AMERICAN RESIDENTIAL INVESTMENT TRUST INC
Form 10-Q
August 14, 2002

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended: June 30, 2002

OR

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

Commission File Number: 1-13485

AMERICAN RESIDENTIAL INVESTMENT TRUST, INC.

(Exact name of registrant as specified in its charter)

Maryland	**33-0741174**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
10421 Wateridge Circle, Suite 250 **San Diego, California**	**92121**
(Address of principal executive offices)	(Zip Code)

(858) 909-1200
(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.

ý YES o NO

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

Common Stock ($0.01)	7,880,090 as of July 16, 2002

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PART I. FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

American Residential Investment Trust, Inc. and Subsidiaries

Consolidated Balance Sheets, Unaudited

(in thousands, except share and per share data)

	June 30, 2002	December 31, 2001
ASSETS		
Cash and cash equivalents	$ 12,348	$ 10,945
Mortgage loans held for sale, net, pledged, (lower of cost or market)	210,031	38,095
Bond collateral, mortgage loans, net	337,153	452,152
Bond collateral, real estate owned	11,022	9,226
Retained interests in securitization	1,079	1,582
Derivative financial instruments	3,701	926
Accrued interest receivable	2,641	3,048
Due from affiliate		159
Investment in American Residential Holdings, Inc.	1,991	1,789
Other assets	2,342	1,802
	$ 582,308	$ 519,724
LIABILITIES AND STOCKHOLDERS EQUITY		
Liabilities:		
Short-term debt	$ 205,554	$ 35,265
Long-term debt, net	312,925	422,349
Accrued interest payable	150	85
Due to affiliate	1,964	1,786
Accrued expenses and other liabilities	3,274	1,612
Total liabilities	523,867	461,097
Stockholders Equity:		
Preferred stock, par value $.01 per share; 1,000 shares authorized; no shares issued and outstanding		
Common stock, par value $.01 per share; 25,000,000 shares authorized; 7,880,090 shares issued and outstanding at June 30, 2002 and 7,959,900 shares issued and outstanding at December 31, 2001	79	80
Additional paid-in-capital	108,797	108,995
Accumulated other comprehensive income	31	448
Accumulated deficit	(50,466)	(50,896)
Total stockholders equity	58,441	58,627
	$ 582,308	$ 519,724

See accompanying notes to consolidated financial statements.

American Residential Investment Trust, Inc. and Subsidiaries

Consolidated Statements of Operations, unaudited

(in thousands, except per share data)

	For the Three Months Ended June 30, 2002	For the Three Months Ended June 30, 2001	For the Six Months Ended June 30, 2002	For the Six Months Ended June 30, 2001
Interest income:				
Mortgage assets	$ 10,021	$ 13,983	$ 20,042	$ 32,059
Cash and investments	37	168	66	356
Interest rate cap and floor agreement expense				(9)
Total interest income	10,058	14,151	20,108	32,406
Interest expense	4,072	8,990	7,899	23,239
Net interest spread	5,986	5,161	12,209	9,167
Premium amortization	2,526	2,960	5,628	5,436
Net interest income	3,460	2,201	6,581	3,731
Provision for loan losses	1,024	779	3,127	2,420
Net interest income after provision for loan losses	2,436	1,422	3,454	1,311
Other operating income:				
Gain on sale of mortgage loans	4,952		6,504	
Management fee income	31	45	59	96
Equity in income of American Residential Holdings, Inc.	128	46	202	157
Prepayment penalty income	170	853	510	1,674
Total other operating income	5,281	944	7,275	1,927
Net operating income	7,717	2,366	10,729	3,238
Other income:				
Litigation settlement	10,281		10,281	
Total other income	10,281		10,281	
Other expenses:				
Loss (gain) on sale of real estate owned, net	347	(98)	432	154
Loss (gain) on derivative financial instruments	8,765		8,459	
Underwriting costs on loan orginations	66		109	
Management fees		674		1,440
Professional fees	1,097	222	1,861	481
General and administrative expenses	5,386	243	9,719	433
Write-off of acquisition due diligence costs		514		514
Total other expenses	15,661	1,555	20,580	3,022
Income before cumulative effect of a change in accounting principle	2,337	811	430	216

Adoption of SFAS 133 Accounting Change:								
Reduce Cap Agreement cost to market								(1,106)
Net income (loss)		2,337		811		430		(890)
Other comprehensive income (loss)								
Unrealized gains (losses) on retained interest in securitization		(415)		184		(417)		217
Unrealized holding gains (losses) arising during the period		(415)		184		(417)		217
Comprehensive income (loss)		1,922		995		13		(673)
Income (loss) per share before cumulative effect of accounting change	$	0.30	$	0.10	$	0.05	$	0.03
Net income (loss) per share of common stock-basic and diluted	$	0.29	$	0.10	$	0.05	$	(0.11)
Dividends per share of common stock for the related period	$		$		$		$	

See accompanying notes to consolidated financial statements

American Residential Investment Trust, Inc. and Subsidiaries

Consolidated Statements of Cash Flows, unaudited

(in thousands)

	For the Six Months Ended June 30, 2002	For the Six Months Ended June 30, 2001
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	$ 430	$ (890)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Amortization of mortgage assets premiums	5,415	5,436
Cumulative effect of change in accounting principle		1,115
Amortization of interest rate cap agreements		9
Amortization of CMO capitalized costs	326	568
Amortization of CMO premium		(82)
Provision for loan losses	3,127	2,420
Equity in undistributed income of American Residential Holdings, Inc.	(202)	(157)
Decrease in deposits to retained interest in securitization	1	168
Decrease in retained interest in securitization	85	4
Loss on sale of real estate owned	1,681	154
Proceeds from sale of mortgage loans held for sale	786,732	
Mortgage loan originations	(958,668)	
Increase in derivative financial instruments	(2,775)	
Decrease in accrued interest receivable	891	3,697
Increase (decrease) in due from affiliate	159	(58)
(Increase) decrease in other assets	(1,024)	12
Increase (decrease) in accrued interest payable	65	(166)
Increase in due to affiliate	178	239
Increase in accrued expenses and other liabilities	1,662	378
Net cash (used in) provided by operating activities	(161,917)	12,847
CASH FLOWS FROM INVESTING ACTIVITIES:		
Principal payments on bond collateral, mortgage loans, net	97,431	187,484
Proceeds from sale of real estate owned	5,549	6,308
Net cash provided by investing activities	102,980	193,792
CASH FLOWS FROM FINANCING ACTIVITIES:		
Increase (decrease) in net borrowings from short-term debt	170,289	(2,871)
Dividends paid		(1,606)
Payments on long-term debt	(109,750)	(196,895)
Purchase of Treasury Stock	(199)	(196)
Net cash provided by (used in) financing activities	60,340	(201,568)
Net increase in cash and cash equivalents	1,403	5,071
Cash and cash equivalents at beginning of period	10,945	14,688
Cash and cash equivalents at end of period	$ 12,348	$ 19,759
Supplemental information interest paid	$ 7,828	$ 23,163

Non-cash transactions:		
Transfers from bond collateral to real estate owned	$ 13,043	$ 6,859

See accompanying notes to consolidated financial statements.

AMERICAN RESIDENTIAL INVESTMENT TRUST, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies and Practices

Basis of Financial Statement Presentation

The interim financial statements included herein have been prepared by American Residential Investment Trust, Inc., (AmRIT or the Company) without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) have been condensed or omitted pursuant to such SEC rules and regulations. These financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company s latest Annual Report. In the opinion of management, all adjustments, including normal recurring adjustments necessary to present fairly the consolidated financial position of the Company with respect to the interim financial statements and the results of the operations for the interim period ended June 30, 2002, have been included. Certain reclassifications may have been made to prior interim period amounts to conform to the current presentation. The results of operations for interim periods are not necessarily indicative of results for the full year.

The Company reports segments in accordance with SFAS 131, Disclosures about Segments of an Enterprise and Related Information. SFAS 131 establishes standards for the way companies report information about operating segments in annual financial statements. It also establishes standards for related disclosures about products and services, geographic areas and major customers. Effective January 1, 2002, the Company was reorganized into two segments: the Mortgage Asset Portfolio Investments Spread Lending Business and the Mortgage Banking Business.

New Accounting Standards

In June 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities (SFAS 146), which addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue No. 94-3 Liability Recognition for Certain Employee Terminations Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). SFAS 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred as opposed to the date of an entity s commitment to an exit plan as required under EITF Issue No. 94-3. SFAS 146 also requires that measurement of the liability associated with exit or disposal activities be at fair value. SFAS 146 is effective for the Company for exit or disposal activities that are initiated after December 31, 2002. The implementation of SFAS 146 is not expected to have a material impact on the Company s financial statements.

SFAS 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead tested for impairment at least annually in accordance with the provisions of SFAS 142. SFAS 142 also requires that intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment. As permitted by SFAS 142, the Company adopted the new standard in the first quarter of the fiscal year 2002. Intangible assets are less than $1,000 and therefore adoption of SAS 142 has no material effect on the consolidated financial statements.

SFAS 144 provides guidance on how a long-lived asset that is used as a part of a group should be evaluated for impairment, establishes criteria for when a long-lived asset is held for sale, and prescribes the accounting for a long-lived asset that will be disposed of other than by sale. The Company adopted SFAS 144 beginning January 1, 2002. The Company does not expect the adoption of SFAS 144 for long-lived assets held for use to have a material impact on the Company s consolidated financial statements.

Note 2. Income (Loss) Per Share

The following table illustrates the computation of basic and diluted income (loss) per share (in thousands, except share and per share data):

	For the Three months ended June 30, 2002	For the Three months ended June 30, 2001	For the Six Months Ended June 30, 2002	For the Six Months Ended June 30, 2001
	(in thousands, except share data) (unaudited)			
Numerator:				
Numerator for basic income (loss) per share net earnings	$ 2,337	$ 811	$ 430	$ (890)
Denominator:				
Denominator for basic income per share - weighted average number of common shares outstanding during the period	7,880,090	7,959,900	7,899,340	7,965,000
Incremental common shares attributable to exercise of outstanding options	75,000		75,000	
Denominator for diluted income per share	7,955,090	7,959,900	7,974,340	7,965,000
Income (loss) per share before cumulative effect of accounting change	$ 0.30	$ 0.10	$ 0.05	$ 0.03
Basic income (loss) per share	0.30	0.10	0.05	(0.11)
Diluted income (loss) per share	0.29	0.10	0.05	(0.11)

For the six months ended June 30, 2002 and 2001 there were 1,199,100 and 1,218,100 options, respectively, that were antidilutive and, therefore, not included in the calculations above.

Note 3. Mortgage loans held for sale, net pledged

The AmRIT subsidiary, American Mortgage Network, Inc. (AmNet   ) has pledged loans held for sale to secure credit lines (warehouse facilities) from two financial institutions. See Note 7 Short-Term Debt. Mortgage loans held for sale at June 30, 2002, consist of loans which have been committed for sale of approximately $127.3 million and loans available for sale at approximately $80.7 million, both of which are carried at the lower of cost or market.

Note 4. Bond Collateral, Mortgage Loans, net

AmRIT has pledged mortgage loans and real estate owned, net, as collateral in order to secure long-term-debt. Bond collateral consists primarily of adjustable-rate, conventional, 30-year mortgage loans secured by first liens on one to four-family residential properties. All bond collateral is pledged to secure repayment of the related long-term-debt obligation. All principal and interest (less servicing and related fees) on the bond collateral is remitted to a trustee and is available for payment on the long-term-debt obligation. The obligations under the long-term-debt are payable solely from the bond collateral and are otherwise non-recourse to AmRIT. The components of the bond collateral at June 30, 2002 and December 31, 2001 are summarized as follows (dollars in thousands)(unaudited):

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	CMO/REMIC 2000-2 Securitization	CMO/REMIC 1999-A Securitization	CMO 1999-2 Securitization	CMO 1999-1 Securitization	CMO/FASIT 1998-1 Securitization	TOTAL Bond Collateral
At June 30, 2002						
Mortgage loans	$ 22,090	$ 83,917	$ 126,174	$ 57,802	$ 40,386	$ 330,369
Unamoritized premium	754	2,403	5,172	1,884	702	10,915
Allowance for loan losses	(270)	(1,019)	(1,435)	(955)	(452)	(4,131)
	$ 22,574	$ 85,301	$ 129,911	$ 58,731	$ 40,636	$ 337,153
Weighted average net coupon	9.25%	9.77%	9.11%	9.00%	10.62%	9.45%
Unamortized premiums as a percent of Mortgage loans	3.41%	2.86%	4.10%	3.26%	1.74%	3.30%
At December 31, 2001						
Mortgage loans	$ 32,340	$ 112,770	$ 173,118	$ 71,732	$ 50,719	$ 440,679
Unamoritized premium	1,127	3,978	7,233	2,623	1,369	16,330
Allowance for loan losses	(246)	(1,582)	(1,137)	(761)	(1,131)	(4,857)
	$ 33,221	$ 115,166	$ 179,214	$ 73,594	$ 50,957	$ 452,152
Weighted average net coupon	9.23%	9.99%	9.31%	9.29%	10.84%	9.65%
Unamortized premiums as a percent of Mortgage loans	3.48%	3.53%	4.18%	3.66%	2.70%	3.71%

The Company maintains an allowance for losses on mortgage loans held-for-investment and bond collateral at an amount which it believes is sufficient to provide adequate protection against losses in the mortgage loan portfolio.

Note 5. Derivative Financial Instruments

The following is a summary of AmNet s derivative instruments (dollars in thousands)(unaudited):

Security	Notional Amount	Strike	Derivative	Short Long	Expiration
Treasury Bond	$ 300,000	108	Calls	Long	September 19, 2002
Treasury Bond	$ 500,000	107	Calls	Short	September 19, 2002
Treasury Bond	$ 550,000	110	Calls	Long	September 19, 2002
Treasury Bond	$ 200,000	116	Calls	Long	September 19, 2002
Treasury Bond	$ 200,000	92	Puts	Long	September 19, 2002

Treasury Bond	$	200,000	97	Puts	Long	September 19, 2002
Treasury Bond	$	300,000	98	Puts	Short	September 19, 2002
Ten Year Treasuries	$	300,000	110	Calls	Short	September 19, 2002
Ten Year Treasuries	$	200,000	112	Calls	Long	September 19, 2002
Ten Year Treasuries	$	100,000	112	Calls	Long	December 19, 2002
Ten Year Treasuries	$	200,000	98	Puts	Long	September 19, 2002
Ten Year Treasuries	$	200,000	100	Puts	Long	September 19, 2002
Ten Year Treasuries	$	250,000	103	Puts	Long	September 19, 2002
Ten Year Treasuries	$	500,000	104	Puts	Short	September 19, 2002
Ten Year Treasuries	$	100,000	106	Puts	Long	September 19, 2002
Ten Year Treasuries	$	100,000	102	Puts	Short	December 19, 2002
FNMA 30 -Year MBS	$	100,000	101.125	TBA	Short	August 14, 2002
GNMA 30-Year MBS	$	75,000	101.16	TBA	Short	August 21, 2002

These derivatives are accounted for as trading securities in the accompanying consolidated financial statements. The decrease in fair market value of derivative financial instruments is included in the Consolidated Statements of Operations and Comprehensive Loss.

The short and long positions noted in the schedule above represent options to purchase or sell the underlying security. Long positions gain in value as market interest rates increase and short positions gain in value as market interest rates decrease.

Hedges are put in place to help mitigate market interest rate fluctuations, which may adversely impact the locked mortgage loan pipeline and mortgage loans closed which are unsold. At June 30, 2002, the locked pipeline was approximately $368.3 million and closed loans which were unsold were approximately $80.7 million. The locked pipeline (potential loans) and closed loans are for single family residences collateralized by first trust deeds. For the purposes of valuing the locked loan pipeline an assumption is made as to the estimated percentage of these loans that will eventually be funded. Prior to the period ending June 30, 2002, the estimated percentage was calculated using industry standards, because the Company had little loan origination history available. As the Company continues to build a loan origination history, the estimated percentage will be based on this history and the constant reassessment of market interest rates.

Note 6. Bond Collateral, Real Estate Owned

The Company owned 159 properties and 148 properties as of June 30, 2002 and December 31, 2001, respectively. Upon transfer of the loans to real estate owned (as a result of default or foreclosure), the Company recorded a corresponding charge against the allowance for loan losses to write-down the real estate owned to fair value less estimated cost of disposal. As of June 30, 2002 and December 31, 2001, real estate owned totaled approximately $11.0 million and $9.2 million, respectively.

Note 7. Short-Term Debt

As of June 30, 2002, short-term debt consists of a revolving credit line (warehouse facility) used to fund the Company s lending activities. As of June 30, 2002, mortgage loans held for sale were pledged as collateral for the warehouse facility. The facility consists of borrowings of $202.5 million with two financial institutions for a maximum amount of $260 million, secured by mortgage loans held for sale, generally bearing interest at LIBOR plus spread (3.23% at June 30, 2002). The weighted average interest rate was 3.30% in 2002 and the facility fee is 0.25% on the aggregate committed amount of the warehouse facility which matures on November 25, 2002. The facility is repaid as principal payments on mortgage loans are received, or as the mortgage loans are sold. The agreement governing the facility contains a number of covenants, including covenants based on tangible net worth, cash flows, net income, and liquidity of the Company. As of June 30, 2002 the Company was out of compliance with a net worth covenant. The non-compliance was waived by the financial institution.

In 2001, the Company entered into a $5 million senior subordinated revolving loan agreement (Subordinated Loan Agreement). Borrowings related to the Subordinated Loan Agreement are secured by an interest in a securitization held by the Company. The Subordinated Loan Agreement bears interest at 12% and matures in December 2002, with provisions for extension of two additional one year periods at the Company s option. The Subordinated Loan Agreement contains a number of covenants, including covenants based on tangible net worth, cash flows, net income and liquidity of the Company. As of June 30, 2002, the Company has $3.0 million in borrowings on the Subordinated Loan Agreement.

Note 8. Long-Term Debt, Net

The components of the long-term-debt at June 30, 2002 and December 31, 2001, along with selected other information are summarized below (dollars in thousands)(unaudited):

	CMO/REMIC 2000-2 Securitization	CMO/REMIC 1999-A Securitization	CMO 1999-2 Securitization	CMO 1999-1 Securitization	CMO/FASIT 1998-1 Securitization	TOTAL Long-Term Debt
At June 30, 2002						
Long-term debt	$ 22,097	$ 78,976	$ 121,100	$ 50,534	$ 41,264	$ 313,971
Capitalized costs on long-term debt	(84)	(7)	(566)	(389)		(1,046)
Total long-term debt	$ 22,013	$ 78,969	$ 120,534	$ 50,145	$ 41,264	$ 312,925
Weighted average financing rates	2.06%	2.03%	3.28%	2.21%	2.98%	2.68%
At December 31, 2001						
Long-term debt	$ 31,809	$ 107,574	$ 167,200	$ 65,546	$ 51,592	$ 423,721
Capitalized costs on long-term debt	(122)	(10)	(761)	(479)		(1,372)
Total long-term debt	$ 31,687	$ 107,564	$ 166,439	$ 65,067	$ 51,592	$ 422,349
Weighted average financing rates	2.56%	2.25%	3.45%	2.45%	3.27%	2.90%

Note 9. Commitments and Contingencies

The Company has used, and will continue to use, Forward Loan Sale Commitments to help mitigate the locked pipeline s exposure to market interest rate fluctuations (See section **Mortgage Banking Business**). These commitments provide that the Company agrees to sell an established volume of mortgage loans to a particular institution at a fixed price. An established time frame, or settlement date is also agreed upon. The Company could incur a loss if the loan volume committed for sale is not delivered.

Note 10. Related Party Transactions

During the month of June the Company made first trust deed loans on the personal residences of John Robbins, Chairman of the Board and Chief Executive Officer; and Jay Fuller, President and Chief Operating Officer for $950,000 and $550,000 respectively. The loans were immediately sold thru the normal channels to financial institutions. There were no discounts or special incentives regarding these loans.

Note 11. Business Segments

The Company was reorganized into two segments: the Mortgage Asset Portfolio Investments Spread Lending Business and the Mortgage Banking Business. The Mortgage Asset Portfolio Investments Spread Lending segment manages a portfolio of mortgage loans pledged as collateral for long-term debt. The Mortgage Banking Business originates home mortgage loans through a network of mortgage loan brokers. These mortgage loans are subsequently sold to financial institutions.

The accounting policies of the segments are the same as described in Note 1 Summary of Significant Accounting Policies and Practices. The Company evaluates the performance of its business segments based on income before income taxes. Expenses under the direct control of each business segment and the expense of premises and equipment incurred to support business operations are allocated accordingly, by segment.

The table below reflects the second quarter and year to date income statement activity by segment.

American Residential Investment Trust, Inc. and Subsidiaries

Consolidated Statements of Operations by Business Segment, unaudited

(in thousands)

	For the Three Months Ended June 30, 2002 Spread Lending	For the Three Months Ended June 30, 2002 Mortgage Banking	For the Six Months Ended June 30, 2002 Spread Lending	For the Six Months Ended June 30, 2002 Mortgage Banking
Interest income:				
Mortgage assets	$ 8,679	$ 1,342	$ 16,149	$ 3,893
Cash and investments	34	3	59	7
Total interest income	8,713	1,345	16,208	3,900
Interest expense	2,942	1,130	6,075	1,824
Net interest spread	5,771	215	10,133	2,076
Premium amortization	2,526		5,628	
Net interest income	3,245	215	4,505	2,076
Provision for loan losses	1,024		3,127	
Net interest income after provision for loan losses	2,221	215	1,378	2,076
Other operating income:				
Gain on sale of mortgage loans		4,952		6,504
Management fee income	31		59	
Equity in income of American Residential Holdings, Inc.	128		202	
Prepayment penalty income	170		510	
Total other operating income	329	4,952	771	6,504
Net operating income	2,550	5,167	2,149	8,580
Other income:				
Litigation settlement	10,281		10,281	
Total other income	10,281		10,281	
Other expenses:				
Loss on sale of real estate owned, net	347		432	
Loss on derivative financial instruments		8,765		8,459
Underwriting costs on loan orginations		66		109
Professional fees	580	517	897	964
General and administrative expenses	330	5,056	547	9,172
Total other expenses	1,257	14,404	1,876	18,704

Net income (loss)	$	11,574	$	(9,237)	$	10,554	$	(10,124)

For the purpose of internal management reporting, the Company records inter-segment funds transfers and eliminates these transfers on a consolidated basis for GAAP reporting. Inter-segment assets and liabilities eliminated for consolidation purposes were $29.2 million for the six month period ending June 30, 2002.

Note 12. Subsequent Events

The Company held their annual meeting on July 19, 2002, at which time voting took place with respect to certain proposals. This meeting was adjourned to August 2, 2002 to permit additional voting with respect to initiatives to eliminate certain restrictions in the Company s charter requiring it to remain a Real Estate Investment Trust (REIT). Subsequently, a final vote count indicates the Company s shareholders have voted in favor of the de-REIT proposals. The Company estimates the elimination of REIT status will begin January 1, 2003.

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

The statements contained in this Form 10-Q that are not purely historical are forward looking statements, including statements regarding our expectations, hopes, beliefs, intentions, or strategies regarding the future. Statements that use the words expects , will , may , anticipates , goal intends , seeks , strategy and derivatives of such words are forward looking statements. These forward looking statements include statements regarding:

the effect on our interest income, interest expense, gains on loan sales, gain/loss on derivative financial instruments and operating performance from changes in interest rates

diversifying and re-building our revenue streams

our anticipated lack of dividends in 2002

our belief regarding future prepayment rates, anticipated prepayment penalties, future borrowing costs and appropriate premium amortization levels

the sufficiency of our cash reserves

the anticipated timing of eliminating our REIT status

the impact of new accounting standards

our intent to hold bond collateral to maturity

In addition, we have included a number of statements regarding the development of our new mortgage loan origination capabilities, which are forward looking. These statements include statements regarding:

our creation of operational capabilities to originate and sell A quality mortgage loans including our expectation of deriving our revenues primarily from sales of loans net of hedging

growth and profit potential from American Mortgage Network, Inc. (AmNet)

projected loan origination volumes, including the anticipated effect of fluctuations in interest rates, the estimated size of the loan origination market and our market share

expenses associated with AmNet

our ability to obtain and expand debt facilities to fund AmNet loan originations *our ability to resell our loans on the secondary market and the timing of these re-sales*

the levels of investment that we will need to make in our loan inventory

the effectiveness of our hedge instruments and our expectation of recouping in part past hedging losses with increased loan sale revenues

our ability to hedge against market fluctuations in interest rates

achieving profitability at the AmNet level, and the correlation of loan origination volume and profitability and our expected loss for tax purposes for fiscal 2002

sources of revenue that may be generated by our loan origination operations

the adequacy of our allowances for losses on sale of mortgage loans, and our intent to set aside reserves for non-saleable loans

These forward looking statements are based on information available to the Company on the date hereof, and the Company assumes no obligation to update any such forward looking statements. It is important to note that the Company s actual results and timing of certain events could differ materially from those in such forward looking statements due to a number of factors, including but not limited to, general economic conditions, overall interest rates, the shape of the yield curve, reductions in the value of retained interests in securitizations, the Company s ability to successfully grow its origination subsidiary and the Company s ability to obtain the financing necessary to fund its origination business. Other risk factors that could cause actual results to differ materially are set forth in this item under the heading Business Risk Factors.

Introduction

The Company is currently structured as a REIT, thereby generally eliminating federal taxes at the corporate level on income it distributes to stockholders. The proxy for the 2002 Annual Stockholders Meeting included two proposals that would eliminate restrictions on the Company s charter documents to permit the Company to eliminate its REIT status. These proposals were passed as required of the shareholders. The Company plans to de-REIT as of January 2003.

In 2001, the Company formed an operating subsidiary, American Mortgage Network, Inc. (AmNet), a wholly owned taxable REIT subsidiary, for the purpose of engaging in mortgage banking activities. Through a network of regional offices in the United States, AmNet originates loans through mortgage brokers and then sells them to institutional purchasers. All servicing rights are also sold along with the mortgage loans. Effective January 1, 2002, the Company was reorganized into two segments: The Mortgage Asset Portfolio Investments Spread Lending Business and the Mortgage Banking Business. The Mortgage Banking Business was not significant in 2001.

Mortgage Asset Portfolio Investments Spread Lending Business

Currently, the Company s spread lending revenue primarily consists of net interest income generated from its bond collateral mortgage loans (consisting mainly of A- and B sub-prime mortgage loans secured by residential properties) and its cash and investment balances (collectively, earning assets), prepayment penalty income and income generated by equity in income of American Residential Holdings, Inc.

For that portion of the Company s earning assets funded with borrowings (spread lending), the resulting net interest income is the difference between the Company s average yield on earning assets and the cost of borrowed funds. The table below illustrates interest rates on mortgage loans (net coupon) and interest rates on long-term debt (financing rates)(unaudited):

	CMO/REMIC 2000-2 Securitization	CMO/REMIC 1999-A Securitization	CMO 1999-2 Securitization	CMO 1999-1 Securitization	CMO/FASIT 1998-1 Securitization	TOTAL
At June 30, 2002						
Weighted average net coupon	9.25%	9.77%	9.11%	9.00%	10.62%	9.45%
Weighted average financing rates	2.06%	2.03%	3.28%	2.21%	2.98%	2.68%
At December 31, 2001						
Weighted average net coupon	9.23%	9.99%	9.31%	9.29%	10.84%	9.65%
Weighted average financing rates	2.56%	2.25%	3.45%	2.45%	3.27%	2.90%

Gross income from spread lending will generally decrease following an increase in short term interest rates due to increases in borrowing costs but a lag in adjustments to the earning asset yields. The majority of the Company s earning assets are adjustable rate loans that adjust periodically every six months based on a margin over the six-month LIBOR index. Gross income from spread lending will generally increase following a fall in short term interest rates due to decreases in borrowing costs and a lag and/or floor in downward adjustments to the earning asset yields.

The Company s primary expenses, besides its borrowing costs, are amortization of loan purchase premiums, provision for loan losses and losses on sale of real estate owned (REO). Provision for loan losses represent the Company s best estimate of expenses related to loan defaults. Gains or losses on the sale of REO represent differences between sale proceeds and the net carrying amount of the property. The carrying value includes a reduction (credit provision) to reflect an estimate of net proceeds at time of sale. Premiums are amortized using the interest method over their estimated lives.

During the past twenty-seven months the Company s asset base has declined due to the Company s decision to avoid loan acquisitions if market conditions did not meet its investment criteria and to reserve capital for the pursuit of direct loan origination strategies. Revenues from the

Spread Lending Business have declined in direct proportion to the decline in earning assets. The mortgage loan portfolio was approximately $1,292 million at December 31, 1999 to $858 million at December 31, 2000; $452 million at December 31, 2001; and $337 million at June 30, 2002. Simultaneously, premium amortization and credit provision expense have increased as a percentage of gross revenue, reflecting increases in prepayments and delinquencies tied to a favorable refinance market and normal seasoning of the mortgage loans in the Copany s portfolio. See Business Risks Mortgage Asset Portfolio Investments Spread Lending Business.

Mortgage Banking Business

One of the Company s primary objectives continues to be to augment and eventually diversify its revenue base and earnings. The Company intends to deploy capital to augment declining revenues from its current, declining mortgage loans which have not been replenished due to unfavorable pricing on bulk purchases of mortgage loans. The primary strategy in diversifying the Company s income stream has been to establish a loan origination business, and to sell the loans on a servicing released basis to loan purchasers for a profit.

As of June 30, 2002, AmNet has hired 214 loan production and loan operations employees and will continue to expand AmNet in 2002. Two regional production centers located in Oregon and Northern California began originating loans in November 2001. Three centers in California, Connecticut and Georgia were opened in the first quarter of 2002, and an additional center was opened in Florida during the second quarter of 2002. AmNet utilizes a dedicated sales force to offer AmNet s loan products to approved wholesale mortgage brokers, who refer their client s loans to AmNet for underwriting and funding. Loans meeting AmNet s underwriting criteria are approved and funded at AmNet s regional underwriting loan centers. AmNet s headquarters office performs various functions through multiple departments including establishment of policy, risk management, secondary marketing, finance, accounting, administration, and information technology. The Company completed a relocation to new corporate headquarters in February 2002 in order to accommodate the space requirements of the Company and AmNet.

All loans produced are expected to be sold on a servicing-released basis to loan purchasers, typically within 30 days of origination. In November 2001, the Company obtained an initial warehouse facility for $75 million to fund and accumulate loans prior to sale to its loan purchasers. In March 2002 the warehouse facility was increased to $160 million. Additionally, a second facility was obtained in late March 2002 for $150 million. By prior agreement, upon securing the second facility, the original facility was decreased to $110 million. AmNet is required to maintain an equity investment in its loan inventory ranging from 1% to 4%, and must comply with various lender covenants restricting the absolute level of leverage and minimum levels of cash reserves. The Company expects to increase its warehouse borrowing facilities to enable it to increase loan production. There can be no assurances that credit lines will be obtained in time to enable continued growth and expansion of AmNet s loan origination.

AmNet s primary sources of revenue are gains on the sale of mortgages, fees charged to borrowers and net interest income earned on its loan inventory and net of gains or losses on hedging transactions. Its primary expenses are commissions, salaries and occupancy costs associated with its network of regional loan origination offices, and headquarter payroll and occupancy costs and other related general and administrative expenses. Other expenses include potential costs and losses associated with hedging activities (i.e., losses on derivative financial instruments and losses on loan sales subject to certain forward loan sale contracts).

As is customary in the mortgage banking industry, AmNet routinely provides rate lock commitments to borrowers for up to 30 days prior to funding, with such loans priced to reflect the Company s targeted gain on sale margin. The Company has exposure to interest rate changes on its rate lock commitments (loan pipeline) because a large majority of rate locks will close if interest market rates subsequently increase, and conversely, rate locks may fall out if market interest rates decline significantly. The gain on sale of loans (loan sale margin) will generally decline if rates have risen, since the loans which were priced when rates were lower carry lower-than-current-market interest rates. Accordingly, AmNet attempts to hedge (or protect) its loan sale margin in its pipeline and closed loan inventory by utilizing certain derivative financial instruments, Forward Loan Sale Commitments and similar agreements. Hedges are typically designed to protect against rising interest rates. AmNet has generally adjusted its hedge coverage on a daily basis based on changes in the composition of the pipeline, market conditions and market volatility while seeking to meet these objectives. For a variety of reasons, however, the Company does not believe its hedging strategy was entirely effective in the second quarter.

Since hedges are generally designed to protect against rising rates, should rates drop unexpectedly and significantly over a short time period prompting the Company to reduce its hedge coverage, hedges losses may occur, and may not always be offset by higher loan sale margins due to pipeline fallout.

See Results of Operations Six Month Results and Mortgage Banking Business Business Risks

Critical Accounting Policies

The following analysis of financial condition and results of operations are based upon our consolidated financial statements, and the notes thereto, which have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The preparation of these consolidated financial statements requires us to make a number of estimates and assumptions that affect the reported amounts and disclosures in the consolidated financial statements. On an ongoing basis, we evaluate our estimates and assumptions based upon historical experience and various other factors and circumstances. We believe that our estimates and assumptions are reasonable in the circumstances; however, actual results may differ significantly from these estimates and assumptions which could have a material impact on the carrying value of assets and liabilities at the balance sheet dates and our results of operations for the reporting periods.

Our accounting policies relating to the basic procures listed below have not changed in the six-month period ending June 30, 2002:

Allowance for loan losses

Amortization of premiums on bond collateral, mortgage loans

Derivative and hedging activities

Please refer to the Company Form 10-K for the one-year period ending December 31, 2001, for a detailed discussion of these procedures.

Results of Operations

Six Month Results

For the six months ended June 30, 2002, the Company generated net income of approximately $430 thousand and net income per share of $0.05 compared to the six months ended June 30, 2001 when the Company generated net income of approximately $216 thousand and net income per share of $0.03.

Net interest income decreased approximately $12.0 million to approximately $20.0 million for the six months ended June 30, 2002 from approximately $32.1 million for the six months ended June 30, 2001. This decrease was primarily due to a decrease in the value of mortgage loans. Mortgage loans were approximately $337.1 million at June 30, 2002 and approximately $643.6 million at June 30, 2001 which represents approximately a 47.61% decline. The mortgage loan decline was the result of high prepayment activity and no portfolio replenishment. Due to a favorable refinance market, the adjustable rate mortgage re-set rates are generally higher than rates available in the market place. Furthermore, in many cases, prepayment penalties have expired, or have not served as a deterrent to refinances.

Interest expense decreased by approximately $15.3 million to approximately $7.9 million for the six months ended June 30, 2002 from approximately $23.2 million for the six months ended June 30, 2001. This decrease is attributable to lower borrowings outstanding as well as lower borrowing rates. A majority of the Company s borrowing rates are based upon a spread over the one-month London InterBank Offered Rate (LIBOR). One month LIBOR rates decreased from approximately 3.86% at June 30, 2001 to approximately 1.84% at June 30, 2002.

Net interest income for the six months ended June 30, 2002 and June 30, 2001 was approximately $6.6 million and $3.7 million, respectively. The increase of approximately $2.9 million was due to an increase in net interest spread (discussed in the two preceding paragraphs) and despite an increase in premium amortization. The premium amortization rate for the six months ended June 30, 2002 increased approximately $192 thousand from the same period ended June 30, 2001 due to the use of a level yield amortization method and the fact that prepayments increased on the two largest components of the portfolio, the 1999-2 and 1999-A segments. Premium amortization expense represents the amortization of purchase premiums paid for mortgage loans acquired in excess of the par value of the loans. Premium amortization expense including adjustments, was approximately $5.6 million for the six months ended June 30, 2002 and approximately $5.4 million for the six months ended

June 30, 2001.

The following chart repesents constant prepayment rates (CPRs):

	As of June 30, 2002			As of June 30, 2001		
	Three Months	**Six Months**	**Life-Time**	**Three Months**	**Six Months**	**Life-Time**
Bond collateral:						
CMO/FASIT 1998-1	39.0%	38.5%	43.0%	50.8%	51.0%	45.3%
CMO 1999-1	32.5%	33.4%	34.9%	38.2%	37.6%	34.2%
CMO 1999-2	52.0%	44.1%	32.3%	46.0%	33.7%	21.6%
CMO/REMIC 1999-A	46.4%	42.6%	37.2%	66.5%	51.7%	30.1%
CMO 2000-2	61.6%	49.3%	36.0%	35.8%	29.7%	21.8%

Net interest income, after provision for loan losses, increased $2.1 million from income of approximately $1.3 million for the six months ended June 30, 2001, to income of approximately $3.4 million for the six months ended June 30, 2002. This increase was due primarily to the increase in net interest spread discussed above. Loan loss provision increased $707 thousand from approximately $2.4 million for the six months ended June 30, 2001 to approximately $3.1 million for the six months ended June 30, 2002. The provision for loan losses as a percentage of total interest income has been steadily increasing due to normal aging of the mortgage asset portfolio (bond collateral). For the six month period ending June 30, 2001 the percentage of the provision for loan losses to total interest income was approximately 7.5% and for the six month period ending June 30, 2002 the percentage has increased to approximately 15.6%. The increases are related to seasoning of the sub-prime mortgage portfolio and expected increases in the number of loans in foreclosure which are likely to result in a loss to the Company.

During the six months ended June 30, 2002, other operating income increased $5.3 million as compared to the six months ended June 30, 2001, primarily due to AmNet s gain on sale of mortgage loans from its mortgage banking business which was not in existence in the prior period. A gain over the prior period was also experienced in the equity in income of American Residential Holdings, Inc. of approximately $45 thousand. This increase is offset by decreases for the period in management fee income (approximately $37 thousand) and prepayment penalty income (approximately $1.2 million) caused by the expiration of a high percentage of prepayment penalty clauses on loans in the mortgage asset portfolio.

For the six months ended June 30, 2002, other income increased approximately $10.3 million as a result of legal settlements. See Part II. OTHER INFORMATION for further description of these matters. There was no other income for the period ending June 30, 2001.

For the six months ended June 30, 2002, other expenses increased $17.6 million as compared to the six months ended June 30, 2001. This increase was mainly the result of an increase in general and administrative costs of approximately $9.2 million related to the increase in AmNet loan origination activity; the loss on derivative financial instruments of $8.5 million; the increase in professional fees of approximately $1.4 million related to litigation costs and multi-state business license authorizations and loss increases of approximately $278 thousand related to the sale of real estate owned. These other expense increases were partially offset by decreases in management fee expense of approximately $1.4 million and acquisition cost write-off s of approximately $514 thousand.

During the second quarter of 2002 there were significant declines and uncertainties in the equity markets which contributed to unprecedented volatility in the bond markets as a flight to quality occurred. This significant volatility in the bond markets was characterized by large and/or sudden upward and downward changes in interest rates, or yields. The volatility in the bond market yields caused significant changes in value of AmNet s mortgage pipeline and derivative financial instrument positions, and required the Company to purchase and sell derivative financial instruments in order to attempt to offset this volatility on several occasions, incurring significantly higher transaction costs. Additionally, the Company incurred losses on its derivative financial instruments which were partially offset by gains on the sale of mortgages during the quarter ended June 30, 2002. The Company expects a portion of the loss on derivative financial instruments will be partially offset by gains on the sale of mortgages in the third quarter of 2002.

While the intent of our hedging strategy is primarily to stabilize the value of the loans we are originating against possible interest rate fluctuations, the strategy we employed in the second quarter was not effective for several reasons. Keeping hedge positions aligned with our loan originations can be complex, and involves choosing from among a variety hedge instruments in the futures markets and delivery contracts with large buyers of loans. Ideally, if interest rates rise, the value of the mortgage loans in our pipeline decreases, but the derivative financial instruments used to hedge against this risk would create an offsetting profit. Conversely, if we execute our hedging strategy well, we would expect that if interest rates fall, the value of the mortgage loans in our pipeline would increase, but the hedge position would create an acceptable offsetting loss. For a variety of reasons, our strategy did not perform in accordance with this objective. First, we elected to use primarily short option positions, which were only capable of offsetting interest rate moves of approximately 20 basis points. Second, the interest rate volatility of the second quarter was well in excess of historical norms, and on many days was in excess of 50 basis points. Third, the nature of our short option positions was such that once interest rates dropped below the range protected by the option premium proceeds we collected, those same short positions actually accentuated our losses, and those losses overtook the amount of the gains in our loans. Fourth, in order to create additional option premiums, we periodically had a larger notional amount of coverage than the face amount of loans actually in the pipeline, thus exacerbating the divergence between the value of the assets we sought to protect and our loss on the options. Fifth, because the decline in rates was so dramatic, we did not enjoy some of our hoped for profits in the loans we were originating because many of our borrowers elected not to close those loans in favor of seeking alternative loan approvals at lower rates. Subsequent to the second quarter and considering the recent volatility in interest rates, we have elected to dramatically reduce the use of short option positions, and instead are using alternative approaches, such as mandatory delivery contracts and similar techniques.

Three Month Results

For the three months ended June 30, 2002, the Company generated net income of approximately $2.3 million and net income per share of $0.30 compared to the three months ended June 30, 2001 when the Company generated net income of approximately $811 thousand and net income per share of $0.10.

Mortgage asset interest income decreased approximately $4.0 million to approximately $10.0 million for the three months ended June 30, 2002 from approximately $14.0 million for the three months ended June 30, 2001. This decrease was primarily due to lower average mortgage assets. Mortgage assets were approximately $337.1 million at June 30, 2002 and approximately $643.6 million at June 30, 2001, which represents a 47.61% decline. The Mortgage asset decline was the result of high prepayment activity and no portfolio replenishment. Due to a favorable refinance market, the adjustable rate mortgage re-set rates are generally higher than rates available in the market place. Furthermore, in many cases, prepayment penalties have expired, or have not served as a deterrent to refinances.

Interest expense decreased by approximately $4.9 million to approximately $4.1 million for the three months ended June 30, 2002 from approximately $9.0 million for the three months ended June 30, 2001. This decrease is attributable to lower borrowings outstanding as well as lower borrowing rates. A majority of the Company s borrowing rates are based upon a spread over the one-month London InterBank Offered Rate (LIBOR). One month LIBOR rates decreased from approximately 3.86% at June 30, 2001 to approximately 1.84% at June 30, 2002.

Net interest income for the three months ended June 30, 2002 and June 30, 2001 was approximately $3.5 million and $2.2 million respectively. The increase of approximately $1.3 million was due to an increase in net interest spread (discussed in the two preceding paragraphs) and a decrease in premium amortization. The premium amortization rate for the three months ended June 30, 2002 decreased approximately $434 thousand from the same period ended June 30, 2001. Although for the six month period premium amortization increased over the prior period (see explanation above - ***Six Month Results***), the three month period decreased. The decrease for the three month period reflects the gradual decrease in level yield amortization as portfolio balances continue to decline. Premium amortization expense including adjustments, was approximately $2.5 million for the three months ended June 30, 2002 and approximately $3.0 million for the three months ended June 30, 2001.

Net interest income, after provision for loan losses, increased $1.0 million from income of approximately $1.4 million for the three months ended June 30, 2001, to income of approximately $2.4 million for the three months ended June 30, 2002. This increase was due primarily to the increase in net interest spread discussed above. Loan loss provision increased $245 thousand from approximately $779 thousand for the three months ended June 30, 2001 to approximately $1.0 million for the three months ended June 30, 2002. The provision for loan losses as a percentage of total interest income has been steadily increasing. For the three month period ending June 30, 2001 the percentage of the provision for loan losses to total interest income was approximately 5.5% and for the three month period ending June 30, 2002 the percentage has increased to approximately 10.2%. The increases are related to seasoning of the sub-prime mortgage portfolio and expected increases in the number of loans in foreclosure which are likely to result in a loss to the Company.

During the three months ended June 30, 2002, other operating income increased $4.3 million as compared to the three months ended June 30, 2001, primarily due to AmNet s gain on sale of mortgage loans from its origination business of approximately $5.0 million. This activity was not in existence in the prior period. In addition the equity in income from American Residential Holdings, Inc. increased approximately $82 thousand. These increases were offset by decreases for the period in management fee income (approximately $14 thousand) and prepayment penalty income (approximately $683 thousand).

For the three months ended June 30, 2002, other income increased approximately $10.3 million as a result of lawsuit and arbitration proceedings settlements. See Part II. OTHER INFORMATION for further description of these matters. There was no other income for the period ending June 30, 2001.

For the three months ended June 30, 2002, other expenses increased $14.1 million as compared to the three months ended June 30, 2001. This increase was mainly the result of a loss on derivative financial instruments of $8.8 million and an increase in general and administrative costs related to the increase in AmNet loan origination activity of approximately $5.1 million. Additionally, legal fees related to the Company s litigation increased professional fees approximately $875 thousand. Other increases included losses on sale of real estate owned by approximately $445 thousand and underwriting costs on loan originations of approximately $66 thousand. These other expense increases were partially offset by decreases in management fee expense of approximately $674 thousand and acquisition cost write-offs of approximately $514 thousand.

During the second quarter of 2002 there were significant declines and uncertainties in the equity markets which contributed to unprecedented volatility in the bond markets as a flight to quality occurred. This significant volatility in the bond markets was characterized by large and/or sudden upward and downward changes in interest rates, or yields. The volatility in the bond market yields caused significant changes in value of AmNet s mortgage pipeline and treasury positions, and required the Company to adjust its hedge positions on several occasions, incurring significantly higher transaction costs. Additionally, the Company incurred losses on its derivative financial instruments which were partially offset by gains on the sale of mortgages during the quarter ended June 30, 2002. The Company expects a portion of the loss on derivative financial instruments will be partially offset by gains on the sale of mortgages in the third quarter of 2002. See also Six Month Results above.

Liquidity and Capital Resources

During the six months ended June 30, 2002, net cash used in operating activities was approximately $161.9 million. The difference between net use of cash provided by operating activities and the net income of approximately $553 thousand was primarily the result of using $958.7 million to fund mortgage loan originations. This use was partially offset by $786.7 million in proceeds from loan sales. The other primary use of cash during the period was $2.8 million for investments in derivative financial instruments. Mortgage loans held for sale, net, pledged at June 30, 2002 was approximately $210.0 million of which approximately $129.3 million was committed for sale.

Net cash provided by investing activities for the six months ended June 30, 2002 was approximately $103.0 million. Cash flows from investing activities for the six months ended March 31, 2002 came from principal payments on bond collateral of approximately $97.4 million and proceeds from the sale of real estate owned of approximately $5.5 million.

For the six months ended June 30, 2002, net cash provided by financing activities was approximately $60.3 million, primarily due to the increase in short-term debt of approximately $170.3 million. The increase in cash was partially offset by payments on long-term debt of approximately $110.0 million and the purchase of outstanding common stock pursuant to the share repurchase program of approximately $199 thousand. Available short-term credit increased approximately $185 million during the period from approximately $75 million to approximately $260 million by increases in loan limits from an existing warehouse loan facility and the addition of a short-term borrowing facility. (See Note 7 to the financial statements). The Company s mortgage banking strategy requires that the Company increase its loan origination levels to a profitable level and continue to increase loan production volumes for sustained and increased profitability. In order to continue to increase loan origination volumes, the Company must obtain additional warehouse lines of credit, or reduce the time loans are held for sale (warehoused). There are a number of financial institutions which specialize in lending to mortgage banking companies and these types of secured borrowings. AmNet expects to expand its current warehouse lines of credit however, there can be no assurances that AmNet will be successful in obtaining additional warehouse facilities.

The Company s mortgage banking activities will require a significant level of cash reserves and capital to support start-up operating losses, loan inventories and hedge positions. Specifically, the Company expects its operations from mortgage banking to be cash flow negative for several months. Additionally, while AmNet utilizes warehouse credit facilities to fund its loan origination activity, AmNet must invest cash equity in its loan inventories approximating 1% to 4% of the cost basis for these loans. The Company also maintains interest rate hedges, requiring margin accounts set by the Chicago Board of Trade. While the Company believes its capital base, cash reserves and cash revenues from its spread lending business and mortgage banking revenues will be sufficient to enable the Company to execute its mortgage banking strategy, there can be no assurances that capital shortages will not occur, requiring the Company to raise additional debt or equity capital or decrease or cease its origination activities.

The Company does not expect to pay dividends in 2002. As a REIT, it has been the Company s policy to distribute at least 90% of taxable income to its shareholders in the form of dividends. While the Company expects to report profits in 2002 for financial reporting (GAAP) purposes, it expects to have a loss in 2002 for tax purposes. This is because 1. the Company has certain loss carryforwards from previous years, and 2. certain expenses and charges taken for GAAP purposes in previous years, primarily related to loan premium amortization and credit provisions, will be expensed for tax purposes in 2002 and 2003. Furthermore, the proceeds received from the settlement of legal claims totaling $10.3 million in the second quarter of 2002, is income for GAAP purposes but only partially recorded as income for tax purposes.

During the six months ended June 30, 2001, net cash provided by operating activities was approximately $12.8 million. The difference between net cash provided by operating activities and the net loss of approximately $890 thousand was primarily the result of amortization of Mortgage Asset premiums, reduction of interest rate cap agreements to market value, provision for loan losses, and a decrease in accrued interest receivable. Accrued interest receivable increased cash flow during the first six months of 2001 due to the Mortgage Asset portfolio decreasing approximately $203.7 million from December 31, 2000 to June 30, 2001. The primary uses of cash that lowered amounts available to fund operations included: an increase in equity income of American Residential Holdings, Inc.; a decrease in accrued interest payable; and, payments which increase amounts due from affiliates.

Net cash provided by investing activities for the six months ended June 30, 2001 was approximately $193.8 million. Cash flows from investing activities for the six months ended June 30, 2001 came from principal payments on bond collateral of approximately $187.5 million and proceeds from the sale of real estate owned of approximately $6.3 million.

For the six months ended June 30, 2001, net cash used in financing activities was approximately $201.6 million, primarily due to payments on long-term debt of approximately $196.9 million and payments on short-term debt of approximately $2.9 million. Net cash used in financing was further increased by the payment of dividends of approximately $1.6 million and the purchase of outstanding common stock pursuant to the share repurchase program of approximately $196 thousand.

Business Risks Mortgage Asset Portfolio Investments Spread Lending Business

High Levels of Bond Collateral Mortgage Loan Prepayments May Reduce Operating Income

The level of prepayments of bond collateral mortgage loans purchased at a premium by the Company directly impacts the level of amortization of capitalized premiums. The Company uses a calculation for determining the premium amortization which is based on the interest method. If prepayment levels exceed projections used for the premium amortization calculation, the potential exists for impairment write-downs as a result of under-amortized premiums.

Bond collateral mortgage loan prepayment rates generally increase when market interest rates fall below the current interest rates on mortgage loans. Prepayment experience also may be affected by the expiration of prepayment penalty clauses, the ability of the borrower to obtain a more favorable mortgage loan, geographic location of the property securing the adjustable-rate mortgage loans, the assumability of a mortgage loan, conditions in the housing and financial markets and general economic conditions. The level of prepayments is also subject to the same seasonal influences as the residential real estate industry with prepayment rates generally being highest in the summer months and lowest in the winter months. The Company experienced high levels of prepayments during 1999 through 2000 on its CMO/FASIT segment of its bond collateral mortgage loan portfolio due principally to the fact that the underlying adjustable rate loans were subject to their first initial interest rate adjustment (after being fixed for the first two years), prepayment penalty clauses expired and borrowers were able to secure more favorable rates by refinancing. In 2001 and 2002, the same phenomenon occurred in the 99-A and 1999-2 segments of the portfolio, as the loans in these portfolios reached the end of their 2 year fixed rate periods and prepayment penalty clauses expired. The overall rate of prepayments has decreased over the past several months averaging 40.15% in the first six months of 2002, 41.66% in the fourth quarter of 2001, down from 52.15% in the third quarter and 49.60% in the second quarter. The Company anticipates that overall prepayment rates are likely to remain in the 40% to 50% range in 2002. There can be no assurance that prepayment rates will not be higher or that prepayment penalty income will offset premium amortization expense. Accordingly, the Company s financial condition and results of operations could be materially adversely affected.

As of June 30, 2002 approximately 23.1% of the Company s Bond Collateral Mortgage Loan portfolio had prepayment penalty clauses, with a weighted average of fifteen months remaining before prepayment penalties expire. Prepayment penalty clauses serve as a deterrent to early prepayments and the penalties collected help to offset the premium amortization expense. However, prepayment penalty fees may be in an amount which is less than the figure which would fully compensate the Company for its remaining capitalized premiums, and prepayment penalty provisions may expire before the prepayment occurs.

Borrower Credit Defaults, Special Hazard Losses and National Recessions May Decrease Value and Cash Flow from the Company Bond Collateral Mortgage Assets

During the time the Company holds bond collateral mortgage assets or retained interest in securitizations, it is subject to credit risks, including risks of borrower defaults, bankruptcies and special hazard losses that are not covered by standard hazard insurance (such as those occurring from earthquakes or floods). In the event of a default on any mortgage loan held by the Company or mortgages underlying bond collateral or retained interest in securitization, the Company will bear the risk of loss of principal to the extent of any deficiency between the value of the secured property and the amount owing on the mortgage loan, less any payments from an insurer or guarantor. Although the Company has established an allowance for loan losses, there can be no assurance that any allowance for loan losses which is established will be sufficient to offset losses on mortgage loans in the future.

Credit risks associated with non-conforming mortgage loans, especially sub-prime mortgage loans, will be greater than those associated with mortgage loans that conform to FNMA and FHLMC guidelines. The principal difference between sub-prime mortgage loan and conforming mortgage loans is that sub-prime mortgage loans typically include one or more of the following: worse credit and income histories of the mortgagors, higher loan-to-value ratios, reduced or alternative documentation required for approval of the mortgagors, different types of properties securing the mortgage loans, higher loan sizes and the mortgagor s non-owner occupancy status with respect to the mortgaged property. As a result of these and other factors, the interest rates charged on non-conforming mortgage loans are often higher than those charged for conforming mortgage loans. The combination of different underwriting criteria and higher rates of interest may lead to higher delinquency rates and/or credit losses for non-conforming as compared to conforming mortgage loans and thus require high loan loss allowances. All of the Company s Bond Collateral Mortgage Loans at June 30, 2002 were originated as sub-prime mortgage loans.

A downturn in the national economy and the resultant adverse impact on employment rates could adversely affect mortgage loan defaults. Additional credit could become scarce in such an environment and therefore risk of loss through loan default and decreased property value could increase. The Company s allowances for loan losses may be inadequate should economic conditions worsen significantly causing higher than expected defaults and property value decreases. Management believes the allowances for loan losses are adequate as of June 30, 2002.

Even assuming that properties secured by the mortgage loans held by the Company provide adequate security for such mortgage loans, substantial delays could be encountered in connection with the foreclosure of defaulted mortgage loans, with corresponding delays in the receipt of related proceeds by the Company. State and local statutes and rules may delay or prevent the Company s foreclosure on or sale of the mortgaged property and typically prevent the Company from receiving net proceeds sufficient to repay all amounts due on the related mortgage loan.

Prepayments, Credit Losses and Increases in Short Term Interest Rates May Adversely Affect the Value of Retained Interest in Securitization

In 1998, the Company completed a sale of residential mortgage loans through the securitization of such loans through a REMIC. The REMIC consisted of pooled, first-lien mortgages and was issued by American Residential Holdings, Inc (Holdings) to the public through a registration statement of an underwriter. The interest-only strip referred to as the Class X Certificate was created in the process of the securitization and was transferred from Holdings to American Residential Eagle, Inc., a wholly owned REIT subsidiary of the Company. The value of this investment is impacted by the level of future prepayments, credit loss and net interest spread on the underlying mortgages. There were no impairment charges during the six months ending June 30, 2002. However, during the year ending December 31, 2000, the Company incurred a $5.1 million impairment charge related to its retained interest in a REMIC securitization (the Residual). GAAP requires that any decline in residual asset value that is other than temporary be reflected through the Company s current period statement of operations. There are no other retained interests in securitizations owned by the Company.

Requirements to Maintain Over-collateralization Accounts May Reduce the Company s Cash Flow and Inhibit Plans for Expansion of the Mortgage Banking Business

In connection with securing long term debt, virtually all of the Company s Bond Collateral Mortgage Loans have been pledged as collateral to secure long term debt. Certain overcollateralization accounts have been established representing the excess principal amount of these mortgages over the associate bond obligations. Various indenture agreements associated with these financings call for the overcollateralization levels to be maintained on an ongoing basis depending on the amount of remaining bond obligations as well as the status of delinquency of the underlying bond collateral or the loan loss performance of bond collateral. Although its long-term financing agreements are non-recourse, net interest income from some segments of the Company s Bond Collateral Mortgage Loans has in the past, and could in the future, be trapped to pay down debt in order for the Company to achieve its over-collateralization requirements. While the Company believes that it has sufficient cash reserves and other liquidity to support its planned mortgage banking activities, there can be no assurances that the Company will not be required to reduce or cease its planned mortgage banking activities should it be required to divert cash flow to maintain overcollateralization requirements.

Because Mortgage Assets Are Pledged to Secure Long-Term Debt, the Company may not be Able to Sell Such Assets and Therefore the Company s Liquidity and Capital Resources may be Adversely Affected

All of the Company s bond collateral mortgage assets at June 30, 2002 were pledged as bond collateral to secure Long-Term Debt. These assets are subject to the terms of the Long-Term Debt agreements and may not be separately sold or exchanged. While the Company may sell its interests in the bond collateral subject to the liens and other restrictions of the Long-Term Debt agreements, there is not a liquid market for such encumbered interests and a significant liquidity discount would be applied. As such, the Company would expect to receive less than its book value should it sell its interests in the bond collateral.

Increases In Short Term Interest Rates May Increase the Cost of Borrowings by the Company Which May Reduce Income From Operations

The majority of the Company s Bond Collateral Mortgage Loans have a repricing frequency of six months or less, while substantially all of the Company s borrowings have a repricing frequency of one month or less. Accordingly, the interest rates on the Company s borrowings may be based on interest rate indices which are different from, and adjust more rapidly than, the interest rate indices of its related mortgage loans. Consequently, increases in (short-term) interest rates may significantly influence the Company s net interest income. While increases in short-term interest rates will increase the yields on a portion of the Company s adjustable-rate Bond Collateral Mortgage Loans, rising short term rates will also increase the cost of borrowings by the Company. To the extent such costs rise more than the yields on such Bond Collateral Mortgage Loans the Company s net interest income will be reduced or a net interest loss may result. The Company may mitigate its gap risk by purchasing interest rate hedges (referred to as caps), however potential income from these hedges may only partially offset the adverse impact of rising borrowing costs.

Loans Serviced by Third Parties May Result in Increased Delinquency Rates and Credit Losses which May Adversely Affect the Company s Results of Operations and Financial Condition

All of the Company s Bond Collateral Mortgage Loans are serviced by sub-servicers. The Company continually monitors the performance of the sub-servicers through performance reviews, comparable statistics for delinquencies and on-site visits. The Company has on occasion determined that sub-servicers have not followed standard collection and servicing practices related to the Company s Bond Collateral Mortgage Loans which the Company believes has led to increased delinquencies and higher loan losses on selected segments. The Company continues to monitor these servicers, has put these entities on notice of such deficiencies, and has instituted other mitigating processes. The Company has arranged for servicing with entities that have particular expertise in non-conforming mortgage loans. Although the Company has established these relationships and procedures, there can be no assurance that these sub-servicers will service the Company s mortgage loans in such a way as to minimize delinquency rates and/or credit losses and not cause an adverse effect on the Company s results of operations.

Risks Associated with Changing the Company s Business Strategy

The Company has a Limited Operating History in the Mortgage Origination Industry, which Makes it Difficult to Evaluate the Company s Current Business Performance and Future Prospects

The Company was formed in 1997 and operated as a mortgage REIT (mortgage portfolio investment) until the fourth quarter of 2001, at which time the Company began originating and selling mortgages (mortgage banking). The Company must originate increasing amounts of mortgages in the future to grow its business. While the Company s executive officers have extensive mortgage origination and mortgage banking experience, and have hired experienced personnel in its mortgage banking subsidiary, there are a significant number of risks and uncertainties inherent in the mortgage origination industry, especially in light of the Company s limited relevant operating history and experience originating mortgages.

The Company Expects Operating Expenses to Increase Significantly which May Adversely Affect its Results of Operations

Although the Company earned a net profit of approximately $430 thousand for the six month period ending June 31, 2002, this profit was entirely due to lawsuit and arbitration settlements totaling $10.3 million. Without these settlements the Company would have incurred a net loss of approximately $9.9 million for the first six months of 2002. The Company expects operating losses to continue, which may render it unable to generate sufficient revenues to be profitable in the future. In particular, the Company expects to incur additional costs and expenses related to the expansion of the sales force and regional underwriting centers as well as the expansion of its management team and internal infrastructure necessary to support the growth of the mortgage banking business.

Unprofitable operations may have an adverse effect on the price of the Company s common stock.

The Company May Not Be Able to Effectively Manage the Growth of its Business

Recently, the Company has experienced rapid growth. In the beginning of 2001, the Company had approximately 20 employees. As of June 30, 2002, it had approximately 214 employees. Many of these employees have very limited experience with the Company and a limited understanding of its systems and controls. Many of the Company s financial, operational and managerial systems and controls were designed for a small business and have only recently been adopted or replaced to support larger scale operations. The

Company will need to attract and hire additional sales and management personnel in an intensely competitive hiring environment. At the same time, the Company will need to continue to upgrade and expand its financial, operational and managerial systems and controls and policies and procedures. If the Company fails to manage its growth effectively, the Company s expenses could increase and the management s time and attention could be diverted. If the Company does not succeed in these efforts, it will be unable to effectively grow and manage the business, and its financial results could be negatively affected.

Mortgage Banking Business Business Risks

Failure to Renew and Obtain Adequate Financing May Adversely Affect Results Of Operations

The Company s mortgage banking strategy requires that the Company increase its loan origination levels to a profitable level and continue to increase loan production volumes for sustained and increased profitability. The Company currently has warehouse borrowing facilities in place totaling $260 million. In order to continue to increase loan origination volumes, the Company must obtain additional warehouse lines of credit, or reduce the time loans are held for sale (warehoused). There are a number of financial institutions which specialize in lending to mortgage banking companies and these types of secured borrowings. AmNet expects to expand its current warehouse facilities with JP Morgan/Chase and UBS Warburg; however, there can be no assurances that AmNet will expand its current warehouse facility or obtain additional warehouse facilities.

Among the factors that will affect AmNet s ability to expand its warehouse line borrowings are financial market conditions and the value and performance of AmNet prior to the time of such financing. There can be no assurance that any such financing can be successfully completed at advantageous rates or at all. Additionally, the Company s warehouse borrowing facilities contain various financial covenants including maximum leverage and cash reserve (liquidity) requirements. Failure to comply with these covenants would accelerate these debt agreements and if waivers or modifications could not be obtained, the Company could have an interruption in its ability to fund its mortgage loan originations, which could materially adversely impact the Company s results of operations and financial condition.

Overhead Expenses May Not Be Covered By Sufficient Revenues To Achieve Or Sustain Profitable Operations.

The Company made a number of fixed overhead commitments to establish the operational and administrative infrastructure necessary to support the loan origination business. At June 30, 2002, lease commitments for headquarter and regional offices totaled approximately 35,000 square feet. There were 214 salaried employees. In order to achieve profitability, AmNet s monthly originations must be in the $350 million to $400 million range, such that the revenues associated with this loan production exceed fixed and variable overhead costs. Since AmNet s revenues are tied directly to the level of loan production, it is imperative that AmNet achieves a profitable level of originations, and the level of future profitability from mortgage banking will be in direct correlation to the level of loan origination volume. There can be no assurances that AmNet will increase its loan origination volumes sufficiently to cover its fixed overhead costs, and should it incur significant operating losses during its start-up phase, the capital base and cash reserves could be materially adversely impacted, precluding the Company from fully implementing its mortgage banking strategies.

Non-saleable or Repurchased Loans May Adversely Impact Results of Operations and The Company s Financial Position

In connection with the sale of loans to correspondent investors, AmNet makes a variety of representations and warranties on the loans including those that are customary in the industry relating to, among other things, compliance with laws, regulations and investor program standards and as to the accuracy of information on the loan documents and loan file. In the event that an investor finds that a loan or group of loans violates AmNet s representations, the investor may require AmNet to repurchase the loan and bear any potential related loss on the disposition of the loan, or provide an indemnification for any losses sustained by the investor on the loan. Additionally, AmNet may originate a loan that does not meet investor underwriting criteria or has some other defect, requiring AmNet to sell the loan at a significant discount. AmNet has hired experienced personnel at all levels and has established significant controls to ensure that all loans are originated to AmNet s underwriting standards, and are maintained in compliance with all of the representations made by AmNet in connection with its loan sale agreements. However there can be no assurances that mistakes will not be made or that certain employees will not deliberately violate AmNet s lending policies, and accordingly AmNet is subject to repurchase risk and losses on unsaleable loans. Typically, with respect to any loan that might be repurchased or unsaleable, AmNet would correct the flaws if possible and re-sell the loan in the market. AmNet intends to create repurchase allowances to provide for this contingency on its financial statements, but there can be no assurances that loan losses associated with repurchased or unsaleable loans will not adversely impact results of operations or the financial condition of the Company.

Volatility in Interest Rates

AmNet s primary source of revenues is expected to be gains from the sale of loans, net of gains or losses on hedging transactions. AmNet sets rates and pays broker premiums based on a pricing process designed to create a targeted profit margin on each loan. Appropriately pricing these loans can be complex, and AmNet may not always successfully price its loans with adequate margin to compensate it for the risk of interest rate volatility. In addition, AmNet uses derivative financial instruments in an effort to limit its exposure to changes in interest rates between the time it makes a rate lock commitment and the time each loan is closed and/or sold to investors.

Unexpected gains or losses on sales of mortgage loans have resulted from and may in the future result from changes in interest rates from the time the interest rate on a customer s mortgage loan application is established to the time AmNet sells the loan. At any given time, AmNet has committed to sell substantially all of its mortgage loans that are closed (closed loan inventory) and a percentage of the mortgage loans that are not yet closed but for which the interest rate has been established (pipeline loans). To manage the interest rate risk of AmNet s pipeline loans, AmNet continuously projects the percentage of the pipeline loans it expects to close. Projecting a percentage of pipeline loans which will close is especially difficult during periods of volatile interest rates. On the basis of such projections, AmNet employs a variety of techniques, currently consisting of a combination of mandatory forward sales commitments and put and call option contracts on United States Treasury obligations to partially mitigate market interest rate risk. The Company cannot assure however, that AmNet s use of derivative securities will offset the risk of changed in interest rates. In certain instances it may even increase this risk. See Management s Discussion and Analysis of Financial Condition and Results of Operations --- Six Month Results.

If interest rates make an unanticipated change, the actual percentage of pipeline loans that close may differ from the projected percentage. A sudden increase in interest rates can cause a higher percentage of pipeline loans to close than projected. AmNet may not have made forward sales commitments to sell these additional loans and consequently may incur significant losses upon their sale at current market prices, which may not be offset by gains in the value of derivative securities, adversely affecting results of operations. Likewise, if a lower percentage of pipeline loans closes than was projected, due to a sudden decrease in interest rates or otherwise, AmNet has had to and may in the future adjust its hedge positions or mandatory sales commitments at a significant cost, adversely affecting results of operations. This risk is greater during times of volatility of interest rates.

Changes in Interest Rates Could Adversely Impact Results of Operations

The profitability of AmNet is likely to be adversely affected during any period of unexpected or rapid increases in interest rates. Such interest rate increases could have the effect of reducing the value of loans held for sale with such decline not fully offset by gains from hedging activities. Higher mortgage rates could also cause a decline in the overall market for new loans, adversely impacting AmNet s origination levels. Furthermore, while the Company currently enjoys a positive net interest spread on its loans held for sale, inverse or flattened interest yield curves (the relationship between long term rates and short term rates) could have an adverse impact on AmNet s warehouse interest spread income because AmNet generally has loans in inventory based on the 30-year fixed rate while the warehouse line of credit facility bears a short-term interest rate.

Capital Shortages Could Impede the Company s Ability to Execute Its Mortgage Banking Strategy

The Company s mortgage banking activities will require a significant level of cash reserves and capital to support start-up operating losses, loan inventories and hedge positions. Specifically, the Company expects its operations from mortgage banking to be cash flow negative for several months. Additionally, while AmNet utilizes warehouse credit facilities to fund its loan origination activity, AmNet must invest cash equity in its loan inventories approximating 1% to 4% of the cost basis for these loans. The Company also maintains interest rate hedges, requiring margin accounts set by the Chicago Board of Trade. While the Company believes its capital base, cash reserves and cash revenues from its spread lending business and mortgage banking revenues will be sufficient to enable the Company to execute its mortgage banking strategy, there can be no assurances that capital shortages will not occur, requiring the Company to raise additional debt or equity capital or decrease or cease its origination activities.

Non-Compliance With State or Federal Rules And Regulations May Adversely Impact AmNet s Ability to Originate and Sell Loans

In connection with the origination and sale of residential 1-4 unit mortgages, AmNet and the Company are subject to various state licensing requirements, and various state and federal rules and regulations of the department of Housing and Urban Development, the Federal Housing Administration and the Veterans Administration. Failure to comply with state and federal laws and requirements could impact the AmNet s ability to originate and/or sell loans, and thus could have an adverse impact on the Company s results of operation and financial condition. While AmNet has controls and processes to ensure compliance with laws and regulations, there can be no assurances that it fully complies with all regulatory requirements.

A number of legislative initiatives are underway in several local and state jurisdictions as well as on the federal level that would define and potentially restrict or prohibit predatory lending. While the Company does not consider its lending practices to be predatory, there can be no assurances that practices or disclosure requirements used by the company to originate mortgages (while widely used throughout the A paper mortgage industry) could be required to change pursuant to new legislation. Restrictions, prohibitions and more onerous disclosure or reporting requirements, particularly those that would be directed to lenders who originate mortgages through independent mortgage brokers, could adversely impact loan origination volume or increase the cost of originating mortgages.

Competition In The Mortgage Banking Industry and Demand for Mortgages May Hinder The Company s Ability to Achieve or Sustain Profitable Origination Levels.

The Company s success in its mortgage banking strategy will depend, in large part, on AmNet s ability to originate A paper loans in sufficient quantity such that gains on the sale of these mortgages combined with broker fees and interest spread are in excess of both fixed and variable overhead costs. There can be no assurance that AmNet will be able to originate sufficient levels or mortgages to achieve and sustain profitability. In originating and selling A paper loans, AmNet will compete with investment banking firms, savings and loan associations, banks, mortgage bankers and other entities originating A paper residential 1-4 unit mortgages, many of which have greater financial resources than AmNet. The Company will face competition from companies already established in these markets. In addition to the level of home purchase activity, the origination market is directly tied to the general level of interest rates and refinance activity. The origination market exceeded $1.2 trillion in 2000 and $2 trillion in 2001, due to both strong home sales and low interest rates. While it is expected that the loan origination market will continue to be in the trillion-plus level in 2002 and beyond, the overall market size could contract, increasing competitiveness in the mortgage markets, and putting pressure on the market competitors to reduce revenues to sustain origination volumes and market share. The Company believes that it has identified a market niche that will allow it to gain market share over the next several years, even if the overall demand for mortgages declines, however there can be no assurance that the Company will be able to successfully compete.

AmNet Is Subject To Losses Due To Fraudulent Acts On The Part Of Loan Applicants or Mortgage Brokers

Mortgage brokers, who assist loan applicants in obtaining mortgage loans, refer all of the mortgage loans originated by AmNet. As such, the loan application, property appraisal, credit report and other supporting documentation are furnished by the mortgage broker and used by AmNet s underwriters to make approval or denial decisions. AmNet employees have virtually no contact with applicants, and rely on the mortgage broker to obtain and furnish all of the documentation supporting the mortgage loan application.

Further, in rare cases, the mortgage broker may knowingly or unknowingly submit an application wherein multiple parties to the transaction (borrower, appraiser, seller, or title insurer) work in collusion to inflate the property value and/or falsify other documentation in order to obtain a mortgage loan. These types of fraudulent mortgage loans will have a high risk of default, and will likely not be fully recoverable through disposition of the underlying property securing the mortgage loan.

Should material fraud be detected on a mortgage loan prior to sale to an investor, the mortgage loans may have to be sold at a significant discount or may not be saleable. Should material fraud be detected after a mortgage loan is sold to a correspondent investor, AmNet may be required to repurchase the loan or indemnify the investor. While the investor and/or AmNet can initiate foreclosure proceedings on any loans deemed to be fraudulently obtained, AmNet could incur significant losses on these fraudulent mortgage loans if principal or interest is not fully recovered through the foreclosure and disposition of the underlying property securing the mortgage loan.

AmNet has established risk management and quality control committees to set policy and manage exposure to credit losses due to fraud, compliance errors or non-compliance with AmNet s underwriting standards. Regular quality control audits are done on representative samples of mortgage loans and all mortgage loans submitted by brokers who come under suspicion in the normal course. Additionally, AmNet has numerous controls and processes to ensure that all of the mortgage loan applications submitted through mortgage brokers are not based on fraudulent or intentionally misrepresented documentation. However there can be no assurances that the broker and/or borrowers do not submit fraudulent or inaccurate documentation that is not detected by AmNet personnel, or by electronic fraud checks utilized by AmNet. Should AmNet originate significant numbers of fraudulent loans, the Company s results of operations and financial condition could be materially adversely affected.

AmNet is Subject to Counterparty Risks on Loan Sales Commitments and Hedging Transactions

In connection with its mortgage loan sales, which involve the sale of mortgage loans and mortgage-backed securities on a forward or other deferred delivery and payment basis, AmNet also enters into treasury option purchases and sales in connection with its hedging activities. AmNet has credit risk exposure to the extent purchasers/sellers are unable to meet the terms of their forward purchase/sale contracts. As is customary in the marketplace, none of the forward payment obligations of any of AmNet s counterparties is currently secured or subject to margin requirements. AmNet attempts to limit its credit exposure on forward sales arrangements on mortgage loans and mortgage backed securities by entering into forward contracts only with institutions that AmNet believes are acceptable credit risks, and which have substantial capital and an established track record in correspondent lending. In its treasuries futures transactions, AmNet enters into transactions with the Chicago Board of Trade through an approved dealer to minimize potential trade risk however there can be no assurances that counterparties will perform. If counterparties do not perform, AmNet s results of operations may adversely affected.

Mortgage Banking Revenues Can Fluctuate From Period to Period Based on a Number of Factors

AmNet s operating results have and may in the future fluctuate significantly from period to period as a result of a number of factors, including the volume of loan production, interest rates and the level of unrealized gains/losses in unsold loans, pipeline loans or hedge positions. Accordingly, the consolidated net income of the Company may fluctuate from period to period.

Dependency on Correspondent Investors, Secondary Markets

AmNet s ability to generate gains on the sale of mortgages is largely dependent upon the continuation of correspondent lending programs offered by large correspondent lenders, as well as AmNet s continued eligibility to participate in such programs. Although AmNet is in good standing with a number of large correspondent lenders and is not aware of any proposed discontinuation of, or significant reduction in, the operation of such programs, any such changes could have a material adverse effect on AmNet s operations. AmNet anticipates that it will continue to remain eligible to participate in such programs, but any significant impairment of such eligibility would materially adversely affect its operations.

Origination Activity Is Concentrated In California, Making the Company s Results Subject to Adverse Economic Conditions In California.

A large proportion of loans expected to be originated by AmNet will be concentrated in California. Although AmNet is expanding its operations to the East Coast of the United States in 2002, a significant portion of its loan origination volume is likely to be based in California for the foreseeable future. Consequently, AmNet s results of operations and financial conditions are dependent upon general trends in the California economy and its residential real estate market. Residential real estate market declines may adversely affect the levels of new mortgages in California or the value paid by correspondent lenders for loans in California, potentially adversely affecting the Company s results of operations and financial condition.

A Recent Federal Circuit Decision Regarding the Legality of Yield Spread Premiums Could Increase Litigation Against Us and Other Mortgage Lenders

A recent federal circuit court decision regarding the legality of yield spread premiums could increase litigation against other mortgage lenders and us. In June 2001, the Eleventh Circuit Court of Appeals issued a decision in *Culpepper v. Irwin Mortgage Corp*. in which the court revisited the legality of certain payments that lenders commonly make to mortgage brokers, often referred to as yield spread premiums, under the federal Real Estate Settlement Procedures Act. A yield spread premium is an amount paid by a mortgage lender to a mortgage broker for the origination of a loan, typically measured by the difference, or spread, between the amount the lender is willing to pay with respect to a given loan based on the loan s specific characteristics, such as interest rate, loan to value ratio, and credit grade, and the amount of the lender s baseline or par price that the lender offers to pay for loans with certain baseline or par characteristics. For example, if a broker produces a $100,000 loan meeting the requirements that lender has specified in order to pay 101% (1% above the lender s par price) then the lender will pay that broker a yield spread premium of $1,000 ($100,000 times 1%). In 1999, the Department of Housing and Urban Development issued a policy statement taking the position that lender payments to mortgage brokers, including yield spread premiums, are not *per se* illegal, and it reiterated this basic position in a statement issued in October 2001. The *Culpepper* decision is inconsistent with the position taken by the Department of Housing and Urban Development; however, the Department of Housing and Urban Development statements do not have the binding effect of a statue or regulation. Other mortgage lenders and we now face inconsistent judicial decision about such payments. If the *Culpepper* decision is not overturned or otherwise superseded by law or regulation, there could be a substantial increase in litigation regarding lender payments to brokers and potential costs defending these types of claims and in paying any judgments that might result. The Real Estate Settlement Procedures Act imposes severe penalties, including damages equal to three times the amount of the illegal payments in the event such payments were determined to have violated the law, in addition to exposing the violating party to substantial amounts of attorney s fees. The Company is abiding by industry standards while this issue is being resolved through the legal system.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

A primary market risk facing the Company is interest rate risk. The Company attempts to manage this risk by striving to balance its mortgage loan origination and mortgage loan sale business. To a lesser degree the Company also manages the interest rate risk on it portfolio business between interest earned on bond collateral mortgage assets and interest paid on long term debt collaterized by mortgage assets.

The Company has performed various sensitivity analyses that quantify the net financial impact of changes in interest rates on its interest rate-sensitive assets, liabilities and commitments. These analyses presume an instantaneous parallel shift of the yield curve. Various techniques are employed to value the underlying financial instruments and rely upon a number of critical assumptions. The scenarios presented are illustrative. Actual experience may differ materially from the estimated amounts presented for each scenario. To the extent that yield curve shifts are non-parallel and to the extent that actual variations in significant assumptions differ from those applied for purposes of the valuations, the resultant valuations can also be expected to vary. Such variances may prove material.

	June 30, 2002		If Interest Rates Were To			
			Increase	Decrease	Increase	Decrease
	Carrying Amount	Estimated Fair Value	50 Basis Points Estimated Fair Value		100 Basis Points Estimated Fair Value	
Interest-earning assets:						
Cash and cash equivalents	$ 12,348	$ 12,348	$ 12,348			