OCWEN FINANCIAL CORP
Form 10-Q
November 06, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2008

or

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from: ____________________to ____________________
Commission File Number: 1-13219

Ocwen Financial Corporation

(Exact name of registrant as specified in its charter)

Florida	65-0039856
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1661 Worthington Road, Suite 100, West Palm Beach, Florida 33409

(Address of principal executive offices) (Zip Code)

(561) 682-8000

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

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

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

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

Number of shares of Common Stock, $0.01 par value, outstanding as of October 31, 2008: 62,716,530 shares.

OCWEN FINANCIAL CORPORATION
FORM 10-Q

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PART I – FINANCIAL INFORMATION
ITEM 1. INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
OCWEN FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Dollars in thousands, except share data)

	September 30, 2008	December 31, 2007
Assets		
Cash	$ 162,306	$ 114,243
Trading securities, at fair value		
Investment grade auction rate	253,944	—
Other investment grade	—	34,876
Subordinates and residuals	4,239	7,362
Loans held for resale, at lower of cost or fair value	55,642	75,240
Advances	140,079	292,887
Match funded advances	1,070,899	1,126,097
Mortgage servicing rights	150,234	197,295
Receivables	69,307	79,394
Deferred tax assets, net	171,004	178,178
Intangibles, including goodwill of $15,255 and $17,615	52,276	58,301
Premises and equipment, net	32,495	35,572
Investments in unconsolidated entities	32,485	76,465
Other assets	107,505	118,786
Total assets	$ 2,302,415	$ 2,394,696
Liabilities and Stockholders' Equity		
Liabilities		
Match funded liabilities	$ 985,316	$ 1,001,403
Lines of credit and other secured borrowings	144,259	339,976
Investment line	215,220	—
Servicer liabilities	110,297	204,484
Debt securities	135,734	150,279
Other liabilities	98,789	110,429
Total liabilities	1,689,615	1,806,571
Minority interest in subsidiaries	2,124	1,979
Commitments and Contingencies (Note 18)		
Stockholders' Equity		
Common stock, $.01 par value; 200,000,000 shares authorized; 62,716,530 and 62,527,360 shares issued and outstanding at September 30, 2008 and December 31, 2007, respectively	627	625
Additional paid-in capital	179,726	177,407
Retained earnings	428,424	406,822

Accumulated other comprehensive income, net of income taxes		1,899		1,292
Total stockholders’ equity		610,676		586,146
Total liabilities and stockholders’ equity	$	2,302,415	$	2,394,696

The accompanying notes are an integral part of these consolidated financial statements.

OCWEN FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Dollars in thousands, except share data)

	Three months		Nine months	
For the periods ended September 30,	**2008**	**2007**	**2008**	**2007**
Revenue				
Servicing and subservicing fees	$ 91,298	$ 99,077	$ 290,200	$ 283,714
Process management fees	27,453	23,158	81,794	63,708
Other revenues	2,510	3,115	8,743	9,837
Total revenue	121,261	125,350	380,737	357,259
Operating expenses				
Compensation and benefits	33,726	30,515	96,567	75,821
Amortization of servicing rights	12,106	22,022	40,712	81,810
Servicing and origination	11,540	16,738	37,589	45,666
Technology and communications	6,022	6,165	17,713	16,158
Professional services	5,973	5,756	27,058	18,718
Occupancy and equipment	5,131	7,121	17,471	18,009
Other operating expenses	2,960	3,327	9,689	6,918
Total operating expenses	77,458	91,644	246,799	263,100
Income from operations	43,803	33,706	133,938	94,159
Other income (expense)				
Interest income	3,448	5,091	11,492	24,292
Interest expense	(18,418)	(17,494)	(63,698)	(47,744)
Gain (loss) on trading securities	(621)	(1,408)	(22,366)	17,672
Gain (loss) on debt repurchases	—	(3)	3,595	(3)
Loss on loans held for resale, net	(674)	(4,359)	(11,112)	(11,376)
Equity in earnings (losses) of unconsolidated entities	(2,928)	3,537	(10,628)	3,359
Other, net	(201)	(8,928)	72	(8,879)
Other expense, net	(19,394)	(23,564)	(92,645)	(22,679)
Income from continuing operations before income taxes	24,409	10,142	41,293	71,480
Income tax expense	8,662	3,882	14,119	25,015
Income from continuing operations	15,747	6,260	27,174	46,465
Loss from discontinued operations, net of income taxes	(186)	(309)	(5,572)	(943)
Net income	$ 15,561	$ 5,951	$ 21,602	$ 45,522

Basic earnings per share				
Income from continuing operations	$ 0.25	$ 0.10	$ 0.43	$ 0.74
Loss from discontinued operations	—	—	(0.09)	(0.01)
Net income	$ 0.25	$ 0.10	$ 0.34	$ 0.73
Diluted earnings per share				
Income from continuing operations	$ 0.23	$ 0.10	$ 0.42	$ 0.67
Loss from discontinued operations	—	(0.01)	(0.08)	(0.01)
Net income	$ 0.23	$ 0.09	$ 0.34	$ 0.66
Weighted average common shares outstanding				
Basic	62,715,551	62,505,269	62,655,655	62,774,324
Diluted	69,750,889	71,130,040	69,664,324	71,638,649

The accompanying notes are an integral part of these consolidated financial statements.

OCWEN FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Dollars in thousands)

	Three months		Nine months	
For the periods ended September 30,	**2008**	**2007**	**2008**	**2007**
Net income	$ 15,561	$ 5,951	$ 21,602	$ 45,522
Other comprehensive income, net of taxes:				
Change in unrealized foreign currency translation adjustment arising during the period (1)	(88)	440	456	(63)
Less: Reclassification adjustment for foreign currency translation losses included in net income (2)	—	—	—	347
Net change in unrealized foreign currency translation adjustment	(88)	440	456	284
Change in deferred loss on cash flow hedge (3)	—	—	151	—
	(88)	440	607	284
Comprehensive income (loss)	$ 15,473	$ 6,391	$ 22,209	$ 45,806

(1) Net of tax benefit (expense) of $63 and $(258) for the three months ended September 30, 2008 and 2007, respectively, and $(268) and $56 for the nine months ended September 30, 2008 and 2007, respectively.

(2) Net of tax expense of $204 for the nine months ended September 30, 2007.

(3) Net of tax expense of $88 for the nine months ended September 30, 2008.

The accompanying notes are an integral part of these consolidated financial statements.

OCWEN FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2008
(Dollars in thousands, except share data)

	Common Stock		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income, Net of Taxes	Total
	Shares	Amount				
Balance at December 31, 2007	62,527,360	$ 625	$ 177,407	$ 406,822	$ 1,292	$ 586,146
Net income	—	—	—	21,602	—	21,602
Issuance of common stock awards to employees	169,632	2	(137)	—	—	(135)
Exercise of common stock options	3,008	—	8	—	—	8
Expiration of common stock options (1)	—	—	1,053	—	—	1,053
Excess tax benefits related to share-based awards	—	—	3	—	—	3
Employee compensation – Share-based awards	—	—	1,324	—	—	1,324
Director's compensation – Common stock	16,530	—	68	—	—	68
Other comprehensive income, net of income taxes	—	—	—	—	607	607
Balance at September 30, 2008	62,716,530	$ 627	$ 179,726	$ 428,424	$ 1,899	$ 610,676

(1) Net of tax effect of $347 resulting from the reduction of the deferred tax asset.

The accompanying notes are an integral part of these consolidated financial statements.

OCWEN FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in thousands)

For the nine months ended September 30,	2008	2007
Cash flows from operating activities		
Net income	$ 21,602	$ 45,522
Adjustments to reconcile net income to net cash provided (used) by operating activities		
Amortization of mortgage servicing rights	40,712	81,810
Premium amortization (discount accretion) on securities, net	109	(2,847)
Depreciation and other amortization	9,599	6,873
Provision for bad debts	872	784
Impairment of mortgage servicing assets	1,401	—
Impairment of investment in Bankhaus Oswald Kruber GmBH & Co. KG	4,980	—
Loss (gain) on trading securities	22,366	(17,672)
Loss on loans held for resale, net	11,112	11,376
Loss on redemption of certificates of deposit	—	8,673
Equity in (earnings) losses of unconsolidated entities	10,628	(3,359)
Gain on repurchase of debt	(3,595)	—
Net cash provided (used) by trading activities	(238,303)	93,034
Net cash provided by loans held for resale activities	5,641	387
Excess tax benefits related to share-based awards	(3)	(606)
Decrease (increase) in advances and match funded advances	207,405	(240,254)
Decrease in deferred tax asset	7,400	4,663
Decrease (increase) in receivables and other assets, net	19,851	(19,950)
Decrease in servicer liabilities	(94,187)	(213,736)
Decrease in other liabilities, net	(10,241)	(14,301)
Other	3,879	2,433
Net cash provided (used) by operating activities	21,228	(257,170)
Cash flows from investing activities		
Purchase of mortgage servicing rights	(3,638)	(108,668)
Proceeds from the sale of mortgage servicing rights	5,985	—
Redemption of certificates of deposit	—	66,260
Return of investment in BMS Holdings, Inc.	—	45,894
Distributions from Ocwen Structured Investments, LLC and Ocwen Nonperforming Loans, LLC and related entities	32,748	—
Investment in Ocwen Structured Investments, LLC	—	(37,500)
Investment in Ocwen Nonperforming Loans, LLC and related entities	(1,250)	(18,083)
Cash paid to acquire NCI Holdings, Inc., net of cash acquired	—	(48,918)
Additions to premises and equipment	(4,566)	(3,192)
Proceeds from sales of real estate	6,003	1,882
Other	154	1,545
Net cash provided (used) by investing activities	35,436	(100,780)
Cash flows from financing activities		
Proceeds from (repayment of) match funded liabilities, net	(17,313)	184,276
Proceeds from (repayment of) lines of credit and other secured borrowings, net	(195,717)	93,466

Repurchase of debt securities	(10,797)	(50)
Proceeds from investment line, net	215,220	—
Excess tax benefits related to share-based awards	3	606
Repurchase of common stock	—	(14,520)
Exercise of common stock options	3	1,529
Net cash provided (used) by financing activities	(8,601)	265,307
Net increase (decrease) in cash	48,063	(92,643)
Cash at beginning of period	114,243	236,581
Cash at end of period	$ 162,306	$ 143,938

The accompanying notes are an integral part of these consolidated financial statements.

OCWEN FINANCIAL CORPORATION AND SUBSIDIARIES
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2008
(Dollars in thousands, except share data)

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization

Ocwen Financial Corporation ("OCN"), through its subsidiaries, is a business process outsourcing ("BPO") provider to the financial services industry specializing in loan servicing, mortgage fulfillment and receivables management services. At September 30, 2008, OCN owned all of the outstanding stock of its primary subsidiaries: Ocwen Loan Servicing, LLC ("OLS"), Ocwen Financial Solutions, Private Limited ("OFSPL"), Investors Mortgage Insurance Holding Company and NCI Holdings, Inc. ("NCI"). OCN also owns 70% of Global Servicing Solutions, LLC ("GSS") with the remaining 30% minority interest held by ML IBK Positions, Inc.

Basis of Presentation

The accompanying unaudited interim consolidated financial statements have been prepared in conformity with the instructions of the Securities and Exchange Commission ("SEC") to Form 10-Q and SEC Regulation S-X, Article 10, Rule 10-01 for interim financial statements. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America ("GAAP") for complete financial statements. In our opinion, the accompanying unaudited financial statements contain all adjustments, consisting only of normal recurring accruals, necessary for a fair presentation. The results of operations and other data for the three and nine months ended September 30, 2008 are not necessarily indicative of the results that may be expected for any other interim period or for the entire year ending December 31, 2008. The unaudited interim consolidated financial statements presented herein should be read in conjunction with the audited consolidated financial statements and related notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2007.

The preparation of financial statements in conformity with GAAP requires that we make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly significant in the near or medium term relate to our determination of the valuation of securities, loans held for resale, mortgage servicing rights ("MSRs"), intangibles and the deferred tax asset.

Certain amounts included in our 2007 consolidated financial statements have been reclassified to conform to the 2008 presentation, including the reclassification of charge-offs of loans held for resale. These charge-offs, totaling $1,885 and $6,209 for the three and nine months ended September 30, 2007, were reclassified from other operating expenses to loss on loans held for resale, net, in the consolidated statements of operations.

Principles of Consolidation

We evaluate each special purpose entity ("SPE") for classification as a "qualifying special purpose entity" ("QSPE") as specified by Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standards ("SFAS") No. 140, "*Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*" ("SFAS No. 140"). When we determine that an SPE is classified as a QSPE, it is excluded from our consolidated financial statements. When we determine that an SPE is not classified as a QSPE, it is further evaluated for classification as a variable interest entity ("VIE") as specified by FASB Interpretation No. 46, "Consolidation of Variable Interest Entities," as revised ("FIN 46(R)"). When an SPE meets the definition of a VIE, and OCN is identified as the primary beneficiary, we include it in our consolidated financial statements.

As of September 30, 2008, we have included six VIEs in our interim consolidated financial statements. Three of these entities are significant to our consolidated financial statements.

We include the assets and liabilities and the results of operations of Ocwen Servicer Advance Receivables Funding Company Ltd. ("OSARFC") in our consolidated financial statements. OSARFC is a special purpose entity, and we are the primary beneficiary. The holders of the debt issued by OSARFC can look only to the assets of OSARFC for satisfaction of the debt and have no recourse against OCN. As of September 30, 2008, OSARFC had assets of $446,036, including $444,672 of servicing advances that were pledged to secure the debt of $392,746 issued by OSARFC.

We also include in our consolidated financial statements two additional SPEs that were created to acquire advances from OLS and to securitize the advances by issuing debt that is secured by the advances: Ocwen Servicer Advance Funding (Wachovia), LLC ("OSAFW") and

Ocwen Servicer Advance Variable Funding Issuer (DB), LLC ("OSAVFI"). We evaluated both entities as VIEs and determined that we are the primary beneficiary. Holders of the debt issued by these two entities can look only to the assets of the entities for satisfaction of the debt and have no recourse against OCN. However, OLS has guaranteed the payment by OSAFW of its obligations under the securitization documents. The maximum amount payable under the guarantee is limited to 10% of the notes outstanding at the end of the facility's revolving period. As of September 30, 2008, OSAFW had total assets of $251,502, including $250,949 of servicing advances that were pledged to secure the $230,976 of debt issued by OSAFW. Similarly, at September 30, 2008, OSAVFI had total assets of $246,758 including $245,168 of servicing advances that were pledged to secure the $217,312 of debt issued by OSAVFI.

OCN holds approximately a 46% interest in BMS Holdings, Inc. (“BMS Holdings”), a 25% interest in Ocwen Structured Investments, LLC (“OSI”) and approximately a 25% interest in Ocwen Nonperforming Loans, LLC (“ONL”) and Ocwen REO, LLC (“OREO”). We account for our investments in these entities using the equity method of accounting. We discontinue the equity method of accounting if our share of losses reduces our investment to zero unless we have guaranteed obligations or are otherwise committed to provide further financial support to the investee. If the investee subsequently reports net income, we will only continue the equity method after our share of net income equals the share of net losses not recognized during the periods the equity method was suspended.

We have eliminated all material intercompany accounts and transactions in consolidation. We report minority interests in our majority-owned subsidiaries as a separate item on our consolidated balance sheets. Minority interest in our earnings, which is immaterial, is included in other income (expense), net, on our consolidated statements of operations.

NOTE 2 CURRENT ACCOUNTING PRONOUNCEMENTS

SFAS No. 157, “Fair Value Measurements.” The FASB issued SFAS No. 157 in September 2006. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in GAAP and expands disclosures about fair value measurement. The statement establishes a fair value hierarchy that distinguishes between (1) quoted prices in an active market, (2) observable market data from sources independent of the reporting entity and (3) unobservable inputs. In all instances, the use of an exit price or a sale price is emphasized by the statement. The adoption of SFAS No. 157 on January 1, 2008 did not have a material impact on our consolidated balance sheet or consolidated statement of operations other than the additional disclosures that are contained in Note 3.

In February 2008, the FASB issued FASB Staff Position (“FSP”) No. FAS 157-2, *“Effective Date of FASB Statement No. 157.”* This FSP defers the effective date of Statement 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in an entity’s financial statements on a recurring basis (at least annually). In accordance with this FSP, we did not apply the provisions of SFAS No. 157 to goodwill and intangibles.

In October 2008, the FASB issued FSP No. FAS 157-3, *“Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active.”* This FSP clarifies, without changing the definition of fair value as defined in SFAS No. 157, that in determining fair value for a financial asset in an inactive market, the use of a reporting entity’s own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available. The FSP was effective upon issuance, including prior periods for which the financial statements have not been issued. We considered the guidance provided by FSP No. 157-3 in the determination of the estimated fair values of our investments in auction rate securities, subordinate and residual securities and loans held for resale. The adoption of this FSP did not have a material impact on our consolidated balance sheet or consolidated statement of operations.

SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities.” In February 2007, the FASB issued SFAS No. 159 which permits entities to choose to measure many financial instruments and certain other items at fair value. Upon adoption of SFAS No. 159 on January 1, 2008, we did not elect the fair value option for any instrument we do not currently measure at fair value; therefore, the adoption did not have an impact on our consolidated balance sheet or consolidated statement of operations.

SFAS No. 141 (R), “Business Combination — a replacement of FASB Statement No. 141.” SFAS No. 141 (R) retains the fundamental requirements in SFAS No. 141 that the acquisition method of accounting be used for all business combinations and for an acquirer to be identified for each business combination. The statement requires an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date, measured at the full amounts of their fair values, with limited exceptions specified in the statement. If the business combination is achieved in stages (a step acquisition), an acquirer is also required to recognize the identifiable assets and liabilities, as well as the noncontrolling interest in the acquiree, at the full amounts of their fair values. The statement eliminates SFAS No. 141’s acquisition cost-allocation process. The statement requires the acquirer to recognize restructuring and acquisition costs separately from the business combination. The statement also requires the disclosure of information necessary to understand the nature and effect of the business combination. SFAS No. 141(R) applies prospectively to business combinations for which the acquisition date is on or after January 1, 2009 with early adoption prohibited.

SFAS No. 160, “Non-controlling Interests in Consolidated Financial Statements-an Amendment of ARB No. 51.” The FASB issued SFAS No. 160 on December 4, 2007. The statement establishes new accounting and reporting standards for a non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. Specifically, this statement requires the recognition of a non-controlling interest (minority interest) as equity in the consolidated financial statements separate from the parent’s equity. The amount of net income attributable to the non-controlling interest will be included in consolidated net income on the face of the income statement. The statement clarifies that changes in a parent’s ownership interest in a subsidiary that do not result in deconsolidation are equity transactions if the parent retains its controlling financial interest. In addition, this statement requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. Such a gain or loss will be measured using the fair value of the non-controlling equity investment on the deconsolidation date. The statement also includes expanded disclosure requirements regarding the interests of the parent and its non-controlling interest. SFAS No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008, which for us begins with our 2009 fiscal year. We are currently evaluating the impact that SFAS No. 160 will have on our consolidated financial statements; however, because the outstanding non-controlling interests in our subsidiaries are not significant we do not expect the implementation of SFAS No. 160 to have a material impact on our consolidated balance sheets or statements of operations.

SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities-an amendment of FASB Statement No. 133." The FASB issued SFAS No. 161 in March 2008. This statement requires enhanced disclosures about an entity's derivative and hedging activities and thereby improves the transparency of financial reporting. Under this statement, entities are required to provide enhanced disclosures relating to: (a) how and why an entity uses derivative instruments; (b) how derivative instruments and related hedge items are accounted for under SFAS No. 133, "*Accounting for Derivative Instruments and Hedging Activities*" and its related interpretations; and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The statement must be applied prospectively to all derivative instruments and non-derivative instruments that are designated and qualify as hedging instruments and related hedged items accounted for under SFAS No. 133 for all financial statements issued for fiscal years and interim periods beginning after November 15, 2008, which for us begins with our 2009 fiscal year, with early application encouraged. The adoption of SFAS No. 161 will not have an effect on our consolidated balance sheets or statements of operations but may require additional disclosures.

Proposed amendment of SFAS No. 140 and FIN 46(R) and issuance of FSP No. FAS 140-e and FIN 46(R)-e. In April 2008, the FASB voted to eliminate the QSPE concept from SFAS No. 140 and to remove the scope exception for QSPEs from FIN 46(R). During September 2008, the FASB issued three separate but related exposure drafts for public comment. The proposed FASB Statements address amendments to SFAS No. 140 and to FIN 46(R). Proposed FASB Staff Position FAS 140-e and FIN 46 (R)-e, *Disclosures about Transfers of Financial Assets and Interests in Variable Interest Entities*, addresses related disclosure requirements for public entities. The proposed changes will require an analysis of VIEs previously accounted for as QSPEs, and therefore currently exempt from the consolidation provisions of FIN 46(R), for consolidation according to the provisions of FIN 46(R). The proposed changes will also require a revision of the current risk and rewards consolidation model to a qualitative model based on control.

The purpose of the proposed FSP is to require improved disclosures by public entities until the pending amendments to FASB Statement No. 140 and FASB Interpretation No. 46(R) are effective. This proposed FSP would amend SFAS No. 140 and FIN 46(R) to require enhanced disclosures by public entities about transfers of financial assets and interests in VIEs. Additionally, the proposed FSP would require certain disclosures by a public entity that is (a) a sponsor that has a variable interest in a VIE (irrespective of the significance of the variable interest) and (b) an enterprise that holds a significant variable interest in a QSPE but was not the transferor of financial assets to the QSPE.

The proposed amendments to SFAS No. 140 are to be applied in fiscal years beginning after November 15, 2009. Transition disclosures would be provided for QSPEs during the one-year deferral period.

We have retained investments in certain subordinate and residual securities in connection with loan securitization transactions completed in prior years (primarily 2006). As a result, if the proposed amendments become final, we will be required to analyze the VIEs previously accounted for as QSPEs to determine if consolidation of the assets and liabilities is appropriate in accordance with the provisions of FIN 46(R) for the year beginning January 1, 2010. Our subordinate and residual securities at September 30, 2008 include retained interests with a fair value of $381.

FSP No. APB-14, "Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)." This FSP clarifies that convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) are not addressed by paragraph 12 of APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*. Additionally, this FSP specifies that issuers of such instruments should separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Upon adoption of this FSP, we will recognize a discount to reduce the carrying value of the 3.25% convertible notes component of our debt securities and an offsetting increase to stockholders' equity. Although we have not yet determined the amounts, due to the retrospective accretion of the resulting debt discount to interest expense over the expected life of the notes our consolidated balance sheet will reflect an adjustment to opening retained earnings on January 1, 2009, and our consolidated statements of operations will reflect increased non-cash interest expense.

NOTE 3 FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS No. 157 establishes a fair value hierarchy that maximizes the use of observable inputs and minimizes the use of unobservable inputs. Observable inputs are inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity. Unobservable inputs are inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The fair value hierarchy prioritizes the inputs to valuation techniques into three broad levels whereby the highest priority is given to Level 1 inputs and the lowest to Level 3 inputs. The three broad categories are:

Level 1: Quoted prices in active markets for identical assets or liabilities.

Level 2: Inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly for substantially the full term of the financial instrument.

Level 3: Unobservable inputs for the asset or liability.

Where available, we utilize quoted market prices or observable inputs rather than unobservable inputs to determine fair value.

We classify assets in their entirety based on the lowest level of input that is significant to the fair value measurement. The following table sets forth assets and liabilities measured at fair value at September 30, 2008, categorized by input level within the fair value hierarchy:

	Carrying value	Level 1	Level 2	Level 3
Measured at fair value on a recurring basis:				
Trading securities (1):				
Investment grade auction rate	$ 253,944	$ —	$ —	$ 253,944
Subordinates and residuals	4,239	—	—	4,239
Derivative financial instruments, net (2)	1,169	6	—	1,163
Measured at fair value on a non-recurring basis:				
Loans held for resale (3)	55,642	—	37,122	18,520
Residential MSRs (4)	2,655	—	2,655	—

(1) We account for trading securities at fair value. We report changes in fair value in gain (loss) on trading securities in the period of the change.

(2) Derivative financial instruments consist of interest rate caps that we use to protect against our exposure to rising interest rates on two of our match funded variable funding notes and foreign currency futures contracts that we use to hedge our net investment in Bankhaus Oswald Kruber GmbH & Co. KG (“BOK”), our wholly-owned German banking subsidiary, against adverse changes in the value of the Euro versus the U.S. Dollar. The interest rate caps are classified within Level 3 of the fair value hierarchy and the futures contracts within Level 1. See Note 16 for additional information on our derivative financial instruments at September 30, 2008.

(3) Loans held for resale are measured at fair value on a non-recurring basis. At September 30, 2008, the carrying value of loans held for resale is net of a valuation allowance of $16,405. We estimate the fair value of uncommitted non-performing loans (those for which we have not received a purchase commitment) based on the expected future cash flows discounted using a rate commensurate with the risks involved.

(4) The carrying value of MSRs at September 30, 2008 is net of a valuation allowance for impairment of $1,401 established during the third quarter of 2008. The valuation allowance related exclusively to the high-loan-to-value stratum of our residential MSRs. The estimated fair value exceeded amortized cost for all other strata. See Note 8 for additional information on MSRs.

The following table sets forth a reconciliation of the changes in fair value during the three and nine months ended September 30, 2008 of our Level 3 assets that we measure at fair value on a recurring basis:

	Fair value at beginning of period	Purchases, collections and settlements, net(1)	Total realized and unrealized gains and (losses)	Transfers in and/or out of Level 3	Fair value at September 30, 2008
<u>*Three months:*</u>					
Trading securities:					
Investment grade auction rate	$ 254,745	$ (801)	$ —	$ —	$ 253,944
Subordinates and residuals	4,860	—	(621)	—	4,239
Derivative financial instruments	1,326	—	(163)	—	1,163
<u>*Nine months:*</u>					
Trading securities:					
	$ —	$ 270,313	$ (16,369)	$ —	$ 253,944

Investment grade auction rate					
Subordinates and residuals	7,362	22	(3,145)	—	4,239
Derivative financial instruments	4,867	(7,063)	3,359	—	1,163

(1) Purchases, collections and settlements, net, related to trading securities exclude interest received.

NOTE 4 DISCONTINUED OPERATIONS

In the fourth quarter of 2007, management of OCN approved and committed to a plan to sell its investment in BOK, and accordingly, its operations have been reclassified in the accompanying consolidated financial statements as discontinued. For segment reporting purposes, the operations of BOK are included in Corporate Items and Other. We recorded a charge of $4,980 in the second quarter of 2008 that included the impairment of the remaining $3,423 carrying value of goodwill and intangibles, a $1,377 write-down of receivables and a $180 write-down of premises and equipment. We recorded no additional write-downs in the third quarter of 2008. We continue to actively market BOK and have received proposals that are in excess of the current book value but are non-binding and subject to due diligence. We expect to reach an agreement of sale (subject to regulatory approval) of our investment in 2008.

Results of BOK's operations for the three and nine months ended September 30 are as follows:

	Three months		Nine months	
	2008	2007	2008	2007
Revenue	$ 68	$ 102	$ 339	$ 233
Operating expenses	593	608	6,891	1,728
Loss from operations	(525)	(506)	(6,552)	(1,495)
Other income, net	339	197	980	552
Loss before income taxes	(186)	(309)	(5,572)	(943)
Income tax expense (benefit)	—	—	—	—
Net loss	$ (186)	$ (309)	$ (5,572)	$ (943)

The following table presents BOK's assets and liabilities at the dates indicated:

	September 30, 2008	December 31, 2007
Cash	$ 5,227	$ 8,338
Trading securities, at fair value	—	537
Receivables	11,232	9,968
Goodwill and intangibles	—	3,423
Other	42	268
Total assets	$ 16,501	$ 22,534
Total liabilities (including customer deposits of $6,983 and $7,439)	$ 7,600	$ 7,866

NOTE 5 TRADING SECURITIES

Trading securities consisted of the following at the dates indicated:

	September 30, 2008	December 31, 2007
Investment grade auction rate (Corporate Items and Other)	$ 253,944	$ —
Other investment grade (Corporate Items and Other):		
Collateralized mortgage obligations ("CMOs")	$ —	$ 33,171
Other	—	1,705
	$ —	$ 34,876

Subordinates and residuals:				
Loans and Residuals:				
Single family residential	$	4,055	$	7,016
Corporate Items and Other:				
Single family residential		184		296
Commercial		—		50
	$	4,239	$	7,362

Gain (loss) on trading securities for the three and nine months ended September 30 was comprised of the following:

	Three months		Nine months	
	2008	**2007**	**2008**	**2007**
Unrealized losses (1)	$ (621)	$ (1,049)	$ (20,670)	$ (7,621)
Realized gains (losses) (2)	—	(359)	(1,696)	25,293
	$ (621)	$ (1,408)	$ (22,366)	$ 17,672

(1) Unrealized losses for 2008 include $15,707 recognized during the first six months related to auction rate securities. We did not record any unrealized losses on auction rate securities during the third quarter of 2008.

(2) During the second quarter of 2007, we sold residual securities that were backed by subprime residential loans originated in the United Kingdom (the “UK residuals”) and realized a gain of $25,587 in our Loans and Residuals segment.

Investment Grade Auction Rate Securities

Under our Investment Line agreements, we borrowed funds each month under a revolving demand note equal to our projected average float balance and invested those funds in certain permitted investments. The custodial funds comprising most of the float balance remained on deposit in bank accounts that meet the requirements of each trust. The terms of the Investment Line required that we sell the investments and repay the associated borrowings prior to the end of each quarter.

During the first quarter of 2008, we invested Investment Line borrowings in AAA-rated auction rate securities backed by student loans originated under the U. S. Department of Education’s Federal Family Education Loan Program. Auction rate securities are long-term variable rate bonds tied to short-term interest rates that are reset through an auction process that typically occurs every 7 to 35 days. The underlying student loans backing the auction rate securities carry a guarantee of no less than 97% of the unpaid principal balance in the event of default. The auction rate securities that we hold are in the senior-most position and are smaller in amount than the federally guaranteed portion of the underlying loans. Historically, the par value of auction rate securities approximated fair value due to the frequent auctions of these securities at par. In the first quarter of 2008, the auction rate security market began experiencing levels of illiquidity, and auctions began to fail because there were not enough orders to purchase all of the securities being sold at the auction. As a result, we have been unable to liquidate our holdings. Within the context of a failed auction, the issuer pays the investor a “fail rate” penalty interest until the auction returns to clearing status, the notes mature at par or the notes are called or redeemed.

On August 28, 2008, Moody’s Investors Services, Inc. announced that it had downgraded several tranches of auction rate securities. Auction rate securities we hold with a par value of $70,350 at September 30, 2008 were affected by this ratings action and were downgraded to a rating of ‘Baa’. The AAA ratings from both Standard and Poor’s Ratings Services and Fitch Ratings have not been revised. To date we have received all interest payments when due.

Because sufficient liquidity has not returned to the auction rate securities market, we were unable to liquidate our entire investment prior to September 30, 2008. We estimated the fair value of the auction rate securities based on actual sales and redemptions of the auction rate securities that we hold and a discounted cash flow analysis.

The discounted cash flow analysis included the following range of assumptions at September 30, 2008:

• Expected term	15 - 27 months
• Illiquidity premium	1.91% - 2.08%
• Discount rate	3.03% - 6.73%

The expected term was based upon our best estimate of market participants’ expectations of future successful auctions. The discount rate and illiquidity premium are consistent with prevailing rates for similar securities.

Other significant assumptions that we considered in our analysis included the credit risk profiles of the issuers, the impact on the issuers of the increased debt service costs associated with the payment of penalty interest rates and the collateralization of the securitization trusts.

During the nine months ended September 30, 2008, issuers have called at par notes with a face value of $3,799, including $800 during the third quarter. During the second quarter of 2008, we sold notes with a face value $27,350 at a discount to par of 5.5%. There were no sales during the third quarter. The amount outstanding under the Investment Line term note that finances the auction rate securities represented 80% of the face value of the auction rate securities at September 30, 2008. See Note 13 for a more detailed discussion and status of the Investment Line.

Subordinates and Residuals

Through our investment in subordinate and residual securities, we support senior classes of securities. Principal from the underlying mortgage loans generally is allocated first to the senior classes, with the most senior class having a priority right to the cash flow from the mortgage loans until its payment requirements are satisfied. To the extent that there are defaults and unrecoverable losses on the underlying mortgage loans, resulting in reduced cash flows, the most subordinate security will be the first to bear this loss.

We estimate the fair value of our subordinate and residual securities based on the present value of expected future cash flows. Significant assumptions used in the discounted cash flow model include discount, delinquency and cumulative loss rates as well as prepayment speeds associated with the loans underlying mortgage backed securities. Discount rates for the subordinate and residual securities range from 21% to 30% and are determined based upon an assessment of prevailing market conditions and prices for similar assets. We project the delinquency, loss and prepayment assumptions based on a comparison to actual historical performance curves, adjusted for prevailing market conditions. Peak delinquency assumptions range from 21% to 40%, and loss assumptions range from 13% to 21%. Average prepayment assumptions range from 10% to 15%.

NOTE 6 ADVANCES

During any period in which the borrower is not making payments, we are required under most servicing agreements to advance funds to the investment trust to meet contractual principal and interest remittance requirements for investors. As the servicer, we are obligated to advance funds only to the extent that we believe the advances are recoverable. Most of our advances have the highest standing for reimbursement from payments, repayments and liquidation proceeds at the loan level. In addition, for any advances that are not covered by loan proceeds, the large majority of our pooling and servicing agreements provide for reimbursement at the pool level, either by using collections on other loans or by requesting reimbursement from the securitization trust. We are also required to pay property taxes and insurance premiums, to process foreclosures and to advance funds to maintain, repair and market real estate properties on behalf of investors, and these advances are accorded the same high priority for repayment as principal and interest advances.

Advances consisted of the following at the dates indicated:

	September 30, 2008	December 31, 2007
Servicing:		
Principal and interest	$ 42,554	$ 111,199
Taxes and insurance	38,185	77,431
Foreclosures and bankruptcy costs	31,095	45,269
Real estate servicing costs	13,969	34,537
Other	8,711	17,493
	134,514	285,929
Loans and Residuals	5,451	6,872
Corporate Items and Other	114	86
	$ 140,079	$ 292,887

At September 30, 2008, no advances were pledged under the senior secured credit agreement as this facility was converted to a term note secured only by MSRs in August 2008. See Note 12 for additional information regarding this term note.

NOTE 7 MATCH FUNDED ADVANCES

Match funded advances on residential loans serviced for others are comprised of the following at the dates indicated:

	September 30, 2008	December 31, 2007
Principal and interest	$ 598,858	$ 659,207
Taxes and insurance	301,732	281,062
Foreclosures and bankruptcy costs	74,090	86,384
Real estate servicing costs	76,555	80,785
Other	19,664	18,659
	$ 1,070,899	$ 1,126,097

Match funded advances on loans serviced for others result from our transfers of residential loan servicing advances to SPEs in exchange for cash. We made these transfers under the terms of four advance facility agreements. We have either retained control of the advances, or the advances were transferred to trusts that are not QSPEs under SFAS No. 140. As a result, we include the SPEs in our Consolidated Financial Statements. The match funded advances are owned by the SPEs and are not available to satisfy general claims of our creditors. Conversely, the holders of the debt issued by the SPEs generally can look only to the assets of the issuer for satisfaction of the debt and have no recourse against

OCN. However, OLS has guaranteed the payment of the obligations of the issuer under the match funded facility that we executed in April 2008. The maximum amount payable under the guarantee is limited to 10% of the notes outstanding at the end of the facility's revolving period.

NOTE 8 MORTGAGE SERVICING RIGHTS

	Residential	Commercial	Total
Carrying value of MSRs:			
Balance at December 31, 2007	$ 191,935	$ 5,360	$ 197,295
Purchases	3,638	—	3,638
Sales	—	(5,036)	(5,036)
Servicing transfers and adjustments	(3,500)	(50)	(3,550)
Amortization	(40,438)	(274)	(40,712)
Impairment	(1,401)	—	(1,401)
Balance at September 30, 2008	$ 150,234	$ —	$ 150,234
Estimated fair value of MSRs:			
September 30, 2008	$ 186,159	$ —	$ 186,159
December 31, 2007	$ 271,108	$ 5,781	$ 276,889
Unpaid principal balance of assets serviced:			
September 30, 2008:			
Servicing	$ 31,719,060	$ —	$ 31,719,060
Subservicing (1)	10,729,971	1,320,076	12,050,047
	$ 42,449,031	$ 1,320,076	$ 43,769,107
December 31, 2007:			
Servicing	$ 38,005,999	$ 2,385,343	$ 40,391,342
Subservicing (1)	15,539,986	2,764,634	18,304,620
	$ 53,545,985	$ 5,149,977	$ 58,695,962

(1) Unpaid principal balance ("UPB") serviced under subservicing agreements includes $694,663 and $798,148 of foreclosed residential properties serviced for the United States Department of Veterans Affairs ("VA") at September 30, 2008 and December 31, 2007, respectively. We elected to allow our contract with the VA to expire in July 2008. Transition of the remaining properties to the new service provider was completed in October 2008.

We service residential mortgage loans and real estate that we do not own under contractual servicing agreements. We generally obtain MSRs by purchasing them from the owners of the mortgages. We also enter into subservicing agreements with entities that own the servicing rights. Residential assets serviced consist almost entirely of mortgage loans, primarily subprime, but also include real estate. Assets serviced for others are excluded from our balance sheet. Custodial accounts, which hold funds representing collections of principal and interest plus tax and insurance payments that we have received from borrowers, are escrowed with an unaffiliated bank and excluded from our balance sheet. Custodial accounts amounted to $341,000 and $356,700 at September 30, 2008 and December 31, 2007, respectively. An agreement between the various parties to a mortgage securitization transaction typically specifies the rights and obligations of servicing rights which include guidelines and procedures for servicing the loans including remittance and reporting requirements, among other provisions.

We estimate the fair value of our servicing rights by discounting the future underlying servicing cash flows. The more significant assumptions used in the September 30, 2008 valuation (depending on loan type) include long-term prepayment speeds ranging from 15.2% to 27.5% and delinquency rates ranging from 15.3% to 23.5%. Other assumptions include an interest rate of one-month LIBOR plus 300 basis points for computing the cost of servicing advances, an interest rate equal to one-month LIBOR minus 20 basis points for computing float earnings and a discount rate of 18%.

As of September 30, 2008, we established a valuation allowance for impairment of $1,401 on the high-loan-to-value stratum of our mortgage servicing rights as the external valuation that we consider in our impairment analysis fell below the carrying value due primarily to the declining market value for rights to service second liens. The external valuation reflects industry averages for delinquencies on loans in the second lien position that are higher than those experienced by our servicing portfolio. We may adjust this valuation allowance in the future, as the estimated fair value increases or decreases. For all other strata, the external valuation was above the carrying value at September 30, 2008.

As of September 30, 2008, MSRs with a carrying value of $147,735 had been pledged as collateral for borrowings under the senior secured credit agreement.

NOTE 9 INVESTMENT IN UNCONSOLIDATED ENTITIES

	September 30, 2008	December 31, 2007
Asset Management Vehicles:		
Investment in OSI (1)	$ 20,851	$ 37,189
Investment in ONL and affiliates (2)	11,555	33,531
	32,406	70,720
Technology Products:		
Investment in BMS Holdings (4)	—	5,666
Corporate Items and Other	79	79
	$ 32,485	$ 76,465

Equity in earnings (losses) of unconsolidated entities was as follows for the periods ended September 30:

	Three months		Nine months	
	2008	2007	2008	2007
OSI (1) (3)	$ (1,864)	$ 1,169	$ (3,411)	$ 1,169
ONL and affiliates (2) (3)	(1,064)	—	(1,551)	—
BMS Holdings (4)	—	2,368	(5,666)	2,190
	$ (2,928)	$ 3,537	$ (10,628)	$ 3,359

(1) Our investment in OSI represents a 25% equity interest. OSI invests in the lower tranches and residuals of residential mortgage-backed securities, the related mortgage servicing rights and other similar assets. During 2008, we have received distributions from OSI totaling $12,000, all during the third quarter. Our remaining commitment to invest up to an additional $37,500 in OSI expired on September 18, 2008.

(2) Our investments in ONL and OREO represent equity interests of approximately 25%. On July 18, 2008, Nonperforming Loan Company I, LLC (“NPL”) merged with and into ONL, with ONL as the surviving entity. At the time of the transaction, we had a 25% equity interest in NPL. Subsequent to this consolidation, we sold a 0.2% equity interest in both ONL and OREO to another investor. We recognized a gain of $68 on the sale of our ownership interests. ONL resolves non-performing loans purchased at a discount. OREO purchases real estate for sale, including real estate that ONL may obtain through foreclosure. During the first nine months of 2008, we have received distributions totaling $20,748 from ONL and OREO and invested an additional $1,250 in OREO. We have a remaining commitment, which expires on September 13, 2010, to invest up to an additional $37,423 in ONL and OREO, collectively.

(3) OLS earns loan servicing and management fees from OSI and from ONL and affiliates. In determining the amount of consolidated equity in earnings to recognize, we add back our share of the loan servicing and management fee expense recognized by OSI and ONL and affiliates. During the first nine months of 2008, OLS earned $2,542 and $2,997 of loan servicing fees and management fees, respectively, from OSI and from ONL and affiliates. On a consolidated basis, we have recognized approximately 75% of the loan servicing and management fee revenue.

(4) Our investment in BMS Holdings represents an equity interest of approximately 46%. During the second quarter of 2008, our share of the losses of BMS Holdings reduced our investment to zero. Because we are not required to advance funds to BMS Holdings to finance operations, and we are not a guarantor of any obligations of BMS Holdings, we suspended the application of the equity method of accounting for our investment in BMS Holdings. For the third quarter of 2008, BMS Holdings reported a loss, and therefore, we did not resume application of the equity method of accounting.

NOTE 10 OTHER ASSETS

Other assets consisted of the following at the dates indicated:

	September 30, 2008	December 31, 2007
Debt service accounts (1)	$ 68,337	$ 77,819
Interest earning collateral deposits	14,116	8,947
Real estate	10,708	11,483
Deferred debt related costs, net	8,185	11,446
Prepaid expenses and other	6,159	9,091
	$ 107,505	$ 118,786

(1) Under our four match funded advance funding facilities, we are contractually required to remit collections on pledged advances to the trustee within two days of receipt. The collected funds are not applied to reduce the related match funded debt until the payment dates specified in the indenture. The balance also includes amounts that have been set aside from the proceeds of our four match funded advance facilities to provide for possible shortfalls in the funds available to pay certain expenses and interest. These funds are held in interest earning accounts.

NOTE 11 MATCH FUNDED LIABILITIES

Match funded liabilities are obligations secured by the collateral underlying the related match funded advances and are repaid through the cash proceeds arising from those assets. We account for and report match funded liabilities as secured borrowings with pledges of collateral. All of our match funded liabilities are secured by advances on residential loans serviced for others. The amortization date is the date on which the revolving period ends under our advance facilities and repayment of the outstanding balance must begin if the facility is not renewed or extended. The maturity date is the date on which all outstanding balances must be repaid. After the amortization date, all collections that represent the repayment of advances that have been financed through the facility must be applied to reduce the balance outstanding under the facility, and any new advances under the securitizations pledged to the facility are ineligible to be financed.

Borrowing Type	Interest Rate (1)	Maturity	Amortization Date	Unused Borrowing Capacity	Balance Outstanding September 30, 2008	Balance Outstanding December 31, 2007
Variable Funding Note Series 2007-1	Commercial paper rate + 200 basis points (2)	November 2013	December 2008 (2)	$ 78,198	$ 221,802	$ 218,590
Term Note Series 2004 -1	1-Month LIBOR + 50 basis points	October 2013	January 2008 (3)	—	—	100,000
Term Note Series 2005 -1	1-Month LIBOR + 40 basis points	March 2014	May 2008 (4)	—	—	75,000
Term Note Series 2006 -1	5.335%	November 2015 (5)	November 2009	—	165,000	165,000
Variable Funding Note (6)	Commercial paper rate + 150 basis points (6)	December 2013				