u>Recourse Financing Structures and Other Liabilities</u>						
(G)						
Financial instruments:						
Repurchase agreements	\$ 212,164	\$ 212,164	\$ 212,164	Market comparables	0.33%	0.2
Junior subordinated notes payable	51,004	51,250	30,613	Pricing models	7.41%	23.6
Due to affiliates		1,532	1,532			
Accrued expenses and other liabilities		19,511	19,511			
		<u>\$ 284,457</u>	<u>\$ 263,820</u>			

* Measured at fair value on a recurring basis.

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2011

(dollars in thousands, except share data)

- (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 that 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 result 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 derivative agreements as follows:

<u>Year of Maturity</u>	<u>Weighted Average Month of Maturity</u>	<u>Aggregate Notional Amount</u>	<u>Weighted Average Fixed Pay Rate / Cap Rate</u>	<u>Aggregate Fair Value Asset / (Liability)</u>
Interest rate cap agreements which receive 1-Month LIBOR:				
2015	Sep	\$ 21,000	2.26%	\$ 192
2016	Jul	77,905	2.66%	1,084
2017	Jan	5,300	1.86%	108
		<u>\$ 104,205</u>		<u>\$ 1,384</u>
Interest rate swap agreements which receive 1-Month LIBOR:				
2011	Dec	\$ 91,401	5.00%	\$ (738)
2014	Nov	15,313	5.08%	(2,009)
2015	Apr	531,770	5.44%	(35,956)
2016	May	180,155	5.04%	(22,857)
2017	Aug	174,034	5.24%	(37,971)
		<u>\$ 992,673</u>		<u>\$(99,531)</u>

- (D) This represents two interest rate swap agreements with a total notional balance of \$316.9 million, maturing in March 2014 and March 2015, and three interest rate cap agreements with a total notional balance of \$36.4 million, maturing in August 2017 and January 2019. Newcastle entered into these hedge agreements to reduce its exposure to interest rate changes on the floating rate financings of CDO IV, CDO VI and CDO X. These derivative agreements were not designated as hedges for accounting purposes as of September 30, 2011.
- (E) Newcastle's derivatives fall into two categories. As of September 30, 2011, all derivatives were held within Newcastle's nonrecourse CDO structures. An aggregate notional balance of \$1.3 billion, which were liabilities at period end, are only subject to the credit risks of the respective CDO structures. As they are senior to all the debt obligations of the respective CDOs and the fair value of each of the CDO's investments exceeded the fair value of the CDO's derivative liabilities, no credit valuation adjustments were recorded. In addition, the credit ratings of two of Newcastle's derivative counterparties were downgraded in the quarter ended September 30, 2011. However, such downgrades had no impact on the fair value or on the respective CDOs as all of these derivatives were a liability payable to the counterparties. An aggregate notional balance of \$140.6 million were assets at period end and therefore are subject to the counterparty's credit risk. No adjustments have been made to the fair value quotations received related to credit risk as a result of the counterparty's "AA" credit rating. Newcastle's significant derivative counterparties include Bank of America, Credit Suisse and Wells Fargo.
- (F) 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, creditors or beneficial interest holders of these structures have no recourse to the general credit of Newcastle. Therefore, Newcastle's exposure to the economic losses from such structures is limited to its invested equity in them and economically their book value cannot be less than zero. As a result, the fair value of Newcastle's net investments in these non-recourse financing structures is equal to the present value of their expected future net cash flows.
- (G) Newcastle notes that the unrealized gain on the liabilities within such structures cannot be fully realized.

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2011

(dollars in thousands, except share data)

Valuation Hierarchy

The methodologies used for valuing such instruments have been categorized into three broad levels which form a hierarchy.

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

Level 2 – Valuations based principally on other observable market parameters, including

- Quoted prices in active markets for similar instruments,
- Quoted prices in less active or inactive markets for identical or similar instruments,
- Other observable inputs (such as interest rates, yield curves, volatilities, prepayment speeds, loss severities, credit risks and default rates), and
- Market corroborated inputs (derived principally from or corroborated by observable market data).

Level 3 – Valuations based significantly on unobservable inputs.

- Level 3A – Valuations based on third party indications (broker quotes, counterparty quotes or pricing services) which were, in turn, based significantly on unobservable inputs or were otherwise not supportable as Level 2 valuations.
- Level 3B – Valuations based on internal models with significant unobservable inputs.

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 measured at fair value on a recurring basis at September 30, 2011:

	Principal Balance or Notional Amount	Carrying Value	Fair Value			Total
			Level 2	Level 3A (1)	Level 3B (2)	
Assets:						
Real estate securities, available-for-sale:						
CMBS	\$ 1,492,614	\$ 1,060,634	\$ —	\$ 877,301	\$ 183,333	\$ 1,060,634
REIT debt	137,393	134,351	134,351	—	—	134,351
ABS - subprime	270,430	150,904	—	86,888	64,016	150,904
ABS - other real estate	52,623	40,010	—	32,566	7,444	40,010
FNMA / FHLMC	210,673	222,558	222,558	—	—	222,558
CDO	207,287	57,338	—	50,135	7,203	57,338
Debt security total	<u>\$ 2,371,020</u>	<u>1,665,795</u>	<u>356,909</u>	<u>1,046,890</u>	<u>261,996</u>	<u>1,665,795</u>
Equity securities		2,561	—	—	2,561	2,561
Real estate securities total		<u>\$ 1,668,356</u>	<u>\$ 356,909</u>	<u>\$ 1,046,890</u>	<u>\$ 264,557</u>	<u>\$ 1,668,356</u>
Derivative assets:						
Interest rate caps, treated as hedges	\$ 104,205	\$ 1,384	\$ 1,384	\$ —	\$ —	\$ 1,384
Interest rate caps, not treated as hedges	36,428	999	999	—	—	999
Derivative assets total	<u>\$ 140,633</u>	<u>\$ 2,383</u>	<u>\$ 2,383</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 2,383</u>
Liabilities:						
Derivative Liabilities:						
Interest rate swaps, treated as hedges	\$ 992,673	\$ 99,531	\$ 99,531	\$ —	\$ —	\$ 99,531
Interest rate swaps, not treated as hedges	316,922	32,525	32,525	—	—	32,525
Derivative liabilities total	<u>\$ 1,309,595</u>	<u>\$ 132,056</u>	<u>\$ 132,056</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 132,056</u>

(1) Third party pricing sources with significant unobservable inputs.

(2) Internal models with significant unobservable inputs.

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2011

(dollars in thousands, except share data)

Newcastle's investments in instruments measured at fair value on a recurring basis using Level 3 inputs changed during the nine months ended September 30, 2011 as follows:

	Level 3A					Total
	CMBS		ABS		Equity/Other Securities	
	Conduit	Other	Subprime	Other		
Balance at December 31, 2010	\$ 840,227	\$ 331,904	\$ 83,582	\$ 36,193	\$ —	\$1,291,906
Transfers (A)						
Transfers from Level 3B	9,334	25,000	19,950	718	—	55,002
Transfers into Level 3B	(88,464)	—	(15,031)	(7,548)	(2,475)	(113,518)
CDO V deconsolidation	(59,970)	(55,838)	(5,107)	—	—	(120,915)
Total gains (losses) (B)						
Included in net income (C)	42,641	579	(23)	(97)	—	43,100
Included in other comprehensive income (loss)	(106,312)	35,881	(7,443)	(571)	(10,661)	(89,106)
Amortization included in interest income	17,078	5,567	3,995	280	1,995	28,915
Purchases, sales and settlements						
Purchases	229,558	27,262	29,359	7,548	69,308	363,035
Proceeds from sales	(125,358)	(54,885)	(6,573)	—	—	(186,816)
Proceeds from repayments	(36,910)	(159,993)	(15,821)	(3,957)	(8,032)	(224,713)
Balance at September 30, 2011	<u>\$ 721,824</u>	<u>\$ 155,477</u>	<u>\$ 86,888</u>	<u>\$ 32,566</u>	<u>\$ 50,135</u>	<u>\$1,046,890</u>

	Level 3B					Total
	CMBS		ABS		Equity/Other Securities	
	Conduit	Other	Subprime	Other		
Balance at December 31, 2010	\$ 107,457	\$ 21,146	\$ 94,424	\$ 8,985	\$ 4,282	\$ 236,294
Transfers (A)						
Transfers from Level 3A	88,464	—	15,031	7,548	2,475	113,518
Transfers into Level 3A	(9,334)	(25,000)	(19,950)	(718)	—	(55,002)
CDO V deconsolidation	(32,289)	(1,908)	(14,568)	(3,833)	—	(52,598)
Total gains (losses) (B)						
Included in net income (C)	5,107	722	(1,210)	(65)	3,385	7,939
Included in other comprehensive income (loss)	23,931	14	3,307	(3,005)	(1,613)	22,634
Amortization included in interest income	13,950	60	6,923	880	404	22,217
Purchases, sales and settlements						
Purchases	4,501	25,000	25	—	10,192	39,718
Proceeds from sales	(24,535)	(721)	(8,624)	(348)	(3,884)	(38,112)
Proceeds from repayments	(13,206)	(26)	(11,342)	(2,000)	(5,477)	(32,051)
Balance at September 30, 2011	<u>\$ 164,046</u>	<u>\$ 19,287</u>	<u>\$ 64,016</u>	<u>\$ 7,444</u>	<u>\$ 9,764</u>	<u>\$ 264,557</u>

- (A) Transfers are assumed to occur at the beginning of the quarter. CDO V was deconsolidated on June 17, 2011.
- (B) None of the gains (losses) recorded in earnings during the period is attributable to the change in unrealized gains (losses) relating to Level 3 assets still held at the reporting dates.
- (C) These gains (losses) are recorded in the following line items in the consolidated statement of income:

	Nine Months Ended September 30, 2011	
	Level 3A	Level 3B
Gain (loss) on settlement of investments, net	\$44,604	\$ 20,030
Other income (loss), net	—	—
OTTI	(1,504)	(12,091)
Total	<u>\$43,100</u>	<u>\$ 7,939</u>
Gain (loss) on settlement of investments, net, from investments transferred into Level 3 during the period	\$ —	\$ —

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2011

(dollars in thousands, except share data)

Securities Valuation

As of September 30, 2011, Newcastle's securities valuation methodology and results are further detailed as follows:

Asset Type	Outstanding Face Amount	Amortized Cost Basis (A)	Fair Value			Total
			Multiple Quotes (B)	Single Quote (C)	Internal Pricing Models (D)	
CMBS	\$1,492,614	\$1,068,948	\$607,774	\$269,527	\$183,333	\$1,060,634
REIT debt	137,393	136,760	40,167	94,184	—	134,351
ABS – subprime	270,430	144,048	48,012	38,876	64,016	150,904
ABS – other real estate	52,623	41,483	31,915	651	7,444	40,010
FNMA / FHLMC	210,673	221,915	82,968	139,590	—	222,558
CDO	207,287	67,893	—	50,135	7,203	57,338
Debt security total	<u>\$2,371,020</u>	1,681,047	810,836	592,963	261,996	1,665,795
Equity securities		1,112	—	—	2,561	2,561
Total		<u>\$1,682,159</u>	<u>\$810,836</u>	<u>\$592,963</u>	<u>\$264,557</u>	<u>\$1,668,356</u>

- (A) Net of discounts (or gross of premiums) and after OTTI, including impairment taken during the period ended September 30, 2011.
- (B) Management generally obtained pricing service quotations or 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 or pricing services 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 or pricing services, 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.
- (C) 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) or a pricing service.
- (D) Securities whose fair value was estimated based on internal pricing models are further detailed as follows:

	Amortized Cost Basis (A)	Fair Value	Impairment Recorded In Current Period	Unrealized Gains (Losses) in Accumulated OCI	Assumption Ranges			
					Discount Rate	Prepayment Speed (E)	Cumulative Default Rate	Loss Severity
CMBS – Conduit	\$ 131,033	\$164,045	\$ 5,969	\$ 33,012	12%	N/A	2% - 100%	30% - 100%
CMBS – Large loan / Single borrower	20,940	19,288	—	(1,652)	9% - 16%	N/A	0% - 100%	0% - 100%
ABS – subprime	51,854	64,016	2,502	12,162	8%	0% - 8%	27% - 88%	60% - 100%
ABS – other RE	9,039	7,444	53	(1,595)	8%	1% - 3%	38% - 63%	80% - 100%
CDO Securities	7,103	7,203	—	100	10% - 16%	0% - 6%	21% - 100%	21% - 100%
Debt security total	\$ 219,969	\$261,996	\$ 8,524	\$ 42,027				
Equity securities	1,112	2,561	—	1,449				
Total	<u>\$ 221,081</u>	<u>\$264,557</u>	<u>\$ 8,524</u>	<u>\$ 43,476</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. Newcastle uses assumptions that generate its 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 a widely published investment bank model which considers factors such as collateral FICO score, 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. Newcastle typically uses projected severities that are higher than the historic experience for collateral that is relatively new to account for this effect. Collateral characteristics such as loan size, lien position, and location (state) also effect loss severity. Newcastle considers whether a collateral pool has experienced a significant change in its composition with respect to these factors when assigning severity projections.

Default rates 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.

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2011

(dollars in thousands, except share data)

The discount rates Newcastle uses 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 Newcastle transacts have become less liquid, Newcastle has had to rely on fewer data points in this analysis.

(E) Projected annualized average prepayment rate.

Loan Valuation

Loans which Newcastle does not have the ability or intent to hold into the foreseeable future are classified as held-for-sale. As a result, these held-for-sale loans are carried at the lower of amortized cost or fair value and are therefore recorded at fair value on a non-recurring basis. 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.

The following tables summarize certain information for real estate related loans and residential mortgage loans held-for-sale as of September 30, 2011:

Loan Type	Outstanding Face Amount	Carrying Value	Fair Value	Valuation Allowance/ (Reversal) In Current Year	Significant Input Ranges	
					Discount Rate	Loss Severity
Mezzanine	\$ 560,563	\$443,361	\$448,665	\$ (49,892)	8.0% - 24.3%	0.0% - 100.0%
Bank Loan	277,541	159,878	161,901	17,346	10.3% - 25.0%	0.0% - 74.0%
B-Note	255,085	187,865	187,865	(11,151)	6.4% - 26.2%	0.0% - 100.0%
Whole Loan	30,670	30,670	30,687	—	4.2% - 7.1%	0.0% - 15.0%
Total Real Estate Related Loans Held-for-Sale, Net	\$1,123,859	\$821,774	\$829,118	\$ (43,697)		

Loan Type	Outstanding Face Amount	Carrying Value	Fair Value	Valuation Allowance/ (Reversal) In Current Year	Significant Input Ranges			
					Discount Rate	Prepayment Speed	Constant Default Rate	Loss Severity
Non-securitized Manufactured Housing Loans I	\$ 775	\$ 200	\$ 200	\$ 81	47.9%	3.0%	53.0%	75.0%
Non-securitized Manufactured Housing Loans II	5,407	2,831	2,831	(929)	15.6%	5.0%	12.7%	80.0%
Total Residential Mortgage Loans Held-for-Sale, Net	\$ 6,182	\$ 3,031	\$ 3,031	\$ (848)				

Loans which Newcastle has the intent and ability to hold into the foreseeable future are classified as held-for-investment. Loans held-for-investment are carried at the aggregate unpaid principal balance adjusted for any unamortized premium or discount, deferred fees or expenses, an allowance for loan losses, charge-offs and write-downs for impaired loans.

The following table summarizes certain information for residential mortgage loans held-for-investment as of September 30, 2011:

Loan Type	Outstanding Face Amount	Carrying Value	Fair Value	Valuation Allowance/ (Reversal) In Current Year	Significant Input Ranges			
					Discount Rate	Prepayment Speed	Constant Default Rate	Loss Severity
Securitized Manufactured Housing Loans I	\$ 139,116	\$115,357	\$117,960	\$ 568	9.5%	3.0%	4.0%	75.0%
Securitized Manufactured Housing Loans II	184,615	180,926	179,125	2,011	7.6%	5.0%	3.5%	80.0%
Residential Loans	61,391	44,206	44,206	3,748	5.0% - 7.0%	0.0% - 4.0%	0.0% - 3.0%	0.0% - 50.0%
Total Residential Mortgage Loans, Held-for-Investment, Net	\$ 385,122	\$340,489	\$341,291	\$ 6,327				

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2011

(dollars in thousands, except share data)

Derivatives

Newcastle's derivative instruments are valued using counterparty quotations. These quotations are generally based on valuation models with model inputs that can generally be verified and which do not involve significant judgment. The significant observable inputs used in determining the fair value of our Level 2 derivative contracts are contractual cash flows and market based interest rate curves. Newcastle's derivatives are recorded on its balance sheet as follows:

	Balance sheet location	Fair Value	
		September 30, 2011	December 31, 2010
Derivative Assets			
Interest rate caps, designated as hedges	Derivative Assets	\$ 1,384	\$ 4,537
Interest rate caps, not designated as hedges	Derivative Assets	999	2,530
		<u>\$ 2,383</u>	<u>\$ 7,067</u>
Derivative Liabilities			
Interest rate swaps, designated as hedges	Derivative Liabilities	\$ 99,531	\$ 136,575
Interest rate swaps, not designated as hedges	Derivative Liabilities	32,525	40,286
		<u>\$ 132,056</u>	<u>\$ 176,861</u>

The following table summarizes information related to derivatives:

	September 30, 2011	December 31, 2010
Cash flow hedges		
Notional amount of interest rate swap agreements	\$ 992,673	\$1,473,669
Notional amount of interest rate cap agreements	104,205	104,205
Amount of (loss) recognized in OCI on effective portion	(79,034)	(118,608)
Deferred hedge gain (loss) related to anticipated financings, which have subsequently occurred, net of amortization	314	357
Deferred hedge gain (loss) related to dedesignation, net of amortization	(576)	1,343
Expected reclassification of deferred hedges from AOCI into earnings over the next 12 months	1,750	2,289
Expected reclassification of current hedges from AOCI into earnings over the next 12 months	(42,787)	(63,541)
Non-hedge Derivatives		
Notional amount of interest rate swap agreements	316,922	343,570
Notional amount of interest rate cap agreements	36,428	36,428

The following table summarizes gains (losses) recorded in relation to derivatives:

	Income statement location	Three Months Ended September 30,		Nine Months Ended September 30,	
		2011	2010	2011	2010
Cash flow hedges					
Gain (loss) on the ineffective portion	Other income (loss)	\$ (1,181)	\$ 83	\$ (881)	\$ (85)
Gain (loss) immediately recognized at dedesignation	Gain (loss) on sale of investments; Other income (loss)	—	(7,279)	(13,796)	(10,558)
Amount of gain (loss) reclassified from AOCI into income, related to effective portion	Interest expense	(12,824)	(20,304)	(51,532)	(63,426)
Deferred hedge gain reclassified from AOCI into income, related to anticipated financings	Interest expense	15	14	43	461
Deferred hedge gain (loss) reclassified from AOCI into income, related to effective portion of dedesignated hedges	Interest expense	497	(1,025)	1,799	(4,172)
Non-hedge derivatives gain (loss)	Other income (loss)	(2,109)	(1,861)	194	(5,992)

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2011

(dollars in thousands, except share data)

7. EQUITY AND 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, 2011, based on the treasury stock method, Newcastle had 16,396 and 8,454 dilutive common stock equivalents, respectively, resulting from its outstanding options. During the nine months ended September 30, 2010, Newcastle had no dilutive common stock equivalents (common stock equivalents are not dilutive in periods of net loss or when all of the exercise prices exceed the current average market price). Net income available for common stockholders is equal to net income less preferred dividends plus the excess of the carrying amount of exchanged preferred stock over the fair value of consideration paid.

In March 2011, Newcastle filed a shelf registration statement with the SEC covering common stock, preferred stock, depositary shares, debt securities and warrants.

In March 2011, Newcastle issued 17,250,000 shares of its common stock in a public offering at a price to the public of \$6.00 per share for net proceeds of approximately \$98.4 million. For the purpose of compensating the Manager for its successful efforts in raising capital for Newcastle, in connection with this offering, Newcastle granted options to the Manager to purchase 1,725,000 shares of Newcastle's common stock at the public offering price, which were valued at approximately \$7.0 million as of the grant date. The assumptions used in valuing the options were: a 1.7% risk-free rate, 107.8% volatility and a 3.3 year expected term.

In September 2011, Newcastle issued 25,875,000 shares of its common stock in a public offering at a price to the public of \$4.55 per share for net proceeds of approximately \$112.3 million. Certain principals of Fortress and officers of Newcastle participated in this offering and purchased an aggregate of 1,314,780 shares at the offering price. For the purpose of compensating the Manager for its successful efforts in raising capital for Newcastle, in connection with this offering, Newcastle granted options to the Manager to purchase 2,587,500 shares of Newcastle's common stock at the public offering price, which were valued at approximately \$5.6 million as of the grant date. The assumptions used in valuing the options were: a 1.13% risk-free rate, 13.2% dividend yield, 151.1% volatility and a 4.6 year expected term.

As of September 30, 2011, Newcastle's outstanding options were summarized as follows:

Held by the Manager	5,998,947
Issued to the Manager and subsequently transferred to certain of the Manager's employees	798,162
Issued to the independent directors	14,000
Total	<u>6,811,109</u>

8. COMMITMENTS AND CONTINGENCIES

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 that existed at September 30, 2011, if any, will not materially affect Newcastle's consolidated results of operations or financial position.

Contingent Gain in CDOs — 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. For non-recourse financing structures with negative GAAP book value, the aggregate negative GAAP book value will eventually be recorded as an increase to GAAP book value. As of September 30, 2011, Newcastle has recorded \$156.0 million of losses in its CDOs in excess of its economic exposure which must eventually be reversed through amortization, sales at gains, or as reductions to accumulated deficit at the deconsolidation or termination of the CDOs.

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2011

(dollars in thousands, except share data)

9. GAIN (LOSSES) ON SETTLEMENT OF INVESTMENTS, NET AND OTHER INCOME (LOSS), NET

These items are comprised of the following:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Gain (loss) on settlement of investments, net				
Gain on settlement of real estate securities	\$ 5,635	\$ 638	\$ 78,570	\$ 28,744
Loss on settlement of real estate securities	(24)	(1,772)	(5,047)	(7,968)
Gain on repayment/disposition of loans held-for-sale	25	—	1,811	—
Realized gain (loss) on termination of derivative instruments	—	—	—	(3,279)
	<u>\$ 5,636</u>	<u>\$ (1,134)</u>	<u>\$ 75,334</u>	<u>\$ 17,497</u>
Other income (loss), net				
Gain (loss) on non-hedge derivative instruments	\$(2,109)	\$(1,861)	\$ 194	\$ (5,992)
Unrealized (loss) recognized at de-designation of hedges	—	(7,279)	(13,796)	(7,279)
Hedge ineffectiveness	(1,181)	83	(881)	(85)
Equity in earnings of equity method investees	43	(1)	43	77
Collateral management fee income, net	496	—	1,864	—
Other income (loss)	—	230	—	673
	<u>\$(2,751)</u>	<u>\$(8,828)</u>	<u>\$(12,576)</u>	<u>\$(12,606)</u>

10. COMPREHENSIVE INCOME

The following table summarizes our comprehensive income for the interim periods presented:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Net income	\$ 29,943	\$ 163,502	\$ 238,751	\$ 423,281
Net unrealized gain (loss) on securities	(118,326)	79,534	(16,579)	341,566
Reclassification of net realized (gain) loss on securities into earnings	(1,605)	11,117	(59,928)	66,047
Net unrealized gain (loss) on derivatives designated as cash flow hedges	(6,651)	(16,078)	6,424	(48,758)
Reclassification of net realized (gain) loss on derivatives designated as cash flow hedges into earnings	670	8,207	12,835	14,353
Comprehensive income (loss)	<u>\$ (95,969)</u>	<u>\$ 246,282</u>	<u>\$ 181,503</u>	<u>\$ 796,489</u>

11. SUPPLEMENTAL NON-CASH INVESTING AND FINANCING ACTIVITIES RELATED TO CDOs

Newcastle considers all activity in its CDOs' restricted cash accounts to be non-cash activity for purposes of its consolidated statement of cash flows since transactions conducted with restricted cash have no effect on its cash and cash equivalents. Supplemental non-cash investing and financing activities relating to CDOs are disclosed below:

	Nine Months Ended September 30,	
	2011	2010
Restricted cash generated from sale of securities	\$ 320,017	\$ 98,907
Restricted cash generated from sale of real estate related loans	\$ 125,141	\$ 53,020
Restricted cash generated from paydowns on securities and loans	\$ 452,693	\$ 371,265
Restricted cash used for purchases of real estate securities	\$ 297,054	\$ 283,244
Restricted cash used for purchases of real estate related loans	\$ 339,850	\$ 104,117
Restricted cash used for repayments of CDO bonds payable	\$ 94,210	\$ 134,286
Restricted cash used for repurchases of CDO bonds payable and other bonds payable	\$ 3,213	\$ 14,183
Restricted cash used for repurchases of derivative instruments	\$ —	\$ 5,187
CDO V deconsolidation:		
Real estate securities	\$ 262,617	\$ —
Restricted cash	\$ 37,988	\$ —
Derivative liabilities	\$ 20,257	\$ —
CDO bonds payable	\$ 336,046	\$ —

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2011

(dollars in thousands, except share data)

12. RECENT ACTIVITIES

These financial statements include a discussion of material events that have occurred subsequent to September 30, 2011 (referred to as “subsequent events”) through the issuance of these consolidated financial statements. Events subsequent to that date have not been considered in these financial statements.

In January 2011, Newcastle, through two of its CDOs, made a cash investment of approximately \$47 million in a portion of a new secured loan to a portfolio company of a private equity fund managed by Newcastle’s manager. Newcastle’s chairman and secretary are officers or directors of the borrower. The terms of the loan were negotiated by a third party bank that acted as agent for the creditors on the loan. At closing, Newcastle received an origination fee on the loan equal to 2% of the amount of cash it loaned to the portfolio company, which was the same fee received by other creditors on the loan. In February 2011, the portfolio company repaid the loan in full.

In February 2011, Newcastle, through one of its subsidiaries, purchased the management rights with respect to certain C-BASS Investment Management LLC (“C-BASS”) CDOs pursuant to a bankruptcy proceeding for \$2.2 million. As a result, Newcastle became the collateral manager of certain CDOs previously managed by C-BASS and will earn, on average, a 20 basis point annual senior management fee on a portion of the total collateral, which was \$1.3 billion at acquisition.

In February 2011, two mezzanine loan investments with a total outstanding principal balance of \$88.8 million were paid off in full. The payoff increased Newcastle’s restricted cash available for reinvestment in two CDOs by \$60.8 million and its unrestricted cash by \$28.0 million.

In March 2011, Newcastle issued 17,250,000 shares of its common stock in a public offering at a price to the public of \$6.00 per share for net proceeds of approximately \$98.4 million. For the purpose of compensating the Manager for its successful efforts in raising capital for Newcastle, in connection with this offering, Newcastle granted options to the Manager to purchase 1,725,000 shares of Newcastle’s common stock at the public offering price, which were valued at approximately \$7.0 million.

In April 2011, Newcastle entered into an agreement to sell its retained interests in Newcastle CDO VII. Pursuant to the agreement, the buyer of the retained interests liquidated CDO VII in June 2011 and paid Newcastle total consideration of approximately \$3.9 million. As a result, Newcastle recorded a gain of approximately \$3.4 million in the second quarter of 2011, representing the excess of the sales proceeds over the carrying value of Newcastle’s retained interests.

On May 4, 2011, Newcastle completed a securitization transaction to refinance its Manufactured Housing Loans Portfolio II. Newcastle sold approximately \$197.0 million outstanding principal balance of manufactured housing loans to Newcastle Investment Trust 2011-MH 1 (the “Issuer”), an indirect wholly-owned subsidiary of Newcastle. The Issuer issued approximately \$159.8 million aggregate principal amount of investment grade notes, of which \$142.8 million was sold to third parties and \$17.0 million was sold to one of the CDOs managed and consolidated by Newcastle. In addition, Newcastle retained the below investment grade notes and residual interest. As a result, Newcastle invested approximately \$20.0 million of its unrestricted cash in the new securitization structure. The notes issued to third parties have an average expected maturity of 3.8 years and bear interest at an average rate of 3.23% per annum. At the closing of the securitization transaction, Newcastle used the gross proceeds received from the issuance of the notes to repay the previously existing debt in full, terminate the related interest rate swap contracts and pay the related transaction costs. Under the applicable accounting guidance, the securitization transaction is accounted for as a secured borrowing. As a result, no gain or loss is recorded for the transaction. Newcastle continues to recognize the portfolio of manufactured housing loans as pledged assets, which have been classified as residential mortgage loans held-for-investment at securitization, and records the notes issued to third parties as a secured borrowing. The associated assets, liabilities, revenues and expenses are presented in the non-recourse financing structure sections of the consolidated financial statements.

In June 2011, Newcastle deconsolidated a non-recourse financing structure, CDO V. Newcastle determined that it does not currently have the power to direct the relevant activities of CDO V as an event of default had occurred and Newcastle may be removed as the collateral manager by a single party.

In September 2011, Newcastle issued 25,875,000 shares of its common stock in a public offering at a price to the public of \$4.55 per share for net proceeds of approximately \$112.3 million. Certain principals of Fortress and officers of Newcastle participated in this offering and purchased an aggregate of 1,314,780 shares at the offering price. For the purpose of compensating the Manager for its successful efforts in raising capital for Newcastle, in connection with this offering, Newcastle granted options to the Manager to purchase 2,587,500 shares of Newcastle’s common stock at the public offering price, which were valued at approximately \$5.6 million as of the grant date.

[Table of Contents](#)

NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2011

(dollars in thousands, except share data)

In the first nine months of 2011, Newcastle purchased \$222.3 million principal balance of FNMA/FHLMC securities (primarily one-year ARMs) for approximately \$233.0 million, using \$11.9 million of unrestricted cash and financed with \$221.1 million of repurchase agreements. These repurchase agreements bear interest at 0.31%, mature in November 2011, and are subject to customary margin call provisions.

[Table of Contents](#)

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 thereto included herein, and with Part II, Item 1A, "Risk Factors."

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, liquidity, 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 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 of September 30, 2011, we had complied with the general investment guidelines adopted by our board of directors that limit total leverage. We utilize leverage for the sole purpose of financing our portfolio and not for the purpose of speculating on changes in interest rates.

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 seek to 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, while market conditions have improved meaningfully since 2008, the current conditions continue to reduce the array of capital resources available to us and have 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 onset of challenging conditions. Specifically, the economic environments and capital markets have become extremely challenging in the third quarter of 2011. That said, we have recently been able to access more types of capital – and on better terms – than we had been able to access during 2008 and 2009.

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 the following segments: (i) investments financed with non-recourse collateralized debt obligations ("CDOs"), (ii) investments financed with other non-recourse debt, (iii) investments and debt repurchases financed with recourse debt, (iv) unlevered investments and (v) corporate. With respect to the first two nonrecourse segments, Newcastle is generally entitled to receive the net cash flows from these structures on a periodic basis. Revenues attributable to each segment are disclosed below (in thousands).

For the Nine Months Ended September 30,	Non-recourse					Intersegment Elimination	Total
	CDOs	Other Non-Recourse	Recourse	Unlevered	Corporate		
2011	\$164,523	\$ 54,421	\$ 1,626	\$ 2,053	\$ 99	\$ (3,983)	\$218,739
2010	\$168,150	\$ 54,952	\$ 976	\$ 1,189	\$ 48	\$ —	\$225,315

Table of Contents

Market Considerations

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 our ability to do this 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.

From mid-2007 through early 2009, credit spreads widened substantially. One of the key drivers of the widening of credit spreads over these years was 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 quarter of 2009. In the latter part of 2009, credit spreads tightened substantially and continued to tighten in 2010 and the first half of 2011. However, credit spreads have widened in the third quarter of 2011, reflecting the currently challenging economic environment. These changes in credit spreads caused the net unrealized gains on our securities to increase during the first half of 2011, but these increases have been reversed and this has resulted in net unrealized losses in the third quarter of 2011. Market conditions remain challenging, could change rapidly, and we cannot predict how recent or future changes in market conditions will affect our business.

We utilize multiple forms of financing, depending on their appropriateness and availability, to finance our investments, including collateralized debt obligations (CDOs) or other securitizations, private or public offerings of debt, term loans, trust preferred securities, and short-term financing in the form of loans and repurchase agreements. One component of our investment strategy is to use match funded financing structures, such as CDOs, at rates that provide a positive net spread relative to our investment returns.

Recent conditions in the credit markets have impaired our ability to match fund investments. During the past two years, financing in the form of securitizations or other long-term non-recourse structures not subject to margin requirements was generally not available or economical, and it remains difficult to obtain under current market conditions. Lenders have generally tightened their underwriting standards and increased their margin requirements, resulting in a decline in the overall amount of leverage available to us and an increase in our borrowing costs. 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. Moreover, financial market conditions remain volatile and have been adversely affected by the unrest in the Middle East, the earthquake in Japan, the European financial crisis, continuing weakness in the U.S. job market and concern about the United States' level of indebtedness. Volatility in equity markets could impair our ability to raise debt or equity capital or otherwise finance our business.

Liquidity

Credit and liquidity conditions improved during 2010 and the first half of 2011, but deteriorated in the third quarter of 2011, and such conditions are still less favorable than those we experienced prior to 2007. Recent challenging credit and liquidity conditions have adversely affected us and the markets in which we operate in a number of ways. For example, they have 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, as well as volatility and uncertainty with respect to such valuations. 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

Table of Contents

- requiring us to pay additional amounts under certain financing arrangements.

Failed CDO triggers, impairments resulting from incurred losses, and asset sales made at prices significantly below face amount while the related debt is being repaid at its full face amount, as well as the retention of cash, could further contribute to reductions in future earnings, cash flow and liquidity.

With respect to dividends, we have paid all dividends on our preferred stock through October 31, 2011. We declared a quarterly dividend of \$0.10 per common share for the second quarter of 2011, which was paid in July 2011 and a quarterly dividend of \$0.15 per common share for the third quarter of 2011, which was paid in October 2011. 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 / Recovery

Market conditions have meaningfully improved over the last two years, but it is not clear whether a sustained recovery will occur or, if so, for how long it will last. We do not currently know the full extent to which the continuing challenging market conditions will affect us or the markets in which we operate. If such conditions continue, particularly with respect to commercial real estate, we may experience additional impairment charges, potential reductions in cash flows from our investments and additional challenges in raising capital and obtaining investment or other financing on attractive terms. Moreover, we will likely need to continue to place a high priority on managing our liquidity. 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 historically 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

Variable interest entities (“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 has the power to direct the activities of a VIE that most significantly impact its economic performance and who has the obligation to absorb losses or the right to receive benefits from the VIE that could potentially be significant to the VIE.

The VIEs in which we have a significant interest include (i) our CDOs, and (ii) our manufactured housing loan financing structures. Our CDOs were all consolidated under prior guidance; however, under current guidance we do not have the power to direct the relevant activities of CDO V, as a result of the event of default which allows us to be removed as collateral manager of CDO V and prevents us from purchasing or selling collateral within CDO V, and therefore we have deconsolidated CDO V as of June 17, 2011. Similar events of default in the future, if they occur, could cause us to deconsolidate additional financing structures. Our manufactured housing loan financing structures were consolidated under prior guidance and continue to be consolidated under the current guidance. However, we completed two securitization transactions to refinance our Manufactured Housing Loan Portfolios I and II. We analyzed the securitization under the applicable accounting guidance and concluded that the securitization transaction should be accounted for as a secured borrowing. As a result, we continue to recognize the portfolio of manufactured housing loans as pledged assets, which have been classified as loans held-for-investment at securitization, and recorded the notes issued to third parties as a secured borrowing.

Our subprime securitizations are also considered VIEs, but we do not control their activities and no longer receive a significant portion of their returns. These subprime securitizations were not consolidated under the current or prior guidance.

Table of Contents

In addition, our investments in CMBS, CDO securities and loans may be deemed to be variable interests in VIEs, depending on their structure. We are not obligated to provide, nor have we provided, any financial support to these VIEs. We monitor these investments and, to the extent we determine that we potentially own a majority of the currently controlling class, analyze them for potential consolidation. As of September 30, 2011, we have not consolidated these potential VIEs due to the determination that, based on the nature of our investments and the provisions governing these structures, we do not have the power to direct the activities that most significantly impact their economic performance.

We will continue to analyze future investments, as well as reconsideration events in existing entities, pursuant to the VIE requirements. These analyses require considerable judgment in determining the primary beneficiary of a VIE since they involve subjective determinations of significance, with respect to both power and economics. The result could be the consolidation of an entity that would otherwise not have been consolidated or the de-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 the sources described above. The determination of estimated cash flows used in pricing models is inherently subjective and imprecise. Changes in market conditions, as well as changes in the assumptions or methodology used to determine fair value, could result in a significant and immediate increase or decrease in our book 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, 2011.

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 GAAP 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 and pricing service 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 quarterly procedures we have performed with respect to quotations received from these brokers, including 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. For the \$1.4 billion carrying value of securities valued using quotations as of September 30, 2011, a 100 basis point change in credit spreads would impact estimated fair value by approximately \$49.8 million.

Our estimation of the fair value of level 3B assets (as described below) involves significant judgment. 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 liquidity conditions currently in the markets. In the first nine months of 2011, we have generally used lower discount rates as inputs to our models for ABS securities in order to reflect current market conditions. The other inputs to our models, including prepayment speeds, default rates and severity assumptions, have generally remained consistent with the assumptions used at year-end, other than certain modifications we have made to the assumptions to reflect conditions relevant to specific assets.

Table of Contents

For CMBS and ABS securities valued with internal models, which have an aggregate fair value of \$254.8 million as of September 30, 2011, a 10% unfavorable change in our assumptions would result in the following decreases in such aggregate fair value (in thousands):

	CMBS	ABS
Outstanding face amount	\$406,760	\$167,362
Fair value	\$183,333	\$ 71,460
Effect on fair value with 10% unfavorable change in:		
Discount rate	\$ (6,135)	\$ (2,676)
Prepayment rate	N/A	\$ (587)
Default rate	\$ (16,350)	\$ (5,373)
Loss severity	\$ (8,933)	\$ (10,310)

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.

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 certain securities which represent "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. These securities 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 definition of beneficial interests in securitized financial assets.

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.

As of September 30, 2011, we had 65 securities, with a carrying amount of \$195.5 million, that had been downgraded during the nine months ended September 30, 2011, and recorded a net other-than-temporary impairment charge of \$1.5 million on these securities in 2011. 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, but 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.

Table of Contents

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, we recognize the excess of all cash flows expected over our investment in the securities as Interest Income on a “loss adjusted yield” basis. The loss-adjusted yield 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. 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 fair value is reflected on a net by counterparty basis when Newcastle believes a legal right of offset exists under an enforceable netting agreement. To the extent they qualify as cash flow hedges, net unrealized gains or losses are reported as a component of accumulated other comprehensive income; otherwise, the net unrealized gains and losses 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 credit risk. The results of such variability, the effectiveness of our hedging strategies and the extent to which a forecasted hedged transaction remains probable of occurring, could result in a significant increase or decrease in our GAAP equity and/or earnings.

Impairment of Loans

We own, directly and indirectly, real estate related, commercial mortgage and residential mortgage loans, including manufactured housing loans and subprime mortgage loans. To the extent that they are classified as held-for-investment, 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.

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 loans 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 Valuation Allowance. The provision is determined based on an evaluation of the loans as described under “Impairment of Loans” above.

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 based on the loan’s coupon rates to the extent management believes it is collectible. Purchase discounts are not amortized as interest income during the period the loans are held-for-sale. A change in the market value of the loans, to the extent that the value is not above the cost basis, is recorded in Valuation Allowance.

[Table of Contents](#)

Recent Accounting Pronouncements

In May 2011, the FASB issued new guidance regarding the measurement and disclosure of fair value, which will become effective for Newcastle on January 1, 2012. Newcastle has not yet completed its assessment of the potential impact of this guidance.

In June 2011, the FASB issued a new accounting standard that eliminates the current option to report other comprehensive income and its components in the statement of stockholders' equity. Instead, an entity will be required to present items of net income and other comprehensive income in one continuous statement or in two separate, but consecutive, statements. The standard will become effective for Newcastle on January 1, 2012, with early adoption permitted.

The FASB has recently issued or discussed a number of proposed standards on such topics as consolidation, financial statement presentation, revenue recognition, leases, financial instruments, hedging, contingencies and contingencies. Some of the proposed changes are significant and could have a material impact on Newcastle's reporting. Newcastle has not yet fully evaluated the potential impact of these proposals, but will make such an evaluation as the standards are finalized.

[Table of Contents](#)

RESULTS OF OPERATIONS

The following table summarizes the changes in our results of operations for the three and nine months ended September 30, 2011 compared to the three and nine months ended September 30, 2010 (dollars in thousands):

	Three Months Ended September 30,		Increase (Decrease)	
	2011	2010	Amount	%
Interest income	\$72,393	\$ 81,040	\$ (8,647)	(10.7%)
Interest expense	32,587	42,547	(9,960)	(23.4%)
Net interest income	39,806	38,493	1,313	3.4%
Impairment (Reversal)				
Valuation allowance (reversal) on loans	17,644	(105,360)	123,004	116.7%
Other-than-temporary impairment on securities, net	4,006	10,041	(6,035)	(60.1%)
	21,650	(95,319)	116,969	122.7%
Net interest income after impairment/reversal	18,156	133,812	(115,656)	(86.4%)
Other Income (Loss)				
Gain (loss) on settlement of investments, net	5,636	(1,134)	6,770	597.0%
Gain on extinguishment of debt	15,917	46,624	(30,707)	(65.9%)
Other income (loss), net	(2,751)	(8,828)	6,077	68.8%
	18,802	36,662	(17,860)	(48.7%)
Expenses				
Loan and security servicing expense	1,198	1,116	82	7.3%
General and administrative expense	1,399	1,811	(412)	(22.7%)
Management fee to affiliate	4,569	4,258	311	7.3%
	7,166	7,185	(19)	(0.3%)
Income from continuing operations	\$29,792	\$ 163,289	\$ (133,497)	(81.8%)
	Nine Months Ended September 30,		Increase (Decrease)	
	2011	2010	Amount	%
Interest income	\$218,739	\$ 225,315	\$ (6,576)	(2.9%)
Interest expense	106,502	131,277	(24,775)	(18.9%)
Net interest income	112,237	94,038	18,199	19.4%
Impairment (Reversal)				
Valuation allowance (reversal) on loans	(38,218)	(292,668)	254,450	86.9%
Other-than-temporary impairment on securities, net	13,595	86,822	(73,227)	(84.3%)
	(24,623)	(205,846)	181,223	88.0%
Net interest income after impairment/reversal	136,860	299,884	(163,024)	(54.4%)
Other Income (Loss)				
Gain (loss) on settlement of investments, net	75,334	17,497	57,837	330.6%
Gain on extinguishment of debt	60,402	141,698	(81,296)	(57.4%)
Other income (loss), net	(12,576)	(12,606)	30	0.2%
	123,160	146,589	(23,429)	(16.0%)
Expenses				
Loan and security servicing expense	3,458	3,473	(15)	(0.4%)
General and administrative expense	4,649	6,912	(2,263)	(32.7%)
Management fee to affiliate	13,313	12,993	320	2.5%
	21,420	23,378	(1,958)	(8.4%)
Income from continuing operations	\$238,600	\$ 423,095	\$ (184,495)	(43.6%)

[Table of Contents](#)

Interest Income

Three months ended September 30, 2011 compared to the three months ended September 30, 2010

Interest income decreased by \$8.6 million during the three months ended September 30, 2011 compared to the three months ended September 30, 2010 primarily due to (i) a \$5.8 million decrease in interest income as a result of the deconsolidation of CDO V in June 2011, (ii) a \$3.6 million decrease in prepayment penalties received in the quarter ended September 30, 2010, offset by (iii) a \$0.8 million increase in interest income as a result of new investments made, partially offset by paydowns and changes in interest rates.

Nine months ended September 30, 2011 compared to the nine months ended September 30, 2010

Interest income decreased by \$6.6 million during the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010 primarily due to (i) a \$7.5 million decrease in interest income as a result of the deconsolidation of CDO V in June 2011, (ii) a \$4.7 million decrease in prepayment penalties received in the quarter ended September 30, 2010, offset by (iii) a \$5.6 million increase in interest income as a result of new investments made, partially offset by paydowns and changes in interest rates.

Interest Expense

Three Months ended September 30, 2011 compared to the three months ended September 30, 2010

Interest expense decreased by \$10.0 million primarily due to (i) a \$3.6 million decrease in interest expense on debt as a result of the paydowns and repurchases of our CDO debt obligations and the deconsolidation of CDO V, (ii) a \$5.5 million decrease in interest expense on derivatives as a result of the termination of interest rate swaps, decreases in swap notional amounts, changes in interest rates and the deconsolidation of CDO V and (iii) a \$1.5 million decrease in the amortization of deferred hedge losses. The decreases described in (i) to (iii) above were partially offset by a \$0.6 million increase in interest expense on other bonds payable and repurchase agreements due to the refinancing of our manufactured housing loan portfolios and a higher outstanding balance of repurchase agreement financing on our FNMA/FHLMC securities.

Nine months ended September 30, 2011 compared to the nine months ended September 30, 2010

Interest expense decreased by \$24.8 million primarily due to (i) a \$7.2 million decrease in interest expense on debt as a result of the paydowns and repurchases of our CDO debt obligations and the deconsolidation of CDO V, (ii) an \$13.7 million decrease in interest expense on derivatives as a result of the termination of interest rate swaps, decreases in swap notional amounts, changes in interest rates and the deconsolidation of CDO V and (iii) a \$5.6 million decrease in the amortization of deferred hedge losses. The decreases described in (i) to (iii) above were partially offset by a \$1.6 million increase in interest expense on other bonds payable and repurchase agreements due to the refinancing of our manufactured housing loan portfolios and a higher outstanding balance of repurchase agreement financing on our FNMA/FHLMC securities.

Valuation Allowance on Loans

Three Months ended September 30, 2011 compared to the three months ended September 30, 2010

The valuation allowance (reversal) on loans changed by \$123.0 million primarily due to (i) a net increase in fair values by \$104.3 million on our real estate related loans and residential mortgage loans during the three months ended September 30, 2010 compared to a net allowance of \$16.0 million for the three months ended September 30, 2011 as a result of the challenging market conditions in the 2011 period and (ii) a larger net reversal of valuation allowance on our manufactured housing loans by \$2.7 million in the period ended 2010 than in the 2011 period due to the reclassification of our manufactured housing loan portfolio II from held-for-sale to held-for-investment in May 2011. This change in fair values and the reclassification impacted the amount of valuation allowance we were able to reverse during those periods.

Nine months ended September 30, 2011 compared to the nine months ended September 30, 2010

The valuation allowance (reversal) on loans changed by \$254.5 million primarily due to (i) a significantly larger net increase in fair values by \$217.4 million on our real estate related loans and residential mortgage loans during the nine months ended September 30, 2010 compared to the nine months ended September 30, 2011 as a result of market conditions improving more in the 2010 period than in the 2011 period and (ii) a larger net reversal of valuation allowance on our manufactured housing loans by \$37.1 million in the 2010 period than the 2011 period due to the reclassification of our manufactured housing loan portfolios I and II from held-for-sale to held-for-investment in April 2010 and May 2011, respectively. This change in fair values and the reclassification impacted the amount of valuation allowance we were able to reverse during those periods.

Table of Contents

In addition, the reversal of previously established valuation allowances will likely decline over time as the reversal is subject to (i) a continued improvement in loan valuations and (ii) the amount of previously established allowances that have not yet been reversed.

Other-than-temporary Impairment on Securities, Net

Three months ended September 30, 2011 compared to the three months ended September 30, 2010

The other-than-temporary impairment on securities decreased by \$6.0 million primarily due to improved market conditions. We recorded an impairment charge of \$4.0 million on 12 securities during the quarter ended September 30, 2011, compared to an impairment charge of \$10.0 million on 21 securities during the quarter ended September 30, 2010.

Nine months ended September 30, 2011 compared to the nine months ended September 30, 2010

The other-than-temporary impairment on securities decreased by \$73.2 million primarily due to improved market conditions. We recorded an impairment charge of \$13.6 million on 25 securities during the nine months ended September 30, 2011, compared to an impairment charge of \$86.8 million on 101 securities during the nine months ended September 30, 2010.

Gain (Loss) on Settlement of Investments, Net

Three months ended September 30, 2011 compared to the three months ended September 30, 2010

The net gain on settlement of investments increased by \$6.8 million as a result of the increased volume of sales at a gain and repayments of investments. We recorded a net gain of \$5.6 million on 19 securities and loans that were sold or paid off during the quarter ended September 30, 2011, compared to a net loss of \$1.1 million on 6 securities and loans that were sold or paid off during the quarter ended September 30, 2010.

Nine months ended September 30, 2011 compared to the nine months ended September 30, 2010

The net gain on settlement of investments increased by \$57.8 million as a result of the increased volume of sales and repayments of investments. We recorded a net gain of \$75.3 million on 90 securities, loans and derivatives that were sold, paid off or terminated during the nine months ended September 30, 2011, compared to a net gain of \$17.5 million on 46 securities, loans and derivatives that were sold, paid off or terminated during the nine months ended September 30, 2010.

Gain (Loss) on Extinguishment of Debt

Three months ended September 30, 2011 compared to the three months ended September 30, 2010

The gain on extinguishment of debt decreased by \$30.7 million due to a lower face amount and a higher average price of debt repurchased in the three months ended September 30, 2011 compared to the three months ended September 30, 2010. We repurchased \$20.0 million face amount of our own CDO debt and other bond payable at an average price of 19.9% of par during the three months ended September 30, 2011 compared to \$48.1 million face amount of CDO bonds repurchased at an average price of 3.1% of par during the three months ended September 30, 2010.

Nine months ended September 30, 2011 compared to the nine months ended September 30, 2010

The gain on extinguishment of debt decreased by \$81.3 million due to a lower face amount and a higher average price of debt repurchased in the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010. We repurchased \$155.1 million face amount of our own CDO debt and other bond payable at an average price of 60.8% of par during the nine months ended September 30, 2011 compared to \$168.0 million face amount of CDO bonds repurchased at an average price of 15.2% of par during the nine months ended September 30, 2010.

Other Income (Loss), Net

Three months ended September 30, 2011 compared to the three months ended September 30, 2010

Other loss decreased by \$6.1 million primarily due to the recognition of net unrealized losses on certain interest rate swap agreements in the quarter ended September 30, 2010. These interest rate swap agreements were de-designated as accounting hedges during the quarter ended September 30, 2010 as the hedged items were considered not probable of occurring.

Table of Contents

Nine months ended September 30, 2011 compared to the nine months ended September 30, 2010

Other loss remained relatively unchanged during the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010. A \$1.8 million increase in management fees, included in Other Income, in 2011 related to our acquisition of the collateral management rights with respect to certain C-BASS CBOs in February 2011 was partially offset by a \$1.1 million increase in net unrealized losses on certain interest rate swap agreements recorded during the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010.

Loan and Security Servicing Expense

Loan and security servicing expense remained relatively stable during the three and nine months ended September 30, 2011 compared to the three and nine months ended September 30, 2010.

General and Administrative Expense

Three months ended September 30, 2011 compared to the three months ended September 30, 2010

General and administrative expense decreased by \$0.4 million primarily due a \$0.3 million decrease in directors and officers liability insurance expense.

Nine months ended September 30, 2011 compared to the nine months ended September 30, 2010

General and administrative expense decreased by \$2.3 million primarily due (i) a \$1.2 million decrease in legal and professional fees which was incurred in connection with the preferred stock exchange and the restructuring of our junior subordinated notes during the nine months ended September 30, 2010 and (ii) a \$0.9 million decrease in directors and officers liability insurance expense.

Management Fee to Affiliate

Three months ended September 30, 2011 compared to the three months ended September 30, 2010

Management fees increased by \$0.3 million primarily due to an increase in gross equity as a result of the closing of our public offering of common stock in March 2011.

Nine months ended September 30, 2011 compared to the nine months ended September 30, 2010

Management fees increased by \$0.3 million during the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010 due to a net increase in gross equity as a result of the closing of our public offering of common stock in March 2011, partially offset by the return of capital distributions made on our preferred stock in 2010.

Our public offering of common stock on September 27, 2011 had no significant impact on management fees during the period presented.

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 feasible. We have an effective shelf registration statement with the SEC, which allows us to issue common stock, preferred stock, depository shares, debt securities and warrants. Our debt obligations are generally secured directly by our investment assets, except for the junior subordinated notes payable.

Sources of Liquidity and Uses of Capital

As of the date of this filing, we have sufficient liquid assets, which include unrestricted cash and FNMA/FHLMC securities, to satisfy all of our short-term recourse liabilities and junior subordinated notes payable, which are long-term

Table of Contents

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, hedging activity, 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 recourse 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.

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 or 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), less (iv) interest on the junior subordinated notes payable and less (v) preferred dividends.

Our cash flow provided by operations differs from our net income 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 deferred hedge gains and losses, (ii) gains and losses from sales of assets financed with CDOs, (iii) the 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 gain on extinguishment of debt, and (vi) net income (loss) generated within CDOs that have failed their over collateralization or interest coverage tests. 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

In March 2011, we raised approximately \$98 million through a public offering of our common shares.

On May 4, 2011, we completed a securitization transaction to refinance our Manufactured Housing Loans Portfolio II and invested approximately \$20.0 million of our unrestricted cash in the new securitization structure.

In September 2011, we raised approximately \$112 million through a public offering of our common shares.

From January 1, 2011 through November 4, 2011, we purchased \$222.3 million principal balance of FNMA/FHLMC securities (primarily one-year ARM) for \$233.0 million, using \$11.9 million of unrestricted cash and financed with \$221.1 million of new repurchase agreements.

Certain details regarding our liquidity, current financings and capital obligations as of November 4, 2011 are set forth below:

- *Cash* – We had a total of \$274.9 million of cash, comprised of \$190.5 million of unrestricted cash and \$84.4 million of restricted cash held for reinvestment in our CDOs;
- *Margin Exposure and Recourse Financings* – We have margin exposure on a \$11.6 million repurchase agreement related to the financing of the Newcastle Class-I MM notes (of which only \$2.9 million is recourse) and a \$206.7 million repurchase agreement related to the financing of FNMA/FHLMC securities. The following table compares our recourse financings excluding the junior subordinated notes:

<u>Recourse Financings</u>	<u>November 4, 2011</u>	<u>September 30, 2011</u>	<u>December 31, 2010</u>
<u>CDO Securities</u>	<u>\$ 2,908</u>	<u>\$ 2,922</u>	<u>\$ 4,683</u>
Non-FNMA/FHLMC recourse financings	2,908	2,922	4,683
<u>FNMA/FHLMC securities</u>	<u>206,707</u>	<u>209,242</u>	<u>—</u>
Total recourse financings	<u>\$ 209,615</u>	<u>\$ 212,164</u>	<u>\$ 4,683</u>

Table of Contents

The non-FNMA/FHLMC recourse financings and the FNMA/FHLMC recourse financing will mature in December 2011 and November 2011, respectively.

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;
- As described above, under “– Update on Liquidity, Capital Resources and Capital Obligations,” we are subject to margin calls in connection with our repurchase agreements;
- 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” above.

In addition to the information referenced above, the following factors could 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. Recent conditions and events have 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 onset of challenging conditions. Our business strategy is dependent upon our ability to finance our real estate securities, loans and other real estate related assets at rates that provide a positive net spread. Currently, spreads for such liabilities have widened relative to historical levels and demand for such liabilities remains lower than the demand prior to the onset of challenging market conditions.
- *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.

Table of Contents

Investment Portfolio

The following summarizes our investment portfolio at September 30, 2011 (dollars in millions).

	Outstanding Face Amount	Amortized Cost Basis (1)	Percentage of Total Amortized Cost Basis	Carrying Value	Number of Investments	Credit (2)	Weighted Average Life (years) (3)
Investment (7)							
Commercial							
CMBS	\$ 1,493	\$ 1,069	37.3%	\$ 1,061	206	BB	3.9
Mezzanine Loans	560	443	15.5%	443	16	68%	2.3
B-Notes	255	188	6.5%	188	9	78%	1.8
Whole Loans	31	31	1.1%	31	3	48%	2.1
CDO Securities (4)	90	68	2.4%	57	3	BB+	3.7
Other Investments (5)	25	25	0.9%	25	1	—	—
Total Commercial Assets	<u>2,454</u>	<u>1,824</u>	<u>63.7%</u>	<u>1,805</u>			<u>3.3</u>
Residential							
Manufactured Housing and Residential Mortgage Loans	391	338	11.8%	338	10,340	705	6.3
Subprime Securities	270	144	5.0%	151	64	B+	6.5
Real Estate ABS	53	41	1.4%	40	14	BBB	6.4
	714	523	18.2%	529			6.4
FNMA/FHLMC securities	211	221	7.7%	221	26	AAA	4.6
Total Residential Assets	<u>925</u>	<u>744</u>	<u>25.9%</u>	<u>750</u>			<u>6.0</u>
Corporate							
REIT Debt	137	137	4.8%	134	20	BB+	2.7
Corporate Bank Loans	278	160	5.6%	160	6	CC	3.0
Total Corporate Assets	<u>415</u>	<u>297</u>	<u>10.4%</u>	<u>294</u>			<u>2.9</u>
TOTAL / WA	<u>\$ 3,794</u>	<u>\$ 2,865</u>	<u>100.0%</u>	<u>\$ 2,849</u>			<u>3.9</u>
Reconciliation to GAAP total assets:							
Other assets							
Subprime mortgage loans subject to call option (6)				404			
Real estate held-for-sale				8			
Cash and restricted cash				383			
Other				39			
GAAP total assets				<u>\$ 3,683</u>			

WA – Weighted average, in all tables.

- (1) Net of impairment.
- (2) Credit represents the weighted average of minimum rating for rated assets, the loan-to-value ratio (based on the appraised value at the time of purchase or refinancing) for non-rated commercial assets, or the 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 at any time.
- (3) Weighted average life is based on the timing of expected principal reduction on the asset.
- (4) Represents non-consolidated CDO securities, excluding those with a zero value, which had an aggregate face amount of \$117 million
- (5) Represents an equity investment in a real estate owned property.
- (6) 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.
- (7) The following tables summarize certain supplemental data relating to our investments (dollars in tables in thousands):

Table of Contents

CMBS

Deal Vintage (A)	Average Minimum Rating (B)	Number	Outstanding Face Amount	Amortized Cost Basis	Percentage of Total Amortized Cost Basis	Carrying Value	Delinquency 60+/FC/REO (C)	Principal Subordination (D)	Weighted Average Life (years) (E)
Pre 2004	BB+	67	\$ 330,670	\$ 311,149	29.1%	\$ 287,725	6.4%	13.7%	1.6
2004	BB+	31	144,015	112,741	10.5%	105,214	3.1%	7.7%	3.6
2005	BB	30	312,213	175,555	16.4%	201,250	4.6%	7.8%	3.3
2006	BB	43	387,280	261,494	24.5%	254,312	7.6%	11.9%	3.9
2007	B	16	121,638	34,936	3.3%	52,134	19.7%	11.5%	4.4
2010	BB+	4	46,798	43,434	4.1%	39,608	0.0%	3.5%	9.1
2011	BBB	15	150,000	129,639	12.1%	120,391	0.0%	6.8%	8.8
Total / WA	BB	206	\$1,492,614	\$1,068,948	100.0%	\$1,060,634	6.3%	10.2%	3.9

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

(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 at any time. We had \$24.4 million of CMBS assets that were on negative watch for possible downgrade by at least one rating agency as of September 30, 2011.

(C) The percentage of underlying loans that are 60+ days delinquent, in foreclosure or considered real estate owned (REO).

(D) The percentage of the outstanding face amount of securities that is subordinate to our investments.

(E) Weighted average life is based on the timing of expected principal reduction on the asset.

CDO Securities (A)

Collateral Manager	Primary Collateral Type	Number	Average Minimum Rating (B)	Outstanding Face Amount	Amortized Cost Basis	Percentage of Total Amortized Cost Basis	Carrying Value	Principal Subordination (C)
Third Party	CMBS	1	BBB-	\$ 78,338	\$ 60,791	89.4%	\$ 50,136	51.6%
Newcastle	CMBS	1	BBB-	6,053	4,562	6.8%	4,562	27.7%
Newcastle	ABS	1	CC	5,500	2,540	3.8%	2,640	56.4%
TOTAL/WA		3	BB+	\$ 89,891	\$ 67,893	100.0%	\$ 57,338	50.3%

(A) Represents non-consolidated CDO securities, excluding ten securities with a zero value, which had an aggregate face amount of \$117 million.

(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 at any time.

(C) The percentage of the outstanding face amount of securities that is subordinate to our investments.

Mezzanine Loans, B-Notes and Whole Loans

Asset Type	Number	Outstanding Face Amount	Amortized Cost Basis	Percentage of Total Amortized Cost Basis	Carrying Value	Weighted Average First Dollar Loan to Value (A)	Weighted Average Last Dollar to Loan Value (A)	Delinquency (B)
Mezzanine Loans	16	\$ 560,563	\$443,361	67.0%	\$443,361	57.5%	68.0%	11.3%
B-Notes	9	255,085	187,865	28.4%	187,865	65.0%	77.7%	17.7%
Whole Loans	3	30,670	30,670	4.6%	30,670	0.0%	48.2%	0.0%
Total/WA	28	\$ 846,318	\$661,896	100.0%	\$661,896	57.7%	70.2%	12.8%

(A) Loan to value is based on the appraised value at the time of purchase or refinancing.

(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	Average FICO Score (A)	Outstanding Face Amount	Amortized Cost Basis	Percentage of Total Amortized Cost Basis	Carrying Value	Average Loan Age (years)	Original Balance	Delinquency 90+/FC/REO (B)	Cumulative Loss to Date
Manufactured Housing Loans Portfolio I	703	\$ 139,891	\$113,566	33.6%	\$113,566	9.8	\$ 327,855	1.1%	7.6%
Manufactured Housing Loans Portfolio II	702	190,022	180,371	53.4%	180,371	12.1	434,743	1.7%	5.8%
Residential Loans Portfolio I	715	57,612	40,699	12.0%	40,699	8.3	646,357	12.5%	0.4%
Residential Loans Portfolio II	737	3,779	3,395	1.0%	3,395	7.1	83,950	0.0%	0.0%
Total / WA	705	\$ 391,304	\$338,031	100.0%	\$338,031	10.6	\$1,492,905	3.0%	5.6%

Table of Contents

- (A) Based on updated FICO scores provided by the loan servicer of the manufactured housing loan portfolios and original FICO scores for the residential loan portfolios as the loan servicers of the residential loan portfolios do not provide updated FICO scores.
 (B) 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 Total Amortized Cost Basis	Carrying Value	Principal Subordination (D)	Excess Spread (E)
2003	B-	14	\$ 14,313	\$ 6,945	4.8%	\$ 8,337	24.5%	4.2%
2004	BB-	9	36,162	17,484	12.1%	19,478	24.8%	3.8%
2005	B-	26	111,255	43,171	30.0%	44,355	32.5%	4.6%
2006	B+	7	59,541	39,545	27.5%	40,240	41.3%	5.1%
2007 and later	BB	8	49,159	36,903	25.6%	38,494	20.5%	2.5%
Total / WA	B+	64	\$ 270,430	\$144,048	100.0%	\$150,904	30.8%	4.2%

Vintage (B)	Collateral Characteristics				
	Average Loan Age (years)	Collateral Factor (F)	3 month CPR (G)	Delinquency (H)	Cumulative Losses to Date
2003	8.8	0.09	6.6%	17.0%	4.0%
2004	7.3	0.14	8.4%	17.4%	4.1%
2005	6.4	0.18	11.0%	28.8%	10.7%
2006	5.5	0.33	13.1%	24.2%	17.9%
2007 and later	3.4	0.33	6.8%	15.9%	13.8%
Total / WA	5.9	0.23	10.1%	23.3%	11.6%

Real Estate ABS

Asset Type	Security Characteristics							
	Average Minimum Rating (C)	Number	Outstanding Face Amount	Amortized Cost Basis	Percentage of Total Amortized Basis	Carrying Value	Principal Subordination (D)	Excess Spread (E)
Manufactured Housing	BBB+	7	\$ 31,446	\$ 30,614	73.8%	\$31,909	41.1%	1.5%
Small Business Loans	BBB-	7	21,177	10,869	26.2%	8,101	24.6%	0.9%
Total / WA	BBB	14	\$ 52,623	\$ 41,483	100.0%	\$40,010	34.5%	1.3%

Asset Type	Collateral Characteristics				
	Average Loan Age (years)	Collateral Factor (F)	3 Month CPR (G)	Delinquency (H)	Cumulative Loss to Date
Manufactured Housing	12.1	0.26	7.0%	1.1%	13.2%
Small Business Loans	6.2	0.55	9.3%	20.0%	15.3%
Total / WA	9.7	0.37	7.9%	8.7%	14.1%

- (A) Includes subprime retained securities 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.
 (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 at any time. We had approximately \$79.0 million of ABS assets that were on negative watch for possible downgrade by at least one rating agency as of September 30, 2011.
 (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).

Table of Contents

REIT Debt

Industry	Average Minimum Rating (A)	Number	Outstanding Face Amount	Amortized Cost Basis	Percentage of Total	
					Amortized Cost Basis	Carrying Value
Retail	A-	4	\$ 34,525	\$ 33,671	24.6%	\$ 36,497
Diversified	CCC+	4	39,286	39,282	28.7%	31,631
Office	BBB	6	34,117	34,501	25.2%	35,116
Multifamily	BBB	3	12,765	12,800	9.4%	13,522
Healthcare	BBB-	3	16,700	16,506	12.1%	17,585
Total / WA	BB+	20	\$ 137,393	\$ 136,760	100.0%	\$ 134,351

Corporate Bank Loans

Industry	Average Minimum Rating (A)	Number	Outstanding Face Amount	Amortized Cost Basis	Percentage of Total	
					Amortized Cost Basis	Carrying Value
Real Estate	NR	1	\$ 17,811	\$ 16,208	10.1%	\$ 16,208
Media	CCC-	2	110,710	28,830	18.0%	28,830
Resorts	NR	1	130,952	100,952	63.2%	100,952
Restaurant	B	2	18,068	13,888	8.7%	13,888
Total / WA	CC	6	\$ 277,541	\$ 159,878	100.0%	\$ 159,878

(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 at any time. We had no corporate assets] that were on negative watch for possible downgrade by at least one rating agency as of September 30, 2011.

Debt Obligations

Our debt obligations, as summarized in Note 5 to our consolidated financial statements included herein, existing at September 30, 2011 (gross of \$4.6 million of discounts) had contractual maturities as follows (in thousands):

	Nonrecourse	Recourse	Total
Period from October 1, 2011 through December 31, 2011	\$ 8,764	\$ 212,164	\$ 220,928
2012	—	—	—
2013	—	—	—
2014	—	—	—
2015	—	—	—
2016	—	—	—
Thereafter	3,047,667	51,004	3,098,671
Total	\$ 3,056,431	\$ 263,168	\$ 3,319,599

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 of the covenants in our non-CDO financings as of September 30, 2011.

The following table provides additional information regarding short-term borrowings. These short-term borrowings were used to finance certain of our investments in real estate securities and loans, including FNMA/FHLMC securities, and our investments in the senior notes issued by Newcastle CDO VI.

	Outstanding Balance at September 30, 2011	Three Months Ended September 30, 2011			Nine Months Ended September 30, 2011		
		Average Daily Amount Outstanding	Maximum Amount Outstanding	Weighted Average Interest Rate	Average Daily Amount Outstanding	Maximum Amount Outstanding	Weighted Average Interest Rate
Repurchase agreements	\$ 220,928*	\$ 214,790	\$ 228,214	0.39%	\$ 127,340	\$ 228,214	0.47%

* Of which only \$212.2 million had recourse to us.

Table of Contents

On May 4, 2011, we completed a securitization transaction to refinance Manufactured Housing Loans Portfolio II. We sold approximately \$197.0 million outstanding principal balance of manufactured housing loans to Newcastle Investment Trust 2011-MH 1 (the "Issuer"), an indirect wholly-owned subsidiary of Newcastle. The Issuer issued approximately \$159.8 million aggregate principal amount of investment grade notes, of which \$142.8 million was sold to third parties and \$17.0 million was sold to one of the CDOs managed and consolidated by us. In addition, we retained the below investment grade notes and residual interest. As a result, we invested approximately \$20.0 million of unrestricted cash in the new securitization structure. The notes issued to third parties had an average expected maturity of 3.8 years and bore interest at an average rate of 3.23% per annum at issuance. At the closing of the securitization transaction, we used the gross proceeds received from the issuance of the notes to repay the previously existing debt in full, terminate the related interest rate swap contracts and pay the related transaction costs. Under the applicable accounting guidance, the securitization transaction is accounted for as a secured borrowing. As a result, no gain or loss is recorded for the transaction. We continue to recognize the portfolio of manufactured housing loans as pledged assets, which have been classified as loans held-for-investment at securitization, and record the notes issued to third parties as a secured borrowing. The associated assets, liabilities, revenues and expenses are presented in the non-recourse financing structure sections of the consolidated financial statements.

In the first nine months of 2011, we purchased \$222.3 million principal balance of FNMA/FHLMC securities (primarily one-year ARMs) for approximately \$233.0 million, using \$11.9 million of unrestricted cash and financed with \$221.1 million of repurchase agreements. These repurchase agreements bear interest at 0.31%, mature in November 2011, and are subject to customary margin provisions.

In the first nine months of 2011, we repurchased \$155.1 million face amount of CDO bonds and notes payable for \$94.3 million. As a result, we extinguished \$155.1 million face amount of CDO debt and notes payable and recorded a gain on extinguishment of debt of \$60.4 million.

Each of our CDO financings contains tests that measure the amount of over collateralization and excess interest in the transaction. At issuance, each of our CDOs passed all of these tests. Failure to satisfy these tests would generally cause (or has caused) the cash flow that would otherwise be distributed to the 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 (and has been) material. The table set forth below presents data, including the most recent quarterly cash flows received by Newcastle, for each of our CDOs, and sets forth which of the CDOs have satisfied these tests in the most recent quarter. The amounts set forth are as of September 30, 2011 unless otherwise noted (dollars in thousands). For those CDOs that have failed their applicable over collateralization tests, the impact of failing is already reflected in the cash flow set forth in the table. For those CDOs that have satisfied their applicable over collateralization tests, we could potentially lose substantially all of the cash flows from those CDOs in future quarters if we fail to satisfy the tests in the future. The amounts in the table reflect data at the CDO level and thus are different from the GAAP balance sheet due to intercompany amounts eliminated in Newcastle's consolidated balance sheet.

Table of Contents

Balance Sheet:	CDO IV		CDO VI		CDO VIII		CDO IX		CDO X						
Assets Face Amount	\$219,863		\$ 265,328		\$929,787		\$791,076		\$1,368,688						
Assets Fair Value	188,788		164,501		657,261		624,453		999,364						
Issued Debt Face Amount (1)	114,857		124,049		658,313		530,125		1,204,250						
Derivative Net Liabilities Fair Value	8,123		24,137		19,309		665		76,332						
Cash Receipts:															
Quarterly net cash receipts (2)	\$ 394		\$ 155		\$ 4,686		\$ 5,245		\$ 5,704						
Collateral Composition (3):	Face	Fair Value	Face	Fair Value	Face	Fair Value	Face	Fair Value	Face	Fair Value					
CMBS	\$143,704	\$119,939	BB-	\$138,999	\$ 76,929	BB-	\$160,445	\$ 85,457	B+	\$ 78,000	\$ 67,681	BB	\$ 954,095	\$ 710,627	BB+
REIT Debt	43,617	45,346	BBB	54,200	54,236	BBB-	—	—	—	—	—	—	39,576	34,770	B
ABS	21,105	14,031	BB-	70,348	31,715	B	79,415	58,334	BB-	3,232	2,956	BBB+	233,987	165,642	BB+
Bank Loans	1,705	1,552	D	1,781	1,621	D	207,862	144,865	B-	164,833	116,187	CCC	28,913	7,530	CCC-
Mezzanine Loans / B-Notes / Whole Loans	9,732	7,920	BB+	—	—	—	358,953	304,988	CCC	407,998	347,675	CCC	—	—	—
CDO	—	—	—	—	—	—	80,250	20,755	CCC-	76,466	27,230	CCC+	55,017	23,695	B-
Residential Loans	—	—	—	—	—	—	—	—	—	3,778	3,395	D	—	—	—
Other Investments	—	—	—	—	—	—	—	—	—	18,883	21,443	—	—	—	—
Cash for Reinvestment	—	—	—	—	—	—	42,862	42,862	—	37,886	37,886	—	57,100	57,100	—
Total	\$219,863	\$188,788	BB	\$265,328	\$ 164,501	BB-	\$929,787	\$657,261	B-	\$791,076	\$624,453	CCC+	\$1,368,688	\$ 999,364	BB+
Collateral on Negative Watch (4)	\$ 1,155		\$ 7,878		\$ 25,563		\$ 1,170		\$ 66,970						
CDO Cash Flow Triggers (5):															
Over Collateralization (6):															
As of Sep-2011 remittance Cushion (Deficit) (\$)		\$ (10,260)		\$ (165,735)		\$ 54,135		\$ 93,283		\$ 105,811					
As of Oct-2011 remittance Cushion (Deficit) (\$)		—		(172,787)		56,590		96,190		97,654					
Interest Coverage (6):															
As of Sep-2011 remittance Cushion (Deficit) (%)		44.5%		19.1%		324.4%		363.8%		388.5%					
As of Oct-2011 remittance Cushion (Deficit) (%)		—		(93.2%)		342.4%		383.8%		240.9%					
CDO Overview:															
Effective	Sep-04		Aug-05		Mar-07		Jul-07		Dec-07						
Reinvestment Period End (7)	Passed		Passed		Nov-11		May-12		Jul-12						
Optional Call (8)	Passed		Passed		Passed		Passed		Passed						
Auction Call (9)	Mar-14		Apr-15		Nov-16		May-17		Jul-17						
WA Debt Spread (bps) (10)	75		45		44		58		36						

See notes on next page.

Table of Contents

- (1) Includes CDO bonds issued to third parties and held by Newcastle's consolidated CDOs.
- (2) Represents net cash received from each CDO based on all of our interests in such CDO (including senior management fees but excluding principal received from senior CDO bonds owned by Newcastle) for the three months ended September 30, 2011. Cash receipts for this period include \$1.5 million of senior collateral management fees, and may not be indicative of cash receipts for subsequent periods. Excluded from the quarterly net cash receipts was \$8.2 million of unrestricted cash received from principal repayment on Newcastle CDO debt. This cash represents a return of principal and the realization of the difference between par and the discounted purchase price of Newcastle CDO debt. See "Cautionary Note Regarding Forward Looking Statements" for risks and uncertainties that could cause our receipts for subsequent periods to differ materially from these amounts.
- (3) Collateral composition is calculated as a percentage of the face amount of collateral and includes CDO bonds of \$202.5 million and other bonds and notes payable of \$104.4 million issued by Newcastle and three bank loans of \$127.6 million, collateralized by Newcastle's CDO VI bonds, real estate properties and a third party CDO security, which are eliminated in consolidation. The fair value of these CDO bonds, other bonds and notes payable and bank loans was \$65.8 million, \$82.5 million and \$109.9 million at September 30, 2011, respectively. 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 a "negative watch" assignment) at any time.
- (4) 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 the determination date in September 2011 for CDO IV, as this CDO only reports actual over collateralization excess percentages on a quarterly basis, and as of the determination date in October 2011 for all other CDOs. The amount does not include any bonds issued by Newcastle, which are eliminated in consolidation and not reflected in the investment portfolio disclosures.
- (5) 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 used 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, 2011 or October 31, 2011, as applicable, and may change or have changed subsequent to that date. CDO IV only reports on a quarterly basis and, therefore, no updated October 2011 information is available. 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. On June 17, 2011, as a result of the failure of the collateral manager over-collateralization trigger, we deconsolidated CDO V. However, we continue to receive the senior collateral manager fee from this 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 being distributed to us. As of the September 2011 remittance date for CDO IV and as of the October 2011 remittance date for CDO VI, these CDOs were not in compliance with their applicable over collateralization tests and, consequently, we were not receiving cash flows from these CDOs (other than senior management fees and cash flows on senior classes of bonds we own). 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. For a more detailed discussion of the impact of CDO financings on our cash flows, see Part II, Item 1A, "Risk Factors – The Use of CDO financings with coverage tests may have a negative impact on our operating results and cash flows."
- (6) Represents excess or deficiency under the applicable over collateralization or interest coverage tests to the first threshold at which cash flow would be redirected. We generally do not receive material cash flow from the junior classes of a CDO until a deficiency is corrected. 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 5 above or, in certain circumstances, in our removal as manager of the applicable portfolio.
- (7) 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.
- (8) At the option call date, Newcastle, as the equity holder, has the right to payoff the CDO bonds at their related redemption price.
- (9) At the auction call date, there is a mandatory auction of the assets pursuant to which the collateral manager will solicit bids for the CDO assets. If the aggregate amount of the bids are sufficient to pay off the outstanding CDO bonds set forth in the CDO governing document, the assets will be sold and the CDO bonds will be redeemed. However, if the aggregate amount of the bids are insufficient to pay off the outstanding CDO bonds set forth in the CDO governing document, the assets will not be sold and the redemption of CDO bonds will not occur.
- (10) Debt spread represents the spread above the benchmark interest rate (LIBOR or U.S. Treasuries) that Newcastle pays on its debt.

Table of Contents

The following table sets forth further information with respect to the bonds of our consolidated CDO financings as of September 30, 2011 (dollars in thousands):

Class	Original Face Amount	Current Face Amount (1)			Total	Stated Interest Rate	
		Held By					
		Third Parties	Newcastle CDOs (2)	Newcastle Outside of its CDOs (3)			
CDO IV							
Class I	\$353,250	\$ 81,929	\$ —	\$ 62,778	\$144,707	LIBOR +	0.40%
Class II-FL	13,000	3,000	—	10,000	13,000	LIBOR +	0.65%
Class II-FX	7,250	—	5,250	2,000	7,250		4.73%
Class III-FL	7,500	5,000	—	2,500	7,500	LIBOR +	1.00%
Class III-FX	15,000	1,462	—	10,623	12,085		5.11%
Class IV-FL	9,000	8,325	—	—	8,325	LIBOR +	2.25%
Class IV-FX	9,000	9,891	—	—	9,891		6.34%
Class V	13,500	—	—	16,375	16,375		8.67%
Preferred	22,500	—	—	22,500	22,500		N/A
	<u>\$450,000</u>	<u>\$109,607</u>	<u>\$ 5,250</u>	<u>\$ 126,776</u>	<u>\$241,633</u>		
CDO VI							
Class I-MM	\$323,000	\$ —	\$33,017	\$ 145,760*	\$178,777	LIBOR +	0.25%
Class I-B	59,000	59,000	—	—	59,000	LIBOR +	0.40%
Class II	33,000	23,416	—	10,181	33,597	LIBOR +	0.50%
Class III-FL	15,000	5,143	—	10,287	15,430	LIBOR +	0.80%
Class III-FX	5,000	—	—	5,787	5,787		5.67%
Class IV-FL	9,600	632	—	9,479	10,111	LIBOR +	1.70%
Class IV-FX	2,400	2,841	—	—	2,841		6.55%
Class V	21,000	—	—	25,679	25,679		7.81%
Preferred	32,000	—	—	32,000	32,000		N/A
	<u>\$500,000</u>	<u>\$ 91,032</u>	<u>\$33,017</u>	<u>\$ 239,173</u>	<u>\$363,222</u>		
CDO VIII (4)							
Class I-A	\$462,500	\$462,500	\$ —	\$ —	\$462,500	LIBOR +	0.28%
Class I-AR	60,000	60,000	—	—	60,000	LIBOR +	0.34%
Class I-B	38,000	4,000	—	34,000	38,000	LIBOR +	0.36%
Class II	42,750	—	29,000	13,750	42,750	LIBOR +	0.42%
Class III	42,750	—	22,750	20,000	42,750	LIBOR +	0.50%
Class IV	28,500	—	—	—	—	LIBOR +	0.60%
Class V	28,500	28,500	—	—	28,500	LIBOR +	0.75%
Class VI	27,312	—	—	—	—	LIBOR +	0.80%
Class VII	21,375	—	—	—	—	LIBOR +	0.90%
Class VIII	22,563	11,063	8,250	3,250	22,563	LIBOR +	1.45%
Class IX-FL	6,000	6,000	—	—	6,000	LIBOR +	1.80%
Class IX-FX	7,600	7,600	—	—	7,600		6.80%
Class X	19,650	18,650	—	—	18,650	LIBOR +	2.25%
Class XI	26,125	—	—	24,125	24,125	LIBOR +	2.50%
Class XII	28,500	—	—	28,500	28,500		7.50%
Preferred	87,875	—	—	87,875	87,875		N/A
	<u>\$950,000</u>	<u>\$598,313</u>	<u>\$60,000</u>	<u>\$ 211,500</u>	<u>\$869,813</u>		

* Of the \$145.8 million CDO VI Class I-MM bonds, \$113.3 million served as collateral for a \$73.0 million bank loan owned jointly by two of Newcastle's CDOs and \$32.5 million served as collateral for a \$11.6 million repurchase agreement financing.

Continued on next page.

[Table of Contents](#)

Class	Original Face Amount	Current Face Amount (1)			Total	Stated Interest Rate	
		Held By					
		Third Parties	Newcastle CDOs (2)	Newcastle Outside of its CDOs (3)			
CDO IX (4)							
Class A-1	\$ 379,500	\$ 379,500	\$ —	\$ —	\$ 379,500	LIBOR +	0.26%
Class A-2	115,500	65,500	—	50,000	115,500	LIBOR +	0.47%
Class B	37,125	35,125	—	2,000	37,125	LIBOR +	0.65%
Class C	33,000	—	—	—	—	LIBOR +	0.93%
Class D	20,625	—	—	—	—	LIBOR +	1.00%
Class E	24,750	—	—	24,750	24,750	LIBOR +	1.10%
Class F	18,562	—	—	18,562	18,562	LIBOR +	1.30%
Class G	18,562	—	—	11,262	11,262	LIBOR +	1.50%
Class H	21,656	—	8,751	9,305	18,056	LIBOR +	2.50%
Class J	21,656	—	21,656	—	21,656	LIBOR +	3.00%
Class K	19,593	—	19,593	—	19,593	LIBOR +	3.50%
Class L	23,718	—	—	23,718	23,718		7.50%
Class M	39,187	—	—	39,187	39,187		8.00%
Preferred	51,566	—	—	51,566	51,566		N/A
	<u>\$ 825,000</u>	<u>\$ 480,125</u>	<u>\$ 50,000</u>	<u>\$ 230,350</u>	<u>\$ 760,475</u>		
CDO X (4)							
Class A-1	\$ 980,000	\$ 980,000	\$ —	\$ —	\$ 980,000	LIBOR +	0.26%
Class A-2	140,000	140,000	—	—	140,000	LIBOR +	0.35%
Class A-3	99,750	30,000	—	—	30,000	LIBOR +	0.60%
Class B	28,000	—	—	—	—	LIBOR +	1.25%
Class C	40,250	—	32,250	—	32,250	LIBOR +	1.75%
Class D	22,000	—	22,000	—	22,000	LIBOR +	2.50%
Class E	13,500	—	—	13,500	13,500	LIBOR +	3.00%
Class F	14,000	—	—	14,000	14,000		9.04%
Preferred	62,500	—	—	62,500	62,500		N/A
	<u>\$1,400,000</u>	<u>\$1,150,000</u>	<u>\$54,250</u>	<u>\$ 90,000</u>	<u>\$1,294,250</u>		

- (1) The amounts presented in these columns exclude the face amount of any cancelled bonds within an applicable class.
- (2) Amounts in this column represent the amount of bonds of the applicable class held by Newcastle's consolidated CDOs. These bonds are eliminated in Newcastle's consolidated balance sheet.
- (3) Amounts in this column represent the amount of bonds of the applicable class held as investments by Newcastle outside of its non-recourse financing structures. These bonds are eliminated in Newcastle's consolidated balance sheet.
- (4) These CDOs issued the following interest only fixed-rate notes with a 5-year maturity from inception:
 - CDO VIII Class S with a notional amount of \$33.9 million at 5.41%
 - CDO IX Class S with a notional amount of \$33.5 million at 5.45%
 - CDO X Class S with a notional amount of \$24.2 million at 5.78%

Stockholders' Equity

Common Stock

The following table presents information on shares of our common stock issued during the nine months ended September 30, 2011:

Shares Issued	Range of Issue Prices (1)	Net Proceeds (millions)	Options Granted to Manager
43,148,013	\$4.55 - \$6.00	\$ 210.7	4,312,500

- (1) Excludes prices of shares issued pursuant to the exercise of options and of shares issued to our independent directors.

At September 30, 2011, we had 105,175,197 shares of common stock outstanding.

Table of Contents

As of September 30, 2011, our outstanding options issued prior to 2011 had a weighted average strike price of \$26.64 and our outstanding options issued in 2011 had a weighted average strike price of \$5.18. Our outstanding options at September 30, 2011 were summarized as follows:

	Issued Prior to 2011	Issued in 2011	Total
Held by the Manager	1,686,447	4,312,500	5,998,947
Issued to the Manager and subsequently transferred to certain of the Manager's employees	798,162	—	798,162
Issued to the independent directors	14,000	—	14,000
Total	<u>2,498,609</u>	<u>4,312,500</u>	<u>6,811,109</u>

As of September 30, 2011, approximately 4.8 million shares of our common stock were held by Fortress, through its affiliates, and its principals.

We declared quarterly dividends of \$0.15 and \$0.10 per common share for the quarters ended September 30 and June 30, 2011, which were paid in October and July 2011, respectively.

Preferred Stock

On January 21, 2011, we paid all current and accrued dividends on our preferred stock as of that date. On April 30, 2011, July 29, 2011 and October 31, 2011 we paid quarterly dividends on our preferred stock.

Accumulated Other Comprehensive Income (Loss)

During the nine months ended September 30, 2011, our accumulated other comprehensive income (loss) changed due to the following factors (in thousands):

	Gains (Losses) on Cash Flow Hedges	Gains (Losses) on Securities	Total Accumulated Other Comprehensive Income (Loss)
Accumulated other comprehensive income (loss), December 31, 2010	<u>\$(116,908)</u>	<u>\$ 70,730</u>	<u>\$ (46,178)</u>
Deconsolidation of unrealized gain on securities in CDO V	—	(8,026)	(8,026)
Deconsolidation of unrealized loss on derivatives designated as cash flow hedges in CDO V	18,353	—	18,353
Net unrealized gain (loss) on securities	—	(16,579)	(16,579)
Reclassification of net realized (gain) loss on securities into earnings	—	(59,928)	(59,928)
Net unrealized gain (loss) on derivatives	6,424	—	6,424
Reclassification of net realized (gain) loss on derivatives designated as cash flow hedges into earnings	<u>12,835</u>	<u>—</u>	<u>12,835</u>
Accumulated other comprehensive income (loss), September 30, 2011	<u><u>\$ (79,296)</u></u>	<u><u>\$(13,803)</u></u>	<u><u>\$ (93,099)</u></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, 2011, a net widening of credit spreads has caused the net unrealized gains recorded in accumulative other comprehensive income on our real estate securities to turn into net unrealized losses. Net unrealized losses on derivatives designated as cash flow hedges decreased for the nine months ended September 30, 2011, primarily as a result of (i) de-designation of certain flow hedges, (ii) deconsolidation of CDO V and (iii) increases in 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.

Table of Contents

Cash Flow

Operating Activities

Net cash flow provided by (used in) operating activities increased to \$41.6 million for the nine months ended September 30, 2011 from \$37.6 million for the nine months ended September 30, 2010. This change resulted primarily from the factors described below:

- Interest received on securities and loans decreased approximately \$13.3 million as a result of a lower average balance of interest earning securities and loans of \$3.7 billion in the first nine months of 2011 compared to \$4.4 billion in the first nine months of 2010. The lower interest earning asset balance is primarily a result of paydowns, sales and deconsolidation of CDO V. This was offset by an increase in the weighted average interest rate to 5.19% in the first nine months of 2011 from 5.04% in the first nine months of 2010 and a decrease in net interest income redirected for reinvestment or CDO paydown in the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010 due to the reduction of defaulted assets through sales or restructuring and improvements in certain CDO over collateralization tests.
- An increase of \$0.9 million in deferred interest received for the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010 as a result of a CDO passing certain over-collateralization tests.
- Collateral management fees and restructuring fees of approximately \$2.7 million received in the nine months ended September 30, 2011.
- A decrease in prepayment penalty income of \$5.2 million for the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010.
- Interest paid on debt obligations decreased approximately \$18.9 million as a result of (i) a lower average debt balance of \$3.1 billion in the first nine months of 2011 compared to \$3.8 billion in the first nine months of 2010 primarily due to the deconsolidation of CDO V and the repurchase of CDO VI Class I-MM notes, (ii) a net decrease in interest payments on our interest rate swaps which experienced a decrease in their average aggregate notional balance from \$1.9 billion at September 30, 2010 to \$1.4 billion at September 30, 2011. The decreases in (i) and (ii) above were partially offset by an increase in the weighted average coupon to 1.06% for the nine months ended September 30, 2011 from 0.97% for the nine months ended September 30, 2010 and an increase in the weighted average effective pay rate on our interest rate swaps from 4.76% for the nine months ended September 30, 2010 to 4.84% for the nine months ended September 30, 2011.

Investing Activities

Investing activities provided (used) (\$182.4) million and \$67.7 million during the nine months ended September 30, 2011 and 2010, respectively. Investing activities consisted primarily of investments made in certain real estate securities, loans and other real estate related assets outside of our CDO financing structures, net of proceeds from the sale, repayment or settlement of investments.

Financing Activities

Financing activities provided (used) \$312.5 million and (\$115.3) million during the nine months ended September 30, 2011 and 2010, respectively. The public offerings of common stock, refinancing of our manufactured housing loans portfolio and borrowings under repurchase agreements 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 financing costs related to our common stock offerings and the refinancing of our manufactured housing loans portfolio, and the payment of common and preferred dividends.

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.”

[Table of Contents](#)

OFF-BALANCE SHEET ARRANGEMENTS

As of September 30, 2011, we had the following material off-balance sheet arrangements.

- 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.
- On June 17, 2011, pursuant to the accounting guidance on consolidation, we deconsolidated CDO V, which is now effectively 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 equity method investees, two of which are dormant at September 30, 2011 and the other of which is immaterial to our financial condition, liquidity and operations.

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 2011, we had all of the material contractual obligations referred to in our annual report on Form 10-K for the year ended December 31, 2010, excluding the debt which was repaid or repurchased, as described in “Liquidity and Capital Resources,” as well as the following:

Contract Category	Change
Repurchase Agreement	We entered into new repurchase agreements to finance newly acquired FNMA/FHLMC securities.
Other Bonds Payable	We refinanced a portfolio of manufactured housing loans.

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.

CORE EARNINGS

Newcastle has five primary variables that impact its operating performance: (i) the current yield earned on its investments that are not included in non-recourse financing structures (i.e., unlevered investments and investments subject to recourse debt), (ii) the net yield it earns from its non-recourse financing structures, (iii) the interest expense and dividends incurred under its recourse debt and preferred stock, (iv) its operating expenses, and (v) its realized and unrealized gains on its investments, derivatives and debt obligations, including impairment. “Core earnings”, which was referred to as “Net Interest Income Less Expenses (Net of Preferred Dividends)” in our previous public filings, is a non-GAAP measure of the operating performance of Newcastle that excludes the fifth variable listed above and is equal to net interest income less expenses and preferred dividends. It is used by management to gauge the current performance of Newcastle without taking into account gains and losses, which, although they represent a part of our recurring operations, are subject to significant variability and are only a potential indicator of future economic performance. Management views this measure as Newcastle’s “core” current earnings, while gains and losses (including impairment) are simply a potential indicator of future earnings. Management believes that this measure provides investors with useful information regarding Newcastle’s “core” current earnings, and it enables investors to evaluate Newcastle’s current performance using the same measure that management uses to operate the business.

Table of Contents

Core earnings 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 our liquidity and is not necessarily indicative of cash available to fund cash needs. For a further description of the differences between cash flow provided by operations and net income see “—Liquidity and Capital Resource” above. Our calculation of core earnings may be different from the calculation used by other companies and, therefore, comparability may be limited. Set forth below is a reconciliation of core earnings to the most directly comparable GAAP financial measure.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Income available for common stockholders	\$ 28,548	\$ 162,107	\$ 234,566	\$ 460,266
Add (Deduct):				
Impairment (reversal)	21,650	(95,319)	(24,623)	(205,846)
Other income	(18,802)	(36,662)	(123,160)	(146,589)
Income from discontinued operations	(151)	(213)	(151)	(186)
Excess of carrying amount of exchanged preferred stock over fair value of consideration paid	—	—	—	(43,043)
Core earnings	<u>\$ 31,245</u>	<u>\$ 29,913</u>	<u>\$ 86,632</u>	<u>\$ 64,602</u>

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 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.

One component of our financing strategy includes 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 reduce 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 seek to 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 we believe 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, 2011, a 100 basis point increase in short term interest rates would increase our earnings by approximately \$2.1 million per annum, assuming a static portfolio of current investments, financings and interest rate derivatives.

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.

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, 2011, a 100 basis point change in short term interest rates would impact our net book value by approximately \$7.7 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

Table of Contents

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.

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. 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, 2011, a 25 basis point movement in credit spreads would impact our net book value by approximately \$19.7 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 challenging credit and liquidity conditions, 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.

[Table of Contents](#)

Margin

We are subject to margin calls on our repurchase agreements. Furthermore, we may, from time to time, be a party to derivative agreements or financing arrangements that 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.

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, 2010. 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 Markets

We do not know what impact the Dodd-Frank Act will have on our business.

On July 21, 2010, the United States enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act” or “Act”). The Dodd-Frank Act affects almost every aspect of the U.S. financial services industry, including certain aspects of the markets in which we operate. The Act imposes new regulations on us and how we conduct our business. For example, the Act will impose additional disclosure requirements for public companies and generally require issuers or originators of asset-backed securities to retain at least five percent of the credit risk associated with the securitized assets. In addition, as a result of the Act we were required to register as an investment advisor with the SEC, which increases our regulatory compliance costs and subjects us to new restrictions as well as penalties for any future non-compliance with these regulations. The Act will impose mandatory clearing, exchange-trading and margin requirements on many derivatives transactions (including formerly unregulated over-the-counter derivatives) in which we may engage. The Act also creates new categories of regulated market participants, such as “swap-dealers,” “security-based swap dealers,” “major swap participants” and “major security-based swap participants” who will be subject to significant new capital, registration, recordkeeping, reporting, disclosure, business conduct and other regulatory requirements that will give rise to new administrative costs. Even if certain new requirements are not directly applicable to us, they may still increase our costs of entering into transactions with the parties to whom the requirements are directly applicable. Moreover, new exchange-trading and trade reporting requirements may lead to reductions in the liquidity of derivative transactions, causing higher pricing or reduced availability of derivatives, or the reduction of arbitrage opportunities for us, which could adversely affect the performance of certain of our trading strategies. Importantly, many key aspects of the changes imposed by the Act will be established by various regulatory bodies and other groups over the next several years. As a result, we do not know how significantly the Act will affect us. It is possible that the Act could, among other things, increase our costs of operating as a public company, impose restrictions on our ability to securitize assets and reduce our investment returns on securitized assets.

We do not know what impact certain U.S. government programs intended to stabilize the economy and the financial markets will have on our business.

In recent years, the U.S. government has taken a number of steps to attempt to strengthen the financial markets and U.S. economy, including direct government investments in, and guarantees of, troubled financial institutions as well as government-sponsored programs such as the Term Asset-Backed Securities Loan Facility program (TALF) and the Public Private Investment Partnership Program (PPIP). The U.S. government continues to evaluate or implement an array of other measures and programs intended to help improve U.S. financial and market conditions. While conditions appear to have improved relative to the depths of the global financial crisis, it is not clear whether this improvement is real or will last for a significant period of time. It is not clear what impact the government’s future actions to improve financial and market conditions will have on our business. To date, we have not benefited in a direct, material way from any government programs, and we may not derive any meaningful benefit from these programs in the future. 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.

Legislation that permits modifications to the terms of outstanding loans has negatively affected our business, financial condition and results of operations.

The U.S. government has enacted legislation that enables government agencies to modify the terms of a significant number of residential and other loans to provide relief to borrowers without the applicable investor’s consent. These modifications allow for outstanding principal to be deferred, interest rates to be reduced, the length of the loan to be extended or other terms to be changed in ways that can permanently eliminate the cash flow (principal and interest) associated with a portion of the loan. These modifications are currently reducing, or in the future may reduce, the value of a number of our current or future investments, including investments in mortgage-backed securities, mortgage servicing rights (“MSRs”) and excess mortgage servicing fees. As a result, such loan modifications are negatively affecting our business, results of operations

[Table of Contents](#)

and financial condition. In addition, certain market participants propose reducing the amount of paperwork required by a borrower to modify a loan, which could increase the likelihood of fraudulent modifications and materially harm the U.S. mortgage market and investors that have exposure to this market. Additional legislation intended to provide relief to borrowers may be enacted and could further harm our business, results of operations and financial condition.

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 us 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 that are higher than their economic interests in us 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 us and have no obligation to offer to us 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 target as its primary investment category investment in U.S. dollar-denominated credit sensitive real estate related securities reflecting primarily U.S. 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 amount of time our manager, its officers or other employees spend managing us. In addition, we may engage (subject to our investment guidelines) 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, investments in excess mortgage servicing fees and senior living facilities, that present an actual, potential or perceived conflict of interest. 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, as well as compensation arrangements that we may enter into with our manager in the future (in connection with new lines of business or other activities), may incentivize our manager to invest in high risk investments. In addition to its management fee, our manager is currently

Table of Contents

entitled to receive incentive compensation based in part upon our achievement of targeted levels of funds from operations (as defined in the management agreement). In evaluating investments and other management strategies, the opportunity to earn incentive compensation based on funds from operations or, in the case of any future incentive compensation arrangement, other financial measures on which incentive compensation may be based, may lead our manager to place undue emphasis on the maximization of such measures 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 since 2008. 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.

It would be difficult and costly for us to terminate our management agreement with our Manager. 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 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 the assets in which we invest 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 our ability to pay dividends on both our common stock and preferred stock or have adverse effects on our liquidity or 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. In addition, a change in our investment strategy may increase our use of non-match-funded financing, increase the guarantee obligations we agree to incur or increase the number of transactions we enter into with affiliates. 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.

We are actively exploring new business opportunities, which may be unsuccessful, divert managerial attention or require significant financial resources, which could have a negative impact on our financial results.

Consistent with our broad investment guidelines and our investment objectives, we are actively exploring the opportunity to acquire excess mortgage servicing fees and additional classes of operating real estate, including senior living facilities. See “—We may purchase interests in mortgage servicing rights, and such investments would expose us to significant risks” and “—We may invest in senior living facilities, which are subject to various risks that could have a negative impact on our financial results.”

Table of Contents

Although we currently believe that we will have significant opportunities to acquire such assets in the future, these opportunities may not materialize. We also believe investing in such assets will provide us attractive risk-adjusted returns, but, assuming we are successful in acquiring these assets, they may not achieve the returns we anticipate and may not even be profitable. Moreover, these investments may not be successful, given that we do not have significant experience in owning these types of assets, or for other reasons. Further, these new business opportunities may divert managerial attention from more profitable opportunities, and they may require significant financial resources. Any or all of the foregoing could have a negative impact on our financial results.

Risks Relating to Our Business

Market conditions could 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, and intensified meaningfully during the fourth quarter of 2008 as a result of the global credit and liquidity crisis, resulting in extraordinarily challenging market conditions. Since then, market conditions have generally improved, but they could deteriorate in the future.

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 recently experienced 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 market conditions 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."

The coverage tests applicable to our CDO financings may have a negative impact on our operating results and cash flows.

We have retained, and may in the future retain or repurchase, 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 generally result in principal and/or interest cash flow that would otherwise be distributed to more junior classes of securities (including those held by us) 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 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

Table of Contents

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 had approximately \$102.7 million of assets in our consolidated CDOs as of September or October 2011, as appropriate, 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 negatively affect – and possibly materially affect – our future cash flows. As of the September 2011 remittance date for CDO IV and as of the October 2011 remittance date for CDO VI, these CDOs 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 and cash flow distributions from senior classes of bonds we own). Based upon our current calculations, we expect these CDOs 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. For example, one strategy we have employed to facilitate compliance with over collateralization tests has been to repurchase notes issued by our CDOs and subsequently cancelling them in accordance with the terms of the relevant governing documentation. There can be no assurance that the trustee of our CDOs will not impose guidelines for such cancellations that would make it more difficult or impossible to employ this strategy in the future. While there are other permissible methods to rebalance or otherwise correct CDO test failures, such methods may be extremely difficult to employ 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 Investors Service 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 Part I, Item 2, "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 be removed 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 specifies 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 could 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 could negatively affect our cash flows, business, results of operations and financial condition. On June 17, 2011, CDO V failed additional over collateralization tests. The consequences of failing these tests are that an event of default has occurred, and we may be removed as the collateral manager under the documentation governing the CDO. So long as the event of default continues, we will not be permitted to purchase or sell any collateral in CDO V. If we are removed as the collateral manager of CDO V, we would no longer receive the senior management fees from such CDO. As of November 4, 2011, we have not been removed as collateral manager. Based upon our current calculations, we estimate that if we are removed as the collateral manager of CDO V, the loss of senior management fees would not have a material negative impact on our cash flows, business, results of operations or financial condition. Given current market conditions, it is possible that events of default may occur in other CDOs, and we could be removed as the collateral manager of those CDOs if certain events of default occur. Moreover, our cash flows, business, results of operations and/or financial condition could be materially and negatively impacted if certain events of default occur.

We have assumed the role of manager of numerous CDOs previously managed by a third party, and we may assume the role of manager of additional CDOs in the future. Each such engagement exposes us to a number of potential risks.

Table of Contents

Changes within our industry may result in CDO collateral managers being replaced. In such instances, we may seek to be engaged as the collateral manager of CDOs currently managed by third parties. For example, in February 2011, one of our subsidiaries became the collateral manager of certain CDOs previously managed by C-BASS Investment Management LLC (“C-BASS”).

While being engaged as the collateral manager of such CDOs potentially enables us to grow our business, it also entails a number of risks that could harm our reputation, results of operations and financial condition. For example, we purchased the management rights with respect to the C-BASS CDOs pursuant to a bankruptcy proceeding. As a result, we were not able to conduct extensive due diligence on the CDO assets even though many classes of securities issued by the CDOs were rated as “distressed” by the rating agencies as of the most recent rating date prior to our becoming the collateral manager of the CDOs. We may willingly or unknowingly assume actual or contingent liabilities for significant expenses, we may become subject to new laws and regulations with which we are not familiar, and we may become subject to increased risk of litigation, regulatory investigation or negative publicity. For example, we determined that it would be prudent to register the subsidiary that became the collateral manager of the C-BASS CDOs as a registered investment advisor, which will increase our regulatory compliance costs. In addition to defending against litigation and complying with regulatory requirements, being engaged as collateral manager may require us to invest other resources for various other reasons, which could detract from our ability to capitalize on future opportunities. Moreover, being engaged as collateral manager may require us to integrate complex technological, accounting and management systems, which may be difficult, expensive and time-consuming and which we may not be successful in integrating into our current systems. In addition to the risk that we face if we are successful in becoming the manager of additional CDOs, we may attempt but fail to become the collateral manager of CDOs in the future, which could harm our reputation and subject us to costly litigation. Finally, if we include the financial performance of the C-BASS CDOs or other CDOs for which we become the collateral manager in our public filings, we are subject to the risk that, particularly during the period immediately after we become the collateral manager, this information may prove to be inaccurate or incomplete. The occurrence of any of these negative integration events could negatively impact our reputation with both regulators and investors, which could, in turn, subject us to additional regulatory scrutiny and impair our relationships with the investment community. The occurrence of any of these problems could negatively affect our reputation, financial condition and results of operations.

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 the 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 was 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 in the applicable period and thereby adversely affect our ability to pay dividends to our stockholders.

As has been widely publicized, the recent market conditions have resulted in a number of financial institutions recording an unprecedented amount of impairment charges, and we were also affected by these conditions. These challenging conditions have 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 our repurchase agreements 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, and we may enter into additional repurchase agreements in the future. Under the terms of these agreements, 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 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 their stated terms, which subjects us to a number of risks. As we have experienced recently and may experience in the future, counterparties electing

Table of Contents

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 for any shortfall between the value of our obligation to the counterparty and the amount for which the collateral was sold (which may be a significantly discounted price). As of September 30, 2011, we had \$220.9 million outstanding under repurchase agreement financings. Moreover, all of our repurchase agreement obligations are with two counterparties. If any of our counterparties elected not to roll these repurchase agreements, we may not be able to find a replacement counterparty in a timely manner.

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. During the recent financial crisis, the return we were able to earn on our investments and cash available for distribution to our stockholders was 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. While our liquidity position has improved, we cannot assure you that we will be able to sustain our improved liquidity position.

We may become party to agreements that require cash payments at periodic intervals. Failure to make such required payments may adversely affect our business, financial condition and results of operations.

We are currently party to repurchase agreements that may require us to post additional margin as collateral at any time during the term of the agreement, based on the value of the collateral. We may become party to additional financing agreements that require us to make cash payments at periodic intervals or upon the occurrence of certain events. Events could occur or circumstances could arise, which we may not be able to foresee, that may cause us to be unable to make any such 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.

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.

Table of Contents

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 a counterparty was downgraded below these levels it may not be able to satisfy its 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 insolvency of a number of major financial institutions (such as Bear Stearns and Lehman Brothers). For example, the consolidation and elimination of counterparties has increased our concentration of counterparty risk and decreased the universe of potential counterparties. We are currently party to repurchase agreements with two counterparties. If any of our counterparties elected not to roll these repurchase agreements, we may not be able to find a replacement counterparty. In addition, counterparties have generally tightened their underwriting standards and increased their margin requirements for 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.

We are not restricted from dealing with any particular counterparty or from concentrating any or all of our transactions with a few counterparties. 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.

We may not match fund certain of our investments, which may increase the risks associated with these investments.

One component of our investment strategy is to use match funded financing structures for our investments, which match assets and liabilities with respect to maturities and interest rates. When available, this strategy mitigates the risk of not being able to refinance an investment on favorable terms or at all. However, our manager may elect for us to bear a level of refinancing risk on a short-term or longer-term basis, as in the case of investments financed with repurchase agreements, when, based on its analysis, our manager determines that bearing such risk is advisable or unavoidable (which is generally the case with respect to the residential mortgage loans and FNMA/FHLMC securities in which we invest). In addition, we may be unable, as a result of conditions in the credit markets, to match fund our investments. For example, non-recourse term financing not subject to margin requirements was generally not available or economical for the past two years and is currently still difficult to obtain, which impairs our ability to match fund our investments. Moreover, we may not be able to enter into interest rate swaps. A decision not to, or the inability to, match fund certain investments exposes us to additional risks.

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, our ability to finance investments with securitizations or other long-term non-recourse financing not subject to margin requirements has been impaired since 2007 as a result of recent market conditions. 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 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

Table of Contents

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 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 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, we may not recover the amount invested in, or, in extreme cases, any of our investment in such securities.

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
- 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.

Table of Contents

We may invest in excess mortgage servicing fees, and such investments could have a negative impact on our financial results.

Subject to maintaining our qualification as a REIT, we may purchase excess mortgage servicing fees. We currently intend to co-invest in excess mortgage servicing fees with Nationstar Mortgage LLC (“Nationstar”), which is a leading residential mortgage servicer that is externally managed by our manager, or to purchase excess mortgage servicing fees directly from Nationstar. We may also enter into similar transaction with other non-bank servicers.

Excess mortgage servicing fees are interests in mortgage servicing rights (“MSRs”), representing a portion of the fee paid to mortgage servicers. Governmentally sponsored entities (“GSEs”), such as the Federal National Mortgage Association (“FNMA”) and the Federal Home Loan Mortgage Corp. (“FHLMC”), generally require mortgage servicers to be paid a minimum servicing fee that significantly exceeds the amount a servicer would charge in an arm’s length transaction. The portion of the fee in excess of what would be charged in an arm’s length transaction is commonly referred to as the excess mortgage servicing fee.

If we acquire excess mortgage servicing fees, we would record them on our balance sheet at fair value, and changes in their fair value would be reflected in our consolidated results of operations. The determination of the fair value of excess mortgage servicing fees would require our management to make numerous estimates and assumptions that could materially differ from actual results. Such estimates and assumptions would include, without limitation, estimates of the future cash flows from the excess mortgage servicing fees, which in turn would be based upon assumptions about interest rates as well as prepayment rates, delinquencies and foreclosure rates of the underlying mortgage loans.

The ultimate realization of the value of excess mortgage servicing fees, which are measured at fair value on a recurring basis, may be materially different than the fair values of such excess mortgage servicing fees as may be reflected in our consolidated statement of financial position as of any particular date. The use of different estimates or assumptions in connection with the valuation of these assets could produce materially different fair values for such assets, which could have a material adverse effect on our consolidated financial position, results of operations and cash flows. Accordingly, there may be material uncertainty about the fair value of any excess mortgage servicing fees we acquire.

Changes in interest rates are a key driver of the performance of excess mortgage servicing fees, since the values of excess mortgage servicing fees are highly sensitive to changes in interest rates. Historically, the value of excess mortgage servicing fees has increased when interest rates rise and decreased when interest rates decline due to the effect those changes in interest rates have on prepayment estimates. We may pursue various hedging strategies to seek to reduce our exposure to adverse changes in interest rates. Our hedging activity will vary in scope based on the level and volatility of interest rates, the type of assets held and other changing market conditions. Interest rate hedging may fail to protect or could adversely affect us. To the extent we do not utilize derivatives to hedge against changes in the fair value of excess mortgage servicing fees, our balance sheet, results of operations and cash flows would be susceptible to significant volatility due to changes in the fair value of, or cash flows from, excess mortgage servicing fees as interest rates change.

Prepayment speeds significantly affect the value of excess mortgage servicing fees. Prepayment speed is the measurement of how quickly borrowers pay down the unpaid principal balance of their loans or how quickly loans are otherwise brought current, modified, liquidated or charged off. If we purchase excess mortgage servicing fees, we will base the price we pay and the rate of amortization of those assets on, among other things, our projection of the cash flows from the related pool of mortgage loans. Our expectation of prepayment speeds will be a significant assumption underlying those cash flow projections. If prepayment speeds are significantly greater than expected, the carrying value of excess mortgage servicing fees could exceed their estimated fair value. If the fair value of excess mortgage servicing fees decreases, we would be required to record a non-cash charge, which would have a negative impact on our financial results. Furthermore, a significant increase in prepayment speeds could materially reduce the ultimate cash flows we receive from excess mortgage servicing fees, and we could ultimately receive substantially less than what we paid for such assets.

Moreover, delinquency rates have a significant impact on the value of excess mortgage servicing fees. An increase in delinquencies will generally result in lower revenue because typically we will only collect servicing fees from GSEs or mortgage owners for performing loans. We will base the price we pay for excess mortgage servicing fees on, among other things, our projections of the cash flows from related pools of mortgage loans. Our expectation of delinquencies is a significant assumption underlying those cash flow projections. If delinquencies were significantly greater than expected, the estimated fair value of the excess mortgage servicing fees could be diminished. As a result, we could suffer a loss, which would have a negative impact on our financial results.

Furthermore, MSRs are subject to numerous federal, state and local laws and regulations and may be subject to various judicial and administrative decisions imposing various requirements and restrictions on our business. If we or the servicer actually or allegedly failed to comply with applicable laws, rules or regulations, we could be subject to fines, penalties or

Table of Contents

potential litigation liabilities, including costs, settlements and judgments, any of which could have a material adverse effect on our business, financial condition, results of operations or cash flows.

Our ability to acquire excess mortgage servicing fees will be subject to the applicable REIT qualification tests, and we may have to hold these interests through taxable REIT subsidiaries, which would negatively impact our returns from these assets.

We will be dependent on mortgage servicers to service the mortgage loans underlying any mortgage servicing rights that we acquire.

In the event that we invest in mortgage servicing rights or excess mortgage servicing fees, the mortgage servicing would continue to be provided by the servicer. As a result, we could be materially and adversely affected if the servicer is unable to adequately service the underlying mortgage loans due to:

- its failure to comply with applicable laws and regulation;
- its failure to perform its loss mitigation obligations;
- a downgrade in its servicer rating;
- its failure to perform adequately in its external audits;
- a failure in its operational systems or infrastructure;
- regulatory scrutiny regarding foreclosure processes lengthening foreclosure timelines;
- a GSE's or a whole-loan owner's transfer of servicing to another party; or
- any other reason.

In addition, a bankruptcy by any mortgage servicer that services the mortgage loans underlying any mortgage servicing rights that we acquire could result in:

- the validity and priority of our ownership in the mortgage servicing rights being challenged in a bankruptcy proceeding;
- payments made by such servicer to us, or obligations incurred by it, being avoided by a court under federal or state preference laws or federal or state fraudulent conveyance laws;
- a re-characterization of any sale of mortgage servicing rights or other assets to us as a pledge of such assets in a bankruptcy proceeding; or
- any agreement pursuant to which we purchased the mortgage servicing rights being rejected in a bankruptcy proceeding.

Any of the foregoing events might have a material and adverse effect on us.

GSE initiatives and other actions may adversely affect returns from investments in MSRs or excess mortgage servicing fees.

On January 17, 2011, the Federal Housing Finance Agency announced that it has instructed FNMA and FHLMC to study possible alternatives to the current residential mortgage servicing and compensation system used for single-family mortgage loans. It is too early to determine what the GSEs, including FNMA and FHLMC, may propose as alternatives to current servicing compensation practices, or when any such alternatives would become effective. Although we do not expect MSRs that have already been created to be subject to any changes implemented by FNMA and FHLMC, it is possible that, because of the significant role of FNMA and FHLMC in the secondary mortgage market, any changes they implement could become prevalent in the mortgage servicing industry generally. Other industry stakeholders or regulators may also implement or require changes in response to the perception that the current mortgage servicing practices and compensation do not appropriately serve broader housing policy objectives. These proposals are still evolving. To the extent the GSEs implement reforms that materially affect the market for conforming loans, there may be secondary effects on the subprime and Alt-A markets. These reforms may have a material adverse effect on the economics or performance of any excess mortgage servicing fees or MSRs that we acquire.

[Table of Contents](#)

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. These competitors may be willing to accept lower returns on their investments or to compromise underwriting standards and, as a result, our origination volume and profit margins could be adversely affected. Furthermore, competition for investments that are suitable for 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 complete successfully against any such companies.

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.

During the reinvestment period, we must invest the restricted cash available for reinvestments in our CDOs. 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 CDO's 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.

[Table of Contents](#)

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. 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.

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

We have acquired 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, 2001, insurance companies have limited or excluded 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. In addition, the real estate securities that we purchase in connection with privately

Table of Contents

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 that it has been historically because, if we were to sell such assets, we would 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 our 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 past, we have utilized hedging transactions to protect our positions from interest rate fluctuations, but as a result of current market conditions we face significant obstacles to entering into new hedging transactions. As a result, we may not be able to protect new investments from interest rate fluctuations to the same degree as in the past, which could adversely affect our financial condition and results of operations.

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.

We may invest in senior living facilities, which are subject to various risks that could have a negative impact on our financial results.

Subject to maintaining our qualification as a REIT, we may invest in senior living facilities. In connection with any such investment, we expect that we would engage a third party (possibly an affiliate of our manager) to manage the operations of these facilities, for which we would pay a management fee. The income from any senior living facilities would be dependent on the ability of the managers of such facilities to successfully manage these properties. The managers would compete with other companies on a number of different levels, including: the quality of care provided, reputation, the physical appearance of a facility, price and range of services offered, alternatives for healthcare delivery, the supply of competing properties, physicians, staff, referral sources, location, the size and demographics of the population in surrounding areas, and the financial condition of tenants and managers. A manager’s inability to successfully compete with

Table of Contents

other companies on one or more of the foregoing levels could adversely affect the senior living facility and materially reduce the income we would receive from an investment in such facility.

In addition, private, federal and state payment programs as well as the effect of laws and regulations may also have a significant impact on the profitability of such facilities. The failure of a manager to comply with any of these laws could result in the loss of accreditation, denial of reimbursement, imposition of fines, suspension or decertification from federal and state healthcare programs, loss of license or closure of the facility. These events, among others, could result in the loss of part or all of any investment we make in a senior living facility.

Furthermore, the ability to successfully manage a senior living facility depends on occupancy levels. Any senior living facility in which we invest may have relatively flat or declining occupancy levels due to falling home prices, declining incomes, stagnant home sales and other economic factors. In addition, the senior housing segment may continue to experience a decline in occupancy due to the weak economy and the associated decision of certain residents to vacate a facility and instead be cared for at home. A material decline in occupancy levels and revenues may make it more difficult for the manager of any senior living facility in which we invest to successfully generate income for us. Alternatively, to avoid a decline in occupancy, a manager may reduce the rates charged, which would also reduce our revenues and therefore negatively impact the ability to generate income.

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 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 quarter 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.

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

We have used (and may continue to use, when feasible and appropriate) 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 any 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, that 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.

Table of Contents

The REIT provisions of the Internal Revenue Code of 1986, as amended, or the Code, limit our ability to hedge. 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. 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 that would cause us to fail the REIT gross income and asset tests.

Accounting for derivatives under U.S. generally accepted accounting principles, or 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 many of our investments.

The value of the majority of assets in which we invest may be affected by prepayment rates on these 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 repaying 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.

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, the Financial Accounting Standards Board and other regulatory bodies that establish the accounting rules applicable to us have recently proposed or enacted a wide array of changes to accounting rules. Moreover, in the future these regulators may propose additional changes that we do not currently anticipate. 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 protect 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 operations, liquidity or financial condition.

Environmental compliance costs and liabilities with respect to 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 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.

Table of Contents

Lawsuits, investigations and indemnification claims could result in significant liabilities and reputational harm, which could materially adversely affect our results of operations, financial condition and liquidity.

From time to time, we may be involved in lawsuits or investigations or receive claims for indemnification.

Our efforts to resolve any such lawsuits, investigations or claims could be very expensive and highly damaging to our reputation, even if the underlying claims are without merit. We could potentially be found liable for significant damages or indemnification obligations. Such developments could have a material adverse effect on our business, 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 us 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 do 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 Internal Revenue Service, or IRS, will not contend that our interests in subsidiaries or other issuers violate 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 Code provisions, we also would be disqualified from taxation as a REIT for the four taxable years following the year during which we initially ceased to qualify as a REIT.

Our failure to qualify as a REIT would create issues under a 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 create issues under a number of our financing and other agreements. 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 we were delisted as a result of losing our REIT status and desired to relist our shares on the NYSE, we 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 us to become a listed company under these heightened standards. Given current conditions, we might not be able to satisfy the NYSE's listing standards for a domestic corporation. As a result, if we were delisted from the NYSE, we might not be able to relist as a domestic corporation, in which case our common and preferred shares could not trade on the NYSE.

The failure of assets subject to repurchase agreements to qualify as real estate assets could adversely affect our ability to qualify as a REIT.

We may enter into financing arrangements that are structured as sale and repurchase agreements pursuant to which we would nominally sell certain of our assets to a counterparty and simultaneously enter into an agreement to repurchase these assets at a later date in exchange for a purchase price. Economically, these agreements are financings which are secured by the assets sold pursuant thereto. We believe that, for purposes of the REIT asset and income tests, we should be treated as the owner of the assets that are the subject of any such sale and repurchase agreement, notwithstanding those agreements may transfer record ownership of the assets to the counterparty during the term of the agreement. It is possible, however, that the IRS could assert that we did not own the assets during the term of the sale and repurchase agreement, in which case we might fail to qualify as a REIT.

[Table of Contents](#)

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

Tax law changes in 2010 extended the 2003 reduction of the maximum tax rate for dividends payable to individuals from 35% to 15% through 2012. 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 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 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.

As of December 31, 2010, we had a loss carryforward, inclusive of net operating loss and capital loss, of approximately \$1.05 billion. The net operating loss carryforward and capital loss carryforward can generally be used to offset future ordinary taxable income and capital gain, for up to twenty years and five years, respectively. As a result, we do not expect that there will be any REIT distribution requirements for the year ending December 31, 2011, except as described below.

Our ability to utilize net operating loss carryforwards and certain built-in losses to reduce our future taxable income and related REIT distribution requirements may become limited by provisions of the Code, thereby jeopardizing our ability to maintain our status as a REIT.

In order to maintain our tax status 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 gains) each year to our stockholders. To qualify for the tax benefits accorded to REITs, we intend to make distributions to our stockholders such that we distribute all or substantially all our net taxable income (if any) each year, subject to certain adjustments. However, our ability to meet this distribution requirement and maintain our status as a REIT may be adversely affected if certain provisions of the Code prevent us from utilizing our net operating loss carryforwards and certain built-in losses to reduce our taxable income, thereby increasing both our taxable income and the related REIT distribution requirement to a level that we are unable to satisfy. Specifically, the Code limits the ability of a company that undergoes an "ownership change" to utilize its net operating loss carryforwards and certain built-in losses to offset taxable income earned in years after the ownership change. An ownership change occurs if, during a three-year testing period, more than 50% of the stock of a company is acquired by one or more persons who own, directly or constructively, 5% or more of the stock of such company. An ownership change can occur as a result of a public offering of stock, as well as through secondary market purchases of our stock and certain types of reorganization transactions.

Generally, if an ownership change occurs, the annual limitation on the use of net operating loss carryforwards and certain built-in losses is equal to the product of the applicable long-term tax exempt rate and the value of the company's stock immediately before the ownership change. If we were to undergo an ownership change as a result of a stock offering or otherwise, depending on the aggregate value of our stock and the level of the applicable federal tax rate at the time of the ownership change, we might be unable to use our net operating loss carryforwards and built-in losses to offset our taxable income, and we would therefore be required to distribute larger amounts to our stockholders in order to maintain our status as a REIT. No assurance can be given that we will be able to satisfy our distribution requirement following an ownership change or otherwise. If we were to fail to satisfy our distribution requirement, it 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.

Table of Contents

We may be required to report taxable income for certain investments in excess of the economic income we ultimately realize from them.

We may acquire debt instruments in the secondary market for less than their face amount. The amount of such discount will generally be treated as “market discount” for federal income tax purposes. Accrued market discount is generally recognized as taxable income over our holding period in the instrument in advance of the receipt of cash. If we collect less on the debt instrument than our purchase price plus the market discount we had previously reported as income, we may not be able to benefit from any offsetting loss deductions.

In addition, we may acquire debt investments that are subsequently modified by agreement with the borrower. If the amendments to the outstanding debt are “significant modifications” under the applicable Treasury regulations, the modified debt may be considered to have been reissued to us in a debt-for-debt exchange with the borrower. In that event, we may be required to recognize taxable gain to the extent the principal amount of the modified debt exceeds our adjusted tax basis in the unmodified debt, even if the value of the debt or the payment expectations have not changed. Following such a taxable modification, we would hold the modified loan with a cost basis equal to its principal amount for federal tax purposes.

Moreover, in the event that any debt instruments acquired by us are delinquent as to mandatory principal and interest payments, or in the event payments with respect to a particular debt instrument are not made when due, we may nonetheless be required to continue to recognize the unpaid interest as taxable income. Similarly, we may be required to accrue interest income with respect to subordinate mortgage-backed securities at the stated rate regardless of whether corresponding cash payments are received.

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 taxable net income without receiving an equivalent amount of cash proceeds from which to make required distributions. This disconnect could have a serious, negative effect on us.

We may experience issues regarding the characterization of income for tax purposes. For example, we may recognize significant ordinary income, which we would not be able to offset with capital losses, which would, in turn, increase the amount of income we would be required to distribute to shareholders in order to maintain our REIT status. We expect that this disconnect will occur in the case of one or more of our non-recourse financing structures, including off balance sheet structures such as our subprime securitizations and non-consolidated CDOs, 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. Through September 30, 2011, no such cancellation of CDO debt had been effected as a result of losses incurred. However, we expect that such cancellation of indebtedness within our CDOs, consolidated or non-consolidated, may occur in the future. In the case of our subprime securitizations, \$23.7 million of such cancellations had been effected through September 30, 2011, and we expect such cancellations will continue as losses are realized. This disconnect could also occur, and has occurred, as a result of the repurchase of our outstanding debt at a discount as the gain recorded upon the cancellation of indebtedness is characterized as ordinary income for tax purposes. We have repurchased our debt at a discount in the past, and we intend to attempt to do so in the future. During 2009 and 2010, we repurchased \$787.8 million face amount of our outstanding CDO debt and junior subordinated notes at a discount, and recorded \$521.1 million of gain. In compliance with tax laws, we had the ability to defer the ordinary income recorded as a result of this cancellation of indebtedness to future years and have deferred or intend to defer all or a portion of such gain for 2009 and 2010. While such deferral may postpone the effect of the disconnect on the ability to offset taxable income and losses, it does not eliminate it. Furthermore, cancellation of indebtedness income recognized on or after January 1, 2011 cannot be deferred and must generally be recognized as ordinary income in the year of such cancellation. During the nine months ended September 30, 2011, we repurchased \$176.5 million face amount of our outstanding CDO debt and notes payable at a discount and recorded \$76.5 million of gain for tax purposes (of which only \$60.4 million gain relating to \$155.1 million face amount of debt repurchased was recognized for GAAP purposes). The elimination of the ability to defer the recognition of cancellation of indebtedness income introduces additional tax implications that may significantly reduce the economic benefit of repurchasing our outstanding CDO debt.

When we experience 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 between taxable income and cash proceeds would be likely to 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 might occur.

[Table of Contents](#)

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 of 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 herein, particularly in light of current market conditions. In the event of a sustained downturn in our operating results and financial performance relative to previous periods or sustained 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 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 Code to include certain entities) at any time during the last half of each taxable year after our first year. Our charter, with certain 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 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 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 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

Table of Contents

fail to comply with these limitations, we could lose our REIT qualification for 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 were 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 could incur a corporate level tax on a portion of our income from the taxable mortgage pool. In that case, we might 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, or the Investment Company Act. 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.

The SEC recently solicited public comment on a wide range of issues relating to Section 3(c)(5)(C) of the Investment Company Act, including the nature of the assets that qualify for purposes of the exemption and whether mortgage REITs should be regulated in a manner similar to investment companies. There can be no assurance that the laws and regulations governing the Investment Company Act status of REITs, or SEC guidance regarding these exemptions, will not change in a manner that adversely affects our operations. If the SEC takes action that could result in our or our subsidiaries’ failure to maintain an exception or exemption from the Investment Company Act, we could, among other things, be required either to (a) change the manner in which we conduct our operations to avoid being required to register as an investment company, (b) effect sales of our assets in a manner that, or at a time when, we would not otherwise choose to do so, or (c) register as an investment company (which, among other things, would require us to comply with the leverage constraints applicable to investment companies), any of which could negatively affect the value of our common stock, the sustainability of our business model, and our ability to make distributions to our shareholders, which could, in turn, materially and adversely affect us and the market price of our shares.

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 the Employee Retirement Income Security Act of 1974, as amended, or ERISA, including whether such investment might constitute or give rise to a prohibited transaction under ERISA, the 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, which 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.

Table of Contents

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 our 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 ensure 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 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.

Risks Related to Our Common Shares

Our share price has fluctuated meaningfully, particularly on a percentage basis, and may fluctuate meaningfully 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 fluctuated significantly over the last three years. 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;
- our ability to make investments with attractive risk-adjusted returns, including, without limitation, investments in excess mortgage servicing fees or senior living facilities;

Table of Contents

- market perception of our current and projected financial condition, potential growth, future earnings and future cash dividends;
- announcements we make regarding 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 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.

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 shares of our common stock 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.

We do not currently have unpaid accrued dividends on our preferred shares. However, to the extent we do, 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. Consequently, the failure to pay dividends on our preferred shares restricts the actions that we may take with respect to our common shares and preferred shares. 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. We cannot predict whether the holders of our preferred stock would take such action or, if taken, how long the process would take or what impact the two new directors on our board of directors would have on our company (other than increasing our director compensation costs). However, the election of additional directors would affect the composition of our board of directors and, thus, could affect the management of our business.

We may in the future choose to pay dividends in our own stock, in which case you could be required to pay income taxes in excess of the cash dividends you receive.

We may in the future distribute taxable dividends that are payable in cash and shares of our common stock at the election of each stockholder. Under IRS Revenue Procedure 2010-12, up to 90% of any such taxable dividend for 2011 could be payable in our stock. Taxable stockholders receiving such dividends will be required to include the full amount of the dividend as ordinary income to the extent of our current and accumulated earnings and profits for federal income tax purposes. As a result, stockholders may be required to pay income taxes with respect to such dividends in excess of the cash dividends received. If a U.S. stockholder sells the stock that it receives as a dividend in order to pay this tax, the sale proceeds may be less than the amount included in income with respect to the dividend, depending on the market price of our stock at the time of the sale. Furthermore, with respect to certain non-U.S. stockholders, we may be required to withhold U.S. tax with respect to such dividends, including in respect of all or a portion of such dividend that is payable in

Table of Contents

stock. In addition, if a significant number of our stockholders determine to sell shares of our common stock in order to pay taxes owed on dividends, it may put downward pressure on the trading price of our common stock.

Further, while Revenue Procedure 2010-12 applies only to taxable dividends payable in cash or stock with respect to any taxable year ending on or before December 31, 2011, it is unclear whether and to what extent we will be able to pay taxable dividends in cash and stock in later years. Moreover, various aspects of such a taxable cash/stock dividend are uncertain and have not yet been addressed by the IRS. No assurance can be given that the IRS will not impose additional requirements in the future with respect to taxable cash/stock dividends, including on a retroactive basis, or assert that the requirements for such taxable cash/stock dividends have not been met.

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 105,175,197 shares of common stock were outstanding as of September 30, 2011. We cannot 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.

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

None.

Item 3. Defaults upon Senior Securities

None.

Item 4. Reserved

Item 5. Other Information

None.

Table of Contents

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).
10.4	Exchange Agreement, dated as of January 29, 2010, by and among Newcastle Investment Corp., Taberna Capital Management, LLC, Taberna Preferred Funding IV, Ltd., Taberna Preferred Funding V, Ltd., Taberna Preferred Funding VI, Ltd. and Taberna Preferred Funding VII, Ltd. (incorporated by reference to the Registrant's Report on Form 8-K, Exhibit 10.1, filed on February 2, 2010).
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, 2010, 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.
101.INS*	XBRL Instance Document.
101.SCH*	XBRL Taxonomy Extension Schema Document.

Table of Contents

101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document.
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document.

* XBRL (Extensible Business Reporting Language) information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934.

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.

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

November 9, 2011

By: /s/ Brian C. Sigman
Brian C. Sigman
Chief Financial Officer and Principal Accounting Officer

November 9, 2011

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, 2011
(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, 2011
(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, 2011 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, 2011

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, 2011 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, 2011

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