ECC Capital CORP
Form 10-Q
June 21, 2007

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 March 31, 2007

OR

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

For the transition period from ______ to ______

Commission file number 001-32430

ECC CAPITAL CORPORATION

(Exact name of registrant as specified in its charter)

Maryland	**84-1642470**
(State or other jurisdiction of incorporation or organization)	**(I. R. S. Employer Identification Number)**
1733 Alton Parkway, Irvine, California	**92606**
(Address of principal executive offices)	**(Zip Code)**

(949) 955-8700

Registrant s telephone number, including area code

Not Applicable

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

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

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

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

As of June 1, 2007, the Registrant had 101,026,743 shares of common stock outstanding.

ECC CAPITAL CORPORATION

QUARTERLY REPORT ON FORM 10-Q

FOR THE PERIOD ENDED MARCH 31, 2007

TABLE OF CONTENTS

PART I FINANCIAL INFORMATION

PART II OTHER INFORMATION

ECC CAPITAL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	March 31, 2007 (unaudited)	December 31, 2006
ASSETS		
Cash and cash equivalents	$ 16,534	$ 44,785
Restricted cash	4,449	3,500
Mortgage loans held for investment, net	2,097,669	2,403,090
Accrued mortgage loan interest	23,017	24,892
Residual interests in securitizations	10,126	45,920
Real estate owned	43,285	33,197
Prepaid expenses and other assets	18,625	20,747
Derivative instruments	26,102	35,523
Assets of discontinued operations	20,925	1,168,340
Total assets	$ 2,260,732	$ 3,779,994
LIABILITIES AND STOCKHOLDERS EQUITY		
Long-term debt	$ 2,095,921	2,384,025
Accounts payable and accrued expenses	31,401	45,861
Dividends payable		24,236
Liabilities of discontinued operations	20,461	1,197,901
Total liabilities	2,147,783	3,652,023
Commitments and contingencies		
Stockholders equity		
Common stock authorized, 200,000,000 shares of $0.001 par value at March 31, 2007 and December 31, 2006; issued and outstanding, 101,026,743 shares at March 31, 2007 and 100,982,684 at December 31, 2006	101	101
Additional paid in capital	374,822	374,280
Accumulated other comprehensive income		740
Accumulated deficit	(261,974)	(247,150)
Total stockholders equity	112,949	127,971
Total liabilities and stockholders equity	$ 2,260,732	$ 3,779,994

The accompanying notes are an integral part of these statements.

ECC CAPITAL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

	March 31, 2007 (unaudited)	March 31, 2006 (unaudited)
Revenue		
Interest income	$ 44,095	68,596
Interest expense	(34,676)	(51,158)
Net interest income	9,419	17,438
Provision for loan losses Loans held for investment	12,688	6,099
Net interest income, after provision for loan losses	(3,269)	11,339
Change in market value of residuals	(1,990)	629
(Loss) gain on derivative instruments, net	(1,680)	15,858
Total revenue	(6,939)	27,826
Expense		
Operating expenses	9,689	14,254
Servicing fees	1,321	2,288
Total expenses	11,010	16,542
(Loss) income from continuing operations before income taxes	(17,949)	11,284
Income tax provision from continuing operations	(32)	
(Loss) income from continuing operations	(17,981)	11,284
Discontinued operations		
Income (loss) from discontinued operations before income taxes	10,987	(17,662)
Income tax (expense) benefit	(14)	3
Income (loss) from discontinued operations	10,973	(17,659)
NET LOSS	$ (7,008)	$ (6,375)
(Loss) income per share of common stock from continuing operations		
Basic	$ (0.18)	$ 0.11
Diluted	$ (0.18)	$ 0.11
Income (loss) per share of common stock from discontinued operations		
Basic	$ 0.11	$ (0.17)
Diluted	$ 0.11	$ (0.17)
Net loss per share of common stock		
Basic	$ (0.07)	$ (0.06)
Diluted	$ (0.07)	$ (0.06)

The accompanying notes are an integral part of these statements.

ECC CAPITAL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands, except per share date)

	For the three months ended March 31, 2007	2006
	(unaudited)	
Cash flows from operating activities:		
Net Loss	$ (7,008)	$ (6,375)
Adjustments to reconcile net loss to cash used in operating activities		
Depreciation and amortization	6,507	4,023
Provision for loan losses	12,688	6,099
Change in mortgage loans	1,126,643	324,985
Gain on sale of mortgage origination operations held for sale	(21,461)	
Fair value adjustment of residual interest	1,991	(629)
Accretion of residual interest	(3,355)	(1,522)
Compensation charge from stock options and warrants	542	310
Net increase in fair value of derivative instruments	10,493	(11,767)
Loss on disposal/impairment of equipment	115	61
Net change in:		
Other receivables	9,020	182
Accrued mortgage loan interest	6,581	4,887
Accrued bond interest payable	(296)	(96)
Prepaid expenses and other assets	(10,635)	(4,110)
Accounts payable and accrued expenses	(19,358)	17,066
Net cash provided by operating activities	1,112,467	333,114
Cash flows from investing activities:		
Purchases of property, equipment and leasehold improvements	(387)	(588)
Principal payments received on loans held for investment	288,649	466,005
Proceeds from sale of loan origination operations	26,061	
Cash received from residual interest	36,418	25
Net cash provided by investing activities	350,741	465,442
Cash flows from financing activities:		
Net decrease in warehouse lines of credit	(1,169,583)	(503,337)
Principal payments on long-term debt	(288,603)	(474,580)
Advance on uncompleted loan sale		153,921
Proceeds from repurchase agreement		29,796
Payments of capital lease obligations	(1,023)	(287)
Net (increase) decrease in restricted cash	(949)	15,305
Dividends paid	(31,301)	(18,043)
Net cash used in financing activities	(1,491,459)	(797,225)
Net (decrease)/increase in cash and cash equivalents	(28,251)	1,331
Cash at beginning of the period	44,785	46,904
Cash at end of the period	$ 16,534	$ 48,235

Supplemental cash flow information:				
Cash used to pay interest	$	51,572	$	83,626
Cash used to pay income taxes	$	136	$	3

The accompanying notes are an integral part of these statements.

NOTE A SUMMARY OF SIGNIFICANT ORGANIZATIONAL AND ACCOUNTING POLICIES

These unaudited interim financial statements have been prepared on the same basis as the annual financial statements and, in the opinion of management, reflect all adjustments, which include normal recurring adjustments, necessary to present fairly the consolidated financial position of ECC Capital Corporation (the Company) as of March 31, 2007 and December 31, 2006 and the consolidated results of operations and cash flows for the three months ended March 31, 2007 and 2006. These financial statements and notes thereto are unaudited and should be read in conjunction with the Company s audited financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006. The results for the three months ended March 31, 2007 are not necessarily indicative of the expected results for the year ending December 31, 2007.

Organization and Summary of Significant Accounting Policies

The Company is a mortgage real estate investment trust (REIT) that owns and manages interests in securitization trusts which issued securities collateralized by mortgages on residential real estate.

The Company originated nonconforming mortgage loans through its taxable REIT subsidiary, Performance Credit Corporation (formerly known as Encore Credit Corp.), principally using its network of brokers throughout the United States. The Company either sold loans to third parties, through Performance Credit, or it transferred loans to a wholly-owned bankruptcy remote subsidiary which financed such loans through the issuance of asset-backed securities in securitization transactions accounted for as financings or sales. The Company s loan origination operations comprised the majority of its business activities within its mortgage banking operations.

Sale of Mortgage Banking Operations

During the second quarter of 2006, ECC Capital s board of directors began to review and evaluate potential strategic alternatives to enhance shareholder value. On October 10, 2006, the Company announced that it had entered into an agreement (the Asset Purchase Agreement) to sell certain operating assets used in its wholesale mortgage banking operation to Bear Stearns Residential Mortgage Corporation, for approximately $26 million in cash and the assumption of certain liabilities by Bear Stearns. Under the terms of the Asset Purchase Agreement, Bear Stearns agreed to acquire the assets of the Company s wholesale mortgage banking operation, including property and equipment, customer lists, intellectual property and information technology systems used by the Company (the Business). Bear Stearns agreed to assume those liabilities that are necessary for it to continue to support the originations generated by the Business, including leases for the Company s operating centers in Irvine, California, Downers Grove, Illinois and Glen Allen, Virginia. The Company also entered into certain agreements with Bear Stearns under which Bear Stearns agreed to fund and acquire the Company s loan production on a monthly basis through the date of closing of the sale of the mortgage banking operations.

On February 9, 2007, the Company closed the sale of its mortgage banking operations to Bear Stearns and settled the sale of approximately $1.2 billion in mortgage loans to Bear Stearns, subject to certain price adjustments and call rights. Upon completion of the transaction, the Company effectively exited the wholesale mortgage origination business. Accordingly, the disposition of the mortgage banking operations is being reported as a discontinued operation for the year ended December 31, 2006 and for the three months ended March 31, 2007. As Bear Stearns also acquired use of the Encore Credit name, the Company changed the name of Encore Credit Corp. to Performance Credit Corporation, which remains the Company s wholly-owned subsidiary. The Company recorded a gain of approximately $21.5 million upon on the sale of its mortgage banking operations during the three months ended March 31, 2007.

Principles of Consolidation

The consolidated financial statements of the Company include the financial position and results of ECC Capital Corporation and its wholly-owned subsidiaries. All material intercompany balances and transactions are eliminated in consolidation. The Company is the primary beneficiary in a variable interest entity (VIE), as defined by FASB Interpretation No. 46 Revised (FIN 46R), *Consolidation of Variable Interest Entities an Interpretation of ARB No. 51*, involved in a retail lending business. The Company has consolidated the financial statements of this VIE. The financial statements of this VIE are not material to the Company s operations or financial position. The Company s maximum exposure to loss with respect to this VIE is approximately $3.9 million as of March 31, 2007.

The Company securitized its loans held for investment by transferring loans to trusts that issued long term debt. The Company retained certain servicing rights and the excess interest spread between the rate paid by the borrowers and the rate paid to the noteholders. The structure of the trusts limits its activities to holding the transferred assets and transferring cash collected to the trusts beneficial interest holders. Certain trusts utilized by the Company do not meet the definition of a qualified special purpose entity as defined by Statement of Financial Accounting Standards No. 140 (SFAS 140), 5

Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, as: (i) the Company retains certain discretionary rights as servicer of the mortgage loans transferred to the trust, (ii) the Company holds a right to repurchase any of the loans in the trust aggregating up to 1% of the initial principal balance of the transferred loans, and (iii) the trust may, with the approval of the beneficial interest holders, acquire derivative financial instruments. Such trusts are considered VIEs. The Company is considered the primary beneficiary of the trust because, as the recipient of the excess cash flows from the trust, the Company s interests in the trust are exposed to the majority of the variability in the trust s cash flows. As the primary beneficiary of the trust, the Company has consolidated the assets and liabilities of the trust in the accompanying financial statements.

Use of Estimates

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make certain estimates and assumptions that affect the reported amounts of assets, liabilities, and contingencies at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant balance sheet items which could be materially affected by such estimates include the residual interests in securitizations, deferred and prepaid taxes, repurchase allowance, the carrying value of loans held for sale, deferred fees, deferred bond issuance costs and allowance for loan losses on loans held for investment.

Management Operating Plans

During 2005 and 2006 the Company experienced significant operating losses, largely as a result of losses in its mortgage banking operations. As noted, on February 9, 2007, the Company closed the sale of its mortgage banking operations to Bear Stearns and exited the wholesale mortgage origination business. The Company continues to own and manage its interests in securitizations, which comprise its portfolio of loans held for investment and its residual interests in securitizations. As a result of the sale of the wholesale mortgage origination business, management anticipates that operating expenses will be significantly reduced. Management also anticipates that cash flow received from its interests in securitizations should provide sufficient liquidity to meet the Company s known obligations, including the distribution of dividends necessary to meet the minimum distribution requirements to retain the Company s status as a real estate investment trust for the next few years, subject to the performance of our residual interests.

If loan delinquencies and losses increase within the Company s securitizations or loan balances prepay faster than projected, the cash flows it receives from these securitizations may be reduced. Based on current market conditions, the Company s ability to sell and/or satisfactorily finance certain assets may be adversely impacted. These market conditions as well as a possible decline in expected cash flows from its residual interests in securitizations may negatively impact its ability to meet its obligations, including its ability to make additional dividend distributions.

While management believes future cash flows from its securitizations will be sufficient to meet the Company s obligations and to make minimum distributions required to retain REIT status, there can be no assurances that this will occur. Achievement of these results depends on many factors outside management s control including, but not limited to, the general economic environment, changes in interest rates, prepayment speeds, loan delinquencies, demand for housing, changes in real estate values and availability of credit. If the Company is unable to operate profitably and generate positive cash flow, the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities may be affected.

Cash and Cash Equivalents

The Company considers all highly liquid instruments with an original maturity of three months or less to be cash equivalents. Cash equivalents include funds invested in interest bearing accounts such as money market funds and similar accounts.

Restricted Cash

At March 31, 2007, restricted cash represented collateral for letters of credit provided in connection with surety bonding requirements.

Mortgage Loans and Loan Origination Fees and Costs

Mortgage loans held for investment are stated at amortized cost, including the outstanding principal balance, less the allowance for loan losses. Deferred origination fees and costs, net of discounts are amortized as an adjustment of yield over the life of the portfolio using the effective yield method in a manner that anticipates prepayments.

Repurchase Obligations

As of March 31, 2007, we have unresolved claims from investors to repurchase approximately $6 million in loans. During the quarter ended March 31, 2007 we paid $200,000 to settle certain outstanding claims. As of March 31, 2007, we have reserved $2 million for potential losses that may be realized on the settlement of these and other incurred but unknown claims. Although management believes the amount reserved is adequate to provide for losses on the settlement of repurchase claims, the timing and amount of any remaining repurchase claims, is highly uncertain and it is reasonably possible that losses ultimately realized may be greater than amounts provided for.

Allowance for Loan Losses on Mortgage Loans Held for Investment

In connection with its mortgage loans held for investment, the Company establishes an allowance for loan losses based on its estimate of losses inherent and probable as of the balance sheet date. The Company charges off uncollectible loans at the time of liquidation. The Company evaluates the adequacy of this allowance each quarter, giving consideration to factors such as the current performance of the loans, characteristics of the portfolio, the value of the underlying collateral and the general economic environment. The Company believes the allowance for loan losses is adequate for known and inherent losses in the portfolio of mortgage loans held for investment. Provision for losses is charged to the Company s consolidated statement of operations and losses incurred are charged to the allowance.

Residual Interests in Securitization

Residual interests in securitizations represent interests retained from the sale of loans through securitizations that the Company structures as sales rather than financings, referred to as off-balance sheet securitizations. The Company may also sell residual interests in securitizations through what are sometimes referred to as net interest margin securities, or NIMS.

In an off-balance sheet securitization, the Company transfers mortgage loans to a Real Estate Mortgage Investment Conduit (the REMIC or Trust), which is a Qualified Special Purpose Entity (QSPE), as defined by SFAS 140 and accounts for the transfer as a sale of loans. The Trust, in turn, issues interest bearing asset-backed securities (the Certificates). The Certificates are sold without recourse except that the Company provides representations and warranties customary to the mortgage banking industry with respect to loans transferred to the Trust. The Trust uses the cash proceeds from the sale of the Certificates to pay the Company the purchase price for the mortgage loans. The Trust also issues certificates representing interests in the excess interest spread and other residuals. The excess interest spread represents the present value of estimated cash flows that the holder of such Certificates will receive as a result of the interest collected from borrowers exceeding the interest paid to security holders by the Trust. The Company retained the Certificates from securitizations in 2003, 2004, and 2006 representing the excess interest spread and other residuals, collectively referred to as residual interests.

In such transactions, the Company allocates its basis in the mortgage loans and residual interests between the portion of the assets sold through the Certificates and the portion of retained interests based on the relative fair values of those portions on the date of sale. The Company recognizes gains or losses attributable to the changes in the fair value of the residual interests, which are recorded at estimated fair value and accounted for as either available-for-sale or trading securities. At March 31, 2007, the Company had $3,519,000 in residual interests classified as available-for-sale and $6,607,000 in residual interests classified as trading securities. The Company determines the estimated fair value of the residual interests by discounting the expected cash flows released from the Trust (the cash out method) using a discount rate commensurate with the risks involved. In accordance with Emerging Issues Task Force 99-20 (EITF 99-20), *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*, increases to the fair value of available-for-sale residual interests are recorded as unrealized gains, net of tax, as a component of other comprehensive income, with the yield being adjusted on a prospective basis. Decreases to the fair value, that are considered to be other than temporary, are recorded as a loss against earnings in the period of the change. Changes to the fair value of trading residual interests are recorded through earnings as a component of the gain or loss on trading securities and derivative instruments.

There is no active market which would provide market quotes for the Company s residual interests in securitizations. While management believes the estimated value of its residual interests in securitizations to be reasonable, these estimates are based upon various assumptions including, but not limited to, the performance of the loans within the securitizations, interest rates and changes in real estate values. The Company s actual experience may be different than management s assumptions and, as a result, the values ultimately realized may be different than the values recorded at March 31, 2007 and December 31, 2006 and the difference may be material.

The Certificate holders and their securitization trusts have no recourse to the Company for failure of mortgage loan borrowers to pay when due. Purchasers of securitization bonds and certificates have no recourse against the other assets of the Company, other than the assets of the Trust. The Company s residual interests are subordinated to the Certificates until the Certificate holders are fully paid. The value of the Company s residual interests is subject to credit, prepayment and interest rate risk on the transferred financial assets.

Real Estate Owned

Real Estate Owned (REO) results from the Company foreclosing on delinquent borrowers. These properties are held for sale and carried at the lesser of the carrying value or fair value less estimated selling costs. Individual properties are periodically evaluated and additional impairments are recorded, if necessary. At March 31, 2007 and December 31, 2006, the Company had REO properties valued at $43,285,000 and $33,197,000, respectively. At March 31, 2007 and December 31, 2006, there are additional REO properties valued at $6,323,000 and $6,220,000, respectively, included with assets of discontinued operations.

Derivative Instruments

In connection with the Company s strategy to mitigate interest rate risk on its residual assets, mortgage loans held for sale and the repricing of long-term debt issued in securitization transactions, the Company uses derivative financial instruments such as Eurodollar futures contracts, interest rate caps, and interest rate swaps. It is not the Company s policy to use derivatives to speculate on interest rates. These derivative instruments are intended to provide income and cash flow to partially offset changes in interest income and cash flows as interest rates change. The derivative financial instruments and any related margin accounts are included in derivative instruments on the consolidated balance sheets and are carried at their fair value. Changes in the fair value of derivative instruments are reported as gain on derivative instruments within the consolidated statements of operations. The Company held the following positions in derivatives (in thousands) at:

	March 31, 2007		**December 31, 2006**		
Contract	**Notional amount**	**Fair value**	**Notional amount**	**Fair value**	**Term**
Interest rate swaps	$ 1,163,307	11,163	$ 1,255,854	15,282	Amortizing through February 2010
Interest rate cap	$ 1,444,096	14,939	$ 1,757,534	20,241	Amortizing through February 2008
Derivative instruments		$ 26,102		$ 35,523	

All Eurodollar futures contracts were settled in conjunction with the sale of the mortgage banking operations to Bear Stearns. These Eurodollar contracts resulted in a gain during the three months ended March 31, 2007 of $348,000 which is reflected in discontinued operations.

During the three months ended March 31, 2007, the Company recorded a loss of $1,680,000 related to the Company s interest rate swaps and caps, representing a loss of $9,421,000 in fair value adjustments and settlement receipts of $7,741,000 on the swaps and caps.

Income Taxes

The Company is not subject to tax on the earnings of the REIT it distributes to its stockholders as long as it distributes at least 90% of its taxable REIT earnings to its stockholders each taxable year and satisfies other qualifying tests. The Company has elected to have its wholly-owned subsidiary, Performance Credit Corporation, treated as a taxable REIT subsidiary (TRS). As a TRS, Performance Credit is subject to federal and state taxes on its income. Accordingly, the Company reports a provision for taxes based upon the earnings of Performance Credit using the asset and liability method of accounting for income taxes.

Under the asset and liability method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the consolidated financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates for the periods in which the differences are expected to reverse. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

The Company records a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax asset will not be realized, as required by Statement of Financial Accounting Standards No. 109 (SFAS 109), *Accounting for Income Taxes.* In determining the possible realization of deferred tax assets, the Company considers future taxable income from the following sources: (i) the reversal of taxable temporary differences, (ii) taxable income from future operations and (iii) tax planning strategies that, if necessary, would be implemented to accelerate taxable income into periods in which net operating losses might otherwise expire.

The Company adopted FASB Interpretation 48, *Accounting for Uncertainties* (FIN 48) an interpretation of SFAS 109 on January 1, 2007. The Interpretation prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. For those benefits to be recognized, a tax position must be more-likely-than-not to be sustained upon examination by taxing authorities. The amount recognized is measured as the largest amount of benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement. The adoption of FIN 48 has resulted in a transition adjustment reducing beginning retained earnings by $751 thousand; $475 thousand in taxes; and $276 thousand in interest. If recognized, the tax portion of the adjustment would affect the effective tax rate. Interest costs and penalties related to income taxes are classified as interest expense and operating expenses from continuing operations in the Company s financial statements. Open tax return years are subject to future examination by tax authorities. Federal tax returns are open for years 2003 and after and some material state tax returns are open for years 2002 and after.

Stock-Based Compensation

On January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123(R) (SFAS 123(R)), *Share-Based Payment*, and began recognizing stock option-based compensation expense in the consolidated statements of operations using the fair value based method applied on a modified prospective basis. Under this transition method, the Company has applied the provisions of SFAS 123(R) to awards granted after January 1, 2006. Additionally, the Company has eliminated its deferred compensation balance against additional paid in capital and will recognize compensation cost over the remaining service period for the portion of awards for which the requisite service period had not been rendered and remains outstanding as of January 1, 2006. The compensation cost for these awards is based on the grant date fair value, as calculated for the pro-forma disclosures previously required by Statement of Financial Accounting Standards No. 123 (SFAS 123), *Accounting for Stock-Based Compensation.* See Note E for additional information on stock-based compensation.

Income/Loss Per Share

Basic income/loss per share is computed by dividing losses available to stockholders by the weighted average number of common shares outstanding for the period. The weighted average number of common shares includes actual shares of common stock outstanding during the period weighted from the date of issuance, less unvested restricted stock. Basic and diluted earnings per share have been calculated based on weighted average shares outstanding of 100,836,000 and 99,617,000 shares for the three months ended March 31, 2007 and 2006, respectively, as using the diluted shares outstanding in the calculation would have had an anti-dilutive effect due to the Company incurring a loss for both periods.

Loss per share was calculated as follows:

	For the three months ended March 31,	
	2007	2006
	(in thousands, except per share data)	
(Loss) income from continuing operations	$ (17,981)	$ 11,284
Income (loss) from discontinued operations	$ 10,973	$ (17,659)
Net loss	$ (7,008)	$ (6,375)
Weighted average number of shares outstanding	100,836	99,617
Weighted average number of unvested restricted stock	N/A	N/A
Net shares assumed issued using the treasury stock method for options outstanding during each period based on average market price	N/A	N/A
Diluted shares	100,836	99,617
Income / (loss) per share from continuing operations:		
Basic	$ (0.18)	$ 0.11
Diluted	$ (0.18)	$ 0.11
Income / (loss) per share from discontinued operations:		
Basic	$ 0.11	$ (0.17)
Diluted	$ 0.11	$ (0.17)
Loss per share:		
Basic	$ (0.07)	$ (0.06)
Diluted	$ (0.07)	$ (0.06)

Recent Accounting Pronouncements

In February 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 155 (SFAS 155), *Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140.* SFAS 155 permits fair value measurement for certain hybrid instruments, clarifies which interest-only and principal-only strips are subject to Statement of Financial Accounting Standards No. 133 (SFAS 133), *Accounting for Derivative Instruments and Hedging Activities*, clarifies and establishes requirements related to derivatives embedded in beneficial interests issued in securitizations, and amends SFAS 140 to eliminate the prohibition on QSPEs holding certain derivative financial instruments. SFAS 155 is effective for fiscal years beginning after September 15, 2006. The Company s adoption of SFAS 155 has not had a material effect on its financial statements.

In March 2006, the FASB issued Statement of Financial Accounting Standards No. 156 (SFAS 156), *Accounting for Servicing of Financial Assets* an amendment of FASB Statement No. 140. SFAS 156 requires companies to record a servicing asset or servicing liability each time they undertake an obligation to service a financial asset from (i) the transfer of financial assets that meet the requirements for sale accounting, (ii) a transfer of financial assets to a QSPE in a guaranteed mortgage securitization in which the transferor retains the securities and accounts for them as available-for-sale or trading, or (iii) an acquisition or assumption of an obligation to service financial assets that does not relate to financial assets of the servicer or its affiliates. In addition, SFAS 156 requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable. SFAS 156 is effective for fiscal years beginning after September 15, 2006. The Company s adoption of SFAS 156 has not had a material effect on its financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 (SFAS 157), *Fair Value Measurements*. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is presently evaluating the impact of the adoption of SFAS 157 on its financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159 (SFAS 159), *Fair Value Option for Financial Assets and Financial Liabilities*. SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The objective of SFAS 159 is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is presently evaluating the impact of the adoption of SFAS 159 on its financial statements.

Reclassifications

Certain reclassifications have been made to prior years balances to conform to the March 31, 2007 presentation.

NOTE B LOANS HELD FOR INVESTMENT

The components of mortgage loans held for investment at March 31, 2007 and December 31, 2006 were as follows:

	March 31, 2007	Weighted Average Coupon	December 31, 2006	Weighted Average Coupon
	(in thousands)			
Unpaid principal balance of mortgage loans	$ 2,123,221	7.52%	$ 2,422,217	7.22%
Net deferred origination costs and discount	20,214		24,298	
Allowance for loan losses	(45,766)		(43,425)	
	$ 2,097,669		$ 2,403,090	

The following table presents a summary of the activity for the allowance for losses on mortgage loans held for investment for the three months ended March 31, 2007 and 2006:

	For the three months ended March 31, 2007	2006
	(in thousands)	
Beginning balance	$ 43,425	$ 40,862
Additions	12,688	6,099
Charge-offs, net	(10,347)	(1,195)
Ending balance	$ 45,766	$ 45,766

NOTE C RESIDUAL INTERESTS IN SECURITIZATIONS

The following table summarizes activity in residual interests:

	For the three months ended March 31, 2007	2006
	(in thousands)	
Beginning balance	$ 45,920	$ 14,753
Residual interests		

Mark-to-market adjustment	(2,731)	80
Accretion of residual interests	3,355	1,523
Cash received from residual interests	(36,418)	(25)
Ending balance	$ 10,126	$ 16,331

The Company uses certain assumptions and estimates to determine the fair value allocated to the residual interests at the time of initial sale and each subsequent reporting date in accordance with SFAS 140. These assumptions and estimates include projections concerning the various rate indices applicable to the Company s loans and the pass-through rate paid to bondholders, credit loss experience, prepayments rates, and a discount rate commensurate with the risks involved. These assumptions are reviewed periodically by management. If these assumptions change, the related asset and income would be affected.

The Company completed a securitization of approximately $1.1 billion in assets in May 2006. The fair value assigned to the residual interests at the date of securitization was $50,184,000. Key economic assumptions used to measure the residual interest at this date were as follows: prepayment curves that resulted in a weighted average life of 1.88 years; a weighted average static pool loss of 4.29%; a discount rate of 18.00%; and the actual LIBOR forward curve at the time of the securitization. At the date of the securitization, the Company recorded a $1.3 million loss on sale of loans in accordance with SFAS 140. In July 2006, the Company sold a portion of its residual interests in this securitization which reduced the fair value of the residual interests to approximately $33 million. In February 2007, the Company completed the sale of its remaining interests in this securitization for $20 million. As of December 31, 2006, residual interests were valued at $20 million and a mark-to-market loss of approximately $13 million was recorded on this asset.

Unpaid loan principal balances underlying the Company s residual interests in securitizations aggregate $199,155,000 as of March 31, 2007. A total of 14.4% of unpaid principal balances are delinquent 60 or more days, in bankruptcy or foreclosure or are real estate owned.

As of March 31, 2007 and December 31, 2006, key economic assumptions and the sensitivity of the current fair value of residual interests in securitizations to immediate 10% and 20% adverse changes in those assumptions are illustrated in the following table:

	March 31, 2007	**December 31, 2006**
	(in thousands)	
Carrying value/fair value of residual interests	$ 10,126	$ 45,920
Assumed weighted average life in years	0.60	0.38
Decline in fair value with 10% adverse change	$ (146)	$ (134)
Decline in fair value with 20% adverse change	$ (295)	$ (259)
Assumed cumulative pool losses	1.19%	1.71%
Decline in fair value with 10% adverse change	$ 146	$ 303
Decline in fair value with 20% adverse change	$ 371	$ 647
Assumed discount rate	27.38%	20.14%
Decline in fair value with 10% adverse change	$ 126	$ 138
Decline in fair value with 20% adverse change	$ 248	$ 272
Interest rate assumptions		1-month LIBOR
Decline in fair value with 10% adverse change	$ 127	$ 164
Decline in fair value with 20% adverse change	$ 365	$ 113

These sensitivities are hypothetical and should be used with caution as immediate adverse changes could exceed 20%. As the amounts indicate, changes in fair value based on a 10% and 20% variation in assumptions generally cannot be extrapolated because the relationship of the change in the assumption to the change in fair value may not be linear. Also, the effect of a variation in a particular assumption on the fair value of the residual interest is calculated without changing any other assumption when, in reality, changes in one factor may result in changes in another (for example, increases in interest rates may result in lower prepayments and higher credit losses) which may magnify or counteract the sensitivities.

NOTE D LONG-TERM DEBT

Long-term debt comprises mortgage-backed securities secured solely by mortgages transferred to the related securitization trust and are non-recourse to the Company. The principal and interest payments on the mortgages provide the funds to pay debt service on the securities. The interest rate on the securities resets monthly and is based upon one-month LIBOR. The weighted average interest rate payable on the Company s long-term debt at March 31, 2007 and December 31, 2006 was 5.80% and 5.76%, respectively. As principal payments on the underlying mortgages are paid through to reduce principal on the bonds, the term of the bonds is ultimately a function of the rate at which principal is paid on the mortgages. Based upon anticipated prepayment speeds the Company estimates that the bonds will be fully repaid by 2015. However, the bonds have a clean-up call provision which allows the Company to dissolve the trust and repay outstanding bonds when the remaining principal balance of the underlying loans is 10% or less of their original balance. If the Company exercises this call provision, the Company estimates that the bonds could be fully repaid as early as 2009. However, the timing of when the Company may be able to exercise the call provision may be delayed based upon the recent tightening of credit standards for subprime borrowers and the continued deterioration of the subprime lending industry.

As of March 31, 2007 and December 31, 2006, the balance of long-term debt comprises the following:

	March 31, 2007	December 31, 2006
	(in thousands)	
	(unaudited)	
Securitized bonds	$ 2,100,481	$ 2,389,084
Discount on bonds	(6,177)	(6,971)
Accrued interest on securitized bonds	1,616	1,912
Total financing on mortgage loans held for investment	$ 2,095,921	$ 2,384,025

Costs associated with issuing long-term debt were capitalized and are being amortized as a component of interest expense over the estimated term of the debt, expecting that the debt will be paid fully from the cash flows from the underlying collateral. Through March 31, 2007 total deferred bond issue costs of $16,168,000 were capitalized. The balance of deferred bond issue costs at March 31, 2007 and December 31, 2006, net of accumulated amortization, was $4,314,000 and $5,528,000, respectively, and is included in prepaid expenses and other assets.

The discount on bonds reflects the difference between the proceeds received from the sale of the bonds and the face amount to be repaid over the life of the bonds. The discount is being amortized as an adjustment of interest expense over the estimated life of the bonds.

NOTE E STOCK-BASED COMPENSATION

Stock option activity during the three months ended March 31, 2007 was as follows:

	Number of shares underlying options	Weighted average exercise price
Balance at December 31, 2006	2,630,691	$ 3.29
Granted		
Exercised	(50,000)	$ 0.43
Forefeited or expired	(740,229)	$ 1.91
Balance at March 31, 2007	1,840,462	$ 3.92

No options were granted during the three months ended March 31, 2007.

In connection with the sale of the mortgage banking operations to Bear Stearns, the Company accelerated the vesting of 279,208 stock options with an exercise price less than $1.50 for those employees that were terminated in connection with the termination of their employment by Performance Credit. On May 9 and 10, 2007, approximately 1,000,000 options expired unexercised leaving approximately 789,000 options outstanding.

Compensation related to restricted stock for the first quarter 2007 is $500,602. The remaining unamortized restricted stock expense at March 31, 2007 is $594,685.

Under the provisions of SFAS 123(R), the Company calculates the expected term of option grants using the simplified method , as defined by Securities and Exchange Commission Staff Accounting Bulletin No. 107 (SAB 107). Under the simplified method , the expected term for plain vanilla options is calculated as the average of the vesting term and the contractual term. The risk free interest rate is based on the U.S. Treasury rate at the date of grant with the maturity date approximately equal to the expected life of the option. Volatility is calculated based on historical stock price volatility of the Company and similar entities over a period that approximates the expected term. The dividend rate is based upon historical dividend distributions and is adjusted based on the dividend yield of similar entities to reduce volatility in calculating this assumption.

During the three months ended March 31, 2007, the Company included $20,095 in stock based compensation expense in the consolidated statements of operations. The Company has no remaining unamortized option expense as of March 31, 2007.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our unaudited condensed consolidated financial statements and related notes contained in this report and with Management s Discussion and Analysis of Financial Condition and Results of Operations and the audited consolidated financial statements and notes contained in our Annual Report on Form 10-K for the year ended December 31, 2006. The following discussion and analysis discusses our financial condition and results of our operations on a consolidated basis, unless otherwise indicated. Except for the historical information contained herein, the following discussion contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, that are subject to known and unknown risks, uncertainties and other factors that may cause our actual results to differ materially from those expressed or implied by such forward-looking statements.

Sale of mortgage banking business

On February 9, 2007, we closed the sale of its mortgage banking operations to Bear Stearns and settled the sale of approximately $1.2 billion in mortgage loans to Bear Stearns, subject to certain price adjustments and call rights. Upon completion of the transaction, we effectively exited the wholesale mortgage origination business, agreeing not to compete in the subprime wholesale mortgage origination business for a period of two years. Accordingly, the disposition of the mortgage banking operations is being reported as a discontinued operation for the year ended December 31, 2006 and the three months ended March 31, 2007. As Bear Stearns also acquired use of the Encore Credit name, we changed the name of Encore Credit Corp. to Performance Credit Corporation, which remains our wholly-owned subsidiary.

Following the transaction, we continue to own and manage interests in securitization trusts which issued securities collateralized by mortgages on residential real estate. Our principal sources of revenue are net interest income on our portfolio of loans held for investment and interest accretion on our investments in residual interests in our securitizations. As part of managing our portfolio of loans held for investment, we may also originate mortgage loans as a broker to generate additional revenue from borrowers wishing to prepay their mortgage loans or to facilitate the workout or modification of a loan to mitigate losses. We refer to this as portfolio protection. Revenue we generate from our portfolio protection activities is not material to our financial statements.

We are currently evaluating various operating alternatives which include, among other things, managing our existing investments in our securitizations, acquiring loan portfolios for securitization and making investments in other residual interests in securitizations. We intend to maintain our REIT status for the period of time during which we hold residual interests in our securitizations. As a REIT, earnings we distribute to our stockholders are not subject to income tax for federal or state purposes as long as we distribute at least 90% of our taxable earnings and satisfy certain other qualifying tests.

General

For the three months ended March 31, 2007, we reported a net loss of $7.0 million, compared to a net loss of $6.4 million for the three months ended March 31, 2006. The increase in losses in 2007 reflects a number of factors including the following:

- Net interest income from loans held for investment has declined reflecting (i) a significant decline in levels of interest earning assets as we have experienced prepayments through March 31, 2007 with no additions since the fourth quarter 2005, and (ii) higher borrowing costs, in particular with respect to the securitizations within the portfolio investment operations where borrowing costs adjust monthly and most of the adjustable rate mortgage loans have not reached scheduled interest rate reset dates;

- We continued to experience higher levels of delinquency and loss severity on mortgage loans held for investment. During the three months ended March 31, 2007, we accrued $12,688,000 allowance for loan loss; and

- Net interest income from loans held for sale has declined as a result of the sale of the mortgage banking operations to Bear Stearns because Bear Stearns funded and acquired our loan production and the interest rate on the warehouse borrowings was equivalent to the weighted average coupon on the loans securing the borrowings.

Critical Accounting Policies

We have established various accounting policies that apply accounting principles generally accepted in the United States of America in the preparation of our historical financial statements. Certain accounting policies require us to make significant estimates and assumptions that may have a material impact on certain assets and liabilities or our results of operations, and we consider these to be critical accounting policies. The estimates and assumptions used are based on historical experience and other factors, which we believe to be reasonable under the circumstances. Actual results could differ materially from these estimates and assumptions, which could have a material impact on the carrying value of our assets and liabilities and our results of operations.

We believe the following are critical accounting policies that require the most significant estimates and assumptions that are subject to significant change in the preparation of our consolidated financial statements:

Mortgage Loans and Origination Costs and Fees

Our mortgage loans are classified as either held for sale or held for investment. Mortgage loans held for sale are carried at the lower of cost or market on an individual loan basis. Market value is determined by reference to prices obtained on recent sales of similar loans, planned loan sale transactions, or through loan pricing models. The provision to reduce held for sale loan inventory to the lower of cost or market is charged to gain on sale of loans.

Mortgage loans that we securitize or expect to securitize through on balance sheet securitizations are classified as held for investment and carried at amortized cost. Mortgage loans transferred from held for sale to held for investment are transferred at the lower of cost or market at the date of the transfer.

We capitalize the fees received from borrowers at the time of loan origination, and various costs of originating loans, which consist of fees and premiums paid to brokers, as well as certain direct internal costs. Net capitalized origination costs and fees on loans held for sale are charged to expense at the time the related loans are sold and reduce the gain on sale recorded. Net capitalized origination costs and fees on loans held for investment are amortized as a component of interest income over the life of the portfolio using the effective yield method in a manner that anticipates prepayments. At each reporting period, if a difference arises between the prepayments anticipated and actual prepayments received, we will recalculate the effective yield to reflect actual prepayments to date and anticipated future prepayments. Accordingly, if actual prepayment speeds exceed anticipated prepayment speeds we will be required to record additional interest expense.

Allowance for Losses on Mortgage Loans Held for Investment

For our mortgage loans held for investment, we establish an allowance for loan losses based on our estimate of losses inherent and probable as of the balance sheet date. We periodically conduct reviews of all loans held in our portfolio in order to determine collectibility. We determine the amount of the loss allowance for these loans based on a review of static pools, gross defaults, recovery rate trends, current economic conditions and trends, and other relevant data. To date, we have had minimal losses; however, as our portfolio continues to mature and we experience more losses, we plan to compare actual loss performance to original loss assumptions and, if necessary, make adjustments to the allowance for losses. In order to increase allowances, a loan loss provision is charged to the statement of operations, resulting in a reduction to earnings. Loans that are deemed to be uncollectible will be charged off and deducted from the allowance. Recoveries on loans previously charged off will be added to the allowance. As our portfolio of loans held for investment increases and ages, we would expect a corresponding increase in our allowance for losses.

Our estimate of expected losses could increase if our actual loss experience is different than originally estimated, or if economic facts change the value we could reasonably expect to obtain from a sale. In particular, if actual losses increase, the allowance for losses would increase. Any increase in the allowance for losses relating to these factors may adversely affect our results of operations.

We cease accruing interest income on loans when any portion of principal or interest is 90 days past due, or earlier when any concern exists as to the ultimate collectibility of principal or interest. Interest income recognized prior to loans becoming 90 days past due is reversed.

Gain or Loss on Sale of Loans

We recognize a gain or loss on the sale of our loans we sell through whole loan sales. Gains or losses resulting from these sales or securitizations of mortgage loans are recognized at the date of settlement and are based on the difference between the selling price for sales or securitizations and the carrying value of the related loans sold. As part of the sale of a mortgage loan, we sell the servicing rights. The purchasing company pays us a service release premium for that right. This premium is included in discontinued operations in the accompanying consolidated statements of operations.

Loan sales and securitizations are accounted for as sales when control of the loans is surrendered, to the extent that consideration other than beneficial interests in the loans transferred is received in the exchange. Retained interests in securitizations accounted for as sales are measured by allocating the previous carrying value between the loans sold and the interests retained, if any, based on their relative fair values at the date of transfer.

Allowance for Repurchase Losses

The terms of our loan sale agreements generally require us to repurchase loans where it has been determined that representations and warranties made by us at the time of sale have been breached or loans for which the borrower has missed the first payment due to the purchaser of the loan. We will generally resell repurchased loans to other investors, but at a discount to par or we will make a separate payment to investors to settle claims. We establish an allowance for such losses based upon our evaluation of historical experience with respect to the principal, premium, interest losses and other costs, if any, expected to occur in the fulfillment of our repurchase obligations. Losses incurred on mortgage loans that we have sold and subsequently repurchased are charged to the allowance for repurchase losses.

Fair Value of Residual Interests in Loan Securitizations

In securitizations completed during 2003, 2004 and 2006, we conveyed loans that we originated to a special purpose entity (such as a trust), or to a third party that subsequently sold the loans to a special purpose entity, in exchange for cash proceeds and a residual interest in the trust. The cash proceeds were raised through an offering of the pass-through certificates or bonds evidencing the right to receive principal payments and interest on the certificate balance or on the bonds. Pursuant to FASB Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* or SFAS No. 140, and its predecessor accounting pronouncements, we recorded gain or loss on sales of loans, equal to the difference between the portion sold and any retained interests, herein referred to as residual interests, based on their relative fair values at the date of transfer and our basis in the loans. The residual interests represent, over the estimated life of the loans, the present value of the estimated cash flows. These cash flows are determined by the excess of the projected interest earned on each pool of securitized loans over the sum of the interest paid to investors, the contractual servicing fee, an estimate for credit losses and other ongoing costs of the securitization. Each agreement that we have entered into in connection with these securitizations requires the over-collateralization of the trust that may initially be funded by cash or an excess of loans deposited into the trust. The amount and timing of the cash flows expected to be released from the securitization trusts consider the impact of the applicable delinquency and credit loss limits specified in the securitization agreements.

We determined the present value of the cash flows at the time each securitization transaction closed using certain assumptions and estimates made by management at the time the loans were sold. These assumptions and estimates included:

- estimates of future interest rates based upon the forward London Interbank Offered Rate, or LIBOR, curve;
- future rates of principal prepayment on the loans;
- timing and magnitude of credit losses; and
- discount rate used to calculate present value.

The future cash flows represent management s best estimate. There can be no assurance of the accuracy of management s estimates. Most of our residual interests are recorded at estimated fair value and are marked to market through a charge (or credit) to earnings. On a quarterly basis, we review the fair value of our residual interests by analyzing prepayment, credit loss, discount rate assumptions and other performance assumptions and estimates in relation to our actual experience and current rates of prepayment and credit loss prevalent in the industry. We may adjust the value of our residual interests or take a charge to earnings related to the residual interests, as appropriate, to reflect a valuation or write-down of the residual interests based upon the actual performance of the residual interests as compared to our key assumptions and estimates used to determine fair value. Although management believes that the assumptions used to estimate the fair value of the residual interests are reasonable, there can be no assurance as to the accuracy of the assumptions or estimates.

Estimated future cash flows in excess of the amortized cost of our investment in residual interests are recognized as income at a constant rate of interest (level-yield) over the estimated period of time that the cash flows will be received, in accordance with Emerging Issues Task Force 99-20 (EITF 99-20), *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*. On a quarterly basis, if estimated cash flows generated from the securitized asset s underlying collateral differ from the cash flows previously estimated due to actual prepayment or credit loss experience, we calculate revised yields based on the current amortized cost of the investment and the revised cash flows. The revised yields are then applied prospectively to recognize interest income.

Deferred Bond Issuance Costs

Direct costs associated with the issuance of long-term collateralized debt are capitalized and amortized as a component of interest expense in a manner that produces a constant rate of interest over the estimated term of the debt, expecting that the debt will be paid fully from the cash flows from the underlying collateral. Changes in the estimated amount and timing in cash flows of the collateral that pass through to the debt may cause us to amortize deferred bond issuance costs faster or slower than we anticipated upon issuance of the bonds.

Derivative Financial Instruments and Hedging Activities

Hedging is a critical aspect of our business because the value of our assets is sensitive to the fluctuation of interest rates. From time to time, we have used, and will continue to use, various financial instruments to economically hedge our exposure to changes in interest rates. The following summarizes the hedging instruments that, subject to limitations imposed by the REIT requirements, we have used to reduce interest rate risks on our residual interests, the loans that we hold for investment and the loans that we hold for sale.

Interest Rate Swap Agreements and Eurodollar Futures. Interest rate swap agreements allow us to exchange floating rate obligations for fixed-rate obligations effectively locking in our borrowing costs for a period of time. When we enter into a swap agreement we agree to pay a fixed-rate of interest and to receive a variable interest rate, generally based on LIBOR. We may also sell Eurodollar futures contracts in order to mitigate the projected impact of interest rate changes on our forecasted one-month LIBOR based liabilities. All Eurodollar futures contracts were settled in conjunction with the sale of the mortgage banking operations to Bear Stearns

Interest Rate Cap Agreements. Interest rate cap agreements allow us to receive cash payments if the interest rate index specified in the cap agreement increases above contractually specified levels. Therefore, the interest rate cap agreements have the effect of capping the interest rate on a portion of our borrowings to the rate specified by the interest rate cap agreement.

We also may use, from time to time, futures contracts and options on futures contracts on the Eurodollar, federal funds, treasury bills and treasury notes and similar financial instruments to mitigate risk from changing interest rates.

We presently do not intend to enter into derivative instruments, except for hedging purposes. Further, it is unlikely that we can obtain hedging instruments that perfectly offset all of the risks of our assets and liabilities. No hedging strategy can completely insulate us from risk, and certain of the federal income tax requirements that we must satisfy to qualify as a REIT may limit our ability to hedge. We intend to monitor and may have to limit our hedging strategies to ensure that we do not realize excessive hedging income or hold hedging assets having excess value in relation to our total assets.

In accordance with SFAS 133, all derivative instruments are recorded at fair value.

While we may change the classification of our derivative financial instruments in the future, we presently account for all our derivative financial instruments as trading instruments and we do not apply hedge accounting treatment as defined by SFAS 133. Accordingly, realized and unrealized changes in fair value are recognized in income during the period in which the changes occur.

Income taxes

The Company is not subject to tax on the earnings of the REIT it distributes to its stockholders as long as it distributes at least 90% of its taxable REIT earnings to its stockholders each taxable year and satisfies other qualifying tests. The Company has elected to have its wholly-owned subsidiary, Encore Credit Corp., now known as Performance Credit Corporation, treated as a taxable REIT subsidiary (TRS). As a TRS, Performance Credit is subject to federal and state taxes on its income. Accordingly, the Company reports a provision for taxes based upon the earnings of Performance Credit using the asset and liability method of accounting for income taxes.

Under the asset and liability method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the consolidated financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates for the periods in which the differences are expected to reverse. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

The Company records a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax asset will not be realized, as required by Statement of Financial Accounting Standards No. 109 (SFAS 109), *Accounting for Income Taxes.* In determining the possible realization of deferred tax assets, the Company considers future taxable income from the following sources: (i) the reversal of taxable temporary differences, (ii) taxable income from future operations and (iii) tax planning strategies that, if necessary, would be implemented to accelerate taxable income into periods in which net operating losses might otherwise expire.

The Company adopted FASB Interpretation 48, accounting for uncertainties (FIN 48) and interpretation SFAS 109 on January 1, 2007. FIN 48 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. For those benefits to be recognized, a tax position must be more-likely-than-not to be sustained upon examination by taxing authorities. The amount recognized is measured as the largest amount of benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement. The adoption of FIN 48 has resulted in a transition adjustment reducing beginning retained earnings by $751 thousand; $475 thousand in taxes and $276 thousand in interest. If recognized, the tax portion of the adjustment would affect the effective tax rate. Interest costs and penalties related to income taxes are classified as interest expense and operating expenses from continuing operations in the Company s financial statements. Open tax return years are subject to future examination by tax authorities. Federal tax returns are open for years 2003 and after and some material state tax returns are open for years 2002 and after.

Stock-Based Compensation

Effective January 1, 2006, we began to account for stock-based employee compensation arrangements in accordance with the provisions of Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment*. Accordingly, stock option-based compensation expense is recorded in the consolidated statement of operations using the fair value based method applied on a modified prospective basis. The effect of this change in accounting did not have a material effect on the financial statements.

Results of Operations

Prior to our initial public offering in February 2005, our business activities consisted primarily of wholesale mortgage origination operations which we sold to Bear Stearns in February 2007. We are reporting our wholesale mortgage origination operations as discontinued operations. Our continuing operations primarily comprise what had been our portfolio investment operations, which did not exist prior to 2005.

Continuing operations

Net Interest Income. The unpaid principal balances on the Company s portfolio of loans held for investment declined from $2.4 billion at December 31, 2006 to $2.1 billion at March 31, 2007 as a result of normal principal payments and loan prepayments. Similarly, the outstanding bond balances secured by these mortgage loans declined from $2.4 billion at December 31, 2006 to $2.1 billion at March 31, 2007.

Interest income is earned on the Company s portfolio of loans held for investment and investments in residual interests.

	Three months ended March 31,	
	2007	**2006**
	(in thousands)	
Loans held for investment		
Coupon interest	$ 42,034	$ 66,738
Premium amortization	(4,084)	(7,794)
Prepayment penalties	2,600	8,130
Total	40,550	67,074
Residual accretion	3,355	1,522
Investment interest income	190	
Total interest income	$ 44,095	$ 68,596

Residual accretion increased during the first quarter of 2007 reflecting higher than expected cash flows from off balance sheet securitizations completed in 2004 and 2003. As the loans underlying these securitizations have seasoned, projected cumulative losses have declined as compared to initial projections resulting in an increase in expected future cash flows and an increase in accretion income. Investment interest income increased primarily due to investing excess cash in higher yielding investments.

Premium amortization and prepayment penalties decreased due to slowing of prepayments and normal seasoning of the portfolio. As a result of aging of the portfolio many of the remaining loans are outside of the prepayment penalty period.

Interest expense primarily relates to the Company s long-term debt which comprises mortgage backed bonds issued in connection with our securitizations. In addition, the Company incurred interest expense on borrowings during the year secured by the Company s retained interests in securitizations and related commitment fees. Components of interest expense are summarized as follows (amounts in thousands):

	Three months ended March 31,	
	2007	**2006**
Bond interest	$ 32,942	$ 48,319
Amortization of bond discount and deferred bond issuance costs	1,734	2,169
	34,676	50,488
Other interest expense		
Securities sold under agreements to repurchase		471
Commitment fees		199
	$ 34,676	$ 51,158

During 2006, we borrowed approximately $60 million under a repurchase arrangement with a financial institution pledging our residual interests in securitizations and our ownership interests in securitization trusts consolidated for financial reporting purposes as collateral. In December 2006, we repaid all amounts outstanding under these borrowing arrangements. Other interest expense associated with securities sold under agreements to repurchase and the amortization of commitment fees was related to this repurchase agreement.

Net interest income (difference between interest income and interest expense) is summarized as follows (amounts in thousands):

	Three months ended March 31, 2007	2006
Interest income	$ 44,095	$ 68,596
Interest expense	34,676	51,158
Net interest income	$ 9,419	$ 17,438

Provision for Loan Losses. Activity in the allowance for loan losses is summarized as follows (amounts in thousands):

	For the three months ended March 31, 2007	2006
	(in thousands)	
Beginning balance	$ 43,425	$ 40,862
Additions	12,688	6,099
Charge-offs, net	(10,347)	(1,195)
Ending balance	$ 45,766	$ 45,766

As the Company s portfolio for loans held for investment seasoned during 2006 and the first quarter of 2007, realized losses increased requiring the Company to record an additional provision for loan losses to maintain the allowance at a level management believes appropriate to provide for losses in its portfolio of loans held for investment that have been incurred as of March 31, 2007.

In assessing the adequacy of the allowance for loan losses management considers, among other things, current delinquency trends. Loan delinquency information is summarized as follows (amounts in thousands):

	March 31, 2007		December 31, 2006	
Aging	**Loan balance**	**Percentage of total**	**Loan balance**	**Percentage of total**
Current	$ 1,864,500	87.8%	$ 2,133,450	88.2%
30 59 days past due	71,908	3.4%	88,274	3.6%
60 89 days past due	34,820	1.6%	41,562	1.7%
90 119 days past due	25,059	1.2%	27,840	1.1%
120 149 days past due	19,402	0.9%	23,884	1.0%
150 179 days past due	18,697	0.9%	22,222	0.9%
180 + days past due	88,834	4.2%	84,985	3.5%
	$ 2,123,221		$ 2,422,217	
Bankruptcy/foreclosure	$ 140,194	6.6%	$ 159,239	6.6%

We believe delinquency levels as of March 31, 2007 have increased due to seasoning of the loan portfolio, increasing interest rates, expiration of the initial fixed interest rate periods and present market conditions. Although unpaid principal balances at March 31, 2007 have declined from the prior quarter by 12.4%, the allowance for loan losses has increased as a percentage of the outstanding portfolio balance from 1.8% as of December 31, 2006 to 2.2% as of March 31, 2007.

As of March 31, 2007, the allowance for loan losses represents 23% of unpaid principal balances 60 days or more delinquent. Through March 31, 2007, average loss severity on all liquidated loans has been 23.60%. For the three months ended March 31, 2007 and December 31, 2006, average loss severity on liquidated loans during these periods was 32.6% and 20.7%, respectively. We believe average loss severity on liquidated loans may continue to increase.

20

Gain (Loss) on Derivative Instruments. The net gain on derivative instruments comprises the following (amounts in thousands):

	For the three months ended March 31, 2007	For the three months ended March 31, 2006
Residual mark-to-market gain (loss)	$ (1,990)	$ 629
Derivative gains (losses):		
Eurodollar futures		
Interest rate agreements	(9,421)	11,017
Net receipts (payments) under interest rate agreements	7,741	4,841
	$ (3,670)	$ 16,487

We completed a securitization of approximately $1.1 billion in assets in May 2006. The fair value assigned to the residual interests at the date of securitization was $50,185,000. In July 2006, we sold a portion of our residual interests in this securitization which reduced the fair value of our residual interests to approximately $33 million. In February 2007 we completed the sale of our remaining interests in this securitization for $20 million. As of December 31, 2006, we valued these residual interests at $20 million and recorded a mark-to-market loss on this asset of approximately $13 million.

A summary of the fair values of our residual interests in securitizations is as follows (amounts in thousands):

	Value as of March 31, 2007	Value as of December 31, 2006
SASCO ECC 2003-1	$ 3,519	$ 3,525
CWABS ECC 2004-1	2,861	9,407
CWABS ECC 2004-2	3,746	12,988
Bravo Mortgage Asset Trust 2006-1		20,000
Total	$ 10,126	$ 45,920

The values of the securitizations we completed in 2003 and 2004 decreased primarily as a result of the recording of cash flows on these residual interests during 2007. Loan principal balances in the 2003 securitization have paid down to the point that the servicer may exercise their clean up call rights, upon which the balance of the overcollateralization account within the securitization will be released to us. We are unable to determine when, or if, such a clean up call will occur.

Operating expenses. The decline in operating expenses is consistent with the sale of our mortgage banking operations to Bear Stearns that occurred on February 9, 2007.

Following the initial public offering in 2005, ECC Capital shared personnel and services with its subsidiaries, principally Performance Credit Corporation through the date of the sale of the mortgage origination business to Bear Stearns. Operating expenses for the three months ended March 31, 2007 and March 31, 2006 include the costs associated with these shared personnel and services despite the fact that many of the personnel providing such services became employees of Bear Stearns after February 9, 2007. Although the number of employees was significantly reduced following the completion of the sale of the mortgage origination business to Bear Stearns and while there can be no assurances as to the amount of operating expenses we incur in the future, we anticipate that our future operating expenses will be less than is being reported in continuing operations for the quarter ended March 31, 2007.

Servicing fees. Servicing fees are paid to third party loan servicers that service our portfolio of loans held for investment.

Discontinued Operations

Summary operating information for our wholesale mortgage origination operations are as follows (amounts in thousands):

	Balance at March 31, 2007	Balance at December 31, 2006
Assets of discontinued operations		
Mortgage loans held for sale	$ 10,499	$ 1,137,142
Other assets	10,426	31,198
Total assets of discontinued operations	$ 20,925	$ 1,168,340
Liabilities of discontinued operations		
Warehouse and repurchase facilities	$ 4	$ 1,169,587
Other liabilities	20,457	28,314
Total liabilities of discontinued operations	$ 20,461	$ 1,197,901

	For the three months ended March 31, 2007	2006
Net interest income	$ (1,003)	$ 15,564
Gain (loss) on sale of loans	(1,305)	(7,099)
Gain on derivative instruments, net	348	4,871
Net revenues	$ (1,960)	$ 13,336

The interest rate on our warehouse borrowings was generally tied to one-month LIBOR and as the general level of interest rates began to increase in 2005, the cost of warehouse financing increased. Increases in interest rates on our mortgage loans held for sale lagged the rate at which interest costs on our warehouse borrowings increased, reducing net interest income beginning in 2005 and through 2006. We also entered into certain agreements under which Bear Stearns agreed to fund and acquire our loan production subsequent to October 10, 2006 and through the date of the close of the transaction. The interest rate on the warehouse borrowings was equivalent to the weighted average coupon on the loans securing the borrowings. As a result, we received no net interest income during the first quarter of 2007.

We experienced negative trends in whole loan sale pricing throughout 2006 and into 2007. As we did not have warehouse financing available to retain our loan inventory following the close of the sale of our wholesale mortgage origination operations to Bear Stearns, in February 2007, we sold approximately $1.2 billion in mortgage loans to Bear Stearns at a weighted average price of 97.5%. Loan inventory as of December 31, 2006 that was sold to Bear Stearns in January and February 2007 was marked to the lower of cost or market (LOCOM) based upon these loan sale transactions, resulting in a LOCOM valuation allowance of approximately $51.4 million at that date and a net LOCOM provision of $16.3 million for the year ended December 31, 2006.

In addition, we experienced an increase in repurchase claims related to early payment defaults (EPD) on mortgage loans for which the borrower has missed the first payment due to the purchaser of the loan or investor. This led to the need to increase our reserve for losses that are incurred in connection with the repurchase and disposition of repurchased loans or the costs incurred in directly settling any repurchase obligation with an investor. During the third and fourth quarters of 2006, we entered into settlement agreements with 11 purchasers of our loans paying or accruing a total of $35.4 million to extinguish various EPD and representation and warranty repurchase claims. Loans sold to these 11 purchasers during 2006 represented the majority of our sales volume for the year. Under the terms of most of the settlement agreements, as well as our agreement with Bear Stearns for the sale of loans through the date of closing the sale of the mortgage banking operations, we settled most known existing and future forecasted claims, limiting the ability of purchasers of our loans to put them back to us. However, there could be additional unknown claims that may result in future material liability.

We utilized Eurodollar futures to hedge the risk of changes in the value of our loan inventory and anticipated originations due to changes in interest rates. We settled all outstanding Eurodollar contracts in February 2007 in connection with the sale of our loan inventory to Bear Stearns.

Operating expenses reflect those expenses that were directly related to the mortgage origination business. Following the initial public offering in 2005, the Company shared personnel and services with its subsidiaries, principally Performance Credit Corporation through the date of the sale of the mortgage origination business to Bear Stearns. Costs associated with these shared personnel and services have been allocated to continuing operations, despite the fact that many of the personnel providing such services became employees of Bear Stearns after February 9, 2007.

Off-Balance Sheet Arrangements

We are party to transactions that have off-balance sheet components. In connection with off-balance sheet securitization transactions, there were $199 million in loans remaining in off-balance sheet trusts as of March 31, 2007. The trusts have issued securities or bonds secured by these loans. We have no obligation to provide funding support to either the third party investors or the off-balance sheet trusts. The third party investors, or the trusts, generally have no recourse to our assets or us.

We have retained certain residual interests in the securitization trusts. The performance of the loans in the trusts will impact our ability to realize the current estimated fair value of these assets that are included on our balance sheet.

Contractual Obligations and Commercial Commitments

The following table summarizes our material contractual obligations and commercial commitments as of March 31, 2007, as well as the consolidated obligations of the securitization entities that we sponsored and are consolidated on our balance sheets (amounts in thousands):

		Payment due by period			
	Total	Less than 1 year	1 to 3 years	4 to 5 years	More than 5 years
Operating leases	$ 6,047	$ 2,924	$ 2,043	$ 1,080	
Repurchase obligations	$ 2,000	$ 2,000			
Long-term debt(1)	$ 2,100,481	$ 1,308,611	$ 555,270	$ 141,100	$ 95,501

(1) The long-term debt had a weighted average interest rate of 5.80% at March 31, 2007.

Operating leases

Through June 8, 2007, we have entered into various agreements to terminate or sublease all our material operating leases of office space and other real estate, with the exception of three leases. One lease agreement expires on June 30, 2007. That space was used for operations. On June 6, 2007 we entered into a new lease that provides space for the remaining work force through December 31, 2008. We hold a minority ownership interest in a small retail lending business which is consolidated in our financial statements. That business leases office space under another lease arrangement that has been guaranteed by the Company and is reflected in the contractual obligations and commercial commitments presented above. Our lease reserves may prove to be inadequate as there is no assurance that our subtenants will meet their obligations under the sublease agreements.

Warehouse and repurchase facilities

There were no amounts due under warehouse and repurchase facilities at March 31, 2007. All warehouse and repurchase facilities were repaid in February 2007 in conjunction with the closing of the sale of our wholesale mortgage origination business to Bear Stearns.

Repurchase obligations

As of March 31, 2007, we have unresolved claims from investors to repurchase approximately $6 million in loans. During the quarter ended March 31, 2007 we paid $200,000 to settle certain outstanding claims. As of March 31, 2007, we have reserved $2 million for potential losses that may be realized on the settlement of these and other incurred but unknown claims. Although management believes the amount reserved is adequate to provide for losses on the settlement of repurchase claims, the timing and amount of any remaining repurchase claims is highly uncertain and it is reasonably possible that losses ultimately realized may be greater than amounts provided for.

Long-term debt

Long-term debt represents amounts payable to bondholders in connection with our securitizations accounted for as financings. As principal payments on the underlying mortgages are paid through to reduce principal on the bonds, the term of the bonds is ultimately a function of the rate at which principal is paid on the mortgages. Based upon anticipated

prepayment speeds the Company estimates that the bonds will be fully repaid by 2015. However, the bonds have a clean-up call provision which allows the Company to dissolve the trust and repay outstanding bonds when the remaining principal balance of the underlying loans is 10% or less of their original balance. If the Company exercises this call provision, the Company estimates that the bonds could be fully repaid by 2009. However, the timing of when the Company may be able to exercise the call provision may be delayed based upon the recent tightening of credit standards for subprime borrowers and the continued deterioration of the subprime lending industry.

Liquidity and Capital Resources

Upon completion of our transactions with Bear Stearns in February 2007, we effectively exited the wholesale mortgage origination business. Following the transaction, our principal source of liquidity is the cash flow we receive from our securitizations. We created our securitizations through transfer of loans to a trust that issued long-term debt or bonds collateralized by the loans. The trust collects the principal and interest on the loans and passes through all principal collected to bondholders. Interest is paid to holders of the debt based upon the stated rate associated with the class of debt. The difference between the interest collected on the loans and interest paid to the bondholders and ongoing expenses of the trust is excess cash flow. The excess cash flow provides additional collateral to the bondholders as it is available to absorb losses realized on defaulted loans. To the extent excess cash flow exceeds losses on the loans, it is used to pay down principal on senior securities issued by the trust to create additional collateralization (over-collateralization or OC) until specified OC levels are maintained by the trust. Excess cash flow not required to cover losses or build OC will be distributed to us. In addition to excess cash flow from the securitizations, we also receive servicing fees to the extent that we have retained ownership in the servicing rights on the loans included in the trust. We receive cash flows from securitizations as described regardless of whether the securitization is accounted for as a sale or a financing.

Through March 31, 2007, we have completed eight securitizations. A summary of our seven remaining securitizations initial and current balances and over collateralization requirements as of March 31, 2007 is as follows (amounts in thousands):

		As of March 31, 2007						
	Date of securitization	Scheduled loan principal balances		Bond balances	NIM bond balances	Over collateralization		
Securitization		Initial	Current			Currently required	Current balance	60+ days delinquencies (1)
				(in thousands) (unaudited)				
Retained interests								
SASCO ECC 2003-1	Apr-03	278,718	25,545	21,885		3,763	3,660	14.7%
CWABS ECC 2004-1	Jul-04	530,000	86,067	82,108		3,959	3,959	13.9%
CWABS ECC 2004-2	Sep-04	549,464	87,543	82,641		4,902	4,902	14.9%
Financing transactions								
ECR 2005-1	Mar-05	1,600,004	494,790	473,990		20,800	20,800	11.9%
ECR 2005-2	May-05	1,400,000	596,918	580,118		16,800	16,800	10.7%
ECR 2005-3	Aug-05	1,029,348	497,250	467,914		29,336	29,336	8.3%
ECR 2005-4	Nov-05	1,000,002	586,459	578,459		8,000	8,000	10.4%
Total			$ 2,374,572	$ 2,287,115	$	$ 87,560	$ 87,457	

(1) 60+ days delinquencies also include bankruptcies, foreclosures and REO.

A summary of cash flows received by us from our retained interests in each securitization during the quarter ended March 31, 2007 and year ended December 31, 2006, is as follows (amounts in thousands):

Securitization	Three months ended March 31, 2007	Year ended December 31, 2006
Retained interests		
SASCO ECC 2003-1	$	$ 55
CWABS ECC 2004-1	6,718	
CWABS ECC 2004-2	9,700	
Bravo Mortgage Asset Trust 2006-1	20,000	3,983
Financing transactions		
ECR 2005-1	2,629	24,576
ECR 2005-2	2,327	25,116
ECR 2005-3	3,555	1,938
ECR 2005-4	888	
Total	$ 45,817	$ 55,668

As of March 31, 2007, we are receiving distributions of cash flow from all of our securitizations except SASCO ECC 2003-1. Loan principal balances in the 2003-1 securitization have paid down to the point that the servicer may exercise their clean up call rights, upon which the balance of the overcollateralization account within the securitization will be released to us. We are unable to determine when, or if, such a clean up call will occur.

We sold our interest in Bravo Mortgage Asset Trust (BMAT) 2006-1 in February 2007 for $20 million. We are continuing to explore opportunities to maximize the value and liquidity of our remaining retained interests, including the sale or financing of all or part of our retained interests in securitizations.

Management believes that cash flows from its securitizations, including cash made available from the sale or financing of all or part of the Company s retained interests in securitizations, will be adequate to provide for operating needs through 2007. However, there has recently been significant adverse publicity regarding market conditions in the subprime mortgage industry. Several companies have announced an increase in loan defaults and losses and concerns regarding the growing impact that slowing appreciation and, in some cases, declines in housing prices may have on loss reserves and the values of their mortgage loans and retained interests in securitizations. If loan delinquencies and losses continue to increase within our securitizations, cash flows we receive from our securitizations may be reduced. Based on current market conditions, our ability to sell and or satisfactorily finance certain assets may be adversely impacted. These market conditions as well as a possible decline in expected cash flows from its residual interests in securitizations may negatively impact the cash flow generated from our securitizations.

Other Borrowings

From time to time we may also enter into repurchase borrowing arrangements, pledging securities we own as collateral or may borrow against the cash surrender value of corporate owned life insurance (COLI). At March 31, 2007, we had $10.2 million in outstanding borrowings against our COLI. The total cash surrender value of the COLI, including amounts securing borrowings, was $14.3 million at March 31, 2007. We maintained COLI as a mechanism for funding liabilities to employees that contribute to a deferred compensation plan. Our liability to the plan at March 31, 2007 was $4.2 million. On June 7, 2007, we terminated our deferred compensation plan which will result in payments of our related liability through January 2008.

Cash Flow

Cash provided by operating activities was $1.1 billion for the three months ended March 31, 2007 as compared to cash provided by operating activities of $333 million for the three months ended March 31, 2006. The majority of the cash provided by operations resulted from the reduction in loans held for sale. We sold the majority of our remaining loans in February 2007 as part of our plan to exit the loan origination business.

Cash provided by investing activities decreased to $351 million for the three months ended March 31, 2007 from $465 million for the three months ended March 31, 2006. The decrease was primarily due to a reduction in principal payments received on our loans held for investment.

Cash used by financing activities was $1.5 billion for the three months ended March 31, 2007 as compared to cash used in financing activities of $797 million for the three months ended March 31, 2006. The increase is mainly due to repayments of long-term debt resulting from payments received on our loans held for investment and a reduction in our warehouse liability due to the sale of our mortgage origination operations to Bear Stearns.

Item 3. ***Quantitative and Qualitative Disclosures About Market Risk***

Market risk is the exposure to loss resulting from changes in interest rates, credit spreads, foreign currency exchange rates, commodity prices and equity prices. As we are invested solely in U.S. dollar denominated instruments, primarily residential mortgage instruments, and our borrowings are also domestic and U.S. dollar denominated, we are not subject to foreign currency exchange, or commodity and equity price risk; the primary market risk that we are exposed to is interest rate risk and its related ancillary risks. Interest rate risk is highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond our control. None of our market risk sensitive assets, liabilities and related derivative positions are held for speculative purposes.

Risk Management

Our risk management focuses on protecting against possible compression in the net interest margin with respect to our portfolio of loans held for investment. The yield curve creates this risk because of different repricing durations for instruments with different maturities. In substance, the hedging objective is to protect the net interest margin by matching repricing durations for the hybrid/adjustable-rate mortgage loan portfolio and the corresponding funding sources. For accounting purposes, these hedges are called cash flow hedges, and the accounting is different than for fair value hedges.

Hybrid/adjustable-rate mortgage loans have longer repricing durations and we may not be able to obtain matched repricing durations for the corresponding funding sources since borrowings generally have a shorter repricing duration than most hybrid/adjustable-rate mortgage loans where the initial rate is fixed for one to five years. We hedge these loans with interest rate swap agreements and cap agreements in order to match the repricing durations of the loans and our funding sources.

Interest Rate Risk

We are subject to interest rate exposure relating to our portfolio of mortgage loans held for investment. Changes in interest rates impact our future earnings in various ways. While we originate and hold in our loan portfolio primarily hybrid/adjustable-rate mortgage loans, rising short-term interest rates may temporarily negatively affect our earnings, and, conversely, falling short-term interest rates may temporarily increase our earnings. This impact can occur for a number of reasons and may be mitigated by portfolio prepayment activity as discussed below. First, our borrowings may react to changes in interest rates sooner than our hybrid/adjustable-rate mortgage loans because the reset dates on our borrowings generally occur sooner than that of the hybrid/adjustable-rate mortgage loans. The interest expense on the mortgage-backed securities is typically adjusted monthly relative to market interest rates, generally the one-month LIBOR. The interest on the underlying mortgage loans is based on fixed rates payable on the underlying loans, generally for the first two or three years from origination, while the holders of the applicable securities are generally paid based on an adjustable LIBOR-based yield. Second, interest rates on hybrid/adjustable-rate mortgage loans may be capped for the first adjustment, per adjustment period and for the life of the loan (commonly referred to as the initial cap, the periodic cap and the lifetime cap, respectively), and our borrowings may not have similar limitations. Third, interest rates on hybrid/adjustable-rate mortgage loans typically change less frequently than the applicable interest rates on our liabilities.

The rate of prepayment on mortgage loans may increase if interest rates decline or if the difference between long-term and short-term interest rates diminishes. Increased prepayments would cause us to amortize the premiums paid for our mortgage loans faster, resulting in a reduced yield on our mortgage loans. Increased prepayments would also reduce the length of time we received excess cash flow from our securitizations, reducing the value of our retained interests in securitizations.

Conversely, the rate of prepayment on mortgage loans may decrease if interest rates rise or if the difference between long-term and short-term interest rates increases. Decreased prepayments would cause us to amortize the premiums paid for our hybrid/adjustable-rate mortgage loans over a longer time period, resulting in an increased yield on our mortgage loans. Decreased prepayments would also increase the length of time we receive excess cash flow from our securitizations, increasing the value of our retained interests in securitizations.

Interest rate changes may also impact our equity as our residual interests and derivative instruments are held at fair value. In general, we would expect that over time, decreases in income from our loan portfolio attributable to interest rate changes will be offset to some degree by increases in cash flow received from our derivative instruments and vice versa.

Changes in market interest rates affect our estimates of the fair value of our mortgage loans held for investment and related derivatives. The changes in fair value that are stated below are derived based upon hypothetical immediate and equal changes to market interest rates of various maturities. The effects of the hypothetical adjustment to the base or current interest rate curve are adjusted by the levels shown below:

Hypothetical Change in Interest Rate (basis points)	**100**	**50**	**-50**	**-100**
		(in thousands)		
As of March 31, 2007				
Change in fair value of loans held for investment	$ (13,996)	$ (6,913)	$ 6,638	$ 13,114
Change in fair value of interest rate cap and swap contracts	19,744	9,937	(10,067)	(20,271)
Net change	$ 5,748	$ 3,024	$ (3,429)	$ (7,158)

Hypothetical Change in Interest Rate (basis points)	**100**	**50**	**-50**	**-100**
		(in thousands)		
As of December 31, 2006				
Change in fair value of loans held for investment	$ (28,670)	$ (14,095)	$ 13,134	$ 26,147
Change in fair value of interest rate cap and swap contracts	3,010	1,505	(1,505)	(3,010)
Net change	$ (25,660)	$ (12,590)	$ 11,629	$ 23,137

Residual Interests. We had residual interests in the loans held in the trust utilized in our off-balance sheet securitization transactions of $10.1 million and $45.9 million outstanding at March 31, 2007 and December 31, 2006, respectively. Residual interests are recorded at estimated fair value. We value these assets based on the present value of estimated future cash flows using various assumptions regarding prepayments, defaults, loss severity and discount rate.

Most of our residual interests are recorded at estimated fair value and are marked to market through a charge (or credit) to earnings. On a quarterly basis, we review the fair value of our residual interests by analyzing prepayment, credit loss and discount rate assumptions in relation to actual experience and current rates of prepayment and credit loss prevalent in the industry. Although we believe that the assumptions used to estimate the fair values of our residual interests are reasonable, there can be no assurance as to the accuracy of the assumptions or estimates.

The residual interests are subject to actual prepayment or credit loss risk in excess of assumptions used in the valuation. Ultimate cash flows realized from these assets would be reduced should actual prepayments or credit losses exceed assumptions used in the valuation. Conversely, cash flows realized would be greater should actual prepayments or credit losses be below expectations.

The table below illustrates the resulting hypothetical fair values of our residual interests at March 31, 2007 and December 31, 2006 caused by assumed immediate increases to the key assumptions used to determine fair value:

	March 31, 2007	December 31, 2006
	(in thousands)	
Carrying value / fair value of residual interests	$ 10,126	$ 45,920
Prepayment speed assumption:		
Fair value after:		
Impact of a 10% increase	$ 10,272	$ 46,055
Impact of a 20% increase	$ 10,421	$ 46,179
Credit loss assumption:		
Fair value after:		
Impact of a 10% increase	$ 9,980	$ 45,618
Impact of a 20% increase	$ 9,755	$ 45,273
Residual interest cash flows discount rate:		
Fair value after:		
Impact of a 10% increase	$ 10,000	$ 45,782
Impact of a 20% increase	$ 9,879	$ 45,648
Interest rate on adjustable mortgage loans and bonds:		
Fair value after:		
Impact of a 10% increase	$ 10,000	$ 45,756
Impact of a 20% increase	$ 9,761	$ 45,807

These sensitivities are hypothetical, are presented for illustrative purposes only, and should be used with caution. The changes in the assumptions regarding prepayments and credit losses were applied to the cash flows of the mortgage loans underlying the retained interests. Changes in assumptions regarding discount rate were applied to the cash flows of the securitization trusts. Generally, changes in fair value based upon a change in assumptions cannot be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. The change in one assumption was calculated without changing any other assumptions. In reality, changes in one assumption may result in changes in others, which may magnify or offset the sensitivities. For example, changes in market interest rates may simultaneously impact the prepayment, credit loss and discount rate assumptions. In addition, it is possible that prepayment speeds, credit losses and changes in interest rates are subject to market conditions and, as such, may increase by more 20% causing a further reduction in the fair value of our residual interests in securitizations.

Counterparty Risk

Our hedging strategy of using derivative instruments also involves certain additional risks such as counterparty credit risk, the enforceability of hedging contracts and the risk that unanticipated and significant changes in interest rates will cause a significant loss of basis in the contract. The counterparties to our derivative arrangements are major financial institutions and securities dealers that are well capitalized with high credit ratings and with which we may also have other financial relationships. While we do not anticipate nonperformance by any counterparty, we will be exposed to potential credit losses in the event the counterparty fails to perform. Our exposure to credit risk in the event of default by a counterparty will be the difference between the value of the contract and the current market price. There can be no assurance that we will be able to adequately protect against the foregoing risks and will ultimately realize an economic benefit that exceeds the related expenses incurred in connection with engaging in such hedging strategies.

Credit Risk

For loans we carry as held-for-investment, we are subject to the risk that a borrower will default, requiring foreclosure on and disposition of the collateral at an amount less than the principal and accrued interest. Our interests in our securitizations are subordinate to other interests and absorb the losses incurred on these loans, reducing the cash flows ultimately distributed to us. However, we are not obligated to fund losses beyond the interests we hold in our securitizations.

A key factor affecting credit risk is the credit quality of the loans we make. Credit quality is impacted by, among other things, the credit history of the borrower, the borrower s FICO score, the income documentation provided by the borrower and value of the collateral in relation to the amount borrowed (loan to value). We make residential mortgage loans to borrowers who generally do not satisfy the credit, collateral, documentation or other standards required by conventional mortgage lenders and loan buyers. As a result the credit risk associated with loans we make is higher than the credit risk associated with loans made by conventional mortgage lenders.

In recent years there have been a number of non-traditional mortgage loan products offered to borrowers such as hybrid loans (interest rate fixed for a period and then converts to adjustable), interest only loans, 80/20 loans (an 80% first mortgage piggybacked with a 20% second mortgage) and mortgages with terms in excess of the traditional 30 years (e.g., 40 years). These non-traditional mortgage loan products carry a higher credit risk principally due to the risk of payment shock (described below) and/or the limited equity a borrower may have in the collateral.

We generally qualified our borrowers based upon the initial payment for the mortgage loan. If the payment is subject to adjustment at some future point in time and if interest rates increase, the borrower s income may not be able to support the monthly payment on the loan when the formerly fixed payment adjusts upward to reflect the increased interest rate (i.e., payment shock).

The equity held by a borrower in the collateral for a mortgage loan provides incentive to the borrower to repay the mortgage loan. If the borrower has limited or no equity in the collateral it is less likely that the borrower will repay the mortgage loan. Loans that provide the borrower essentially 100% financing for the purchase of a home (e.g., 80/20 loan product) leave the borrower limited or no equity in the collateral. In addition, a decline in the value of the collateral will also reduce or eliminate the borrower s equity. While home values have generally increased over the past several years in the areas where we make our loans, there is no assurance that values will continue to increase or that values will not decline. These factors all contribute to the credit risk we assume in originating and investing in mortgage loans.

A summary of loan products in our portfolio of loans held for investment at March 31, 2007 follows:

Product	Loan Count	Balance	Weighted Average Coupon	FICO Score	Loan to Value	Debt to income
		(loan balance in thousands)				
2/28 ARM	5,161	$ 925,620	8.09%	601	80	40
30 YR Fixed	2,439	466,103	6.95%	642	75	40
2 YR I/O 2/28 ARM	726	200,520	7.05%	657	81	41
3/27 ARM	732	137,055	7.49%	617	82	40
5 YR I/O 2/28 ARM	393	105,627	6.75%	660	82	40
2/28 Dual	287	76,670	7.19%	599	78	42
5 YR I/O 3/27 ARM	167	46,272	6.89%	667	83	40
5 YR I/O 30 YR Fixed	145	40,910	6.63%	681	76	39
3 YR I/O 3/27 ARM	121	31,847	6.66%	669	81	41
5 YR 5/25 ARM	126	28,366	6.78%	648	77	42
1 YR 1/29 ARM	117	23,435	9.96%	616	81	40
15 YR Fixed	156	18,097	7.15%	627	64	36
20 YR Fixed	107	15,523	6.87%	648	71	40
6 Month LIBOR	14	3,415	11.03%	647	83	41
25 YR Fixed	12	2,309	6.82%	651	74	35
10 YR Fixed	17	1,452	7.51%	611	57	38
Total/ Average	10,720	2,123,221	7.52%			

Item 4. ***Controls and Procedures***

Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms and that such information is accumulated and communicated to our management, including our Principal Executive Officer and Principal Financial Officer, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As of March 31, 2007, management, under the supervision of our Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e) and Rule 15d-15(e)). Based upon that evaluation and taking into account the deficiencies in internal control over financial reporting identified in our Form 10-K for the year ended December 31, 2006, our Chief Executive Officer and Chief Financial Officer concluded that as of March 31, 2007 and the date of this filing, our disclosure controls and procedures were not effective at a reasonable level.

Changes in Internal Control Over Financial Reporting

Following the close of the sale of the Company s mortgage banking operations to Bear Stearns, the Company has been operating with significantly fewer employees. Management has been reviewing remaining processes and procedures to ensure that there are sufficient and qualified personnel remaining to manage the financial reporting process. As a result of changes in the business and the significant reduction in the number of employees there have necessarily been numerous changes in the internal control process over financial reporting through the fourth quarter of 2006 and into the first quarter of 2007. Principal changes have included changes in processes within our information technology environment and reassignment of accounting and financial reporting responsibilities to facilitate appropriate segregation of duties. We would expect there to continue to be significant changes to our internal controls over financial reporting as we implement actions to remediate the various control deficiencies noted in remaining processes.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

On April 4, 2007, Performance Credit Corporation (Performance), filed suit in the Central District of California, Southern Division, against EMC Mortgage Corporation (EMC), a subsidiary of Bear Stearns, seeking damages of more than $20 million for alleged breach of contract in connection with EMC s purchases of Performance s residential mortgage loan portfolio during the period from and after October 10, 2006 and related matters (as amended, the Complaint). The Complaint alleges that EMC agreed to purchase and securitize Performance s entire loan production monthly and assume responsibility for any early payment defaults by mortgage loan borrowers. The Complaint also alleges that EMC breached the agreement by, among other things, delaying the purchase of certain loans originated by Performance and failing to securitize monthly. As a result of these alleged breaches by EMC, the Complaint alleges that Performance suffered losses of more than $20 million when these mortgage loans declined in value from the date EMC agreed to purchase such loans until the date EMC ultimately did purchase them.

Performance has also commenced arbitration proceedings against EMC, seeking damages of more than $5 million for EMC s breach of a Loan Servicing Agreement (Servicing Agreement). Performance alleges in its Demand for Arbitration that EMC breached the Servicing Agreement by failing to act diligently to collect all payments due under each of the mortgage loans required to be serviced and otherwise to perform its obligations under the Servicing Agreement.

Although we believe that these claims are well-founded, as is true of all legal proceedings, it is impossible at an early stage to predict with accuracy the likely outcome or amount of recovery, if any, that may be obtained from these actions. We expect that there will be substantial costs associated with the prosecution of these claims, which may never be recouped and which may have a material effect on our results of operations. In addition, Bear Stearns has significantly more resources than us, which may lead to prolonged litigation and increased expenses related to the prosecution of these claims.

We are not currently a party to any other material legal proceeding. We have been involved, from time to time, in a variety of mortgage lending related claims and other matters in the ordinary course of our business. In our opinion, the resolution of any of these pending incidental matters is not expected to have a material adverse effect on our consolidated financial position and results of operations.

Item 1A. Risk Factors

In addition to the other information set forth in this report, including the risk factors set forth below, you should carefully consider the factors discussed under the caption Risk Factors included in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2006, including the cautionary statements included therein regarding any forward-looking statements. These risk factors could materially affect our business, financial condition or results of operations. Additional risks and uncertainties not presently known to us or that we currently believe to be immaterial also may adversely impact our business. Should any risk or uncertainties develop into actual events, these developments could have material adverse effects on our business, financial condition, or results of operations.

Risks Related to Our Business Activities

Our internal controls over financial reporting were not adequate and our independent auditors did not certify their adequacy, which could have a significant and adverse effect on our business and reputation.

Section 404 of the Sarbanes-Oxley Act of 2002 and rules and regulations of the SEC requires us, among other things, to evaluate the adequacy of the company s internal controls over financial reporting annually. We evaluated our internal controls over financial reporting and based upon that evaluation and taking into account the deficiencies in internal control over financial reporting identified in our Form 10-K for the year ended December 31, 2006, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were not effective at a reasonable level as of the end of the period covered by this report.

Because we were not able to implement the requirements of Section 404 in a timely manner or with adequate compliance, our independent auditors did not certify the effectiveness of our internal control over financial reporting, which might subject us to sanctions or investigation by regulatory authorities, such as the SEC. As a result, there could be an adverse reaction in the financial markets due to a loss of confidence in the reliability of our financial statements. In addition, we may be required to incur costs in improving our internal control system and the hiring of additional personnel. Any such action could adversely affect our results. We cannot be certain as to the timing of completion of any remediation or the impact of the same on our operations and may not be able to ensure that the internal controls are or will be effective in a timely manner.

Risks Related to Our Common Stock

Our Common Stock is traded on the Over-the-Counter Bulletin Board and therefore your ability to sell your stock may be negatively impacted.

Our common stock was delisted from the New York Stock Exchange, or NYSE, on April 13, 2007. The Company s common stock is currently traded on the Over-the-Counter Bulletin Board, or OTC, under the symbol ECROE.OB. Because the Company has only recently started trading on the OTC and the Company did not timely file its 10-K for the year ended December 31, 2006 and this Form 10-Q for the quarter ended March 31, 2007, the Company s common stock may be removed from trading on the OTC. Our removal from the OTC could reduce the ability of stockholders to sell our common stock as quickly and inexpensively as they would have been able to do had our common stock remained quoted on the OTC. This lack of liquidity also could make it more difficult for us to raise capital in the future and could negatively impact the value of your stock.

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

None

Item 3. Defaults Upon Senior Securities.

None

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

None

Item 5. Other Information.
None

Item 6. Exhibits.
(a) Exhibits

Exhibits required by Item 601 of Regulation S-K are listed in the Exhibit Index hereto and include the following:

3.1	Amended and Restated Bylaws *((incorporated by reference to Exhibit 3.1 to Current Report on Form 8-K filed April 3, 2007).*
10.1	Separation and General Release Agreement dated as of January 17, 2007, by and between Encore Credit Corp. and Troy Gotschall *(incorporated by reference to Exhibit 10.1 to Current Report on Form 8-K filed January 23, 2007).*
10.2	Amended and Restated Employment Agreement by and between Roque A. Santi and Registrant *(incorporated by reference to Exhibit 10.1 to Current Report on Form 8-K filed April 9, 2007).*
10.3	Commercial Lease, dated as of June 6, 2007, by and between Knobbe, Martens, Olsen & Bear, LLP and ECC Capital Corporation *(incorporated by reference to Exhibit 10.1 to Current Report on Form 8-K filed June 13, 2007)*.
10.4	Employment Agreement by and between Registrant and Larry Moretti *(incorporated by reference to Exhibit 10.1 to Current Report on Form 8-K filed June 18, 2007)*.
31.1	Certification of Chief Executive Officer required by Rule 13a-14(a), created by Section 302 of the Sarbanes-Oxley Act.
31.2	Certification of Chief Financial Officer required by Rule 13a-14(a), created by Section 302 of the Sarbanes-Oxley Act.
32.1	Certification of Chief Executive Officer required by Rule 13a-14(b) and 18 U.S.C. §1350, created by Section 906 of the Sarbanes-Oxley Act.
32.2	Certification of Chief Financial Officer required by Rule 13a-14(b) and 18 U.S.C. §1350, created by Section 906 of the Sarbanes-Oxley Act.

SIGNATURES

Pursuant to the requirements of the Securities and Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on June 21, 2007.

ECC CAPITAL CORPORATION

By: /s/ Roque A. Santi
Roque A. Santi
President and Chief Financial Officer
(Principal Accounting Officer)