

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2012

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)

81-0559116

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

1345 Avenue of the Americas, New York, NY

(Address of principal executive offices)

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 S 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 S 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 S 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 S

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: 124,178,801 shares outstanding as of May 8, 2012.**

## CAUTIONARY NOTE REGARDING FORWARD LOOKING STATEMENTS

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

- 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 or at all;
- our ability to take advantage of investment opportunities in interests in excess mortgage servicing rights;
- 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.

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

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

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.

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NEWCASTLE INVESTMENT CORP.  
FORM 10-Q

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**PART I. FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

**NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

(dollars in thousands, except share data)

	<b>March 31, 2012</b>	<b>December 31, 2011</b>
	<b>(Unaudited)</b>	
<b>Assets</b>		
<b>Non-Recourse VIE Financing Structures</b>		
Real estate securities, available-for-sale	\$ 1,536,251	\$ 1,479,214
Real estate related loans, held-for-sale, net	838,818	807,214
Residential mortgage loans, held-for-investment, net	321,347	331,236
Subprime mortgage loans subject to call option	404,979	404,723
Operating real estate, held-for-sale	7,739	7,741
Other investments	18,883	18,883
Restricted cash	107,875	105,040
Derivative assets	1,832	1,954
Receivables and other assets	22,147	23,319
	<u>3,259,871</u>	<u>3,179,324</u>
<b>Recourse Financing Structures and Unlevered Assets</b>		
Real estate securities, available-for-sale	248,638	252,530
Real estate related loans, held-for-sale, net	—	6,366
Residential mortgage loans, held-for-sale, net	2,775	2,687
Investments in excess mortgage servicing rights at fair value	42,587	43,971
Other investments	6,024	6,024
Cash and cash equivalents	156,425	157,356
Receivables and other assets	3,226	3,541
	<u>459,675</u>	<u>472,475</u>
	<u>\$ 3,719,546</u>	<u>\$ 3,651,799</u>
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
<b>Non-Recourse VIE Financing Structures</b>		
CDO bonds payable	\$ 2,365,537	\$ 2,403,605
Other bonds and notes payable	190,091	200,377
Repurchase agreements	5,644	6,546
Financing of subprime mortgage loans subject to call option	404,979	404,723
Derivative liabilities	108,774	119,320
Accrued expenses and other liabilities	15,723	16,112
	<u>3,090,748</u>	<u>3,150,683</u>
<b>Recourse Financing Structures and Other Liabilities</b>		
Repurchase agreements	228,080	233,194
Junior subordinated notes payable	51,247	51,248
Dividends payable	21,966	16,707
Due to affiliates	1,659	1,659
Accrued expenses and other liabilities	2,824	6,219
	<u>305,776</u>	<u>309,027</u>
	<u>3,396,524</u>	<u>3,459,710</u>
<b>Stockholders' Equity</b>		
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 March 31, 2012 and December 31, 2011	61,583	61,583
Common stock, \$0.01 par value, 500,000,000 shares authorized, 105,181,009 shares issued and outstanding at March 31, 2012 and December 31, 2011	1,052	1,052
Additional paid-in capital	1,275,792	1,275,792
Accumulated deficit	(1,022,212)	(1,073,252)
Accumulated other comprehensive income (loss)	6,807	(73,086)
	<u>323,022</u>	<u>192,089</u>
	<u>\$ 3,719,546</u>	<u>\$ 3,651,799</u>

See notes to consolidated financial statements

**NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME (Unaudited)**  
(dollars in thousands, except share data)

	Three Months Ended March 31,	
	2012	2011
Interest income	\$ 74,899	\$ 72,203
Interest expense	30,165	38,165
Net interest income	44,734	34,038
<b>Impairment (Reversal)</b>		
Valuation allowance (reversal) on loans	(9,031)	(41,307)
Other-than-temporary impairment on securities	5,883	3,112
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)	(3,932)	989
	(7,080)	(37,206)
Net interest income after impairment/reversal	51,814	71,244
<b>Other Income (Loss)</b>		
Gain (loss) on settlement of investments, net	4,823	34,092
Gain on extinguishment of debt	20,743	11,042
Other income (loss), net	4,186	335
	29,752	45,469
<b>Expenses</b>		
Loan and security servicing expense	1,098	1,060
General and administrative expense	2,285	1,601
Management fee to affiliate	4,976	4,189
	8,359	6,850
Income from continuing operations	73,207	109,863
Income (loss) from discontinued operations	264	(190)
<b>Net Income</b>	73,471	109,673
Preferred dividends	(1,395)	(1,395)
<b>Income Available for Common Stockholders</b>	\$ 72,076	\$ 108,278
<b>Income Per Share of Common Stock</b>		
Basic	\$ 0.68	\$ 1.73
Diluted	\$ 0.68	\$ 1.73
<b>Income from continuing operations per share of common stock, after preferred dividends</b>		
Basic	\$ 0.68	\$ 1.73
Diluted	\$ 0.68	\$ 1.73
<b>Income (loss) from discontinued operations per share of common stock</b>		
Basic	\$ —	\$ —
Diluted	\$ —	\$ —
<b>Weighted Average Number of Shares of Common Stock Outstanding</b>		
Basic	105,181,009	62,602,184
Diluted	105,670,102	62,611,070
<b>Dividends Declared per Share of Common Stock</b>	\$ 0.20	\$ —

See notes to consolidated financial statements

**NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)**  
(dollars in thousands, except share data)

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	Three Months Ended March 31,	
	2012	2011
Net income	\$ 73,471	\$ 109,673
Other comprehensive income (loss):		
Net unrealized gain (loss) on securities	76,417	126,143
Reclassification of net realized (gain) loss on securities into earnings	(4,487)	(28,271)
Net unrealized gain (loss) on derivatives designated as cash flow hedges	8,174	18,411
Reclassification of net realized (gain) loss on derivatives designated as cash flow hedges into earnings	(211)	4,298
Other comprehensive income (loss)	79,893	120,581
Total comprehensive income	\$ 153,364	\$ 230,254

**NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (Unaudited)**  
FOR THE THREE MONTHS ENDED MARCH 31, 2012  
(dollars in thousands)

	Preferred Stock		Common Stock		Additional Paid-in Capital	Accumulated Deficit	Accum. Other Comp. Income (Loss)	Total Stock- holders' Equity
	Shares	Amount	Shares	Amount				
<b>Stockholders' equity - December 31, 2011</b>	2,463,321	\$ 61,583	105,181,009	\$ 1,052	\$ 1,275,792	\$ (1,073,252)	\$ (73,086)	\$ 192,089
Dividends declared	—	—	—	—	—	(22,431)	—	(22,431)
Net income	—	—	—	—	—	73,471	—	73,471
Other comprehensive income (loss)	—	—	—	—	—	—	79,893	79,893
<b>Stockholders' equity - March 31, 2012</b>	<u>2,463,321</u>	<u>\$ 61,583</u>	<u>105,181,009</u>	<u>\$ 1,052</u>	<u>\$ 1,275,792</u>	<u>\$ (1,022,212)</u>	<u>\$ 6,807</u>	<u>\$ 323,022</u>

See notes to consolidated financial statements



**NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)**  
(dollars in thousands)

	<b>Three Months Ended March 31,</b>	
	<b>2012</b>	<b>2011</b>
<b>Cash Flows From Operating Activities</b>		
Net income	\$ 73,471	\$ 109,673
Adjustments to reconcile net income to net cash provided by (used in) operating activities (inclusive of amounts related to discontinued operations):		
Depreciation and amortization	87	46
Accretion of discount and other amortization	(12,213)	(10,771)
Interest income in CDOs redirected for reinvestment or CDO bond paydown	(1,230)	(3,724)
Interest income on investments accrued to principal balance	(5,293)	(4,535)
Interest expense on debt accrued to principal balance	109	410
Deferred interest received	—	1,027
Valuation allowance (reversal) on loans	(9,031)	(41,307)
Other-than-temporary impairment on securities	1,951	4,101
Impairment on real estate held-for-sale	—	433
Change in fair value on investments in excess mortgage servicing rights	(1,216)	—
Gain on settlement of investments (net) and real estate held-for-sale	(4,823)	(33,158)
Unrealized (gain) loss on non-hedge derivatives and hedge ineffectiveness	(2,086)	201
Gain on extinguishment of debt	(20,743)	(11,042)
Change in:		
Restricted cash	286	109
Receivables and other assets	554	(40)
Due to affiliates	—	(68)
Accrued expenses and other liabilities	(559)	(61)
Net cash provided by (used in) operating activities	<u>19,264</u>	<u>11,294</u>
<b>Cash Flows From Investing Activities</b>		
Principal repayments from repurchased CDO debt	4,497	9,726
Principal repayments from CDO securities	198	—
Return of investments in excess mortgage servicing rights	2,425	—
Principal repayments from loans and non-CDO securities	22,894	37,605
Purchase of real estate securities	(4,340)	(89,601)
Acquisition of investments in excess mortgage servicing rights	(3,072)	—
Acquisition of servicing rights	—	(2,082)
Net cash provided by (used in) investing activities	<u>22,602</u>	<u>(44,352)</u>
<b>Cash Flows From Financing Activities</b>		
Repurchases of CDO bonds payable	(9,159)	(1,083)
Repayments of other bonds payable	(10,450)	(10,460)
Borrowings under repurchase agreements	4,117	79,978
Repayments of repurchase agreements	(10,133)	(2,907)
Issuance of common stock	—	98,843
Costs related to issuance of common stock	—	(58)
Common stock dividends paid	(15,777)	—
Preferred stock dividends paid	(1,395)	(4,185)
Net cash provided by (used in) financing activities	<u>(42,797)</u>	<u>160,128</u>
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	<u>(931)</u>	<u>127,070</u>
<b>Cash and Cash Equivalents, Beginning of Period</b>	<u>157,356</u>	<u>33,524</u>
<b>Cash and Cash Equivalents, End of Period</b>	<u>\$ 156,425</u>	<u>\$ 160,594</u>
<b>Supplemental Disclosure of Cash Flow Information</b>		
Cash paid during the period for interest expense	\$ 20,726	\$ 28,759
<b>Supplemental Schedule of Non-Cash Investing and Financing Activities</b>		
Common stock dividends declared but not paid	\$ 21,036	\$ —
Preferred stock dividends declared but not paid	\$ 930	\$ 930

See notes to consolidated financial statements

**NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES**

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

MARCH 31, 2012

(dollars in thousands, except share data)

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**1. GENERAL**

Newcastle Investment Corp. (and its subsidiaries, "Newcastle") is a Maryland corporation that was formed in 2002. Newcastle conducts its business through the following segments: (i) investments financed with non-recourse collateralized debt obligations ("non-recourse CDOs"), (ii) unlevered investments in deconsolidated Newcastle CDO debt ("unlevered CDOs"), (iii) unlevered investments in excess mortgage servicing rights ("unlevered Excess MSRs"), (iv) investments financed with other non-recourse debt ("non-recourse other"), (v) investments and debt repurchases financed with recourse debt ("recourse"), (vi) other unlevered investments ("unlevered other") and (vii) corporate. With respect to the non-recourse CDOs and non-recourse other 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 April 2012, Newcastle issued 18,975,000 shares of its common stock in a public offering at a price to the public of \$6.22 per share for net proceeds of approximately \$115.2 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 1,897,500 shares of Newcastle's common stock at the public offering price, which had a fair value of approximately \$5.6 million.

Approximately 4.4 million shares of Newcastle's common stock were held by Fortress, through its affiliates, and its principals at March 31, 2012. In addition, Fortress, through its affiliates, held options to purchase approximately 6.0 million shares of Newcastle's common stock at March 31, 2012.

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, 2011 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, 2011.

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 became effective for Newcastle on January 1, 2012. The adoption of this guidance did not have a material impact on Newcastle's financial position, liquidity or results of operations.

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. Newcastle early-adopted this accounting standard in 2011 and opted to present two separate statements.

The FASB has recently issued or discussed a number of proposed standards on such topics as consolidation, the definition of an investment company, 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.

**NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES**

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

MARCH 31, 2012

(dollars in thousands, except share data)

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**2. SEGMENT REPORTING AND VARIABLE INTEREST ENTITIES**

Newcastle conducts its business through the following segments: (i) investments financed with non-recourse collateralized debt obligations (“non-recourse CDOs”), (ii) unlevered investments in deconsolidated Newcastle CDO debt (“unlevered CDOs”), (iii) unlevered investments in excess mortgage servicing rights (“unlevered Excess MSRs”), (iv) investments financed with other non-recourse debt (“non-recourse other”), (v) investments and debt repurchases financed with recourse debt (“recourse”), (vi) other unlevered investments (“unlevered other”) and (vii) corporate. With respect to the non-recourse CDOs and non-recourse other 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.

In the fourth quarter of 2011, Newcastle changed the composition of its reportable segments such that the unlevered segment is further broken down into (i) unlevered CDOs, (ii) unlevered Excess MSRs and (iii) unlevered other. Management believes the additional segments better reflect its investments in deconsolidated CDOs and its new investment in Excess MSRs. Segment information for previously reported periods in the accompanying financial statements has been restated to reflect this change to the composition of its segments.

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.

**NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES**

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

MARCH 31, 2012

(dollars in thousands, except share data)

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

	Non- Recourse CDOs (A)	Unlevered CDOs (B)	Unlevered Excess MSRs	Non- Recourse Other (A) (C)	Recourse (D)	Unlevered Other (E)	Corporate	Inter- segment Elimination (F)	Total
<b>Three Months Ended March 31, 2012</b>									
Interest income	\$ 54,402	\$ 115	\$ 2,037	\$ 18,426	\$ 814	\$ 523	\$ 51	\$ (1,469)	\$ 74,899
Interest expense	17,636	—	—	12,663	268	—	954	(1,356)	30,165
Net interest income (expense)	36,766	115	2,037	5,763	546	523	(903)	(113)	44,734
Impairment (reversal)	(8,531)	—	—	1,648	—	(197)	—	—	(7,080)
Other income (loss)	29,913	92	1,216	—	—	(1,469)	—	—	29,752
Expenses	241	1	123	843	—	13	7,138	—	8,359
Income (loss) from continuing operations	74,969	206	3,130	3,272	546	(762)	(8,041)	(113)	73,207
Income (loss) from discontinued operations	—	—	—	168	—	(17)	—	113	264
Net income (loss)	74,969	206	3,130	3,440	546	(779)	(8,041)	—	73,471
Preferred dividends	—	—	—	—	—	—	(1,395)	—	(1,395)
Income (loss) applicable to common stockholders	\$ 74,969	\$ 206	\$ 3,130	\$ 3,440	\$ 546	\$ (779)	\$ (9,436)	\$ —	\$ 72,076
<b>March 31, 2012</b>									
Investments	\$ 2,488,278	\$ 3,978	\$ 42,587	\$ 781,932	\$ 240,624	\$ 12,835	\$ —	\$ (142,193)	\$ 3,428,041
Cash and restricted cash	107,875	—	—	—	—	—	156,425	—	264,300
Derivative assets	1,832	—	—	—	—	—	—	—	1,832
Other assets	22,040	7	—	107	616	1,998	959	(354)	25,373
Total assets	2,620,025	3,985	42,587	782,039	241,240	14,833	157,384	(142,547)	3,719,546
Debt	(2,371,181)	—	—	(737,263)	(228,080)	—	(51,247)	142,193	(3,245,578)
Derivative liabilities	(108,774)	—	—	—	—	—	—	—	(108,774)
Other liabilities	(12,702)	—	(371)	(3,021)	(21)	(47)	(26,364)	354	(42,172)
Total liabilities	(2,492,657)	—	(371)	(740,284)	(228,101)	(47)	(77,611)	142,547	(3,396,524)
Preferred stock	—	—	—	—	—	—	(61,583)	—	(61,583)
GAAP book value	\$ 127,368	\$ 3,985	\$ 42,216	\$ 41,755	\$ 13,139	\$ 14,786	\$ 18,190	\$ —	\$ 261,439

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	Non- Recourse CDOs (A)	Unlevered CDOs (B)	Unlevered Excess MSRs	Non- Recourse Other (A)	Recourse	Unlevered Other	Corporate	Inter- segment Elimination (F)	Total
<u>Three Months Ended March 31, 2011</u>									
Interest income	\$ 54,828	\$ 11	\$ —	\$ 17,481	\$ 147	\$ 482	\$ 20	\$ (766)	\$ 72,203
Interest expense	24,613	—	—	13,155	98	—	952	(653)	38,165
Net interest income (expense)	30,215	11	—	4,326	49	482	(932)	(113)	34,038
Impairment (reversal)	(38,245)	—	—	1,154	—	(115)	—	—	(37,206)
Other income (loss)	43,107	75	—	1,827	—	460	—	—	45,469
Expenses	313	—	—	744	—	45	5,748	—	6,850
Income (loss) from continuing operations	111,254	86	—	4,255	49	1,012	(6,680)	(113)	109,863
Income (loss) from discontinued operations	—	—	—	(282)	—	(21)	—	113	(190)
Net income (loss)	111,254	86	—	3,973	49	991	(6,680)	—	109,673
Preferred dividends	—	—	—	—	—	—	(1,395)	—	(1,395)
Income (loss) applicable to common stockholders	<u>\$ 111,254</u>	<u>\$ 86</u>	<u>\$ —</u>	<u>\$ 3,973</u>	<u>\$ 49</u>	<u>\$ 991</u>	<u>\$ (8,075)</u>	<u>\$ —</u>	<u>\$ 108,278</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) Represents unlevered investments in CDO securities issued by Newcastle. These CDOs have been deconsolidated as Newcastle does not have the power to direct the relevant activities of the CDOs.
- (C) The following table summarizes the investments and debt in the other non-recourse segment:

	March 31, 2012			
	Investments		Debt	
	Outstanding Face Amount	Carrying Value	Outstanding Face Amount*	Carrying Value*
Manufactured housing loan portfolio I	\$ 130,488	\$ 108,839	\$ 103,026	\$ 93,829
Manufactured housing loan portfolio II	171,858	168,837	137,425	136,300
Residential mortgage loans	55,640	40,229	54,107	53,036
Subprime mortgage loans subject to call options	406,217	404,979	406,217	404,979
Real estate securities	67,512	51,309	47,384	43,119
Operating real estate	N/A	7,739	6,000	6,000
	<u>\$ 831,715</u>	<u>\$ 781,932</u>	<u>\$ 754,159</u>	<u>\$ 737,263</u>

\* An aggregate face amount of \$156.0 million (carrying value of \$142.2 million) of debt represents financing provided by the CDO segment (and included as investments in the CDO segment), which is eliminated upon consolidation.

- (D) The \$228.1 million of recourse debt is comprised of (i) a \$226.2 million repurchase agreement secured by \$240.6 million carrying value of FNMA/FHLMC securities and (ii) a \$1.9 million repurchase agreement secured by \$27.9 million face amount of senior notes issued by Newcastle CDO VI, which was repurchased by Newcastle and is eliminated in consolidation.

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

	March 31, 2012		
	Outstanding Face Amount	Carrying Value	Number of Investments
Real estate securities	\$ 141,493	\$ 4,036	20
Residential mortgage loans	4,696	2,775	156
Other investments	N/A	6,024	1
	<u>\$ 146,189</u>	<u>\$ 12,835</u>	<u>177</u>

(F) 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 CDOs V and VII), 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 are not consolidated.

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 March 31, 2012, 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.

Newcastle had variable interests in the following unconsolidated VIE at March 31, 2012, 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	\$ 300,576	\$ 302,332	\$ 3,978

(A) Face amount.

(B) Includes \$42.0 million face amount of debt owned by Newcastle with a carrying value of \$4.0 million at March 31, 2012.

(C) This amount represents Newcastle’s maximum exposure to loss from this entity, which was the fair value at March 31, 2012, related to \$5.4 million face amount of CDO V Class I notes.

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**3. REAL ESTATE SECURITIES**

The following is a summary of Newcastle's real estate securities at March 31, 2012, 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		Carrying Value (B)	Number of Securities	Weighted Average				
	Outstanding Face Amount	Before Impairment	Other-Than-Temporary Impairment (A)	After Impairment	Gains	Losses			Rating (C)	Coupon	Yield	Maturity (Years) (D)	Principal Subordination (E)
CMBS-Conduit	\$ 1,301,842	\$ 1,112,189	\$ (170,023)	\$ 942,166	\$ 123,177	\$ (53,746)	\$ 1,011,597	161	BB+	5.58%	10.95%	4.1	11.2%
CMBS- Single Borrower	185,438	180,581	(12,364)	168,217	4,183	(11,416)	160,984	33	BB	5.03%	6.24%	3.2	6.7%
CMBS-Large Loan	14,964	14,305	—	14,305	608	(49)	14,864	2	BBB+	5.07%	8.86%	1.0	10.1%
REIT Debt	120,288	119,552	—	119,552	6,051	(2,746)	122,857	18	BB+	5.72%	5.72%	2.4	N/A
ABS-Subprime (F)	255,524	205,060	(78,232)	126,828	12,827	(7,622)	132,033	63	B	1.14%	9.46%	7.0	32.4%
ABS-Manufactured Housing	29,045	28,173	—	28,173	2,227	(77)	30,323	7	BBB+	6.61%	7.35%	3.9	42.3%
ABS-Franchise	22,696	19,988	(9,635)	10,353	194	(3,819)	6,728	6	C	3.55%	4.90%	13.7	21.8%
FNMA/FHLMC	226,808	237,607	—	237,607	3,193	(176)	240,624	32	AAA	2.41%	1.55%	4.6	N/A
CDO (G)	206,323	83,204	(14,861)	68,343	88	(3,552)	64,879	13	CCC+	3.01%	7.94%	1.4	22.1%
Total / Average (H)	\$ 2,362,928	2,000,659	\$ (285,115)	\$ 1,715,544	\$ 152,548	\$ (83,203)	\$ 1,784,889	335	BB+	4.53%	8.48%	4.1	

- (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 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 and residual interests 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 \$1.0 million from Securitization Trust 2006 (Note 4).
- (G) Includes two CDO bonds issued by a third party with a carrying value of \$58.1 million, four CDO bonds issued by CDO V (which has been deconsolidated) and held as investments by Newcastle with a carrying value of \$4.0 million and seven CDO bonds issued by C-BASS with a carrying value of \$2.8 million.
- (H) The total outstanding face amount of fixed rate securities was \$1.6 billion, and of floating rate securities was \$736 million.

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Unrealized losses that are considered other-than-temporary are recognized currently in earnings. During the three months ended March 31, 2012, Newcastle recorded other-than-temporary impairment charges (“OTTI”) of \$5.9 million (gross of \$3.9 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. Newcastle performed analyses in relation to such securities, using management’s best estimate of their cash flows, which support its belief that the carrying values of such securities were fully recoverable over their expected holding period. The following table summarizes Newcastle’s securities in an unrealized loss position as of March 31, 2012.

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	\$ 228,157	\$ 194,327	\$ (15,264)	\$ 179,063	\$ —	\$ (15,321)	163,742	27	BB	4.59%	8.56%	4.3
Twelve or More Months	616,685	580,011	(2,721)	577,290	—	(67,882)	509,408	89	BB	4.45%	6.49%	3.3
<b>Total</b>	<b>\$ 844,842</b>	<b>\$ 774,338</b>	<b>\$ (17,985)</b>	<b>\$ 756,353</b>	<b>\$ —</b>	<b>\$ (83,203)</b>	<b>\$ 673,150</b>	<b>116</b>	<b>BB</b>	<b>4.49%</b>	<b>6.98%</b>	<b>3.6</b>

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:

	March 31, 2012			
	Fair Value	Amortized Cost Basis After Impairment	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	37,244	42,883	(17,379)	(5,639)
Non credit impaired securities	635,906	713,470	—	(77,564)
<b>Total debt securities in an unrealized loss position</b>	<b>\$ 673,150</b>	<b>\$ 756,353</b>	<b>\$ (17,379)</b>	<b>\$ (83,203)</b>

- (A) Newcastle may, at times, be more likely than not to be required to sell certain securities for liquidity purposes. While the amount of the securities to be sold may be an estimate, and the securities to be sold have not yet been identified, 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.



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The following table summarizes the activity related to credit losses on debt securities for the three months ended March 31, 2012:

Beginning balance of credit losses on debt securities for which a portion of an OTTI was recognized in other comprehensive income	\$	(20,207)
Additions for credit losses on securities for which an OTTI was not previously recognized		(462)
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		(75)
Additions for credit losses on securities for which an OTTI was previously recognized without any portion of OTTI recognized in other comprehensive income		(7,489)
Reduction for credit losses on securities for which no OTTI was recognized in other comprehensive income at the current measurement date		9,299
Reduction for securities sold during the period		1,498
Reduction for increases in cash flows expected to be collected that are recognized over the remaining life of the security		57
Ending balance of credit losses on debt securities for which a portion of an OTTI was recognized in other comprehensive income	\$	<u>(17,379)</u>

As of March 31, 2012, Newcastle had \$97.6 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 March 31, 2012 (in thousands):

Geographic Location	CMBS		ABS	
	Outstanding Face Amount	Percentage	Outstanding Face Amount	Percentage
Western U.S.	\$ 589,565	39.3%	\$ 80,001	26.0%
Northeastern U.S.	257,609	17.2%	59,249	19.3%
Southeastern U.S.	296,367	19.7%	76,282	24.8%
Midwestern U.S.	158,212	10.5%	48,690	15.9%
Southwestern U.S.	126,838	8.4%	33,265	10.8%
Other	16,899	1.1%	9,778	3.2%
Foreign	56,754	3.8%	—	0.0%
	<u>\$ 1,502,244</u>	<u>100.0%</u>	<u>\$ 307,265</u>	<u>100.0%</u>

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

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**4. REAL ESTATE RELATED LOANS, RESIDENTIAL MORTGAGE LOANS, SUBPRIME MORTGAGE LOANS, CDO SERVICING RIGHTS AND INVESTMENTS IN EXCESS MORTGAGE SERVICING RIGHTS**

The following is a summary of real estate related loans, residential mortgage loans and subprime mortgage loans at March 31, 2012. 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	\$ 584,234	\$ 462,197	16	10.14%	8.57%	2.4	69.8%	\$ 12,000
Corporate Bank Loans	295,638	183,526	6	19.40%	9.59%	2.9	52.2%	—
B-Notes	187,017	162,635	6	11.67%	5.13%	2.9	68.0%	53,995
Whole Loans	30,460	30,460	3	5.19%	3.89%	1.7	95.6%	—
<b>Total Real Estate Related Loans Held-for-Sale, Net</b>	<b>\$ 1,097,349</b>	<b>\$ 838,818</b>	<b>31</b>	<b>12.28%</b>	<b>8.13%</b>	<b>2.6</b>	<b>65.4%</b>	<b>\$ 65,995</b>
Non-Securitized Manufactured Housing Loan Portfolio I	\$ 711	\$ 193	19	39.05%	8.09%	0.7	0.0%	\$ 166
Non-Securitized Manufactured Housing Loan Portfolio II	3,985	2,582	137	15.50%	10.12%	5.5	7.7%	668
<b>Total Residential Mortgage Loans Held-for-Sale, Net (D)</b>	<b>\$ 4,696</b>	<b>\$ 2,775</b>	<b>156</b>	<b>17.14%</b>	<b>9.81%</b>	<b>4.8</b>	<b>6.5%</b>	<b>\$ 834</b>
Securitized Manufactured Housing Loan Portfolio I	\$ 130,488	\$ 108,839	3,447	9.49%	8.66%	7.4	0.9%	\$ 1,657
Securitized Manufactured Housing Loan Portfolio II	171,858	168,837	5,908	7.55%	9.64%	5.8	17.2%	2,681
<b>Residential Loans</b>	<b>59,419</b>	<b>43,671</b>	<b>210</b>	<b>7.57%</b>	<b>2.47%</b>	<b>6.7</b>	<b>100.0%</b>	<b>7,362</b>
Total Residential Mortgage Loans Held-for-Investment, Net (D) (E)	\$ 361,765	\$ 321,347	9,565	8.21%	8.11%	6.5	24.9%	\$ 11,700
Subprime Mortgage Loans Subject to Call Option	\$ 406,217	\$ 404,979						

- (A) Carrying value includes interest receivable of \$0.1 million for the residential housing loans and principal and interest receivable of \$5.8 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 (including loans that are in foreclosure, or borrower's in bankruptcy) or considered real estate owned ("REO"). As of March 31, 2012, \$124.1 million face amount of real estate related loans was on non-accrual status.
- (D) Loans acquired at a discount for credit quality.
- (E) The following is an aging analysis of past due residential loans held-for-investment as of March 31, 2012:

	30-59 Days Past Due	60-89 Days Past Due	Over 90 Days Past Due	Repossessed	Total Past Due		Total Outstanding Face Amount
					Due	Current	
Securitized Manufactured Housing Loan Portfolio I	\$ 270	\$ 552	\$ 480	\$ 625	\$ 1,927	\$ 128,561	\$ 130,488
Securitized Manufactured Housing Loan Portfolio II	\$ 1,095	\$ 383	\$ 1,652	\$ 646	\$ 3,776	\$ 168,082	\$ 171,858
<b>Residential Loans</b>	<b>\$ 1,068</b>	<b>\$ 107</b>	<b>\$ 6,553</b>	<b>\$ 702</b>	<b>\$ 8,430</b>	<b>\$ 50,989</b>	<b>\$ 59,419</b>

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.

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The following is a summary of real estate related loans by maturities at March 31, 2012:

Year of Maturity <sup>(1)</sup>	Outstanding Face Amount	Carrying Value	Number of Loans
Delinquent <sup>(2)</sup>	\$ 65,995	\$ 41,440	2
Period from April 1, 2012 to December 31, 2012	63,454	277	2
2013	36,137	26,933	3
2014	351,598	238,607	9
2015	238,898	197,135	7
2016	274,936	273,139	5
2017	49,702	46,490	2
Thereafter	16,629	14,797	1
<b>Total</b>	<b>\$ 1,097,349</b>	<b>\$ 838,818</b>	<b>31</b>

(1) Based on the final extended maturity date of each loan investment as of March 31, 2012.

(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:

	Held-for-Sale		Held-for-Investment
	Real Estate Related Loans	Residential Mortgage Loans	Residential Mortgage Loans
<b>December 31, 2011</b>	\$ 813,580	\$ 2,687	\$ 331,236
Purchases / additional fundings	45,481	—	—
Interest accrued to principal balance	5,293	—	—
Principal paydowns	(34,476)	(148)	(9,756)
Sales	—	—	—
Valuation (allowance) reversal on loans	10,482	197	(1,648)
Loss on repayment of loans held-for-sale	(1,614)	—	—
Accretion of loan discount and other amortization	—	—	1,029
Other	72	39	486
<b>March 31, 2012</b>	<b>\$ 838,818</b>	<b>\$ 2,775</b>	<b>\$ 321,347</b>

The following is a rollforward of the related loss allowance.

	Held-For-Sale		Held-For-Investment
	Real Estate Related Loans	Residential Mortgage Loans	Residential Mortgage Loans (B)
Balance at December 31, 2011	\$ (228,017)	\$ (2,461)	\$ (26,075)
Charge-offs (A)	17,648	382	2,447
Valuation (allowance) reversal on loans	10,482	197	(1,648)
Balance at March 31, 2012	<b>\$ (199,887)</b>	<b>\$ (1,882)</b>	<b>\$ (25,276)</b>

(A) The charge-offs for real estate related loans represent a loan which was paid off at a discounted price during the period.

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

**CDO 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 three months ended March 31, 2012 and 2011, respectively, Newcastle recorded \$0.08 million and \$0.04 million of servicing rights amortization and no servicing rights impairment. As of March 31, 2012, Newcastle’s servicing asset had a carrying value of \$2.0 million recorded in Receivables and Other Assets.

**Investments in Excess Mortgage Servicing Rights**

In December 2011, Newcastle entered into an agreement (“MSR Agreement I”) with Nationstar Mortgage LLC (“Nationstar”), an affiliate of Newcastle’s manager, to purchase Excess MSRs from Nationstar. Nationstar acquired the mortgage servicing rights on a pool of agency residential mortgage loans with an outstanding principal balance of

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approximately \$9.9 billion ("MSR Portfolio I") on September 30, 2011. Nationstar is entitled to receive an initial weighted average total mortgage servicing amount of 35 basis points (bps) on the performing unpaid principal balance, as well as any ancillary income from MSR Portfolio I. Pursuant to MSR Agreement I, Nationstar performs all servicing functions and advancing functions related to MSR Portfolio I for a base mortgage servicing fee of 6 bps. Therefore, the remainder, or "Excess MSRs" are initially equal to a weighted average of 29 bps. Newcastle acquired the right to receive 65% of the excess mortgage servicing amount on MSR Portfolio I and, subject to certain limitations and pursuant to a loan replacement agreement (the "Recapture Agreement"), 65% of the excess mortgage servicing amount on certain future mortgage loans originated by Nationstar, that represent refinancings of loans in MSR Portfolio I (which loans then become part of MSR Portfolio I) for \$43.7 million. Nationstar has co-invested, pari passu with Newcastle, in 35% of the Excess MSRs. Nationstar, as servicer, also retains the ancillary income, the servicing obligations and liabilities as the servicer. If Nationstar is terminated as the servicer, Newcastle's right to receive its portion of the excess mortgage servicing amount is also terminated. To the extent that Nationstar is terminated as the servicer and receives a termination payment, Newcastle is entitled to a pro rata share, or 65%, of such termination payment.

The following is a summary of Newcastle's Excess MSRs:

	March 31, 2012				Three Months Ended March 31, 2012
	Amortized Cost Basis	Carrying Value (A)	Weighted Average Yield	Weighted Average Maturity (Years) (B)	Changes in Fair Value Recorded in Other Income (Loss)
MSR Portfolio I	\$ 34,897	\$ 36,280	20.0%	4.6	\$ 1,215
MSR Portfolio I - Recapture Agreement	6,107	6,307	20.0%	10.2	1
	<u>\$ 41,004</u>	<u>\$ 42,587</u>	<u>20.0%</u>	<u>6.0</u>	<u>\$ 1,216</u>

(A) Fair value.

(B) The weighted average maturity is based on the timing of expected return of investments.

The table below summarizes the geographic distribution of the underlying residential mortgage loans of the Excess MSRs at March 31, 2012 (in thousands):

State Concentration	Outstanding		Nonperforming (A)	
	Unpaid Principal Amount	Percentage of Total Outstanding	Unpaid Principal Amount	Percentage of Total Nonperforming
California	\$ 1,829,213	19.4%	\$ 144,163	21.5%
Florida	1,050,543	11.1%	77,858	11.6%
Texas	619,198	6.6%	23,556	3.5%
Arizona	452,872	4.8%	40,219	6.0%
Virginia	325,998	3.5%	17,337	2.6%
Washington	306,343	3.2%	26,395	3.9%
New Jersey	297,264	3.2%	26,771	4.0%
Maryland	290,700	3.1%	19,130	2.9%
Illinois	280,735	3.0%	24,595	3.7%
Nevada	262,206	2.8%	33,743	5.0%
Other U.S.	3,719,200	39.3%	235,738	35.3%
	<u>\$ 9,434,272</u>	<u>100.0%</u>	<u>\$ 669,505</u>	<u>100.0%</u>

(A) Represent loans that missed their most recent payment and therefore Newcastle did not receive its excess servicing amount.

Geographic concentrations of investments expose Newcastle to the risk of economic downturns within the relevant states. Any such downturn in a state where Newcastle holds significant investments could affect the underlying borrower's ability to make the mortgage payment and therefore could have a meaningful, negative impact on Newcastle's Excess MSRs.

See note 11 regarding the agreement to acquire an additional portfolio of Excess MSRs.

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***Securitization of Subprime Mortgage Loans***

The following table presents information on the retained interests in Newcastle's securitizations of subprime mortgage loans at March 31, 2012:

	Subprime Portfolio		Total
	I	II	
Total securitized loans (unpaid principal balance) (A)	\$ 460,432	\$ 601,132	\$ 1,061,564
Loans subject to call option (carrying value)	\$ 299,176	\$ 105,803	\$ 404,979
Retained interests (fair value) (B)	\$ 1,043	\$ —	\$ 1,043

(A) Average loan seasoning of 80 months and 62 months for Subprime Portfolios I and II, respectively, at March 31, 2012.

(B) The retained interests include retained bonds of the securitizations. The fair value of which is estimated based on pricing models. Newcastle's residual interests were written off in 2010. The weighted average yield of the retained bonds was 8.39% as of March 31, 2012.

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 March 31, 2012:

	Subprime Portfolio	
	I	II
Loan unpaid principal balance (UPB)	\$ 460,432	\$ 601,132
Weighted average coupon rate of loans	5.27%	4.63%
Delinquencies of 60 or more days (UPB) (A)	\$ 111,208	\$ 171,102
Net credit losses for the three months ended March 31, 2012	\$ 9,822	\$ 11,106
Cumulative net credit losses	\$ 202,691	\$ 232,959
Cumulative net credit losses as a % of original UPB	13.5%	21.4%
Percentage of ARM loans (B)	51.9%	64.9%
Percentage of loans with original loan-to-value ratio >90%	10.7%	17.1%
Percentage of interest-only loans	21.9%	4.4%
Face amount of debt (C)	\$ 456,432	\$ 601,132
Weighted average funding cost of debt (D)	0.61%	1.31%

(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 March 31, 2012.

(D) Includes the effect of applicable hedges.

Newcastle received negligible cash inflows from the retained interests of Subprime Portfolios I and II during the three months ended March 31, 2012 and 2011.

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.

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**5. DEBT OBLIGATIONS**

The following table presents certain information regarding Newcastle's debt obligations and related hedges at March 31, 2012:

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			Weighted Average Maturity (Years)	Floating Rate Face Amount (C)	Aggregate Notional Amount of Current Hedges (D)
									Outstanding Face Amount (C)	Amortized Cost Basis (C)	Carrying Value (C)			
<b>CDO Bonds Payable</b>														
CDO IV (E)	Mar 2004	\$ 104,019	\$ 103,853	Mar 2039	1.77%	4.90%	2.0	\$ 92,666	\$ 204,263	\$ 193,371	\$ 180,966	2.3	\$ 62,037	\$ 92,666
CDO VI (E)	Apr 2005	91,250	91,250	Apr 2040	0.89%	5.35%	3.1	88,315	216,854	126,376	145,348	3.3	56,748	88,315
CDO VIII	Nov 2006	572,049	570,767	Nov 2052	0.80%	2.10%	2.7	564,449	728,926	535,191	552,075	3.2	440,148	155,465
CDO IX	May 2007	480,125	481,813	May 2052	0.57%	0.57%	2.6	480,125	692,742	564,634	568,214	3.2	373,819	—
CDO X	Jul 2007	1,120,000	1,117,854	Jul 2052	0.58%	3.52%	4.5	1,120,000	1,260,004	954,666	997,130	4.7	220,931	842,485
		2,367,443	2,365,537			2.71%	3.5	2,345,555	3,102,789	2,374,238	2,443,733	3.7	1,153,683	1,178,931
<b>Other Bonds and Notes Payable</b>														
<b>MH loans Portfolio I</b>														
(F)	Apr 2010	66,103	65,345	Jul 2035	5.43%	5.43%	3.0	—	130,488	108,839	108,839	7.4	1,170	—
<b>MH loans Portfolio II (F)</b>														
(F)	May 2011	120,412	119,340	Dec 2033	3.87%	3.87%	3.4	—	171,858	168,837	168,837	5.8	29,493	—
<b>Residential Mortgage Loans</b>														
(G)	Aug 2006	5,406	5,406	Dec 2034	LIBOR+ 0.90%	1.14%	6.7	5,406	55,640	40,229	40,229	6.8	55,640	—
		191,921	190,091			4.33%	3.4	5,406	357,986	317,905	317,905	6.6	86,303	—
<b>Repurchase Agreements</b>														
<b>Real estate securities, loans and properties</b>														
(H)	Dec 2011	7,525	7,525	Jun 2012	LIBOR+ 1.75%	1.99%	0.3	7,525	—	—	—	—	—	—
<b>FNMA/FHLMC securities (I)</b>														
	Various	226,199	226,199	May 2012	0.38%	0.38%	0.2	226,199	226,808	240,624	240,624	4.6	226,808	—
		233,724	233,724			0.43%	0.2	233,724	226,808	240,624	240,624	4.6	226,808	—
<b>Corporate</b>														
<b>Junior subordinated notes payable</b>														
	Mar 2006	51,004	51,247	Apr 2035	7.57% (K)	7.41%	23.1	—	—	—	—	—	—	—
		51,004	51,247			7.41%	23.1	—	—	—	—	—	—	—
<b>Subtotal debt obligations</b>														
		2,844,092	2,840,599			2.71%	3.6	\$ 2,584,685	\$ 3,687,583	\$ 2,932,767	\$ 3,002,262	4.1	\$ 1,466,794	\$ 1,178,931
<b>Financing on subprime mortgage loans subject to call option (J)</b>														
		406,217	404,979											
<b>Total debt obligations</b>														
		\$ 3,250,309	\$ 3,245,578											

- (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 \$42.4 million notional amount of interest rate cap agreements in CDO X and a \$92.7 million and \$88.3 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 March 31, 2012. Newcastle is not receiving cash flows from these CDOs (other than senior management fees and cash flows on senior classes of bonds that 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 \$48.7 million face amount of notes payable relating to residential mortgage loans sold to certain Newcastle CDOs, which were eliminated in consolidation.
- (G) Notes payable issued to CDO V, that are no longer eliminated since the deconsolidation of CDO V.
- (H) The counterparty of this repurchase agreement is Bank of America. It is secured by \$27.9 million face amount of senior notes issued by Newcastle CDO VI, which is eliminated in consolidation. The maximum recourse to Newcastle is \$1.9 million.
- (I) 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.
- (J) Issued in April 2006 and July 2007. See Note 4 regarding the securitizations of Subprime Portfolios I and II.
- (K) LIBOR + 2.25% after April 2016.

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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 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 March 31, 2012, CDOs IV and VI were not in compliance with their applicable over collateralization tests.

In the first three months of 2012, Newcastle repurchased \$30.0 million face amount of CDO bonds payable for \$9.2 million. As a result, Newcastle extinguished \$30.0 million face amount of CDO bonds payable and recorded a gain on extinguishment of debt of \$20.7 million.

Newcastle's non-CDO financings contain various customary loan covenants. Newcastle was in compliance with all of the covenants in its non-CDO financings as of March 31, 2012.

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**6. FAIR VALUE OF FINANCIAL INSTRUMENTS**

*Fair Value Summary Table*

The carrying values and fair values of Newcastle's financial instruments at March 31, 2012 were as follows:

	Principal Balance or Notional Amount	Carrying Value	Estimated Fair Value	Fair Value Method (A)	Weighted Average Yield/Funding Cost	Weighted Average Maturity (Years)
<b>Assets</b>						
<u>Non-Recourse VIE Financing Structures</u>						
(E)						
Financial instruments:						
Real estate securities, available-for-sale*	\$ 1,952,640	\$ 1,536,251	\$ 1,536,251	Broker quotations, counterparty quotations, pricing services, pricing models	9.47%	4.4
Real estate related loans, held-for-sale, net	1,097,349	838,818	845,329	Broker quotations, counterparty quotations, pricing services, pricing models	12.28%	2.6
Residential mortgage loans, held-for-investment, net	361,765	321,347	320,182	Pricing models	8.21%	6.5
Subprime mortgage loans subject to call option (B)	406,217	404,979	404,979	(B)	9.09%	(B)
Restricted cash*	107,875	107,875	107,875			
Derivative assets, treated as hedges (C)(E)*	122,755	1,029	1,029	Counterparty quotations	N/A	(C)
Non-hedge derivative assets (D) (E)*	42,428	803	803	Counterparty quotations	N/A	(D)
Operating real estate, held-for-sale		7,739	7,739			
Other investments		18,883	18,883			
Receivables and other assets		22,147	22,147			
		<u>\$ 3,259,871</u>	<u>\$ 3,264,903</u>			
<u>Recourse Financing Structures and Unlevered Assets</u>						
Financial instruments:						
Real estate securities, available-for-sale*	\$ 410,288	\$ 248,638	\$ 248,638	Broker quotations, counterparty quotations, pricing services, pricing models	2.56%	3.0
Residential mortgage loans, held-for-sale, net	4,696	2,775	2,775	Pricing models	17.14%	4.8
Investments in excess mortgage servicing rights at fair value *(H)	9,434,272	42,587	42,587	Pricing models	20.00%	6.0
Cash and cash equivalents*	156,425	156,425	156,425			
Other investments		6,024	6,024			
Receivables and other assets		3,226	3,226			
		<u>\$ 459,675</u>	<u>\$ 459,675</u>			



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	Principal Balance or Notional Amount	Carrying Value	Estimated Fair Value	Fair Value Method (A)	Weighted Average Yield/Funding Cost	Weighted Average Maturity (Years)
<b>Liabilities</b>						
<b>Non-Recourse VIE Financing Structures (F) (G)</b>						
Financial instruments:						
CDO bonds payable	\$ 2,367,443	\$ 2,365,537	\$ 1,522,029	Pricing models	2.71%	3.5
Other bonds and notes payable	191,921	190,091	192,574	Broker quotations, pricing models	4.33%	3.4
Repurchase agreements	5,644	5,644	5,644	Market comparables	1.99%	0.3
Financing of subprime mortgage loans subject to call option (B)	406,217	404,979	404,979	(B)	9.09%	(B)
Interest rate swaps, treated as hedges (C)(E)*	832,767	81,618	81,618	Counterparty quotations	N/A	(C)
Non-hedge derivatives (D) (E)*	306,077	27,156	27,156	Counterparty quotations	N/A	(D)
Accrued expenses and other liabilities		15,723	15,723			
		<u>\$ 3,090,748</u>	<u>\$ 2,249,723</u>			
<b>Recourse Financing Structures and Other Liabilities (G)</b>						
Financial instruments:						
Repurchase agreements	\$ 228,080	\$ 228,080	\$ 228,080	Market comparables	0.39%	0.2
Junior subordinated notes payable	51,004	51,247	33,638	Pricing models	7.41%	23.1
Due to affiliates		1,659	1,659			
Dividends payable, accrued expenses and other liabilities		24,790	24,790			
		<u>\$ 305,776</u>	<u>\$ 288,167</u>			

\*Measured at fair value on a recurring basis.

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(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:

Year of Maturity	Weighted Average Month of Maturity	Aggregate Notional Amount	Weighted Average Fixed Pay Rate / Cap Rate	Aggregate Fair Value Asset / (Liability)
<b>Interest rate cap agreements which receive 1-Month LIBOR:</b>				
2015	Nov	\$ 39,550	2.10%	\$ 250
2016	Jul	77,905	2.66%	708
2017	Jan	5,300	1.86%	71
		<u>\$ 122,755</u>		<u>\$ 1,029</u>
<b>Interest rate swap agreements which receive 1-Month LIBOR:</b>				
2014	Nov	\$ 15,034	5.08%	\$ (1,726)
2015	May	469,734	5.43%	(24,123)
2016	May	173,965	5.04%	(19,665)
2017	Aug	174,034	5.24%	(36,104)
		<u>\$ 832,767</u>		<u>\$ (81,618)</u>

(D) This represents two interest rate swap agreements with a total notional balance of \$306.1 million, maturing in March 2014 and March 2015, respectively, and four interest rate cap agreements with a total notional balance of \$42.4 million, maturing in March 2013, August 2017 and January 2019. Newcastle entered, respectively, 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 March 31, 2012.

(E) Newcastle's derivatives fall into two categories. As of March 31, 2012, all derivatives were held within Newcastle's nonrecourse CDO structures. An aggregate notional balance of \$1.1 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 CDOs' total investments exceeded the fair value of each of the CDOs' derivative liabilities, no credit valuation adjustments were recorded. An aggregate notional balance of \$165.2 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.

(H) The notional amount represents the total unpaid principal balance of the mortgage loans on which Newcastle is entitled to receive 65% of the excess mortgage servicing amount on performing loans.

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**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 March 31, 2012:

	Principal Balance or Notional Amount	Carrying Value	Fair Value			Total
			Level 2	Level 3A	Level 3B	
<b>Assets:</b>						
Real estate securities, available-for-sale:						
CMBS	\$ 1,502,244	\$ 1,187,445	\$ —	\$ 1,008,497	\$ 178,948	\$ 1,187,445
REIT debt	120,288	122,857	122,857	—	—	122,857
ABS - subprime	255,524	132,033	—	62,231	69,802	132,033
ABS - other real estate	51,741	37,051	—	30,950	6,101	37,051
FNMA / FHLMC	226,808	240,624	240,624	—	—	240,624
CDO	206,323	64,879	—	60,901	3,978	64,879
Real estate securities total	\$ 2,362,928	\$ 1,784,889	\$ 363,481	\$ 1,162,579	\$ 258,829	\$ 1,784,889
Investments in Excess MSR(1)	\$ 9,434,272	\$ 42,587	\$ —	\$ —	\$ 42,587	\$ 42,587
Derivative assets:						
Interest rate caps, treated as hedges	\$ 122,755	\$ 1,029	\$ 1,029	\$ —	\$ —	\$ 1,029
Interest rate caps, not treated as hedges	42,428	803	803	—	—	803
Derivative assets total	\$ 165,183	\$ 1,832	\$ 1,832	\$ —	\$ —	\$ 1,832
<b>Liabilities:</b>						
Derivative Liabilities:						
Interest rate swaps, treated as hedges	\$ 832,767	\$ 81,618	\$ 81,618	\$ —	\$ —	\$ 81,618
Interest rate swaps, not treated as hedges	306,077	27,156	27,156	—	—	27,156
Derivative liabilities total	\$ 1,138,844	\$ 108,774	\$ 108,774	\$ —	\$ —	\$ 108,774

(1) The notional amount represents the total unpaid principal balance of the mortgage loans on which Newcastle is entitled to receive 65% of the excess mortgage servicing amount on performing loans.

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Newcastle's investments in instruments (excluding the Excess MSRs, see below) measured at fair value on a recurring basis using Level 3 inputs changed during the three months ended March 31, 2012 as follows:

	Level 3A					
	CMBS		ABS		Equity/Other	Total
	Conduit	Other	Subprime	Other	Securities	
Balance at December 31, 2011	\$ 816,283	\$ 132,435	\$ 66,141	\$ 31,188	\$ 52,047	\$ 1,098,094
Transfers (A)						
Transfers from Level 3B	6,056	—	—	—	—	6,056
Transfers into Level 3B	—	(14,105)	(11,057)	—	—	(25,162)
Total gains (losses) (B)						
Included in net income (C)	(1)	—	—	—	—	(1)
Included in other comprehensive income (loss)	62,865	3,324	870	1,087	8,173	76,319
Amortization included in interest income	7,882	331	1,122	(83)	1,194	10,446
Purchases, sales and settlements						
Purchases	6,007	—	8,682	—	—	14,689
Proceeds from sales	—	—	—	—	—	—
Proceeds from repayments	(11,965)	(615)	(3,527)	(1,242)	(513)	(17,862)
Balance at March 31, 2012	\$ 887,127	\$ 121,370	\$ 62,231	\$ 30,950	\$ 60,901	\$ 1,162,579

	Level 3B					
	CMBS		ABS		Equity/Other	Total
	Conduit	Other	Subprime	Other	Securities	
Balance at December 31, 2011	\$ 140,622	\$ 39,478	\$ 62,481	\$ 6,919	\$ 3,939	\$ 253,439
Transfers (A)						
Transfers from Level 3A	—	14,105	11,057	—	—	25,162
Transfers into Level 3A	(6,056)	—	—	—	—	(6,056)
Total gains (losses) (B)						
Included in net income (C)	3,634	(329)	1,187	(5)	—	4,487
Included in other comprehensive income (loss)	(8,592)	788	(1,265)	(749)	1	(9,817)
Amortization included in interest income	3,030	157	1,854	79	103	5,223
Purchases, sales and settlements						
Purchases	—	—	—	—	—	—
Proceeds from sales	(5,418)	—	(2,215)	—	—	(7,633)
Proceeds from repayments	(2,750)	279	(3,297)	(143)	(65)	(5,976)
Balance at March 31, 2012	\$ 124,470	\$ 54,478	\$ 69,802	\$ 6,101	\$ 3,978	\$ 258,829

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

(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 date.

(C) These gains (losses) are recorded in the following line items in the consolidated statements of income:

	Three Months Ended March 31, 2012	
	Level 3 A	Level 3 B
Gain (loss) on settlement of investments, net	\$ —	\$ 6,437
Other income (loss), net	—	—
OTTI	(1)	(1,950)
Total	\$ (1)	\$ 4,487
Gain (loss) on settlement of investments, net, from investments transferred into Level 3 during the period	\$ —	\$ —

**NEWCASTLE INVESTMENT CORP. AND SUBSIDIARIES**

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**Securities Valuation**

As of March 31, 2012, Newcastle's securities valuation methodology and results are further detailed as follows:

Asset Type	Outstanding Face Amount (A)	Amortized Cost Basis (B)	Fair Value			
			Multiple Quotes (C)	Single Quote (D)	Internal Pricing Models (E)	Total
CMBS	\$ 1,502,244	\$ 1,124,688	\$ 847,838	\$ 160,659	\$ 178,948	\$ 1,187,445
REIT debt	120,288	119,552	77,512	45,345	—	122,857
ABS - subprime	255,524	126,828	44,878	17,353	69,802	132,033
ABS - other real estate	51,741	38,526	30,329	621	6,101	37,051
FNMA / FHLMC	226,808	237,607	153,103	87,521	—	240,624
CDO	206,323	68,343	2,750	58,151	3,978	64,879
<b>Total</b>	<b>\$ 2,362,928</b>	<b>\$ 1,715,544</b>	<b>\$ 1,156,410</b>	<b>\$ 369,650</b>	<b>\$ 258,829</b>	<b>\$ 1,784,889</b>

- (A) Net of incurred losses
- (B) Net of discounts (or gross of premiums) and after OTTI, including impairment taken during the period ended March 31, 2012.
- (C) 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. 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. 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.
- (D) Management was unable to obtain quotations from more than one source on these securities. The one source was generally the seller (the party that sold us the security) or a pricing service.
- (E) Securities whose fair value was estimated based on internal pricing models are further detailed as follows:

	Amortized Cost Basis (B)	Fair Value	Impairment Recorded In Current Period	Unrealized Gains (Losses) in Accumulated OCI	Assumption Ranges			
					Discount Rate	Prepayment Speed (F)	Default Rate	Loss Severity
CMBS - Conduit	\$ 107,431	\$ 124,470	\$ 1,471	\$ 17,039	12%	N/A	5%-100%	16%-100%
CMBS - Large loan / single borrower	56,728	54,478	—	(2,250)	1%-12%	N/A	0%-100%	0%-100%
ABS - subprime	61,006	69,802	479	8,796	8%	0%-11%	24%-87%	60%-100%
ABS - other RE	8,641	6,101	—	(2,540)	8%	1%-4%	33%-63%	79%-95%
CDO	4,261	3,978	—	(283)	14%	4%	17%	83%
<b>Total</b>	<b>\$ 238,067</b>	<b>\$ 258,829</b>	<b>\$ 1,950</b>	<b>\$ 20,762</b>				

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.

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.

- (F) Projected annualized average prepayment rate.

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**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 March 31, 2012:

Loan Type	Outstanding Face Amount	Carrying Value	Fair Value	Valuation Allowance/ (Reversal) In Current Year	Significant Input Ranges	
					Discount Rate	Loss Severity
Mezzanine	\$ 584,234	\$ 462,197	\$ 468,556	\$ (733)	8.0% -15.0%	0.0% - 100.0%
Bank Loan	295,638	183,526	183,660	(11,299)	8.4% - 24.9%	0.0% - 70.0%
B-Note	187,017	162,635	162,635	1,550	6.3% - 15.0%	0.0%
Whole Loan	30,460	30,460	30,478	—	5.1% - 7.1%	0.0% - 15.0%
Total Real Estate Related Loans Held-for-Sale, Net	<u>\$ 1,097,349</u>	<u>\$ 838,818</u>	<u>\$ 845,329</u>	<u>\$ (10,482)</u>		

Loan Type	Outstanding Face Amount	Carrying Value	Fair Value	Valuation Allowance/ (Reversal) In Current Year	Significant Input Ranges			
					Discount Rate	Prepayment Speed	Default Rate	Loss Severity
Non-securitized Manufactured Housing Loans Portfolio I	\$ 711	\$ 193	\$ 193	\$ 5	39.1%	0.0%	52.9%	75.0%
Non-securitized Manufactured Housing Loans Portfolio II	3,985	2,582	2,582	(202)	15.5%	5.0%	6.6%	80.0%
Total Residential Mortgage Loans Held-for-Sale, Net	<u>\$ 4,696</u>	<u>\$ 2,775</u>	<u>\$ 2,775</u>	<u>\$ (197)</u>				

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 March 31, 2012:

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 Portfolio I	\$ 130,488	\$ 108,839	\$ 109,875	\$ 680	9.5%	3.0%	4.0%	75.0%
Securitized Manufactured Housing Loans Portfolio II	171,858	168,837	165,691	1,069	7.6%	5.0%	3.5%	80.0%
Residential Loans	59,419	43,671	44,616	(101)	4.7%-7.8%	0.0%-5.0%	0.0%-3.0%	0.0%-50.0%
Total Residential Mortgage Loans, Held-for-Investment, Net	<u>\$ 361,765</u>	<u>\$ 321,347</u>	<u>\$ 320,182</u>	<u>\$ 1,648</u>				

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***Excess MSRs Valuation***

Fair value estimates of Newcastle’s Excess MSRs were based on internal pricing models. Significant inputs used in the valuations included expectations of prepayment rates, delinquencies, default rates and recapture rates of the underlying mortgage loans, and discount rates that market participants would use in determining the fair values of servicing assets on similar pools of residential mortgage loans. In addition, in valuing the Excess MSRs, management considered the likelihood of Nationstar being removed as servicer, which likelihood is considered to be remote.

The following table summarizes certain information regarding the inputs used in valuing the Excess MSRs as of March 31, 2012:

	Significant Input Ranges				
	Prepayment Rate (A)	Delinquency Rate (B)	Recapture Rate (C)	Excess Mortgage Servicing Amount (D)	Discount Rate
Portfolio I	20.0%	10.0%	35.0%	29 bps	20.0%
Portfolio I - Recapture Agreement	8.0%	10.0%	35.0%	21 bps	20.0%

- (A) Projected annualized weighted average lifetime voluntary and involuntary prepayment rate using a prepayment vector.
- (B) Projected percentage of mortgage loans in the pool that will miss their mortgage payments.
- (C) Percentage of voluntarily prepaid loans that are expected to be refinanced by Nationstar.
- (D) Weighted average mortgage servicing amount in excess of the base mortgage servicing fee.

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. Prepayment rates are in the form of “curves” or “vectors” that vary over the expected life of the pool. Newcastle uses assumptions that generate its best estimate of future cash flows for each Excess MSR investment.

The prepayment vector specifies the percentage of the collateral balance that is expected to voluntarily and involuntarily (i.e. default) pay off at each point in the future. The prepayment vector is based on projections that consider factors such as the underlying borrower’s FICO score, loan-to-value ratio, debt-to-income ratio, vintage on a loan level basis, as well as the potential effect on loans eligible for the Home Affordable Refinance Program 2.0 (“HARP 2.0”). This vector is scaled up or down to match recent collateral-specific prepayment experience, as obtained from remittance reports, market data services and other market factors.

Delinquency rates are based on recent pool-specific experience of loans that misled their most recent mortgage payments, with additional consideration given to the current “pipeline” of loans that are 30 days or more delinquent, in foreclosure, or are real estate owned (REO).

Recapture rates are based on recent actual average recapture rates experienced by Nationstar on similar GSE mortgage loan pools.

For existing mortgage pools, excess mortgage servicing amount projections are based on actual mortgage servicing amount. For loans that are yet to be refinanced by Nationstar, Newcastle considers the excess mortgage servicing amount on loans recently originated by Nationstar and generally assumes lower excess mortgage servicing amount than the historic experience.

The discount rates Newcastle uses are derived from a range of observable pricing on mortgage servicing assets backed by similar collateral.

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Newcastle's MSR investments measured at fair value on a recurring basis using Level 3B inputs changed during the period ended March 31, 2012 as follows:

	Level 3B		
	Portfolio I	Portfolio I - Recapture Agreement	Total
Balance at December 31, 2011	\$ 37,637	\$ 6,334	\$ 43,971
Transfers (A)			
Transfers from Level 3	—	—	—
Transfers into Level 3	—	—	—
Total gains (losses)			
Included in net income (B)	1,215	1	1,216
Amortization included in interest income	2,037	—	2,037
Purchases, sales and settlements			
Purchase adjustments	(150)	(28)	(178)
Proceeds from sales	—	—	—
Proceeds from repayments	(4,459)	—	(4,459)
Balance at March 31, 2012	<u>\$ 36,280</u>	<u>\$ 6,307</u>	<u>\$ 42,587</u>

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

(B) The gains (losses) recorded in earnings during the period are attributable to the change in unrealized gains (losses) relating to Level 3 assets still held at the reporting dates. These gains(losses) are recorded in "Other Income (Loss)" in the consolidated statement of income.

Newcastle has various processes and controls in place to ensure that fair value is reasonably estimated. With respect to the broker and pricing service quotations, to ensure these quotes represent a reasonable estimate of fair value, Newcastle's quarterly procedures include a comparison to the outputs generated from its internal pricing models and transactions Newcastle has completed with respect to these securities, as well as on its knowledge and experience of these markets. With respect to fair value estimates generated based on Newcastle's internal pricing models, Newcastle's management validates the inputs and outputs of the internal pricing models by comparing them to available independent third party market parameters and models for reasonableness. Newcastle believes its valuation methods and the assumptions used are appropriate and consistent with other market participants.

Fair value measurements categorized within Level 3 are sensitive to changes in the assumptions or methodology used to determine fair value and such changes could result in a significant increase or decrease in the fair value. For Newcastle's investments in real estate securities, real estate related loans and residential mortgage loans categorized within Level 3 of the fair value hierarchy, the significant unobservable inputs include the discount rates, assumptions relating to prepayments, default rates and loss severities. Significant increases (decreases) in any of the discount rates, default rates or loss severities in isolation would result in a significantly lower (higher) fair value measurement. The impact of changes in prepayment speeds would have differing impacts on fair value, depending on the seniority of the investment. Generally, a change in the default assumption is generally accompanied by directionally similar changes in the assumptions used for the loss severity and the prepayment speed. For Newcastle's investments in Excess MSRs, significant unobservable inputs include the discount rate, assumptions relating to prepayments, default rates, delinquency rates, recapture rates and excess mortgage servicing amount. Significant increases (decreases) in the discount rates, prepayments, default rates or delinquency rates in isolation would result in a significantly lower (higher) fair value measurement, whereas significant increases (decreases) in the recapture rates or excess mortgage servicing amount in isolation would result in a significantly higher (lower) fair value measurement. Generally, a change in the default assumption is accompanied by directionally similar changes in the assumptions used for the loss severity and the prepayment speed.



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**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	
		March 31, 2012	December 31, 2011
<b>Derivative Assets</b>			
Interest rate caps, designated as hedges	Derivative Assets	\$ 1,029	\$ 1,092
Interest rate caps, not designated as hedges	Derivative Assets	803	862
		<u>\$ 1,832</u>	<u>\$ 1,954</u>
<b>Derivative Liabilities</b>			
Interest rate swaps, designated as hedges	Derivative Liabilities	\$ 81,618	\$ 90,025
Interest rate swaps, not designated as hedges	Derivative Liabilities	27,156	29,295
		<u>\$ 108,774</u>	<u>\$ 119,320</u>

The following table summarizes information related to derivatives:

	March 31, 2012	December 31, 2011
<b>Cash flow hedges</b>		
Notional amount of interest rate swap agreements	\$ 832,767	\$ 848,434
Notional amount of interest rate cap agreements	122,755	104,205
Amount of (loss) recognized in OCI on effective portion	(61,763)	(69,908)
Deferred hedge gain (loss) related to anticipated financings, which have subsequently occurred, net of amortization	284	299
Deferred hedge gain (loss) related to dedesignation, net of amortization	(1,059)	(893)
Expected reclassification of deferred hedges from AOCI into earnings over the next 12 months	1,745	1,688
Expected reclassification of current hedges from AOCI into earnings over the next 12 months	(33,762)	(35,348)
<b>Non-hedge Derivatives</b>		
Notional amount of interest rate swap agreements	306,077	316,600
Notional amount of interest rate cap agreements	42,428	36,428

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

	Income statement location	Three Months Ended March 31,	
		2012	2011
<b>Cash flow hedges</b>			
Gain (loss) on the ineffective portion	Other income (loss)	\$ 30	\$ 283
Gain (loss) immediately recognized at dedesignation	Gain (loss) on sale of investments; Other income (loss)	(276)	(5,315)
Amount of gain (loss) reclassified from AOCI into income, related to effective portion	Interest expense	(10,646)	(21,191)
Deferred hedge gain reclassified from AOCI into income, related to anticipated financings	Interest expense	15	14
Deferred hedge gain (loss) reclassified from AOCI into income, related to effective portion of dedesignated hedges	Interest expense	442	719
Non-hedge derivatives gain (loss)	Other income (loss)	2,056	4,831

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***Liabilities for Which Fair Value is Only Disclosed***

The following table summarizes the level of the fair value hierarchy, valuation techniques and inputs used for estimating each class of liabilities not measured at fair value in the statement of financial position but for which fair value is disclosed:

<b>Type of Liabilities Not Measured At Fair Value for Which Fair Value Is Disclosed</b>	<b>Fair Value Hierarchy</b>	<b>Valuation Techniques and Significant Inputs</b>
CDO bonds payable	Level 3	Valuation technique is based on discounted cash flow.  Significant inputs include: <ul style="list-style-type: none"> <li>• Underlying security and loan prepayment, default and cumulative loss expectations</li> <li>• Amount and timing of expected future cash flows</li> <li>• Market yields and credit spreads implied by comparisons to transactions of similar tranches of CDO debt by the varying levels of subordination</li> </ul>
Other bonds and notes payable	Level 3	Valuation technique is based on discounted cash flow.  Significant inputs include: <ul style="list-style-type: none"> <li>• Amount and timing of expected future cash flows</li> <li>• Interest rates</li> <li>• Broker quotation</li> <li>• Market yields and credit spreads implied by comparisons to transactions of similar tranches of securitized debt by the varying levels of subordination</li> </ul>
Repurchase agreements	Level 2	Valuation technique is based on market comparables.  Significant inputs include: <ul style="list-style-type: none"> <li>• Amount and timing of expected future cash flows</li> <li>• Interest rates</li> <li>• Collateral funding spreads</li> </ul>
Junior subordinated notes payable	Level 3	Valuation technique is based on discounted cash flow.  Significant inputs include: <ul style="list-style-type: none"> <li>• Amount and timing of expected future cash flows</li> <li>• Interest rates</li> <li>• Market yields and the credit spread of Newcastle</li> </ul>

**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 months ended March 31, 2012 and 2011, based on the treasury stock method, Newcastle had 489,093 and 8,886 dilutive common stock equivalents, respectively, resulting from its outstanding options. Net income available for common stockholders is equal to net income less preferred dividends.

In April 2012, Newcastle issued 18,975,000 shares of its common stock in a public offering at a price to the public of \$6.22 per share for net proceeds of approximately \$115.2 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 1,897,500 shares of Newcastle’s common stock at the public offering price, which had a fair value of approximately \$5.6 million as of the grant date. The assumptions used in valuing the options were: a 1.3% risk-free rate, a 12.9% dividend yield, 149.4% volatility and a 4.7 year expected term.

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As of March 31, 2012, 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	16,000
Total	<u>6,813,109</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, individually and in the aggregate, that existed at March 31, 2012, 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 March 31, 2012, Newcastle has recorded \$121.7 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.

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

These items are comprised of the following:

	Three Months Ended March 31,	
	2012	2011
Gain (loss) on settlement of investments, net		
Gain on settlement of real estate securities	\$ 6,772	\$ 34,157
Loss on settlement of real estate securities	(335)	(1,785)
Gain on repayment/disposition of loans held-for-sale	—	1,720
Loss on repayment /disposition of loans held-for sale	(1,614)	—
	<u>\$ 4,823</u>	<u>\$ 34,092</u>
Other income (loss), net		
Gain (loss) on non-hedge derivative instruments	\$ 2,056	\$ 4,831
Unrealized (loss) recognized at de-designation of hedges	(276)	(5,315)
Increase in fair value of investments in excess mortgage servicing rights	1,216	—
Hedge ineffectiveness	30	283
Collateral management fee income, net	513	536
Other income (loss)	647	—
	<u>\$ 4,186</u>	<u>\$ 335</u>

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**10. 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:

	Three Months Ended March 31,	
	2012	2011
Restricted cash generated from sale of securities	\$ 13,965	\$ 61,052
Restricted cash generated from paydowns on securities and loans	\$ 60,466	\$ 211,786
Restricted cash used for purchases of real estate securities	\$ 14,689	\$ 126,163
Restricted cash used for purchases of real estate related loans	\$ 45,481	\$ 111,667
Restricted cash used for repayments of CDO bonds payable	\$ 7,710	\$ 54,104
Restricted cash used for repurchases of derivative instruments	\$ 168	\$ —

**11. RECENT ACTIVITIES**

These financial statements include a discussion of material events that have occurred subsequent to March 31, 2012 (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.

On March 6, 2012, Newcastle entered into definitive agreements to acquire an investment in Excess MSRs in connection with Nationstar's acquisition of mortgage servicing assets from Aurora Bank FSB, a subsidiary of Lehman Brothers Bancorp Inc. Newcastle expects to invest approximately \$170 million to acquire an approximately 65% interest in the Excess MSRs on a portfolio of residential mortgage loans with an outstanding principal balance of approximately \$63 billion, comprised of approximately 75% non-conforming loans in private label securitizations and approximately 25% conforming loans in GSE pools. Nationstar will co-invest pari passu with Newcastle in approximately 35% of the Excess MSRs and will be the servicer of the loans performing all servicing and advancing functions, and retaining the ancillary income, servicing obligations and liabilities as the servicer. Under the terms of this investment, to the extent that any loans in the portfolio are refinanced by Nationstar, the resulting Excess MSRs will be shared pro rata by Newcastle and Nationstar, subject to certain limitations. The investment is expected to close in the second quarter of 2012 and is subject to regulatory and third-party approvals.

In March 2012, Newcastle repurchased \$30.0 million face amount of Newcastle CDO bonds for \$9.2 million. As a result, Newcastle extinguished \$30.0 million of CDO debt and recorded a gain on extinguishment of debt of \$20.7 million in the first quarter of 2012.

See Note 7 regarding the public offering of Newcastle's common stock in April 2012.

**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, excess mortgage servicing rights (“Excess MSRs”) 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, and other real estate debt investments such as Excess MSRs. 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 March 31, 2012, 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 volatile in recent months. 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 (“non-recourse CDOs”), (ii) unlevered investments in deconsolidated Newcastle CDO debt (“unlevered CDOs”), (iii) unlevered Excess MSRs, (iv) investments financed with other non-recourse debt (“non-recourse other”), (v) investments and debt repurchases financed with recourse debt (“recourse”), (vi) other unlevered investments (“unlevered other”) and (vii) corporate. With respect to the non-recourse CDOs and non-recourse other segments, Newcastle is generally entitled to receive net cash flows from these structures on a periodic basis. Revenues attributable to each segment, as restated for previously reported periods, are disclosed below (in thousands).

For the Three Months Ended March 31,	Non-Recourse CDOs	Unlevered CDOs	Unlevered Excess MSRs	Non-Recourse Other	Recourse	Unlevered Other	Corporate	Inter-segment Elimination	Total
2012	\$ 54,402	\$ 115	\$ 2,037	\$ 18,426	\$ 814	\$ 523	\$ 51	\$ (1,469)	\$ 74,899
2011	\$ 54,828	\$ 11	\$ —	\$ 17,481	\$ 147	\$ 482	\$ 20	\$ (766)	\$ 72,203

## 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 since the third quarter of 2011, reflecting the 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 were reversed and resulted in net unrealized losses in the second half of 2011. Market conditions improved moderately in the first quarter of 2012 but remain challenging and could change rapidly. 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 several 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.

We believe that the current environment has created an attractive opportunity to invest in MSRs. Specifically:

- changes in the regulatory treatment of MSRs for financial institutions subject to Basel III, a revision to the global regulatory capital and liquidity framework for banks, which will impose increased regulatory capital costs on banks for owning MSRs;
- elevated borrower delinquencies and defaults experienced over the last few years, and increased regulatory oversight, has led to substantially higher costs for mortgage servicers and negatively impacted their profitability; and
- mortgage servicing has become less attractive to many financial institutions due to increasingly negative publicity and heightened government and regulatory scrutiny.

These dynamics resulted in a pipeline of MSRs for sale by banks to non-bank servicers, as these institutions are under pressure to exit or reduce their exposure to the mortgage servicing business. As a result, we believe that this relative oversupply of MSRs, combined with a historically low interest rate environment and a challenging credit market, have contributed to an availability of MSRs that are attractively priced. We closed on our first investment in Excess MSRs in December 2011 and are exploring opportunities to acquire additional Excess MSRs that provide attractive risk-adjusted returns.

### *Liquidity*

Credit and liquidity conditions improved during 2010 and 2011, and the early part of 2012 relative to the conditions experienced during the recent financial crisis. That said, the challenging credit and liquidity conditions that we experienced during the financial crisis continue to adversely affect us and the markets in which we operate in a number of ways. For example, these conditions 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; and
- 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).

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 April 30, 2012. We declared a quarterly dividend of \$0.20 per common share for the first quarter of 2012, which was paid in April 2012. 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. Currently, 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 are consolidated. However, we completed two securitization transactions to refinance our Manufactured Housing Loan Portfolios I and II. We analyzed the securitizations under the applicable accounting guidance and concluded that the securitization transactions should be accounted for as secured borrowings. As a result, we continue to recognize the portfolios 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 secured borrowings.

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.

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 March 31, 2012, 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 March 31, 2012.

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 \$1.5 billion carrying value of securities valued using quotations



as of March 31, 2012, a 100 basis point change in credit spreads would impact estimated fair value by approximately \$60.2 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 three months of 2012, the inputs to our models, including discount rates, 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.

For CMBS and ABS securities valued with internal models, which have an aggregate fair value of \$254.9 million as of March 31, 2012, 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	\$ 342,885	\$ 176,301
Fair value	\$ 178,948	\$ 75,903
Effect on fair value with 10% unfavorable change in:		
Discount rate	\$ (4,586)	\$ (2,562)
Prepayment rate	N/A	\$ (577)
Default rate	\$ (8,421)	\$ (4,394)
Loss severity	\$ (5,400)	\$ (7,527)

This 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 March 31, 2012, we had 26 securities, with a carrying amount of \$146.5 million, that had been downgraded during the three months ended March 31, 2012, and recorded a net other-than-temporary impairment charge of \$1.3 million on these securities in 2012. 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.

#### *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 Investments in Excess Mortgage Servicing Rights*

Investments in Excess MSR are aggregated into pools as applicable; each pool of Excess MSR is accounted for in the aggregate. Interest income for Excess MSR is accreted on an effective yield or “interest” method, based upon the expected excess servicing income through the expected life of the underlying mortgages. Changes to expected cash flows result in a cumulative retrospective adjustment, which will be recorded in the period in which the change in expected cash flows occurs. Under the retrospective method, the interest income recognized for a reporting period would be measured as the difference between the amortized cost basis at the end of the period and the amortized cost basis at the beginning of the period, plus any cash received during the period. The amortized cost basis is calculated as the present value of estimated future cash flows using an effective yield, which is the yield that equates all past actual and current estimated future cash flows to the initial investment. In addition, our policy is to recognize interest income only on Excess MSR in existing eligible underlying mortgages. The difference between the fair value of Excess MSR and their amortized cost basis is recorded as “Other Income” or “Other Losses”, as applicable. Fair value is generally determined by discounting the expected future cash flows using discount rates that incorporate the market risks and liquidity premium specific to the Excess MSR, and therefore may differ from their effective yields.

The following tables summarize the estimated change in fair value of the Excess MSR as of March 31, 2012 given several parallel shifts in the discount rate, prepayment rate, delinquency rate and recapture rate (dollars in thousands):

Fair value at March 31, 2012	\$ 42,587			
<u>Discount rate shift in %</u>	<u>-20%</u>	<u>-10%</u>	<u>+10%</u>	<u>+20%</u>
Estimated fair value	\$ 47,020	\$ 44,668	\$ 40,733	\$ 39,072
Change in estimated fair value:				
Amount	\$ 4,433	\$ 2,081	\$ (1,854)	\$ (3,515)
%	10.4%	4.9%	-4.4%	-8.3%
<u>Prepayment rate shift in %</u>	<u>-20%</u>	<u>-10%</u>	<u>+10%</u>	<u>+20%</u>
Estimated fair value	\$ 47,111	\$ 44,762	\$ 40,568	\$ 38,690
Change in estimated fair value:				
Amount	\$ 4,524	\$ 2,175	\$ (2,019)	\$ (3,897)
%	10.6%	5.1%	-4.7%	-9.2%
<u>Delinquency rate shift in %</u>	<u>-20%</u>	<u>-10%</u>	<u>+10%</u>	<u>+20%</u>
Estimated fair value	\$ 43,727	\$ 43,157	\$ 42,017	\$ 41,447
Change in estimated fair value:				
Amount	\$ 1,140	\$ 570	\$ (570)	\$ (1,140)
%	2.7%	1.3%	-1.3%	-2.7%
<u>Recapture rate shift in %</u>	<u>-20%</u>	<u>-10%</u>	<u>+10%</u>	<u>+20%</u>
Estimated fair value	\$ 41,351	\$ 41,966	\$ 43,176	\$ 43,723
Change in estimated fair value:				
Amount	\$ (1,236)	\$ (621)	\$ 589	\$ 1,136
%	-2.9%	-1.5%	1.4%	2.7%

This 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.

### 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.

### Recent Accounting Pronouncements

In May 2011, the FASB issued new guidance regarding the measurement and disclosure of fair value, which become effective for Newcastle on January 1, 2012. The adoption of this guidance did not have a material effect on Newcastle's financial position, liquidity, or results of operations.

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. We early-adopted this accounting standard in 2011 and opted to present two separate statements.

The FASB has recently issued or discussed a number of proposed standards on such topics as consolidation, the definition of an investment company, 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.

### RESULTS OF OPERATIONS

The following table summarizes the changes in our results of operations for the three months ended March 31, 2012 compared to the three months ended March 31, 2011 (dollars in thousands):

	Three Months Ended March 31,		Increase (Decrease)	
	2012	2011	Amount	%
Interest income	\$ 74,899	\$ 72,203	\$ 2,696	3.7%
Interest expense	30,165	38,165	(8,000)	(21.0%)
Net interest income	44,734	34,038	10,696	31.4%
<b>Impairment (Reversal)</b>				
Valuation allowance (reversal) on loans	(9,031)	(41,307)	32,276	78.1%
Other-than-temporary impairment on securities, net	1,951	4,101	(2,150)	(52.4%)
	(7,080)	(37,206)	30,126	81.0%
Net interest income (loss) after impairment/reversal	51,814	71,244	(19,430)	(27.3%)
<b>Other Income (Loss)</b>				
Gain (loss) on settlement of investments, net	4,823	34,092	(29,269)	(85.9%)
Gain on extinguishment of debt	20,743	11,042	9,701	87.9%
Other income (loss), net	4,186	335	3,851	1149.6%
	29,752	45,469	(15,717)	(34.6%)
<b>Expenses</b>				
Loan and security servicing expense	1,098	1,060	38	3.6%
General and administrative expense	2,285	1,601	684	42.7%
Management fee to affiliate	4,976	4,189	787	18.8%
	8,359	6,850	1,509	22.0%
Income (loss) from continuing operations	\$ 73,207	\$ 109,863	\$ (36,656)	(33.4%)

**Interest Income**

*Three months ended March 31, 2012 compared to the three months ended March 31, 2011*

Interest income increased by \$2.7 million during the three months ended March 31, 2012 compared to the three months ended March 31, 2011 primarily due to a \$7.8 million increase in interest income as a result of new investments made, partially offset by a \$5.1 million decrease in interest income as a result of the deconsolidation of CDO V in June 2011, paydowns and changes in interest rates.

**Interest Expense**

*Three Months ended March 31, 2012 compared to the three months ended March 31, 2011*

Interest expense decreased by \$8.0 million primarily due to (i) a \$1.6 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 \$7.0 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. The decreases described in (i) to (ii) 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.

**Valuation Allowance on Loans**

*Three Months ended March 31, 2012 compared to the three months ended March 31, 2011*

The valuation allowance (reversal) on loans changed by \$32.3 million primarily due to (i) a \$31.1 million larger net increase in fair values of our real estate related loans during the three months ended March 31, 2011 compared to the three months ended March 31, 2012 as a result of market conditions improving more in the 2011 period than in the 2012 period and (ii) a \$1.2 million larger net reversal of valuation allowance on our manufactured housing loans and residential mortgage loans in the 2011 period than in the 2012 period due to the reclassification of our manufactured housing loan portfolio II and residential mortgage loans from held-for-sale to held-for-investment in May 2011 and September 2011, respectively. This change in fair values and the reclassification impacted the amount of valuation allowance we were able to reverse during those periods.

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 March 31, 2012 compared to the three months ended March 31, 2011*

The other-than-temporary impairment on securities decreased by \$2.2 million primarily due to improved market conditions. We recorded an impairment charge of \$1.9 million on 5 securities during the quarter ended March 31, 2012, compared to an impairment charge of \$4.1 million on 7 securities during the quarter ended March 31, 2011.

**Gain (Loss) on Settlement of Investments, Net**

*Three months ended March 31, 2012 compared to the three months ended March 31, 2011*

The net gain on settlement of investments decreased by \$29.3 million as a result of the decreased volume of sales at a gain and repayments of investments. We recorded a net gain of \$4.8 million on 10 securities and loans that were sold or paid off during the quarter ended March 31, 2012, compared to a net gain of \$34.1 million on 37 securities and loans that were sold or paid off during the quarter ended March 31, 2011.

## **Gain (Loss) on Extinguishment of Debt**

*Three months ended March 31, 2012 compared to the three months ended March 31, 2011*

The gain on extinguishment of debt increased by \$9.7 million due to a higher face amount, somewhat offset by a higher average price of debt, repurchased in the three months ended March 31, 2012 compared to the three months ended March 31, 2011. We repurchased \$30.0 million face amount of our own CDO debt at an average price of 30.5% of par during the three months ended March 31, 2012 compared to \$12.1 million face amount of CDO bonds repurchased at an average price of 8.9% of par during the three months ended March 31, 2011.

## **Other Income (Loss), Net**

*Three months ended March 31, 2012 compared to the three months ended March 31, 2011*

Other income increased by \$3.9 million primarily due to (i) a \$5.0 million decrease in unrealized losses recognized on certain interest rate swap agreements in the quarter ended March 31, 2012 compared to the quarter ended March 31, 2011 as these interest rate swap agreements were de-designated as accounting hedges during the quarter ended March 31, 2011 since the hedged items were considered not probable of occurring, (ii) a \$1.2 million increase in the fair value of our investments in Excess MSRs, (iii) a \$0.6 million increase in other income related to pay down of certain loans, offset by (iv) a \$2.9 million decrease in other income on certain non-hedge interest rate swap agreements due to a smaller net increase in fair value as a result of changes in interest rates in the quarter ended March 31, 2012 compared to the quarter ended March 31, 2011.

## **Loan and Security Servicing Expense**

Loan and security servicing expense remained relatively stable during the three months ended March 31, 2012 compared to the three months ended March 31, 2011.

## **General and Administrative Expense**

*Three months ended March 31, 2012 compared to the three months ended March 31, 2011*

General and administrative expense increased by \$0.7 million primarily due to an increase in professional fees.

## **Management Fee to Affiliate**

*Three months ended March 31, 2012 compared to the three months ended March 31, 2011*

Management fees increased by \$0.8 million primarily due to an increase in gross equity as a result of our public offerings of common stock in March and September of 2011.

## **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 a portion of this requirement may be able to 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, depositary 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. Our junior subordinated notes payable are long-term obligations. With respect to the next twelve months, we expect that our cash on hand combined with our cash flow provided by operations will be sufficient to satisfy our anticipated liquidity needs with respect to our current investment portfolio, including related financings, 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, Capital Resources and Capital Obligations” 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 non-cash gains or losses associated with our early 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 April 2012, we raised approximately \$115.2 million through a public offering of our common shares.

Certain details regarding our liquidity, current financings and capital obligations as of May 8, 2012 are set forth below:

- *Cash* – We had a total of \$276.3 million of cash, comprised of \$220.7 million of unrestricted cash (of which approximately \$170 million was committed for the purchase of an Excess MSR investment, see Note 11 to our consolidated financial statements) and \$55.6 million of restricted cash available for reinvestment in our CDOs;
- *Margin Exposure and Recourse Financings* – We have margin exposure on a \$7.5 million repurchase agreement related to the financing of the Newcastle Class-I MM notes (of which only \$1.9 million is recourse) and a \$224.1 million repurchase agreement related to the financing of FNMA/FHLMC securities.

The following table compares our recourse financings excluding the junior subordinated notes (in thousands):

Recourse Financings	May 8, 2012	March 31, 2012	December 31, 2011
CDO Securities	\$ 1,879	\$ 1,881	\$ 2,182
Non-FNMA/FHLMC recourse financings	1,879	1,881	2,182
FNMA/FHLMC securities	224,130	226,199	231,012
Total recourse financings	<u>\$ 226,009</u>	<u>\$ 228,080</u>	<u>\$ 233,194</u>

The non-FNMA/FHLMC recourse financings and the FNMA/FHLMC recourse financing will mature in June 2012 and May 2012, 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.



Investment Portfolio

The following summarizes our consolidated investment portfolio at March 31, 2012 (dollars in millions).

	Outstanding Face Amount	Amortized Cost Basis <sup>(1)</sup>	Percentage of Total Amortized Cost Basis	Carrying Value	Number of Investments	Credit <sup>(2)</sup>	Weighted Average Life (years) <sup>(3)</sup>
<b>Investment <sup>(7)</sup></b>							
<b>I. Real Estate Related Investments</b>							
<b>Commercial</b>							
CMBS	\$ 1,502	\$ 1,125	38.3%	\$ 1,187	196	BB+	4.0
Mezzanine Loans	584	462	15.7%	462	16	73%	2.4
B-Notes	187	163	5.5%	163	6	60%	2.9
Whole Loans	30	30	1.0%	30	3	48%	1.7
CDO Securities <sup>(4)</sup>	87	68	2.3%	65	3	BB+	3.3
Other Investments <sup>(5)</sup>	25	25	0.9%	25	1	—	—
<b>Total Commercial Assets</b>	<b>2,415</b>	<b>1,873</b>	<b>63.7%</b>	<b>1,932</b>			<b>3.4</b>
<b>Residential</b>							
Manufactured Housing and Residential Mortgage Loans	367	318	10.8%	318	9,721	704	6.5
Subprime Securities	255	127	4.3%	132	63	B	7.0
Real Estate ABS	52	38	1.3%	37	13	B+	8.2
	674	483	16.4%	487			6.8
FNMA/FHLMC securities	227	238	8.1%	240	32	AAA	4.6
<b>Total Residential Assets</b>	<b>901</b>	<b>721</b>	<b>24.5%</b>	<b>727</b>			<b>6.3</b>
<b>Corporate</b>							
REIT Debt	120	119	4.1%	123	18	BB+	2.4
Corporate Bank Loans	296	184	6.3%	184	6	CC	2.9
<b>Total Corporate Assets</b>	<b>416</b>	<b>303</b>	<b>10.4%</b>	<b>307</b>			<b>2.8</b>
<b>Total Real Estate Related Investments</b>	<b>3,732</b>	<b>2,897</b>	<b>98.6%</b>	<b>2,966</b>			<b>4.0</b>
<b>II. Excess Mortgage Servicing Rights</b>	<b>43</b>	<b>41</b>	<b>1.4%</b>	<b>43</b>	<b>1</b>	<b>—</b>	<b>6.0</b>
<b>TOTAL / WA</b>	<b>\$ 3,775</b>	<b>\$ 2,938</b>	<b>100.0%</b>	<b>3,009</b>			<b>4.0</b>

Reconciliation to GAAP total assets:

Other assets	
Subprime mortgage loans subject to call option <sup>(6)</sup>	405
Real estate held-for-sale	8
Cash and restricted cash	264
Other	34
<b>GAAP total assets</b>	<b>\$ 3,720</b>

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 ten securities with a zero value, which had an aggregate face amount of \$119 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):

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	57	\$ 289,544	\$ 270,715	24.1%	\$ 253,681	9.1%	17.4%	1.2
2004	BBB-	30	139,645	113,678	10.1%	106,917	2.6%	8.0%	2.7
2005	BBB-	26	300,538	201,303	17.9%	235,815	5.4%	9.1%	3.2
2006	BB	43	399,132	284,463	25.3%	300,808	10.0%	12.0%	4.0
2007	B-	16	121,638	35,523	3.1%	54,311	17.1%	11.0%	4.6
2010	BB+	4	46,798	43,565	3.9%	45,526	0.0%	3.5%	8.6
2011	BBB	20	204,949	175,441	15.6%	190,387	0.0%	7.2%	8.2
Total / WA	BB+	196	\$ 1,502,244	\$ 1,124,688	100.0%	\$ 1,187,445	7.1%	11.1%	4.0

- (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 \$7.0 million of CMBS assets that were on negative watch for possible downgrade by at least one rating agency as of March 31, 2012.  
 (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-	\$ 76,514	\$ 61,420	89.9%	\$ 58,151	51.7%
Newcastle	CMBS	1	BBB-	5,437	4,261	6.2%	3,978	29.7%
Newcastle	ABS	1	CC	5,500	2,662	3.9%	2,750	50.3%
TOTAL/WA		3	BB+	\$ 87,451	\$ 68,343	100.0%	\$ 64,879	50.2%

- (A) Represents non-consolidated CDO securities, excluding ten securities with a zero value, which had an aggregate face amount of \$119 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. We had \$5.4 million of CDO assets that were on negative watch for possible downgrade by at least one rating agency as of March 31, 2012.  
 (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	\$ 584,234	\$ 462,197	70.5%	\$ 462,197	61.4%	72.8%	2.1%
B-Notes	6	187,017	162,635	24.8%	162,635	48.0%	60.3%	28.9%
Whole Loans	3	30,460	30,460	4.7%	30,460	0.0%	48.2%	0.0%
Total/WA	25	\$ 801,711	\$ 655,292	100.0%	\$ 655,292	55.9%	68.9%	8.3%

- (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	702	\$ 131,199	\$ 106,792	33.5%	\$ 106,792	10.4	\$ 327,855	1.0%	8.3%
Manufactured Housing Loans Portfolio II	702	175,843	167,881	52.8%	167,881	12.9	434,743	1.7%	6.5%
Residential Loans Portfolio I	714	55,640	40,108	12.6%	40,108	8.9	646,357	8.8%	0.4%
Residential Loans Portfolio II	737	3,779	3,436	1.1%	3,436	7.5	83,950	0.0%	0.0%
Total / WA	<u>704</u>	<u>\$ 366,461</u>	<u>\$ 318,217</u>	<u>100.0%</u>	<u>\$ 318,217</u>	<u>11.3</u>	<u>\$ 1,492,905</u>	<u>2.5%</u>	<u>6.2%</u>

- (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	\$ 13,774	\$ 6,664	5.3%	\$ 8,202	24.6%	4.1%
2004	BB	8	28,613	15,330	12.1%	15,592	28.4%	3.9%
2005	B-	27	127,300	49,129	38.7%	51,086	31.2%	4.2%
2006	B+	7	56,263	37,317	29.4%	37,503	40.8%	4.5%
2007 and later	CCC	7	29,574	18,388	14.5%	19,650	29.3%	3.5%
Total / WA	<u>B</u>	<u>63</u>	<u>\$ 255,524</u>	<u>\$ 126,828</u>	<u>100.0%</u>	<u>\$ 132,033</u>	<u>32.4%</u>	<u>4.1%</u>

Vintage (B)	Collateral Characteristics				
	Average Loan Age (years)	Collateral Factor (F)	3 month CPR (G)	Delinquency (H)	Cumulative Losses to Date
2003	9.3	0.09	8.7%	17.6%	4.3%
2004	7.8	0.13	11.7%	18.5%	4.6%
2005	6.8	0.18	10.4%	27.1%	11.2%
2006	6.0	0.30	11.9%	24.3%	19.3%
2007 and later	5.5	0.46	10.6%	22.5%	22.0%
Total / WA	<u>6.8</u>	<u>0.23</u>	<u>10.8%</u>	<u>24.5%</u>	<u>13.1%</u>

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	\$ 29,045	\$ 28,173	73.1%	\$ 30,323	42.3%	1.5%
Small Business Loans	CC	6	22,696	10,353	26.9%	6,728	21.8%	0.7%
Total / WA	<u>B+</u>	<u>13</u>	<u>\$ 51,741</u>	<u>\$ 38,526</u>	<u>100.0%</u>	<u>\$ 37,051</u>	<u>33.3%</u>	<u>1.1%</u>

Asset Type	Collateral Characteristics				
	Average Loan Age (years)	Collateral Factor (F)	3 Month CPR (G)	Delinquency (H)	Cumulative Loss to Date
Manufactured Housing	12.5	0.24	5.9%	1.3%	13.5%
Small Business Loans	7.1	0.48	4.8%	24.1%	18.1%
Total / WA	<u>10.1</u>	<u>0.35</u>	<u>5.4%</u>	<u>11.3%</u>	<u>15.5%</u>

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- (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 \$34.1 million of ABS assets that were on negative watch for possible downgrade by at least one rating agency as of March 31, 2012.
- (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).

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	\$ 33,755	28.2%	\$ 36,857
Diversified	CCC+	3	32,181	32,170	26.9%	29,475
Office	BBB-	5	24,117	24,325	20.4%	24,755
Multifamily	BBB	3	12,765	12,788	10.7%	13,561
Healthcare	BBB-	3	16,700	16,514	13.8%	18,209
Total / WA	BB+	18	\$ 120,288	\$ 119,552	100.0%	\$ 122,857

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	\$ 16,421	9.0%	\$ 16,421
Media	CCC-	2	110,279	33,421	18.2%	33,421
Resorts	NR	1	141,449	111,449	60.7%	111,449
Restaurant	B	2	26,099	22,235	12.1%	22,235
Total / WA	CC	6	\$ 295,638	\$ 183,526	100.0%	\$ 183,526

- (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 March 31, 2012.

Excess MSR

Collateral Characteristics:

Portfolio I	Collateral Characteristics												
	Current Carrying Amount	Original Principal Balance	Current Principal Balance	FICO Score	WA Coupon	WA Maturity (months)	Average Loan Age (months)	Uncollected Payments (A)	Delinquency 30+ (A)	1 Month CPR (B)	1 Month CRR (C)	1 Month CDR (D)	Recapture Rate
Original Pool	\$ 36,280	\$ 9,940,385	\$ 9,366,653	693	6.1%	285	63	7.1%	13.1%	12.6%	11.8%	0.9%	33.0%
Recaptured Loans	303	—	67,619	753	4.3%	291	1	0.0%	0.0%	1.1%	1.1%	0.0%	0.0%
Recapture Agreements	6,004	—	—	—	—	—	—	—	—	—	—	—	—
Total/WA	\$ 42,587	\$ 9,940,385	\$ 9,434,272	693	6.0%	285	63	7.1%	13.0%	12.6%	11.7%	0.9%	32.8%

- (A) Uncollected payments represent the percentage of underlying loans that missed their most recent payment and therefore we did not receive our Excess MSR amount. Delinquency 30+ represents the percentage of underlying loans that are delinquent by 30 days or more.
- (B) Constant prepayment rate.
- (C) Voluntary prepayment rate.
- (D) Involuntary prepayment rate.

Debt Obligations

Our debt obligations, as summarized in Note 5 to our consolidated financial statements included herein, existing at March 31, 2012 (gross of \$4.7 million of discounts) had contractual maturities as follows (in thousands):

	Nonrecourse	Recourse	Total
Period from April 1, 2012 through December 31, 2012	\$ 5,644	\$ 228,080	\$ 233,724
2013	—	—	—
2014	—	—	—
2015	—	—	—
2016	—	—	—
2017	—	—	—
Thereafter	2,965,581	51,004	3,016,585
Total	<u>\$ 2,971,225</u>	<u>\$ 279,084</u>	<u>\$ 3,250,309</u>

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 March 31, 2012.

The following table provides additional information regarding short-term borrowings. These short-term borrowings were used to finance certain of our investments in FNMA/FHLMC securities and our investments in certain senior notes issued by Newcastle CDO VI. The FNMA/FHLMC repurchase agreements have full recourse to Newcastle and the CDO VI repurchase agreement has recourse to Newcastle for up to twenty-five percent of the outstanding balance of the repurchase facility, which was approximately \$1.9 million as of March 31, 2012. The weighted average differences between the fair value of the assets and the face amount of available financing for the FNMA/FHLMC repurchase agreements and the CDO VI repurchase agreements were 5% and 50%, respectively, during the three months ended March 31, 2012.

	Outstanding Balance at March 31, 2012	Three Months Ended March 31, 2012		
		Average Daily Amount Outstanding	Maximum Amount Outstanding	Weighted Average Interest Rate
Repurchase agreements	\$ 233,724*	\$ 237,083	\$ 240,036	0.45%

\*Of which only \$228.1 million had recourse to us.

In the first three months of 2012, we purchased \$4.1 million principal balance of FNMA/FHLMC securities (primarily one-year ARMs) for approximately \$4.3 million, using \$0.2 million of unrestricted cash and financed with \$4.1 million of repurchase agreements. These repurchase agreements bear interest at 0.40%, mature in June 2012, and are subject to customary margin provisions.

In the first three months of 2012, we repurchased \$30.0 million face amount of CDO bonds and notes payable for \$9.2 million. As a result, we extinguished \$30.0 million face amount of CDO debt and notes payable and recorded a gain on extinguishment of debt of \$20.7 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 March 31, 2012 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.

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	CDO IV		CDO VI		CDO VIII		CDO IX		CDO X							
<b>Balance Sheet:</b>																
Assets Face Amount	\$ 211,113		\$ 216,854		\$ 914,283		\$ 801,401		\$ 1,385,643							
Assets Fair Value	186,328		145,348		659,278		617,138		1,076,139							
Issued Debt Face Amount (1)	109,269		119,598		643,549		530,125		1,174,250							
Derivative Net Liabilities Fair Value	6,047		20,858		16,358		—		62,724							
<b>Cash Receipts:</b>																
Quarterly net cash receipts (2)	\$ 416		\$ 138		\$ 6,215		\$ 7,046		\$ 6,221							
<b>Collateral Composition (3):</b>																
	Face	Fair Value		Face	Fair Value		Face	Fair Value		Face	Fair Value					
CMBS	\$ 137,281	\$ 118,203	BB-	\$ 110,524	\$ 74,042	BB+	\$ 149,486	\$ 108,421	BB-	\$ 80,101	\$ 75,701	BB	\$ 994,840	\$ 810,370	BB+	
REIT Debt	43,617	45,365	BBB-	54,200	56,587	BBB-	—	—	—	—	—	—	22,471	20,904	B-	
ABS	18,778	12,658	BB-	50,349	13,076	CCC-	76,240	56,608	BB-	3,232	3,030	BBB+	237,646	166,460	BB	
												CCC	—	28,800	8,728	CCC-
Bank Loans	1,705	1,573	NR	1,781	1,643	NR	204,169	140,069	B-	173,703	120,172	—	—	—	—	—
Mezzanine Loans / B-Notes / Whole Loans	9,732	8,529	BB+	—	—	—	392,638	328,771	CCC+	399,340	324,369	CCC	—	—	—	—
CDO	—	—	—	—	—	—	91,750	25,409	CCC-	76,251	25,390	CCC+	50,348	18,139	B-	—
Residential Loans	—	—	—	—	—	—	—	—	—	3,779	3,481	NR	—	—	—	—
Other Investments	—	—	—	—	—	—	—	—	—	18,883	18,883	—	—	—	—	—
Cash for Reinvestment	—	—	—	—	—	—	—	—	—	46,112	46,112	—	—	51,538	51,538	—
Total	\$ 211,113	\$ 186,328	BB	\$ 216,854	\$ 145,348	BB-	\$ 914,283	\$ 659,278	B-	\$ 801,401	\$ 617,138	CCC	\$ 1,385,643	\$ 1,076,139	BB+	—
Collateral on Negative Watch (4)	\$ 8,202		\$ —		\$ 30,250		\$ 7,250		\$ 87,876							
<b>CDO Cash Flow Triggers (5):</b>																
<b>Over Collateralization (6):</b>																
As of Mar-2012 remittance																
Cushion (Deficit) (\$)	\$ (4,070)		\$ (177,539)		\$ 53,094		\$ 121,772		\$ 93,725							
As of Apr-2012 remittance																
Cushion (Deficit) (\$)	—		(177,751)		55,821		96,061		81,190							
<b>Interest Coverage (6):</b>																
As of Mar-2012 remittance																
Cushion (Deficit) (%)	42.8%		(5.6%)		395.9%		420.3%		362.9%							
As of Apr-2012 remittance																
Cushion (Deficit) (%)	—		(203.1%)		387.6%		439.5%		332.8%							
<b>CDO Overview:</b>																
Effective	Sep-04		Aug-05		Mar-07		Jul-07		Dec-07							
Reinvestment Period End (7)	Passed		Passed		Passed		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)	76		44		48		58		35							

See notes on next page.

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- (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 March 31, 2012. 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 \$4.5 million of unrestricted cash received from principal repayments on senior CDO bonds owned by Newcastle. This cash represents a return of principal and the realization of the difference between par and the discounted purchase price of these bonds. 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 \$209.4 million and other bonds and notes payable of \$102.6 million issued by Newcastle, and bank loans of \$114.5 million, collateralized by Newcastle 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 \$62.1 million, \$83.3 million and \$88.5 million at March 31, 2012, 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 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 March 2012 for CDO IV, as this CDO only reports actual over collateralization excess percentages on a quarterly basis, and as of the determination date in April 2012 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 March 31, 2012 or April 30, 2012, as applicable, and may change or have changed subsequent to that date. CDO IV only reports on a quarterly basis and, therefore, no updated April 2012 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. 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 March 2012 remittance date for CDO IV and as of the April 2012 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 – Risks Relating to our Business – The coverage tests applicable to our CDO financings 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 is 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.

The following table sets forth further information with respect to the bonds of our consolidated CDO financings as of March 31, 2012 (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)		
<b>CDO IV</b>						
Class I	\$ 353,250	\$ 76,341	\$ —	\$ 58,496	\$ 134,837	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	—	—	17,093	17,093	8.67%
Preferred	22,500	—	—	22,500	22,500	N/A
	<u>\$ 450,000</u>	<u>\$ 104,019</u>	<u>\$ 5,250</u>	<u>\$ 123,212</u>	<u>\$ 232,481</u>	
<b>CDO VI</b>						
Class I-MM	\$ 323,000	\$ —	\$ 28,348	\$ 125,149*	\$ 153,497	LIBOR + 0.25%
Class I-B	59,000	59,000	—	—	59,000	LIBOR + 0.40%
Class II	33,000	23,506	—	10,220	33,726	LIBOR + 0.50%
Class III-FL	15,000	5,171	—	10,342	15,513	LIBOR + 0.80%
Class III-FX	5,000	—	—	5,953	5,953	5.67%
Class IV-FL	9,600	638	—	9,573	10,211	LIBOR + 1.70%
Class IV-FX	2,400	2,935	—	—	2,935	6.55%
Class V	21,000	—	—	26,698	26,698	7.81%
Preferred	32,000	—	—	32,000	32,000	N/A
	<u>\$ 500,000</u>	<u>\$ 91,250</u>	<u>\$ 28,348</u>	<u>\$ 219,935</u>	<u>\$ 339,533</u>	
<b>CDO VIII</b>						
Class I-A	\$ 462,500	\$ 437,375	\$ —	\$ 16,350	\$ 453,725	LIBOR + 0.28%
Class I-AR	60,000	58,861	—	—	58,861	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	—	11,500	17,000	28,500	7.50%
Preferred	87,875	—	—	87,875	87,875	N/A
	<u>\$ 950,000</u>	<u>\$ 572,049</u>	<u>\$ 71,500</u>	<u>\$ 216,350</u>	<u>\$ 859,899</u>	

\* Of the \$125.1 million CDO VI Class I-MM bonds, \$97.2 million served as collateral for a \$61.1 million bank loan owned jointly by two of Newcastle's CDOs and \$27.9 million served as collateral for a \$7.5 million repurchase agreement financing.

Continued on next page.



Class	Current Face Amount (1)					Total	Stated Interest Rate
	Original Face Amount	Held By			Newcastle Outside of its CDOs (3)		
		Third Parties	Newcastle CDOs (2)				
<b>CDO IX (4)</b>							
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>		
<b>CDO X (4)</b>							
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	13,500	35,500	LIBOR +	2.50%
Class E	13,500	—	—	14,000	14,000	LIBOR +	3.00%
Class F	14,000	—	—	62,500	62,500		9.04%
Preferred	62,500	—	—	—	—		N/A
	<u>\$ 1,400,000</u>	<u>\$ 1,120,000</u>	<u>\$ 54,250</u>	<u>\$ 120,000</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 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 three months ended March 31, 2012:

Shares Issued	Range of Issue Prices (1)	Net Proceeds (millions)	Options Granted to Manager
0	N/A	\$0.0	-

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

At March 31, 2012, we had 105,181,009 shares of common stock outstanding.

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As of March 31, 2012, 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 \$5.13. Our outstanding options at March 31, 2012 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	2,000	16,000
Total	2,498,609	4,314,500	6,813,109

In April 2012, we issued 18,975,000 shares of our common stock in a public offering at a price to the public of \$6.22 per share for net proceeds of approximately \$115.2 million. For the purpose of compensating the manager for its successful efforts in raising capital for us, in connection with this offering, we granted options to the manager to purchase 1,897,500 shares of our common stock at the public offering price, which were valued at approximately \$5.6 million.

As of March 31, 2012, approximately 4.4 million shares of our common stock were held by Fortress, through its affiliates, and its principals.

We declared a quarterly dividend of \$0.20 per common share for the quarter ended March 31, 2012, which was paid in April 2012.

#### Preferred Stock

On April 30, 2012, we paid quarterly dividends on our preferred stock.

#### Accumulated Other Comprehensive Income (Loss)

During the three months ended March 31, 2012, 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, 2011	\$ (70,501)	\$ (2,585)	\$ (73,086)
Net unrealized gain (loss) on securities	—	76,417	76,417
Reclassification of net realized (gain) loss on securities into earnings	—	(4,487)	(4,487)
Net unrealized gain (loss) on derivatives designated as cash flow hedges	8,174	—	8,174
Reclassification of net realized (gain) loss on derivatives designated as cash flow hedges into earnings	(211)	—	(211)
Accumulated other comprehensive income (loss), March 31, 2012	\$ (62,538)	\$ 69,345	\$ 6,807

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 three months ended March 31, 2012, a net tightening of credit spreads has caused the net unrealized losses recorded in accumulative other comprehensive income on our real estate securities to turn into unrealized gains. Net unrealized losses on derivatives designated as cash flow hedges decreased for the three months ended March 31, 2012, primarily as a result of 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.

*Cash Flow*

Operating Activities

Net cash flow provided by (used in) operating activities increased to \$19.3 million for the three months ended March 31, 2012 from \$11.3 million for the three months ended March 31, 2011. This change resulted primarily from the factors described below:

- Net cash receipts from our CDOs increased approximately \$7.1 million for the three months ended March 31, 2012 compared to the three months ended March 31, 2011 primarily due to (i) increased interest receipts through increased reinvestments in securities and loans using restricted cash held in CDOs VIII, IX and X, (ii) decreased interest payments on our CDO debt through repurchases of CDO debt, (iii) decreased interest payments on our interest rate swap agreements which had declining notional balances and (iv) decreased redirection of interest receipts for reinvestment or CDO paydown (which in turn increased our net cash receipts from our CDOs) due to the reduction of defaulted assets through sales.
- Net cash receipts from our manufactured housing loan portfolios decreased approximately \$0.2 million for the three months ended March 31, 2012 compared to the three months ended March 31, 2011 primarily due to paydowns.
- Received excess mortgage servicing income of approximately \$2.0 million in the three months ended March 31, 2012. The Excess MSR investment was made in December 2011.
- Net cash receipts from our investments in FNMA/FHLMC securities increased approximately \$1.1 million for the three months ended March 31, 2012 compared to the three months ended March 31, 2011 primarily due to higher investments in FNMA/FHLMC securities.
- Management fees paid increased approximately \$0.7 million for the three months ended March 31, 2012 compared to the three months ended March 31, 2011 due to an increase in gross equity as a result of our public offerings of common stock in March 2011 and September 2011.
- General and administrative expenses paid increased approximately \$1.3 million for the three months ended March 31, 2012 compared to the three months ended March 31, 2011 primarily due to higher professional fees paid in connection with the acquisition of Excess MSRs.

Investing Activities

Investing activities provided (used) \$22.6 million and (\$44.4) million during the three months ended March 31, 2012 and 2011, respectively. Investing activities consisted primarily of proceeds from the sale, repayment or settlement of investments, net of investments made in certain real estate securities, loans, Excess MSRs and other real estate related assets outside of our CDO financing structures.

Financing Activities

Financing activities provided (used) (\$42.8) million and \$160.1 million during the three months ended March 31, 2012 and 2011, respectively. Uses of cash flow from financing activities included the repayment of debt as described above and the payment of financing costs related to our common stock offerings, and the payment of common and preferred dividends. Offsetting sources consisted primarily of the public offerings of common stock and borrowings under repurchase agreements.

**INTEREST RATE, CREDIT AND SPREAD RISK**

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

## OFF-BALANCE SHEET ARRANGEMENTS

As of March 31, 2012, 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, 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 March 31, 2012 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 three months of 2012, we had all of the material contractual obligations referred to in our annual report on Form 10-K for the year ended December 31, 2011, 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 a new repurchase agreement to finance newly acquired FNMA/FHLMC securities.

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

## INFLATION

Virtually all of our assets and liabilities are financial in nature. As a result, interest rates and other factors affect our performance more so than inflation, although inflation rates can often have a meaningful influence over the direction of interest rates. Furthermore, our financial statements are prepared in accordance with GAAP and our distributions are determined by our board of directors primarily based on our taxable income, and, in each case, our activities and balance sheet are measured with reference to historical cost and/or fair market value without considering inflation. 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” 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.

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 March 31,	
	2012	2011
Income available for common stockholders	\$ 72,076	\$ 108,278
Add (Deduct):		
Impairment (reversal)	(7,080)	(37,206)
Other (income) loss	(29,752)	(45,469)
(Income) loss from discontinued operations	(264)	190
Core earnings	<u>\$ 34,980</u>	<u>\$ 25,793</u>

**Cash Available For Distribution (“CAD”)**

Newcastle determines its common dividends based significantly on cash available for distribution, which is net cash flow from operations plus principal repayments less return of capital and preferred dividends. We believe that CAD is useful for investors because it is a meaningful measure of our operating liquidity. Management uses CAD as an important input in determining Newcastle’s dividends. It represents GAAP net cash provided by operating activities adjusted for two factors:

- (i) Principal payments received from Newcastle’s investments in repurchased CDO debt and CDO securities in excess of the portion which represents a return of Newcastle’s invested capital. Although these net principal repayments are reported as investing activities for GAAP purposes, they actually represent a portion of Newcastle’s return on these investments (or yield), rather than a return of Newcastle’s invested capital.
- (ii) Preferred dividends. Although these dividends are reported as financing activities for GAAP purposes, they represent a recurring use of Newcastle’s operating cash flow similar to interest payments on debt.

CAD is limited in its usefulness because it excludes principal repayments from non-CDO investments (since these principal repayments tend to represent primarily returns of capital and/or are required to be used to directly pay down Newcastle’s debt). Furthermore, net cash provided by operating activities, a primary element of CAD, includes timing differences based on changes in accruals. CAD does not represent cash generated from operating activities in accordance with GAAP and 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. Our calculation of CAD may be different from the calculation used by other companies and therefore comparability may be limited.

Set forth below is a reconciliation of CAD to the most directly comparable GAAP liquidity measure (in thousands).

	Three Months Ended March 31,	
	2012	2011
Net cash provided by (used in) operating activities	\$ 19,264	\$ 11,294
Add (Deduct):		
Principal repayments from repurchased CDO debt	4,497	9,726
Principal repayments from CDO securities	198	—
Return of capital included above (1)	(3,005)	(4,595)
Preferred dividends (2)	(1,395)	(1,395)
Cash available for distribution	<u>\$ 19,559</u>	<u>\$ 15,030</u>

Other data from the consolidated statements of cash flows:

	Three Months Ended March 31,	
	2012	2011
Net cash provided by (used in) investing activities	\$ 22,602	\$ (44,352)
Net cash provided by (used in) financing activities	\$ (42,797)	\$ 160,128
Net increase (decrease) in cash and cash equivalents	\$ (931)	\$ 127,070

- (1) Represents the portion of principal repayments from repurchased CDO debt and from CDO securities computed based on the ratio of Newcastle’s purchase price of such debt or securities to the aggregate principal payments expected to be received from such debt or securities.
- (2) Represents preferred dividends to be paid on an accrual basis.

### 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 March 31, 2012, a 100 basis point increase in short term interest rates would increase our earnings by approximately \$0.2 million per annum, based on the current net floating rate exposure from our 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 March 31, 2012, a 100 basis point change in short term interest rates would impact our net book value by approximately \$17.9 million, based on the current net floating rate exposure from our investments and interest rate derivatives.

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

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

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 March 31, 2012, a 25 basis point movement in credit spreads would impact our net book value by approximately \$20.0 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. 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 in “Management’s Discussion and Analysis of Financial Condition and Results of Operations – 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.

## **Prepayment Speed Exposure**

Prepayment speeds significantly affect the value of Excess MSR. 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. The price we pay in acquiring MSR investments will be based on, among other things, our projection of the cash flows from the related pool of mortgage loans. Our expectation of prepayment speeds is a significant assumption underlying those cash flow projections. If prepayment speeds are significantly greater than expected, the carrying value of Excess MSR could exceed their estimated fair value. If the fair value of Excess MSR 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 MSR, and we could ultimately receive substantially less than what we paid for such assets.

We seek to reduce our exposure to prepayment through the structuring of our investments in Excess MSR. For example, pursuant to the terms of the Excess MSR agreements we entered into in December 2011 and March 2012, in the event that mortgage loans are prepaid in full and Nationstar originates the new mortgage loans, subject to certain limitations, we are entitled to the pro rata share of the Excess MSR of such “recaptured” loans. We will seek to enter into similar “recapture” agreements in making any future investments in Excess MSR.

See “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Application of Critical Accounting Policies” for a sensitivity analysis of 10% and 20% changes in key assumptions on the estimated fair value of Excess MSR.

## **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, 2011. 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 “Management’s Discussion and Analysis of Financial Condition and Results of Operations – 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 adviser with the SEC, which increases our regulatory compliance costs and subjects us to the Investment Advisers Act of 1940, as amended (the “Advisers Act”). The Advisers Act imposes numerous obligations on registered investment advisers, including record-keeping, reporting, operational and marketing requirements, disclosure obligations and prohibitions on fraudulent activities. The SEC is authorized to institute proceedings and impose sanctions for violations of the Advisers Act, ranging from fines and censure to termination of an investment adviser’s registration. Investment advisers also are subject to certain state securities laws and regulations. Non-compliance with the Advisers Act or other federal and state securities laws and regulations could result in investigations, sanctions, disgorgement, fines and reputational damage.

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. In addition, the new regulation of over-the-counter derivatives and a recently-adopted implementing rule may require us to register with and be regulated by the U.S. Commodity Futures Trading Commission (“CFTC”) as a commodity pool operator (“CPO”). The Commodity Exchange Act and CFTC regulations impose various requirements on CPOs, including record-keeping, reporting, operational and marketing requirements, disclosure obligations and prohibitions on fraudulent activities. Complying with these requirements could increase our expenses and negatively impact our financial results.

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, and excess mortgage servicing rights ("Excess MSRs"). As a result, such loan modifications are negatively affecting our business, results of operations 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, Excess MSRs 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 MSRs 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 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 have acquired and are actively exploring additional opportunities to acquire Excess MSR and additional classes of operating real estate, including senior living facilities. See “—We invest in Excess MSR, and such investments could have a negative impact on our financial results,” and “—We may invest in senior living facilities, which are subject to various risks that could have a negative impact on our financial results.”

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.

**Our manager will not be liable to us for any acts or omissions performed in accordance with the management agreement, including with respect to the performance of our investments.**

Pursuant to our management agreement, our manager will not assume any responsibility other than to render the services called for thereunder and will not be responsible for any action of our board of directors in following or declining to follow its advice or recommendations. Under the terms of our management agreement, our manager, its officers, partners, members, managers, directors, personnel, other agents, any person controlling or controlled by our manager and any person providing sub-advisory services to our manager will not be liable to us, any subsidiary of ours, our directors, our stockholders or any subsidiary’s stockholders or partners for acts or omissions performed in accordance with and pursuant to our management agreement, except because of acts constituting bad faith, willful misconduct or gross negligence, as determined by a final non-appealable order of a court of competent jurisdiction. In addition, we have agreed to indemnify our Manager, its officers, partners, members, managers, directors, personnel, other agents, any person controlling or controlled by our manager and any person providing sub-advisory services to our manager with respect to all expenses, losses, damages, liabilities, demands, charges and claims arising from acts of our manager not constituting bad faith, willful misconduct or gross negligence, pursuant to our management agreement.

**Our manager’s due diligence of investment opportunities may not identify all pertinent risks, which could materially affect our business, financial condition, liquidity and results of operations.**

Our manager intends to conduct due diligence with respect to each investment opportunity it pursues. It is possible, however, that our manager’s due diligence processes will not uncover all relevant facts regarding such investment opportunities, particularly with respect to any assets we acquire from third parties. In particular, investments that initially appear to be viable may prove not to be over time due to economic, legal, regulatory, political or other factors. These considerations are particularly relevant in light of the current uncertain economic and regulatory environment. Our inability to do any of the foregoing would be likely to materially and adversely affect our business, financial condition, liquidity and results of operations.

*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;
- Prepayment speeds, delinquency rates and legislative/regulatory changes with respect to our investments in Excess MSRs;
- 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 our net interest income from loans and securities in our portfolio and our income from Excess MSRs, 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 “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 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 \$133.6 million of assets in our consolidated CDOs as of March 2012 or April 2012, 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 March 2012 remittance date for CDO IV and as of the April 2012 remittance date for CDO VI, these CDOs were not in compliance with their applicable over collateralization tests and, consequently, we are not receiving residual cash flows from these CDOs. However, we continue to receive 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 cancel them in accordance with the terms of the relevant governing documentation. However, 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 "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 CDO V. 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 May 8, 2012, 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.**

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 adviser, which has increased 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 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 March 31, 2012, we had \$233.7 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.

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.

Furthermore, with respect to our investments in Excess MSR, we are subject to the risks of the mortgage servicer. To the extent that it is terminated as the mortgage servicer of the underlying mortgage loan pool, or files for bankruptcy, our ability to receive excess mortgage servicing amount or eventually recover our investment would be severely impacted. See “—We will be dependent on mortgage servicers to service the mortgage loans underlying the Excess MSR that we acquire.”

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 three 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. Lastly, lenders may be unwilling to finance certain types of assets, such as Excess MSRs, because of the challenges with perfecting security interests in the underlying collateral. As a result, we do not currently expect to match fund investments in Excess MSRs. 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 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.

**We invest in Excess MSRs, and such investments could have a negative impact on our financial results.**

Subject to maintaining our qualification as a REIT and our exemption from the Investment Company Act of 1940, as amended (the "Investment Company Act"), we have purchased and may continue to purchase Excess MSRs with Nationstar, which is a leading residential mortgage servicer that is externally managed by our manager. We may also purchase Excess MSRs directly from Nationstar or enter into similar transaction with other bank or non-bank servicers.

Excess MSRs are interests in mortgage servicing rights. A mortgage servicing right ("MSR") provides a mortgage servicer with the right to service a pool of mortgages in exchange for a portion of the interest payments made on the underlying mortgages, which portion is expressed as a specified percentage of the unpaid principal balance of the mortgages. The typical annual MSR payment on a pool of agency mortgage loans is 25-35 basis points ("bps") on the unpaid principal balance of the loans.

An MSR can be separated into two components: A “base servicing fee,” which represents the arm’s-length reasonable compensation that a servicer would charge for its servicing activities, and the Excess MSR, which represents the amount of interest payable to the servicer in excess of the base servicing fee. The Excess MSR is an ownership interest in the interest payments made on the underlying pool of mortgages, akin to an “interest-only strip” on that pool.

We record Excess MSRs on our balance sheet at fair value, and changes in their fair value are reflected in our consolidated results of operations. The determination of the fair value of Excess MSRs requires our management to make numerous estimates and assumptions that could materially differ from actual results. Such estimates and assumptions include, without limitation, estimates of the future cash flows from the Excess MSRs, which in turn are 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 MSRs, which are measured at fair value on a recurring basis, may be materially different than the fair values of such Excess MSRs 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 MSRs we acquire.

The values of Excess MSRs are highly sensitive to changes in interest rates. Historically, the value of Excess MSRs 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 MSRs, 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 MSRs as interest rates change.

Prepayment speeds significantly affect the value of Excess MSRs. 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. When we purchase Excess MSRs, we 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 is a significant assumption underlying those cash flow projections. If prepayment speeds are significantly greater than expected, the carrying value of Excess MSRs could exceed their estimated fair value. If the fair value of Excess MSRs 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 MSRs, 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 MSRs. An increase in delinquencies will generally result in lower revenue because typically we will only collect the mortgage servicing amount from GSEs or mortgage owners for performing loans. The price we pay for Excess MSRs is based 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 are significantly greater than expected, the estimated fair value of the Excess MSRs 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 the servicer, actually or allegedly failed to comply with applicable laws, rules or regulations, it could be terminated as the servicer, which could have a material adverse effect on our business, financial condition, results of operations or cash flows.

Our ability to acquire Excess MSRs 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, including Nationstar, to service the mortgage loans underlying the Excess MSRs that we acquire.**

Our investments in Excess MSRs are dependent on the mortgage servicer to perform the servicing obligations. As a result, we could be materially and adversely affected if the servicer is terminated. The duties and obligations of mortgage servicers are defined through contractual agreements, generally referred to as Servicing Guides in the case of GSEs, or Pooling and Servicing Agreements in the case of private-label securities (collectively, the “Servicing Guidelines”). Such Servicing Guidelines generally provide for the possibility for termination of the contractual rights of the servicer in the absolute discretion of the owner of the mortgages being serviced. In the event of such termination by a mortgage owner with respect to a particular servicer, the related Excess MSRs could potentially lose all value on a going forward basis. Moreover, the

termination by a mortgage owner of a servicer could take effect across all mortgages of such mortgage owner. Therefore, to the extent we make multiple investments relating to mortgages owned by the same owner and serviced by the same servicer, all such investments, including our investments with Nationstar, could lose all their value in the event of the termination of the servicer by the mortgage owner.

We could also 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.

Favorable ratings from third-party rating agencies such as Standard & Poor's, Moody's and Fitch are important to the conduct of a mortgage servicer's loan servicing business and a downgrade in a mortgage servicer's ratings could have an adverse effect on us and the value of our Excess MSR. Downgrades in a mortgage servicer's servicer ratings could adversely affect their ability to finance servicing advances and maintain their status as an approved servicer by Fannie Mae and Freddie Mac. Downgrades in servicer ratings could also lead to the early termination of existing advance facilities and affect the terms and availability of match funded advance facilities that a mortgage servicer may seek in the future. A mortgage servicer's failure to maintain favorable or specified ratings may cause their termination as a servicer and may impair their ability to consummate future servicing transactions, which could have an adverse effect on our operations since we will rely heavily on mortgage servicers to achieve our investment objective with respect to Excess MSR.

In addition, a bankruptcy by any mortgage servicer that services the mortgage loans underlying any Excess MSR that we have acquired or may acquire in the future could result in:

- the validity and priority of our ownership of the Excess MSR 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 the Excess MSR or other assets to us as a pledge of such assets in a bankruptcy proceeding; or
- any agreement pursuant to which we purchased the MSR being rejected in a bankruptcy proceeding.

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

**GSE initiatives and other actions may adversely affect returns from investments in Excess MSR.**

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 MSR 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 MSR that we may acquire in the future.

**Changes to the minimum servicing amount for GSE loans could occur at any time and could impact us in significantly negative ways that we are unable to predict or protect against.**

Currently, when a loan is sold into the secondary market for FNMA and FHLMC loans, the servicer is generally required to retain a minimum servicing amount ("MSA") of 25 basis points of the outstanding principal balance for fixed rate mortgages. As has been widely publicized, in September 2011, the Federal Housing Finance Agency (FHFA) announced that a Joint Initiative on Mortgage Servicing Compensation was seeking public comment on two alternative mortgage servicing compensation structures detailed in a discussion paper. Changes to MSA could significantly impact our business in negative ways that we cannot predict or protect against. For example, a removal of MSA could radically change the mortgage servicing industry and could severely limit the Excess MSR that will be available for us to invest in. In addition,

a removal of or a reduction in the MSA could significantly reduce the recapture rate on any portfolios in which we are invested, which could negatively affect our investment return on those assets. We cannot predict whether any changes to current MSA rules will occur or what impact any changes will have on our business, results of operations, liquidity or financial condition.

**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, mortgage servicers, 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 compete 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.

**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 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 than 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.

In addition, Excess MSR are highly illiquid and subject to numerous restrictions on transfers. For example, the Servicing Guidelines of a mortgage owner generally require that holders of Excess MSR obtain the mortgage owner's prior approval of any change of direct ownership of such Excess MSR. Such approval may be withheld for any reason or no reason in the discretion of the mortgage owner. Additionally, investments in Excess MSR are a new type of transaction, and there have been extremely few investment products that pursue a similar investment strategy. Accordingly, the risks associated with the transaction and structure are not fully known to buyers or sellers. As a result of the foregoing, there is some risk that we will be unable to locate a buyer at the time we wish to sell an Excess MSR. Additionally, there is some risk that we will be required to dispose of Excess MSR through an in-kind distribution or other liquidation vehicle, which will, in either case, provide little or no economic benefit to us. Therefore, we cannot provide any assurance that we will obtain any return or any benefit of any kind from any disposition of Excess MSR.

**Our ability to acquire and dispose of Excess MSR may be subject to the receipt of third-party consents.**

Our Manager has extremely limited transaction history involving GSEs such as Freddie Mac and Fannie Mae. While we have participated in two transactions involving Freddie Mac, the terms of such transactions may differ significantly from the terms that can be secured for future purchases of Excess MSR. Moreover, because our Manager has no transaction history with any GSEs other than Freddie Mac, the terms on which we would be able to purchase Excess MSR from such other GSEs remain entirely unknown.

In addition, GSEs may require that we subject ourselves to costly or burdensome conditions as a prerequisite for their consent to our purchase of Excess MSR. GSE conditions may diminish or eliminate the investment potential of certain Excess MSR by making such purchases too expensive for us or by severely limiting the potential returns available from Excess MSR. Moreover, we have not received and do not expect to receive any assurances from any GSEs that their conditions for the sale by us of any Excess MSR will not change. Therefore the potential costs associated with receiving such GSEs' consent for any such dispositions by us cannot be determined with any certainty.

**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 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.

As a public company, we are required to maintain effective internal control over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act of 2002. Internal control over financial reporting is complex and may be revised over time to adapt to changes in our business or applicable accounting rules. For example, as a result of new investments, including any investments in senior living facilities, we may be required to consolidate additional entities, and, therefore, to document and test effective internal controls over the financial reporting of these entities in accordance with Section 404, which we may not be able to do. Even if we are able to do so, there could be significant costs and delays, particularly if these entities were not subject to Section 404 prior to being acquired by us. If we are not able to maintain or document effective internal control over financial reporting, our independent registered public accounting firm would not be able to certify as to the effectiveness of our internal control over financial reporting as of the required dates, which could subject us to adverse regulatory consequences, including sanctions or investigations by the SEC, or violations of applicable stock exchange listing rules. There could also be a negative reaction in the financial markets due to a loss of investor confidence in us and the reliability of our financial statements, which could lead to a decline in our share price, impair our ability to raise capital and other adverse consequences.

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.

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 prepaying increases. Since our CDO financing costs are locked in, reinvestment of such prepayment proceeds at lower yields than the initial investments, as a result of changes in the interest rate or credit spread environment, will result in a decrease of the return on our equity and therefore our net income.

**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.

**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 provisions of the Code, 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 (the “NYSE”) 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 that 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 that 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.

**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, 2012, 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 (or certain groups of 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.

**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 March 31, 2012, 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, \$44.5 million of such cancellations had been effected through March 31, 2012, 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 year ended December 31, 2011 and the period ended March 31, 2012, we repurchased \$193.2 million and \$30.0 million face amount of our outstanding CDO debt and notes payable at a discount and recorded \$82.2 million and \$20.7 million of gain for tax purposes, respectively, (of which only \$66.1 million and \$20.7 million gain relating to \$171.8 million and \$30.0 million face amount of debt repurchased, respectively, 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, and to the extent that a distribution through stock dividends is not viable, 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.

**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, a portion 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 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 in reliance on an exemption from the Investment Company Act. 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. 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 maintain our exemption from registration 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.

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 MSRs or senior living facilities;
- 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, a portion 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. 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 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.

It is unclear whether and to what extent we will be able to pay taxable dividends in cash and stock. 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 105,181,009 shares of common stock were outstanding as of March 31, 2012. 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. Mine Safety Disclosures**

None.

**Item 5. Other Information**

None.

**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).
- 10.5 Excess Servicing Spread Sale and Assignment Agreement between NIC MSR I LLC, a wholly owned subsidiary of Newcastle Investment Corp., and Nationstar Mortgage LLC, dated December 8, 2011. (incorporated by reference to the Registrant's Report on Form 10-K, Exhibit 10.5, filed on March 15, 2012).
- 10.6 Excess Spread Refinanced Loan Replacement Agreement between NIC MSR I LLC, a wholly owned subsidiary of Newcastle Investment Corp., and Nationstar Mortgage LLC, dated December 8, 2011. (incorporated by reference to the Registrant's Report on Form 10-K, Exhibit 10.6, filed on March 15, 2012).
- 10.7 Current Excess Servicing Spread Acquisition Agreement for FNMA Mortgage Loans, dated as of March 6, 2012, between Nationstar Mortgage LLC and NIC MSR II LLC (incorporated by reference to the Registrant's Report on Form 8-K, Exhibit 10.1, filed on March 12, 2012).
- 10.8 Future Spread Agreement for FNMA Mortgage Loans, dated March 6, 2012, between Nationstar Mortgage LLC and NIC MSR II LLC (incorporated by reference to the Registrant's Report on Form 8-K, Exhibit 10.2, filed on March 12, 2012).

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10.9	Current Excess Servicing Spread Acquisition Agreement for FHLMC Mortgage Loans, dated as of March 6, 2012, between Nationstar Mortgage LLC and NIC MSR II LLC (incorporated by reference to the Registrant's Report on Form 8-K, Exhibit 10.3, filed on March 12, 2012).
10.10	Future Spread Agreement for FHLMC Mortgage Loans, dated March 6, 2012, between Nationstar Mortgage LLC and NIC MSR II LLC (incorporated by reference to the Registrant's Report on Form 8-K, Exhibit 10.4, filed on March 12, 2012).
10.11	Current Excess Servicing Spread Acquisition Agreement for Non-Agency Mortgage Loans, dated as of March 6, 2012, between Nationstar Mortgage LLC and NIC MSR II LLC (incorporated by reference to the Registrant's Report on Form 8-K, Exhibit 10.5, filed on March 12, 2012).
10.12	Future Spread Agreement for Non-Agency Mortgage Loans, dated March 6, 2012, between Nationstar Mortgage LLC and NIC MSR II LLC (incorporated by reference to the Registrant's Report on Form 8-K, Exhibit 10.6, filed on March 12, 2012).
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, 2011, Exhibit 21.1)
<a href="#">31.1</a>	<a href="#">Certification of Chief Executive Officer as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</a>
<a href="#">31.2</a>	<a href="#">Certification of Chief Financial Officer as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</a>
<a href="#">32.1</a>	<a href="#">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.</a>
<a href="#">32.2</a>	<a href="#">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.</a>
101.INS*	XBRL Instance Document.
101.SCH*	XBRL Taxonomy Extension Schema Document.
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

May 10, 2012

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

May 10, 2012

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**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.

May 10, 2012

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

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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.

May 10, 2012

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

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**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 March 31, 2012 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  
May 10, 2012

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.

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**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 March 31, 2012 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  
May 10, 2012

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.

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