DYNEX CAPITAL INC
Form 10-K
February 27, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-K

(Mark One)
þ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2007
or

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

Commission file number 1-9819

DYNEX CAPITAL, INC.
(Exact name of registrant as specified in its charter)

Virginia	52-1549373
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
4551 Cox Road, Suite 300, Glen Allen, Virginia	23060-6740
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code (804) 217-5800

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, $.01 par value	New York Stock Exchange
Series D 9.50% Cumulative Convertible Preferred Stock, $.01 par value	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:
None
(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act.
Yes o No þ

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 þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.o

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

Large accelerated filer o Accelerated filer þ Non-accelerated filer o Smaller reporting company o

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

As of June 29, 2007, the aggregate market value of the voting stock held by non-affiliates of the registrant was approximately $79,908,733 based on the closing sales price on the New York Stock Exchange of $8.25.

Common stock outstanding as of January 31, 2008 was 12,136,262 shares.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Definitive Proxy Statement for the registrant's 2008 annual meeting of shareholders, expected to be filed pursuant to Regulation 14A within 120 days from December 31, 2007, are incorporated by reference into Part III.

DYNEX CAPITAL, INC.
2007 FORM 10-K ANNUAL REPORT

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PART I

In this annual report on Form 10-K, we refer to Dynex Capital, Inc. and its subsidiaries as “we,” “us,” “Dynex,” or “the Company,” unless specifically indicated otherwise.

ITEM 1. BUSINESS

GENERAL

We are a specialty finance company organized as a mortgage real estate investment trust (REIT). We invest principally in single-family residential and commercial mortgage loans and securities, both investment grade rated and non-investment grade rated. Residential mortgage securities are typically referred to as RMBS and commercial mortgage securities are typically referred to as CMBS. We finance loans and RMBS and CMBS securities through a combination of non-recourse securitization financing, repurchase agreements, and equity. We employ financing in order to increase the overall yield on our invested capital. Our primary source of income is net interest income, which is the excess of the interest income earned on our investments over the cost of financing these investments. We typically intend to hold securities to their maturity but may occasionally record gains or losses from the sale of investments prior to their maturity.

Our ownership of residential and commercial mortgage loans, RMBS and CMBS and use of leverage exposes us to certain risks, including, but not limited to, credit risk, interest rate risk, liquidity or margin call risk and prepayment risk, which are discussed in more detail in ITEM 1A – RISK FACTORS.

Over the last several years, we have sold certain assets and otherwise allowed our investment assets to run off. We retained most of our capital or invested it in short-term instruments. We retained our capital in anticipation of more compelling opportunities for reinvestment given low risk premiums as reflected by spreads to U.S. Treasuries on RMBS and CMBS securities at that time. Low risk premiums were a direct result of excessive competition for these assets from other mortgage REITs, hedge funds, collateralized debt obligations (CDOs) and other similarly highly-leveraged collateral backed vehicles, financial institutions, foreign investors, and other money managers. Since the middle of 2007, risk premiums on RMBS and CMBS assets have increased dramatically presenting opportunities for investing in RMBS and CMBS securities with more acceptable risk-adjusted returns.

In February 2008, our Board of Directors authorized the investment of a significant portion of our capital in RMBS securities issued or guaranteed by a federally chartered corporation, such as Fannie Mae or Freddie Mac, or an agency of the U.S. government, such as Ginnie Mae (commonly referred to as Agency RMBS). While we have occasionally invested in Agency RMBS in the past, we believe that risk-adjusted returns for investing in Agency RMBS are currently compelling given current yields available and the favorable terms and costs to finance the Agency RMBS. We expect to use repurchase agreement leverage in order to enhance the overall returns on our invested capital. Our leverage ratio on these and other investments may vary depending on market and economic conditions. We also expect to employ derivatives in order to manage our interest rate risk.

As a REIT, we are required to distribute to shareholders as dividends at least 90% of our taxable income, which is our income as calculated for tax, after consideration of any tax net operating loss (NOL) carryforwards. However, unlike other mortgage REITs, our required REIT income distributions may be limited into the future due to the reduction of our future taxable income by our NOL carryforwards, which were approximately $150 million at December 31, 2007, although we have not finalized our 2007 federal income tax return. As a result, we have the option of being able to invest our capital and compound the returns on an essentially tax-free basis instead of distributing our earnings to our shareholders. We will balance the desire to retain our capital and compound our returns with dividend distributions to shareholders. On February 5, 2008, the Board declared a dividend of $0.10 per common share, our first dividend to common shareholders since the third quarter of 1998.

We were incorporated in the Commonwealth of Virginia in 1987 and began operations in 1988.

BUSINESS MODEL AND STRATEGY

As a mortgage REIT, we seek to generate net interest income from our investment portfolio. We seek to invest our capital in a prudent manner, focusing on investment assets which have an acceptable risk-adjusted rate of return. Our current investment portfolio consists of highly-seasoned loans and RMBS and CMBS. Net interest income on our investment portfolio is directly impacted by the credit performance of the underlying loans and securities and, to a lesser extent, by the level of prepayments of the underlying loans and securities and changes in interest rates. With the planned investment in Agency RMBS in 2008, our exposure to prepayment and interest rate risk will increase. We intend to invest in assets and structure the financing of these assets in such a way that will generate reasonably stable net interest income in a variety of prepayment, interest rate and credit environments. Our business model and strategy have inherent risks, which are discussed in ITEM 1A – RISK FACTORS below.

Our investment policy governs the allocation of capital among various investment alternatives. Our capital allocations are reviewed annually by the Board of Directors and are adjusted for a variety of factors, including, but not limited to, the current investment climate, the current interest rate environment, competition, liquidity concerns and our desire for capital preservation. Our capital allocations are currently weighted toward our existing investments of highly-seasoned single-family and commercial mortgage loans, RMBS and CMBS. Our capital allocations will shift in 2008 as we deploy our capital in Agency RMBS.

We own both investment grade (credit rating of “BBB-” or higher) and non-investment grade investments. Our investment grade assets are rated by at least one nationally recognized rating agency, such as Moody’s Investors Services, Inc., Standard & Poor’s Corporation or Fitch, Inc. Investment assets that are not rated or are below investment grade are generally highly seasoned. A summary of our investments by credit rating is presented in tabular form in Item 7 below. As it relates to our current investment portfolio, our ownership of non-investment grade securities is generally in the form of the first-loss or subordinate classes of securitization trusts. In securitization trusts, loans and securities are pledged to a trust, and the trust issues bonds (referred to as non-recourse securitization financing) pursuant to an indenture. We have typically been the sponsor of the trust and have retained the lowest-rated bond classes in the trust, often referred to as subordinate bonds or overcollateralization. While all of the loans collateralizing the trust are consolidated in our financial statements, the performance of our investment depends on the performance of the subordinate bonds and overcollateralization we retained. The overall performance of our retained interests in these trusts is principally dependent on the credit performance of the underlying assets. Most of the investments which we own were originated by us and are considered highly seasoned. The single-family mortgage loans that we have in our investment portfolio were originated between 1992 and 1997. The commercial mortgage loans that we have in our investment portfolio were originated in 1997 and 1998. Most of the RMBS and CMBS in our investment portfolio are collateralized by loans originated during the same timeframes.

We currently have $7.5 million of fixed rate Agency RMBS. We anticipate that our investments in Agency RMBS going forward will predominantly be in securities collateralized by hybrid mortgage loans, which have interest rates that are fixed for a specified period (typically three to seven years) and generally adjust annually, thereafter, to an increment over a specified interest rate index, and, to a lesser extent, Agency RMBS collateralized by adjustable rate mortgage loans, which have interest rates that generally adjust annually (although some may adjust more frequently) to an increment over a specified interest rate index, and fixed rate mortgage loans. Agency RMBS collateralized by hybrid mortgage loans and adjustable rate mortgage loans are typically referred to as Hybrid or ARM Agency RMBS, respectively. Interest rates on the adjustable rate loans collateralizing the Hybrid or ARM Agency RMBS are based on specific index rates, such as the one-year constant maturity treasury (CMT) rate, the London Interbank Offered Rate (LIBOR), the Federal Reserve U.S. 12-month cumulative average one-year CMT (MTA) or the 11th District Cost of Funds Index (COFI). In addition, the loans collateralizing Agency RMBS typically have interim and lifetime caps on interest rate adjustments. Hybrid and ARM Agency RMBS typically are less sensitive to changes in interest rates than fixed-rate Agency RMBS.

We intend to finance our acquisition of Agency RMBS by borrowing against a substantial portion of the market value of these assets utilizing repurchase agreements. Repurchase agreements are financings under which we will pledge our Agency RMBS as collateral to secure loans with repurchase agreement counterparties. The amount borrowed under a repurchase agreement is limited to a specified percentage of the estimated market value of the pledged collateral. Under repurchase agreements, a lender may require that we pledge additional assets (i.e., by initiating a margin call) in the event the estimated fair value of our existing pledged collateral declines below a specified percentage during the term of the borrowing. Our pledged collateral fluctuates in value due to, among other things, principal repayments and changes in market interest rates. Generally the cost of repurchase agreement borrowings are based on a spread to LIBOR. As interest rates on Agency

RMBS assets will not reset as frequently as the interest rates on repurchase agreement borrowings, we anticipate extending the interest rate reset dates of our repurchase agreement borrowings by negotiating terms with the counterparty and using derivative financial instruments such as interest rate swap agreements. An interest rate swap agreement will allow us to fix the borrowing cost on a portion of our repurchase agreement financing. We may also use interest rate cap agreements. An interest rate cap agreement is a contract whereby we, as the purchaser, pay a fee in exchange for the right to receive payments equal to the principal (i.e., notional amount) times the difference between a specified interest rate and a future interest rate during a defined “active” period of time.

In the future, we may also use sources of funding, in addition to repurchase agreements, to finance our Agency RMBS portfolio, including but not limited to, other types of collateralized borrowings, loan agreements, lines of credit, commercial paper or the issuance of debt securities.

COMPETITION

The specialty finance industry in which we compete is a highly competitive industry. In making investments and financing those investments, we compete with other mortgage REITs, specialty finance companies, investment banking firms, savings and loan associations, commercial banks, mortgage bankers, insurance companies, federal agencies, foreign investors and other entities, many of which have greater financial resources and a lower cost of capital than we do. Increased competition in the market and our competitors’ greater financial resources have driven down returns on investments and may adversely impact our ability to invest our capital on an acceptable risk-adjusted basis.

AVAILABLE INFORMATION

Our website can be found at www.dynexcapital.com. Our annual reports on Form 10-K, our quarterly reports on Form 10-Q and our current reports on Form 8-K, and amendments to those reports, filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (the Exchange Act) are made available, as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission (SEC), free of charge through our website.

We have adopted a Code of Business Conduct and Ethics (Code of Conduct) that applies to all of our employees, officers and directors. Our Code of Conduct is also available, free of charge, on our website, along with our Audit Committee Charter, our Nominating and Corporate Governance Committee Charter, and our Compensation Committee Charter. We will post on our website amendments to the Code of Conduct or waivers from its provisions, if any, which are applicable to any of our directors or executive officers in accordance with SEC or NYSE requirements.

FEDERAL INCOME TAX CONSIDERATIONS

We believe that we have complied with the requirements for qualification as a REIT under the Internal Revenue Code (the Code). The REIT rules generally require that a REIT invest primarily in real estate-related assets, that our activities be passive rather than active and that we distribute annually to our shareholders substantially all of our taxable income, after certain deductions, including deductions for NOL carryforwards. We could be subject to income tax if we failed to satisfy those requirements or if we acquired certain types of income-producing real property. We use the calendar year for both tax and financial reporting purposes. There may be differences between taxable income and income computed in accordance with generally accepted accounting principles in the United States of America

(GAAP). These differences primarily arise from timing differences in the recognition of revenue and expense for tax and GAAP purposes. We currently have NOL carryforwards of approximately $150 million, which expire between 2019 and 2025. We also had excess inclusion income of an estimated $0.8 million from our ownership of certain residual investments during 2007. Excess inclusion income cannot be offset by NOL carryforwards, so in order to meet REIT distribution requirements, we must distribute all of our excess inclusion income.

Failure to satisfy certain Code requirements could cause us to lose our status as a REIT. If we failed to qualify as a REIT for any taxable year, we may be subject to federal income tax (including any applicable alternative minimum tax) at regular corporate rates and would not receive deductions for dividends paid to shareholders. We could, however, utilize our NOL carryforwards to offset any taxable income. In addition, given the size of our NOL carryforwards, we could pursue a business plan in the future in which we would voluntarily forego our REIT status. If we lost or otherwise surrendered our status as a REIT, we could not elect REIT status again for five years. Several of our investments in securitized mortgage loans have ownership restrictions limiting their ownership to REITs. Therefore, if we chose to forego our REIT status, we would have to sell these investments or otherwise provide for REIT ownership of these investments.

We also have a taxable REIT subsidiary (TRS), which has a NOL carryforward of approximately $4 million. The TRS has limited operations, and, accordingly, we have established a full valuation allowance for the related deferred tax asset.

Qualification as a REIT

Qualification as a REIT requires that we satisfy a variety of tests relating to our income, assets, distributions and ownership. The significant tests are summarized below.

Sources of Income. To continue qualifying as a REIT, we must satisfy two distinct tests with respect to the sources of our income: the "75% income test" and the "95% income test." The 75% income test requires that we derive at least 75% of our gross income (excluding gross income from prohibited transactions) from certain real estate-related sources. In order to satisfy the 95% income test, 95% of our gross income for the taxable year must consist of either income that qualifies under the 75% income test or certain other types of passive income.

If we fail to meet either the 75% income test or the 95% income test, or both, in a taxable year, we might nonetheless continue to qualify as a REIT, if our failure was due to reasonable cause and not willful neglect and the nature and amounts of our items of gross income were properly disclosed to the Internal Revenue Service. However, in such a case we would be required to pay a tax equal to 100% of any excess non-qualifying income.

Nature and Diversification of Assets. At the end of each calendar quarter, we must meet three asset tests. Under the "75% asset test", at least 75% of the value of our total assets must represent cash or cash items (including receivables), government securities or real estate assets. Under the "10% asset test," we may not own more than 10% of the outstanding voting securities of any single non-governmental issuer, provided such securities do not qualify under the 75% asset test or relate to taxable REIT subsidiaries. Under the "5% asset test," ownership of any stocks or securities that do not qualify under the 75% asset test must be limited, in respect of any single non-governmental issuer, to an amount not greater than 5% of the value of our total assets.

If we inadvertently fail to satisfy one or more of the asset tests at the end of a calendar quarter, such failure would not cause us to lose our REIT status, provided that (i) we satisfied all of the asset tests at the close of the preceding calendar quarter and (ii) the discrepancy between the values of our assets and the standards imposed by the asset tests either did not exist immediately after the acquisition of any particular asset or was not wholly or partially caused by such an acquisition. If the condition described in clause (ii) of the preceding sentence was not satisfied, we still could avoid disqualification by eliminating any discrepancy within 30 days after the close of the calendar quarter in which it arose.

Ownership. In order to maintain our REIT status, we must not be deemed to be closely held and must have more than 100 shareholders. The closely held prohibition requires that not more than 50% of the value of our outstanding shares be owned by five or fewer persons at anytime during the last half of our taxable year. The more than 100 shareholders rule requires that we have at least 100 shareholders for 335 days of a twelve-month taxable year. In the event that we failed to satisfy the ownership requirements we would be subject to fines and be required to take curative action to meet the ownership requirements in order to maintain our REIT status.

EMPLOYEES

As of December 31, 2007, we had 11 employees, all of whom were located in our corporate offices in Glen Allen, Virginia. Our Chief Executive Officer, who serves as our Chairman and was appointed CEO on February 5, 2008, works from an office located in Sausalito, California. We believe our relationship with our employees is good. None of our employees are covered by any collective bargaining agreements, and we are not aware of any union organizing activity relating to our employees. Effective February 28, 2007, GLS Capital Services, Inc., our tax lien servicing subsidiary headquartered in Pittsburgh, Pennsylvania, ceased operations, and its five employees were terminated.

ITEM 1A. RISK FACTORS

Our business is subject to various risks, including the risks described below. Our business, operating results and financial condition could be materially and adversely affected by any of these risks. Please note that additional risks not presently known to us or that we currently deem immaterial may also impair our business and operations.

We may be unable to invest in new assets with attractive yields, and yields on new assets in which we do invest may not generate attractive yields, resulting in a smaller than anticipated increase or an outright decline in our earnings per share over time.

For the last several years, we have not actively been reinvesting our capital, and our existing investments have been declining as we have sold investments or assets have otherwise paid down. We have been investing a portion of our available capital in short duration high credit quality assets. We anticipate deploying our capital in 2008 and that the capital deployed will earn greater returns than it is currently earning. However, we may be unable to find assets with attractive yields, and our net interest income may decline, resulting in lower earnings per share over time. In order to maintain our investment portfolio size and our earnings, we need to reinvest a portion of the cash flows we receive into new interest-earning assets. In addition, we may experience competition for assets in which we desire to invest from other entities which may have greater resources and a lower cost of capital than we do, and as a result, we may be unable to find or afford suitable investment opportunities.

New investments may entail risks that we do not currently have in our investment portfolio or may substantially add risks to the investment portfolio which we may or may not have managed in the past as part of our investment strategy. In addition, while we have owned Agency RMBS in the past, we have never had a significant amount of our capital invested in these assets.

We contemplate purchasing investment securities such as Agency RMBS which carry concentrated risks including prepayment risk, interest rate risk, operational risk, credit risk and liquidity or margin-call risk. While our investment portfolio generally already includes these risks to some degree, we may become more concentrated in one type of risk than another as we add investments. While we will attempt to manage these risks, we may inadvertently become overly concentrated in a particular risk which may increase the volatility in our net income or reported book value if these investments are carried at fair value.

In addition, our investing in Agency RMBS and the use of repurchase agreement financing will likely magnify the risks indicated above in the following ways:

- Prepayment risk may increase as we will likely be purchasing these securities at prices exceeding their par value. In such instance our earnings and book value may be negatively impacted if prepayments on these securities exceed our expectations.

- Interest rate risk will increase as result of, among other things, the purchase of Hybrid Agency RMBS, which have interest rates that are fixed for an initial period and will be financed principally with repurchase agreements that are not expected to have fixed rates of interest. In addition, Hybrid Agency RMBS typically have contractually limited periodic or lifetime caps on their interest rates whereas repurchase agreement financing will not.

- Operational risk will increase as we begin to deploy our capital and as we become more concentrated in Agency RMBS.

- Liquidity, or margin-call risk, will increase as a result of our reliance on financing for the purchase of Agency RMBS. In periods of high volatility in the marketplace, such as was experienced in 2007, our access to financing may be substantially reduced, potentially requiring us to sell assets in unfavorable markets to repay financings and impacting our ability to add investments at a positive net interest spread. In addition, if the value of the collateral should fall below the required level, the repurchase agreement lender could initiate a margin call, which would require that we either pledge additional collateral acceptable to the lender or repay a portion of the debt in order to meet the margin requirement. If we are unable to meet a margin call, we could be forced to quickly sell the assets collateralizing the financing, potentially resulting in a lower sales price than could otherwise be obtained if the assets were sold in a more orderly fashion.

Competition may prevent us from acquiring new investments at favorable yields potentially negatively impacting our profitability.

Our net income will largely depend on our ability to acquire mortgage-related assets at favorable spreads over our borrowing costs. In acquiring investments, we may compete with other mortgage REITs, broker-dealers, hedge funds, banks, savings and loans, insurance companies, mutual funds, and other entities that purchase assets similar to ours, many of which have greater financial resources than we do. As a result, we may not be able to acquire sufficient assets at acceptable spreads to our borrowing costs, which would adversely affect our profitability.

Our ownership of certain subordinate interests in securitization trusts subjects us to credit risk on the underlying loans, and we provide for loss reserves on these loans as required under GAAP.

As a result of our ownership of securitized mortgage loans and the overcollateralization portion of the securitization trust, the predominant risk in our investment portfolio is credit risk. Credit risk is the risk of loss to us from the failure by a borrower (or the proceeds from the liquidation of the underlying collateral) to fully repay the principal balance and interest due on a mortgage loan. A borrower’s ability to repay and the value of the underlying collateral could be negatively influenced by economic and market conditions. These conditions could be global, national, regional or local in nature. Upon securitization of a pool of mortgage loans, the credit risk retained by us from an economic point of view is generally limited to the overcollateralization tranche of the securitization trust. We provide for estimated losses on the gross amount of loans pledged to securitization trusts included in our financial statements as required by GAAP. In some instances, we may also retain subordinated bonds from the securitization trust, which increases our credit risk above the overcollateralization tranche from an economic perspective. We provide reserves for existing losses based on the current performance of the respective pool or on an individual loan basis. If losses are experienced more rapidly, due to declining property performance, market conditions or other factors, than we have provided for in our reserves, we may be required to provide additional reserves for these losses.

Our efforts to manage credit risk may not be successful in limiting delinquencies and defaults in underlying loans or losses on our investments.

Despite our efforts to manage credit risk, there are many aspects of credit performance that we cannot control. Third party servicers provide for the primary and special servicing of our loans. We have a risk management function, which oversees the performance of these services and provides limited asset management services. Our risk management operations may not be successful in limiting future delinquencies, defaults, and losses. The securitizations in which we have invested may not receive funds that we believe are due from mortgage insurance companies and other counter-parties. Loan servicing companies may not cooperate with our risk management efforts, or such efforts may be ineffective. Service providers to securitizations, such as trustees, bond insurance providers, and custodians, may not perform in a manner that promotes our interests. The value of the properties collateralizing the loans may decline. The frequency of default and the loss severity on loans that do default may be greater than we anticipated. If loans become “real estate owned” (REO), servicing companies will have to manage these properties and may not be able to sell them. Changes in consumer behavior, bankruptcy laws, tax laws, and other laws may exacerbate loan losses. In some states and circumstances, the securitizations in which we invest have recourse, as the owner of the loan, against the borrower’s other assets and income in the event of loan default; however, in most cases, the value of the underlying property will be the sole source of funds for any recoveries.

Certain investments employ internal structural leverage as a result of the securitization process and are in the most subordinate position in the capital structure, which magnifies the potential impact of adverse events on our cash flows and reported results.

Many of the loans that we own have been pledged to securitization trusts, which employ a high degree of internal structural leverage and results in concentrated credit, interest rate, prepayment, or other risks. We have generally retained the most subordinate classes of the securitization trust as discussed above. As a result of these factors, net interest income and cash flows on our investments will vary based on the performance of the assets pledged to the securitization trust. In particular, should assets significantly underperform as to delinquencies, defaults, and credit losses, it is possible that cash flows which may have otherwise been paid to us as a result of our ownership of the subordinate interests may be retained within the securitization trust and payments of principal amounts of the subordinated class may be delayed or permanently reduced. No amount of risk management or mitigation can change the variable nature of the cash flows and financial results generated by concentrated risks in our investments. None of our existing trusts at December 31, 2007 have reached or are near these levels, but such levels could be reached in the future.

We may be subject to the risks associated with inadequate or untimely services from third-party service providers, which may harm our results of operations.

Our loans and loans underlying securities are serviced by third-party service providers. As with any external service provider, we are subject to the risks associated with inadequate or untimely services. Many borrowers require notices and reminders to keep their loans current and to prevent delinquencies and foreclosures. A substantial increase in our delinquency rate that results from improper servicing or loan performance in general could harm our ability to securitize our real estate loans in the future and may have an adverse effect on our earnings.

Prepayments of principal on our investments, and the timing of prepayments, may impact our reported earnings and our cash flows.

We own many of our securitized mortgage loans and have issued associated securitization financing bonds at premiums or discounts to their principal balances. Prepayments of principal on loans and the associated bonds, whether voluntary or involuntary, impact the amortization of premiums and discounts under the effective yield method of accounting that we use for GAAP accounting. Under the effective yield method of accounting, we recognize yields on our assets and effective costs of our liabilities based on assumptions regarding future cash flows. Variations in actual cash flows from those assumed as a result of prepayments and subsequent changes in future cash flow expectations will cause adjustments in yields on assets and costs of liabilities which could contribute to volatility in our future results.

In a period of declining interest rates, loans and securities in the investment portfolio will generally prepay more rapidly (to the extent that such loans are not prohibited from prepayment), which may result in additional amortization of asset premium. In a flat yield curve environment (i.e., when there exists less spread between short-dated Treasury securities and longer dated ones), adjustable rate mortgage loans and securities tend to rapidly prepay, causing additional amortization of asset premium. In addition, the spread between our funding costs and asset yields may compress, causing a further reduction in our net interest income.

We may finance a portion of our investment portfolio with short-term recourse repurchase agreements which may subject us to margin calls if the assets pledged subsequently decline in value.

We finance a portion of our investments, primarily high credit quality, liquid securities, with recourse repurchase agreements. These arrangements require us to maintain a certain level of collateral for the related borrowings. If the collateral should fall below the required level, the repurchase agreement lender could initiate a margin call. This would require that we either pledge additional collateral acceptable to the lender or repay a portion of the debt in order to meet the margin requirement. Should we be unable to meet a margin call, we may have to liquidate the collateral or other assets quickly. Because a margin call and quick sale could result in a lower than otherwise expected and attainable sale price, we may incur a loss on the sale of the collateral. While we currently only finance a small portion of our investments with repurchase agreements, we anticipate having much greater amounts of repurchase agreements as we purchase new investments.

Interest rate fluctuations can have various negative effects on us and could lead to reduced earnings and/or increased earnings volatility.

Our investment portfolio today is substantially match-funded (meaning fixed rate assets are financed with fixed rate liabilities), and overall our current portfolio is largely insulated from material risks related to changes in interest rates. Future investments, however, may be financed with repurchase agreements which may have different interest rate characteristics or maturities than the investments which they finance. Certain of our current investments and contemplated future investments are adjustable rate loans and securities, which have interest rates that reset semi-annually or annually, based on an index such as the one-year constant maturity treasury or the six-month LIBOR. These investments may be financed with borrowings which reset monthly, based on one-month LIBOR. In a rising rate environment, net interest income earned on these investments may be reduced, as the interest cost for the funding sources could increase more rapidly than the interest earned on the associated asset financed. In a declining interest rate environment, net interest income may be enhanced as the interest cost for the funding sources decreases more rapidly than the interest earned on the associated assets. To the extent that assets and liabilities are both fixed rate or adjustable rate with corresponding payment dates, interest rate risk may be mitigated.

Hedging against interest rate exposure may adversely affect our earnings.

Subject to complying with REIT requirements, we intend to employ techniques that limit, or “hedge,” the adverse effects of changing interest rates on our short-term repurchase agreements and on the value of our assets. Our hedging activity will vary in scope based on the level and volatility of interest rates and principal repayments, the type of securities held and other changing market conditions. These techniques may include entering into interest rate swap agreements or interest rate cap or floor agreements, purchasing or selling futures contracts, purchasing put and call options on securities or securities underlying futures contracts, or entering into forward rate agreements. However, there are no perfect hedging strategies, and interest rate hedging may fail to protect us from loss. In addition, these hedging strategies may adversely affect us, because hedging activities involve an expense that we will incur regardless of the effectiveness of the hedging activity. Hedging activities could result in losses if the event against which we hedge does not occur. Additionally, interest rate hedging could fail to protect us or adversely affect us, because among other things:

- available interest rate hedging may not correspond directly with the interest rate risk for which protection is sought;
- the duration of the hedge may not match the duration of the related liability;
- the party owing money in the hedging transaction may default on its obligation to pay;
- the credit quality of the party owing money on the hedge may be downgraded to such an extent that it impairs our ability to sell or assign our side of the hedging transaction; and
- the value of derivatives used for hedging may be adjusted from time to time in accordance with accounting rules to reflect changes in fair value. Downward adjustments, or “mark-to-market losses,” would reduce our shareholders’ equity.

Our reported income depends on accounting conventions and assumptions about the future that may change.

Accounting rules for our assets and for the various aspects of our current and future business change from time to time. Changes in GAAP, or the accepted interpretation of these accounting principles, can affect our reported income and shareholders’ equity. Interest income on our assets and interest expense on our liabilities may in part be based on estimates of future events. These estimates can change in a manner that negatively impacts our results or can demonstrate, in retrospect, that revenue recognition in prior periods was too high or too low. We use the effective yield method of GAAP accounting for many of our investments. We calculate projected cash flows for each of these assets incorporating assumptions about the amount and timing of credit losses, loan prepayment rates, and other factors. The yield we recognize for GAAP purposes generally equals the discount rate that produces a net present value for actual and projected cash flows that equals our GAAP basis in that asset. We change the yield recognized on these assets based on actual performance and as we change our estimates of future cash flows. The assumptions that underlie our projected cash flows and effective yield analysis may prove to be overly optimistic, or conversely, overly conservative. In these cases, our GAAP yield on the asset, or cost of the liability may change, leading to changes in our reported GAAP results.

Failure to qualify as a REIT would adversely affect our dividend distributions and could adversely affect the value of our securities.

We believe that we have met all requirements for qualification as a REIT for federal income tax purposes, and we intend to continue to operate to remain qualified as a REIT in the future. However, many of the requirements for qualification as a REIT are highly technical and complex and require an analysis of factual matters and an application of the legal requirements to such factual matters in situations where there is only limited judicial and administrative guidance. Thus, no assurance can be given that the Internal Revenue Service or a court would agree with our conclusion that we have qualified as a REIT or that future changes in our factual situation or the law will allow us to remain qualified as a REIT. If we failed to qualify as a REIT for federal income tax purposes and did not meet the requirements for statutory relief, we could be subject to federal income tax at regular corporate rates on our income if we could not otherwise offset taxable income with our NOL carryforward, and we could possibly be disqualified as a REIT for four years thereafter. Failure to qualify as a REIT could force us to sell certain of our investments, possibly at a loss, and could adversely affect the value of our common stock.

Maintaining REIT status may reduce our flexibility to manage our operations.

To maintain REIT status, we must follow certain rules and meet certain tests. In doing so, our flexibility to manage our operations may be reduced. For instance:

- If we make frequent asset sales from our REIT entities to persons deemed customers, we could be viewed as a “dealer,” and thus subject to 100% prohibited transaction taxes or other entity level taxes on income from such transactions.

- Compliance with the REIT income and asset rules may limit the type or extent of hedging that we can undertake.

- Our ability to own non-real estate related assets and earn non-real estate related income is limited. Our ability to own equity interests in other entities is limited. If we fail to comply with these limits, we may be forced to liquidate attractive assets on short notice on unfavorable terms in order to maintain our REIT status.

- Our ability to invest in taxable subsidiaries is limited under the REIT rules. Maintaining compliance with this limitation could require us to constrain the growth of our taxable REIT affiliates in the future.

- Meeting minimum REIT dividend distribution requirements could reduce our liquidity. Earning non-cash REIT taxable income could necessitate our selling assets, incurring debt, or raising new equity in order to fund dividend distributions.

- Stock ownership tests may limit our ability to raise significant amounts of equity capital from one source.

If we fail to properly conduct our operations we could become subject to regulation under the Investment Company Act of 1940.

We seek to conduct our operations so as to avoid falling under the definition of an investment company pursuant to the Investment Company Act of 1940 (the 1940 Act). Specifically, we currently seek to conduct our operations under the exemption afforded under the 1940 Act pursuant to Section 3(c)(5)(C), a provision available to companies primarily engaged in the business of purchasing and otherwise acquiring mortgages and other liens on and interests in real estate. According to SEC no-action letters, companies relying on this exemption must ensure that at least 55% of their assets are mortgage loans and other qualifying assets, and at least 80% of their assets are real estate-related. We recently learned that the staff of the SEC has provided informal guidance to other companies that these asset tests should be measured on an unconsolidated basis. Accordingly, we will make any adjustments necessary to ensure we continue to qualify for, and each of our subsidiaries also continues to qualify for an exemption from registration under the 1940 Act. We and our subsidiaries will rely either on Section 3(c)(5)(C) or other sections that provide exemptions from registering under the 1940 Act, including Sections 3(a)(1)(C) and 3(c)(7).

If the SEC were to determine that we were an investment company with no currently available exemption or exclusion from registration and that we were, therefore, required to register as an investment company our ability to use leverage would be substantially reduced, and our ability to conduct business as we do today would be impaired.

We are dependent on certain key personnel.

We have only two executive officers, Thomas B. Akin, our Chief Executive Officer, and Stephen J. Benedetti, our Executive Vice President and Chief Operating Officer. Mr. Akin has been a director of the Company since 2003 and was appointed Chief Executive Officer in February 2008. Mr. Akin has extensive knowledge of the mortgage industry and the Company. Mr. Benedetti has been with us since 1994 and has extensive knowledge of the Company, our operations, and our investment portfolio. He also has extensive experience in managing a portfolio of mortgage-related investments and as an executive officer of a publicly-traded mortgage REIT. The loss of either Mr. Akin or Mr. Benedetti could have an adverse effect on our operations or an adverse effect on any of our counterparties.

ITEM 1B. UNRESOLVED STAFF COMMENTS

There are no unresolved comments from the SEC Staff.

ITEM 2. PROPERTIES

We lease our executive and administrative offices located in Glen Allen, Virginia. The address is 4551 Cox Road, Suite 300, Glen Allen, Virginia 23060. As of December 31, 2007, we leased 8,244 square feet. The term of the lease runs to May 2008 but may be renewed at our option for three additional one-year periods at substantially similar terms.

We believe that our property is maintained in good operating condition and is suitable and adequate for our purposes.

ITEM 3. LEGAL PROCEEDINGS

We and our subsidiaries may be involved in certain litigation matters arising in the ordinary course of business. Although the ultimate outcome of these matters cannot be ascertained at this time, and the results of legal proceedings cannot be predicted with certainty, we believe, based on current knowledge, that the resolution of any such matters will not have a material adverse effect on our financial position or results of operations. Information on litigation arising out of the ordinary course of business is described below.

One of our subsidiaries, GLS Capital, Inc. (GLS), and the County of Allegheny, Pennsylvania (Allegheny County), are defendants in a class action lawsuit filed in 1997 in the Court of Common Pleas of Allegheny County, Pennsylvania (the Court of Common Pleas). Plaintiffs allege that GLS illegally charged the taxpayers of Allegheny County certain attorney fees, costs and expenses and interest, in the collection of delinquent property tax receivables owned by GLS which were purchased from Allegheny County. In 2007, the Court of Common Pleas stayed this action pending the outcome of other litigation before the Pennsylvania Supreme Court in which GLS is not directly involved but has filed an amicus brief in support of the defendants. Several of the allegations in that lawsuit are similar to those being made against GLS in this litigation. Plaintiffs have not enumerated their damages in this matter, and we believe that the ultimate outcome of this litigation will not have a material impact on our financial condition, but may have a material impact on our reported results for the particular period presented.

Dynex Capital, Inc. and Dynex Commercial, Inc. (DCI), formerly our affiliate and now known as DCI Commercial, Inc., are appellees in the Court of Appeals for the Fifth Judicial District of Texas at Dallas (Fifth District), related to the matter of Basic Capital Management, et al. (collectively, BCM or the Plaintiffs), versus Dynex Commercial, Inc. et al. The Fifth District heard oral arguments in this matter in April 2006. The appeal sought to overturn the trial court's judgment in our and DCI's favor which denied recovery to Plaintiffs. Plaintiffs sought a reversal of the trial court's judgment, and sought rendition of judgment against us for alleged breach of loan agreements for tenant improvements in the amount of $0.25 million. They also sought reversal of the trial court's judgment and rendition of judgment against DCI in favor of BCM under two mutually exclusive damage models, for $2.2 million and $25.6 million, respectively, related to the alleged breach by DCI of a $160 million "master" loan commitment. Plaintiffs also sought reversal and rendition of a judgment in their favor for attorneys' fees in the amount of $2.1 million. Alternatively, Plaintiffs sought a new trial. On February 22, 2008, the Fifth District ruled in our and DCI's favor, upholding the trial court's judgment. It is possible the Plaintiffs may seek to further appeal the ruling of the Fifth District. Even if Plaintiffs were to be successful on appeal, DCI is a former affiliate of ours, and we believe that we would have no obligation for amounts, if any, awarded to the Plaintiffs as a result of the actions of DCI.

Dynex Capital, Inc. and MERIT Securities Corporation, a subsidiary, are defendants in a putative class action complaint alleging violations of the federal securities laws in the United States District Court for the Southern District of New York (District Court) by the Teamsters Local 445 Freight Division Pension Fund (Teamsters). The complaint was filed on February 7, 2005, and purports to be a class action on behalf of purchasers between February 2000 and May 2004 of MERIT Series 12 and MERIT Series 13 securitization financing bonds (the Bonds), which are collateralized by manufactured housing loans. The complaint seeks unspecified damages and alleges, among other things, misrepresentations in connection with the issuance of and subsequent reporting on the Bonds. The complaint initially named our former president and our current Chief Operating Officer as defendants. On February 10, 2006, the District Court dismissed the claims against our former president and our current Chief Operating Officer, but did not dismiss the claims against us or MERIT. We and MERIT petitioned for an interlocutory appeal with the United States Court of Appeals for the Second Circuit (Second Circuit). The Second Circuit granted our petition on September 15, 2006 and heard oral argument on our appeal on January 30, 2008. We have evaluated the allegations made in the complaint and believe them to be without merit and intend to vigorously defend ourselves against them.

Although no assurance can be given with respect to the ultimate outcome of the above litigation, the Company believes the resolution of these lawsuits will not have a material effect on our consolidated balance sheet but could materially affect our consolidated results of operations in a given year or period.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of our shareholders during the fourth quarter of 2007.

EXECUTIVE OFFICERS OF THE REGISTRANT

Name (Age)	Current Title	Offices Held
Thomas B. Akin (56)	Chairman of the Board and Chief Executive Officer	Chief Executive Officer since February 2008; Chairman of the Board since 2003.
Stephen J. Benedetti (45)	Executive Vice President and Chief Operating Officer	Executive Vice President and Chief Operating Officer since November 2005; Executive Vice President and Chief Financial Officer from September 2001 to November 2005.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is traded on the New York Stock Exchange under the trading symbol "DX". The common stock was held by approximately 5,452 holders of record and beneficial holders who hold common stock in street name as of January 31, 2008. On that date, the closing price of our common stock on the New York Stock Exchange was $8.59 per share. During the last two years, the high and low stock prices and cash dividends declared on common stock were as follows:

	High	Low	Dividends Declared
2007:			
First quarter	$ 7.99	$ 7.00	$ –
Second quarter	$ 8.50	$ 7.75	$ –
Third quarter	$ 8.35	$ 7.62	$ –
Fourth quarter	$ 8.92	$ 7.74	$ –
2006:			
First quarter	$ 6.98	$ 6.44	$ –
Second quarter	$ 6.99	$ 6.35	$ –
Third quarter	$ 7.49	$ 6.60	$ –
Fourth quarter	$ 7.20	$ 6.70	$ –

Any dividends declared by the Board of Directors have generally been for the purpose of maintaining our REIT status, and in compliance with requirements set forth at the time of the issuance of the Series D Preferred Stock. The stated quarterly dividend on Series D Preferred Stock is $0.2375 per share. In accordance with the terms of the Series D Preferred Shares, if we fail to pay two consecutive quarterly preferred dividends or if we fail to maintain consolidated shareholders' equity of at least 200% of the aggregate issue price of the Series D Preferred Stock, then these shares automatically convert into a new series of 9.50% senior unsecured notes. Dividends for the preferred stock must be fully paid before dividends can be paid on common stock.

STOCK PERFORMANCE GRAPH

The following graph demonstrates a five year comparison of cumulative total returns for the shares of our common stock, the Standard & Poor's 500 Stock Index (S&P 500), and the Bloomberg Mortgage REIT Index. The table below assumes $100 was invested at the close of trading on December 31, 2002 in the shares of our common stock, S&P 500, and the Bloomberg Mortgage REIT Index.

Comparative Five-Year Total Returns (1)
Dynex Capital, Inc., S&P 500, and Bloomberg Mortgage REIT Index
(Performance Results through December 31, 2007)

	Cumulative Total Stockholder Returns as of December 31,					
Index	2002	2003	2004	2005	2006	2007
Dynex Capital, Inc.	$ 100.00	$ 126.03	$ 161.57	$ 142.57	$ 146.49	$ 183.27
S&P 500 (1)	$ 100.00	$ 128.36	$ 142.15	$ 149.01	$ 172.27	$ 181.71
Bloomberg Mortgage REIT Index (1)	$ 100.00	$ 131.92	$ 167.18	$ 140.47	$ 167.60	$ 92.92

(1) Cumulative total return assumes reinvestment of dividends. The source of this information is Bloomberg and Standard & Poor's. The factual material is obtained from sources believed to be reliable.

ITEM 6. SELECTED FINANCIAL DATA

The following table presents selected financial information and should be read in conjunction with the audited consolidated financial statements.

Years ended December 31, (amounts in thousands except share and per share data)	2007	2006	2005	2004	2003
Net interest income	$ 10,683	$ 11,087	$ 11,889	$ 23,281	$ 38,971
Net interest income after recapture of (provision for) loan losses	11,964	11,102	6,109	4,818	1,889
Impairment charges	–	(60)	(2,474)	(14,756)	(16,355)
Equity in income (loss) of joint venture	709	(852)	–	–	–
Loss on capitalization of joint venture	–	(1,194)	–	–	–
Gain (loss) on sale of investments	755	(183)	9,609	14,490	1,555
Other (expense) income	(533)	617	2,022	(179)	436
General and administrative expenses	(3,996)	(4,521)	(5,681)	(7,748)	(8,632)
Net income (loss)	$ 8,899	$ 4,909	$ 9,585	$ (3,375)	$ (21,107)
Net income (loss) to common shareholders	$ 4,889	$ 865	$ 4,238	$ (5,194)	$ (14,260)
Net income (loss) per common share:					
Basic & diluted	$ 0.40	$ 0.07	$ 0.35	$ (0.46)	$ (1.31)
Dividends declared per share:					
Common	$ –	$ –	$ –	$ –	$ –
Series A and B Preferred	$ –	$ –	$ –	$ –	$ 0.8775
Series C Preferred	$ –	$ –	$ –	$ –	$ 1.0950
Series D Preferred	$ 0.9500	$ 0.9500	$ 0.9500	$ 0.6993	$ –

December 31,	2007	2006	2005	2004	2003
Investments	$ 333,735	$ 403,566	$ 756,409	$ 1,343,448	$ 1,853,675
Total assets	374,758	466,557	805,976	1,400,934	1,865,235
Securitization financing	204,385	211,564	516,578	1,177,280	1,679,830
Repurchase agreements and senior notes	4,612	95,978	133,315	70,468	33,933
Total liabilities	232,822	330,019	656,642	1,252,168	1,715,389
Shareholders’ equity	141,936	136,538	149,334	148,766	149,846
Common shares outstanding	12,136,262	12,131,262	12,163,391	12,162,391	10,873,903
Book value per common share	$ 8.22	$ 7.78	$ 7.65	$ 7.60	$ 7.55

ITEM 7.MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

SUMMARY

We are a specialty finance company organized as a mortgage real estate investment trust (REIT). We invest principally in single-family residential and commercial mortgage loans and securities, both investment grade and non-investment grade rated. Residential mortgage securities are typically referred to as RMBS and commercial mortgage securities are typically referred to as CMBS. We finance loans and RMBS and CMBS securities through a combination of non-recourse securitization financing, repurchase agreements and equity. We employ financing in order to increase the overall yield on our invested capital. Our primary source of income is net interest income, which is the excess of the interest income earned on our investments over the cost of financing these investments. We typically intend to hold securities to their maturity but may occasionally record gains or losses from the sale of investments prior to their maturity.

In recent years, we have elected to sell certain non-core assets, including investments in manufactured housing loans and delinquent property tax receivable portfolios, as well as to contribute certain of our interests in a commercial mortgage loan securitization trust to a joint venture, in order to reduce our exposure to credit risk on these assets, increase our capital available for new investments, and strengthen our balance sheet by reducing our overall leverage. Our emphasis on strengthening the balance sheet and developing investment partnerships, through joint ventures and other means, has been in anticipation of redeploying our invested capital in more compelling investment opportunities.

Over the last several years, we have been able to steadily increase our book value per common share while improving the quality of our investment assets and reducing financial leverage. We have also been able to improve our net income to common shareholders at the same time. During 2007, we earned net income of $8.9 million, and net income to common shareholders of $4.9 million. As a REIT, we are required to distribute 90% of our REIT taxable income. However, we may offset all or a portion of our REIT taxable income with our NOL carryforwards.

In 2007, we received a capital distribution of $18.2 million from our investment in our joint venture. We used these funds primarily to reduce one of our two outstanding repurchase agreements.

During the fourth quarter of 2007, we reissued a securitization bond that was initially issued in April 2002 and redeemed in April 2005. We received proceeds of $35.3 million on the reissuance. Approximately $15.0 million of the resulting cash receipts was used to pay down our repurchase agreement balance. The remaining $20.4 million increased the Company’s liquidity and is available to be invested or used for other general corporate purposes.

FINANCIAL CONDITION

The following table presents certain balance sheet items that had significant activity, which are discussed after the table.

	December 31,	
(amounts in thousands)	2007	2006
Investments:		
Securitized mortgage loans, net	$ 278,463	$ 346,304
Investment in joint venture	19,267	37,388
Securities	29,231	13,143
Securitization financing	204,385	211,564
Repurchase agreements	4,612	95,978
Shareholders’ equity	141,936	136,538

Securitized Mortgage Loans, Net

Securitized mortgage loans are comprised of loans secured by first deeds of trust on single-family residential and commercial properties. The following table presents our net basis in these loans at amortized cost, which includes accrued interest receivable, discounts, premiums, deferred costs and reserves for loan losses, by the type of property collateralizing the loan.

(amounts in thousands)	2007	2006
Securitized mortgage loans, net:		

Commercial	$	190,570	$	228,466
Single-family		87,893		117,838
		278,463		346,304

Securitized commercial mortgage loans includes the loans in two securitization trusts we issued in 1993 and 1997, which have outstanding principal balances of $34.5 million and $151.5 million, respectively, at December 31, 2007. The decrease in these loans was primarily related to scheduled and unscheduled principal payments of $8.5 million and $30.4

million, respectively. The large amount of prepayments during the year is related to favorable commercial loan rates available in the market during the year and the declining prepayment penalties to which the loans are subject as the loans approach the end of their yield maintenance periods. We also recaptured approximately $1.0 million of amounts previously provided for losses on these commercial mortgage loans as a result of a decrease in estimated losses on the commercial loan portfolio and charged-off approximately $0.5 million of losses against the allowance in 2007.

Securitized single-family mortgage loans includes loans in one securitization trust we issued in 2002 using loans that were principally originated between 1992 and 1997. The decrease in the single-family mortgage loans is related to principal payments on the loans of $29.9 million, $26.1 million of which was unscheduled. Although prepayments slowed on the single-family mortgage loans during the year, the portfolio continues to have excellent credit performance demonstrated by the significant decrease in the percentage of single-family loans more than 60 days delinquent from 4.94% at December 31, 2006 to 3.02% at December 31, 2007 as well as having less than $0.1 million of charge-offs during 2007.

Investment in Joint Venture

The decrease in our investment in the joint venture is primarily related to an $18.2 million distribution we received from the joint venture during 2007, which was made in order to distribute excess uninvested capital in accordance with the joint venture's operating agreement. Recognizing our interest in the earnings of the joint venture of $0.7 million increased our investment in the joint venture but was offset by the recognition of $0.6 million for our interest in the other comprehensive loss of the joint venture associated with the decrease in value of the joint venture's available for sale securities.

Securities

Our securities, which are classified as available for sale and carried at their fair value, are comprised of the following:

(amounts in thousands)	2007	2006
Securities:		
Non-agency RMBS	$ 7,726	$ 10,196
Agency RMBS	7,456	1,663
Equity securities	9,701	1,284
Corporate debt securities	4,348	–
	$ 29,231	$ 13,143

Non-agency RMBS declined by approximately $2.5 million to $7.7 million at December 31, 2007. The decrease was primarily related to the principal payments received on these securities during the year.

Agency RMBS increased by $5.8 million to $7.5 million at December 31, 2007. This increase was primarily the result of the purchase of a $6.7 million Agency RMBS during the fourth quarter of 2007, which was partially offset by the receipt of $0.9 million of principal on our agency mortgage backed securities portfolio during the year.

Equity securities increased approximately $8.4 million and include preferred stock and common stock issued by publicly-traded mortgage REITs. We purchased approximately $9.2 million of equity securities during the year and sold $2.7 million on which we recognized a gain of $0.8 million.

We also purchased a senior unsecured convertible note issued by a publicly-traded REIT with a par value of $5.0 million during the year. The note had an estimated fair value of $4.3 million at December 31, 2007.

Securitization Financing

Securitization financing are bonds issued by a securitization trust, which we sponsored and is consolidated in our financial statements. These bonds are secured only by the securitized mortgage loans pledged to the trust and are otherwise non-recourse to us. Principal and interest on the bonds are paid from the cash flows generated by the loans collateralizing the bonds. The following table presents our net basis, which includes accrued interest, discounts, premiums and deferred costs in securitization financing.

(amounts in thousands)	2007	2006
Securitization financing bonds:		
Fixed, secured by commercial mortgage loans	$ 170,623	$ 211,564
Variable, secured by single-family mortgage loans	33,762	–
	$ 204,385	$ 211,564

The fixed rate bonds finance our securitized commercial mortgage loans, which are also fixed rate. The $40.9 million decrease is primarily related to principal payments on the bonds during 2007 of $38.8 million. There was also $1.6 million of net amortization of bond premiums and deferred costs. Approximately $34.5 million of these bonds are callable by us in June of 2008. Those bonds have premiums and deferred costs associated with them, representing a net credit of approximately $1.3 million, which are being amortized over life of the bonds. If we choose to call those bonds in 2008, any unamortized premium and deferred costs would be written-off and recognized as a gain at that time.

Our single-family securitized mortgage loans are financed by variable rate securitization financing bonds. We redeemed all of the bonds issued by this securitization trust in 2005, financing the redemption with repurchase agreements and our own capital, and held the bonds for potential reissue. During the fourth quarter of 2007, we reissued one of these bonds at a $0.8 million discount to its par value of $36.1 million generating proceeds of $35.3 million. Payments of $1.7 million were made on this bond subsequent to its reissuance. We still hold a second bond issued by this trust, which had a par value of $44.3 million at December 31, 2007 and is partially financed with repurchase agreements, which are discussed below. As the securitization trust which issued this bond is consolidated in our financial statements, this bond is eliminated in our consolidated financial statements.

Repurchase Agreements

The decline in repurchase agreements from the prior year was a result of $91.4 million of payments during 2007. The repurchase agreement outstanding at December 31, 2007 of $4.6 million is financing the senior class bond issued by our single-family securitization trust, which at December 31, 2007 had a par value and fair value of $44.3 million and $43.0 million, respectively.

Shareholders’ Equity

Shareholders’ equity increased by $5.4 million to $141.9 million primarily due to net income to shareholders of $4.9 million and unrealized gains on investments of $0.4 million, which is net of realized gains on sales of equity securities of $0.8 million.

Supplemental Discussion of Investments

We manage our investment portfolio in large part based on our net capital invested in a particular investment. Net capital invested, which is referred to as "Net Investment" in the table below, is generally defined as the cost basis of the investment net of the associated financing (securitization financing or repurchase agreement) for that investment. Below is the Net Investment basis as of December 31, 2007. We also estimate on a periodic basis the fair value of this Net Investment. The fair value of our Net Investment in securitized mortgage loans is based on the present value of the projected cash flow from the loan collateral, adjusted for the impact and assumed level of future prepayments and credit losses, less the projected principal and interest due on the associated securitization financing bonds owned by third parties. The fair value of securities is based on quotes obtained from third-party dealers or is calculated by discounting estimated future cash flows at estimated market rates where no dealer quotes are available. We believe the fair value of Net Investment presented in the table below is a reasonable approximation of our net asset value, excluding other assets and other liabilities which are not included in the table below.

	December 31, 2007			
(amounts in thousands)	Amortized cost basis	Financing (4)	Net Investment	Fair value of Net Investment
Securitized mortgage loans: (1)				
Single-family mortgage loans	$ 88,024	$ 38,374	$ 49,650	$ 45,761
Commercial mortgage loans	193,160	170,623	22,537	19,542
Allowance for loan losses	(2,721)	–	(2,721)	–
	278,463	208,997	69,466	65,303
Securities: (2)				
Investment grade RMBS	14,810	–	14,810	14,843
Non-investment grade RMBS	284	–	284	339
Equity and other	12,426	–	12,426	14,049
	27,520	–	27,520	29,231
Investment in joint venture(3)	19,267	–	19,267	18,847
Obligation under payment agreement(1)	–	16,796	(16,796)	(15,473)
Other loans and investments(2)	6,774	–	6,774	7,407
Net unrealized gain(2)	1,711	–	1,711	–
Total	$ 333,735	$ 225,793	$ 107,942	$ 105,315

(1) Fair values for securitized mortgage loans and the obligation under payment agreement are based on discounted cash flows using assumptions set forth in the table below, inclusive of amounts invested in redeemed securitization financing bonds.

(2) Fair values are based on dealer quotes, if available, and closing prices from a national exchange where applicable. Approximately $22 million of fair value of securities were based on available dealer quotes or closing prices from a national exchange. Where dealer quotes are not available, fair values are calculated as the net present value of expected future cash flows, discounted at a weighted average discount rate of 7.1% for investment grade securities and 36.1% for non-investment grade securities.

(3) Fair value for investment in joint venture represents our share of the fair value of the joint venture's assets valued using methodologies and assumptions consistent with Note 1 above.

(4) Financing includes securitization financing issued to third parties and repurchase agreements.

The following table summarizes the assumptions used in estimating fair value, pursuant to Note 1 in the table above, for our Net Investment in securitized mortgage loans and the cash flow related to those net investments during 2007.

	Fair Value Assumptions				
Loan type	Weighted-average prepayment speeds	Losses	Weighted-average discount rate(6)	Projected cash flow termination date	(amounts in thousands) 2007 Cash Flows (1)
Single-family mortgage loans	20% CPR	0.2% annually	20%	Anticipated final maturity 2024	$ 2,757
Commercial mortgage loans(2)	(3)	0.8% annually	(4)	(5)	$ 2,590

(1) Represents the excess of the cash flows received on the collateral pledged over the cash flow required to service the related securitization financing. These cash flows exclude the net principal and interest received on the senior single family bond we owned at December 31, 2007.
(2) Includes loans pledged to two different securitization trusts.
(3) Assumed constant prepayment rate (CPR) speeds generally are governed by underlying pool characteristics, prepayment lock-out provisions, and yield maintenance provisions. Loans currently delinquent in excess of 30 days are assumed to be liquidated in six months at a loss amount that is calculated for each loan based on its specific facts.
(4) Weighed-average discount rates for the two securitization trusts were 16.0% and 14.4%, respectively.
(5) Cash flow termination dates are modeled based on the repayment dates of the loans or optional redemption dates of the underlying securitization financing bonds.
(6) Represents management’s estimate of the market discount rate that would be used by a third party in valuing these or similar assets.

The following table presents the net investment basis included in the first table above by their rating classification. Investments in the unrated and non-investment grade classification primarily include equity securities and commercial mortgage and single-family mortgage loans, which are unrated but are substantially seasoned and performing. Securitization over-collateralization generally includes the excess of the securitized mortgage loans pledged over the outstanding bonds issued by the securitization trust. The joint venture owns primarily interest in non-investment grade CMBS.

	December 31,	
(amounts in thousands)	2007	2006
Investments:		
AAA rated and Agency RMBS fixed income securities	$ 53,849	$ 20,876
AA and A rated RMBS	449	2,777
Unrated and non-investment grade	21,399	8,924
Securitization over-collateralization	12,978	9,760
Investment in joint venture	19,267	37,388
	$ 107,942	$ 79,725

Supplemental Discussion of Common Equity Book Value

We believe that our shareholders, as well as shareholders of other companies in the mortgage REIT industry, consider book value per common share an important measure. Our reported book value per common share is based on the carrying value our assets and liabilities as recorded in the consolidated financial statements in accordance with generally accepted accounting principles. A substantial portion of our assets are carried on a historical, or amortized, cost basis and not at estimated fair value. The first table included in the “Supplemental Discussion of Investments” section above compares the amortized cost basis of our investments to their estimated fair value based on assumptions set forth in the second table.

We believe that book value per common share, adjusted to reflect the carrying value of investments at their fair value (hereinafter referred to as Adjusted Common Equity Book Value), is also a meaningful measure for our shareholders, representing effectively our estimated going-concern net asset value. The following table calculates Adjusted Common Equity Book Value and Adjusted Common Equity Book Value per share using the estimated fair value information contained in the "Estimated Fair Value of Net Investment" table above. The amounts set forth in the table in the Adjusted Book Value column include all of our financial assets and liabilities at their estimated fair values, and exclude any value attributable to our NOL carryforwards and other matters that might impact our value.

	December 31, 2007	
(amounts in thousands except per share information)	Book Value	Adjusted Book Value
Total investment assets	$ 107,942	$ 105,315
Cash and cash equivalents	35,352	35,352
Other assets and liabilities, net	(1,358)	(1,358)
	141,936	139,309
Less: Preferred stock liquidation preference	(42,215)	(42,215)
Common equity book value and adjusted book value	$ 99,721	$ 97,094
Common equity book value per share and adjusted book value per share	$ 8.22	$ 8.00

Discussion of Credit Risk

As discussed in ITEM 1A – RISK FACTORS above, the predominent risk in our investment portfolio today is credit risk (i.e., the risk that we will not receive all amounts contractually due us on an investment as a result of a default by the borrower and the resulting deficiency in proceeds from the liquidation of the collateral securing the obligation). In many instances, we retained the "first-loss" credit risk on pools of loans and securities that we have securitized. In addition to our retained interests in certain securitizations, we also have credit risk on approximately $3.7 million of unrated or non-investment grade mortgage securities and loans.

The following table summarizes our credit exposure in securitized mortgage loans and subordinate mortgage securities.

Credit Reserves and Actual Credit Losses

(amounts in millions)	Credit Exposure (1)	Credit Exposure, Net of Allowance (2)	Actual Credit Losses	Credit Exposure, Net of Allowance to Outstanding Loan Balance (3)
2005	$ 47.9	$ 28.9	$ 3.6	3.85%
2006	26.3	21.8	7.2	6.20
2007	27.5	24.8	0.5	8.57

(1) Represents the overcollateralization pledged to a securitization trust and subordinate securities we own, net of any discounts.

(2) Represents credit exposure, net of allowance for loan losses.

(3)

Represents credit exposure net of allowance divided by current unpaid principal balance of loans in the securitization trust

Our net credit exposure decreased from 2005 to 2006 primarily as a result of the derecognition of $279.0 million of securitized commercial mortgage loans in 2006. The increase in our net credit exposure in 2007 is primarily due to reduction in the balance of allowance for loan losses of $1.8 million as a result of the improved performance of our securitized commercial mortgage loan portfolio.

We monitor and evaluate our exposure to credit losses and have established reserves based upon anticipated losses, general economic conditions and trends in the investment portfolio. Delinquencies as a percentage of all outstanding securitized mortgage loans decreased to 2.7% at December 31, 2007 from 4.4% at December 31, 2006. At December 31, 2007, management believes the level of credit reserves is appropriate for currently existing losses. The following tables summarize single-family mortgage loan and commercial mortgage loan delinquencies as a percentage of the outstanding commercial securitized mortgage loans or single-family balance for those securitizations in which we have retained a portion of the direct credit risk.

Loans secured by low-income housing tax credit (LIHTC) properties account for 88% of the Company's securitized commercial loan portfolio. Section 42 of the Code provides tax credits to investors in projects to construct or substantially rehabilitate properties that provide housing for qualifying low income families. Failure to comply with certain income and rental restrictions required by Section 42 or default on a loan financing a Section 42 property during the compliance period can result in the recapture of previously received tax credits. The potential cost of tax credit recapture provides an incentive to the property owner to support the property during the compliance period. The following table shows the weighted average remaining compliance period of our portfolio of LIHTC commercial loans at December 31, 2007 as a percent of the total LIHTC commercial loan portfolio ..

Months remaining to end of compliance period	As a Percent of Unpaid Principal Balance
Compliance period already exceeded	26.5%
Zero through twelve months remaining	4.4
Thirteen through thirty six months remaining	50.2
Thirty seven through sixty months remaining	18.9
	100.0%

For commercial mortgage loans, there were no delinquencies at December 31, 2007, down from 1.36% percent of the outstanding securitized mortgage loans at December 31, 2006. The commercial loan that was delinquent in 2006 liquidated with a net loss of $0.5 million during 2007 and had the greatest impact on the reduction of the overall delinquency rate. The joint venture, in which we have a 49.875% interest, currently has a single delinquent commercial mortgage loan, which is not included in this analysis below and has an unpaid principal balance of $1.4 million.

Commercial Mortgage Loan Delinquency Statistics

December 31,	30 to 59 days delinquent	60 to 89 days delinquent	90 days and over delinquent (1)	Total
2005	–%	0.25%	6.65%	6.90%
2006	–%	–%	1.36%	1.36%
2007	–%	–%	–%	–%

(1) Includes foreclosures and real estate owned.

Single-family mortgage loan delinquencies as a percentage of the outstanding loan balance decreased by 1.62% to 8.22% at December 31, 2007 from 9.84% at December 31, 2006. Serious delinquencies, defined as 60+ day delinquencies, declined from 4.94% to 3.02%. Our single-family loan portfolio, which had an aggregate unpaid principal balance of $96.2 million at December 31, 2007, was originated primarily between 1992 and 1997 and continues to perform and pay-down as expected and with minimal losses. Approximately $6.1 million of these loans are credit enhanced with mortgage pool insurance impacting realized losses. During 2007 and 2006, we incurred less than $0.1 million of actual losses in each of those years.

Single-Family Loan Delinquency Statistics

December 31,	30 to 59 days delinquent	60 to 89 days delinquent	90 days and over delinquent (1)	Total
2005	4.28%	0.62%	2.60%	7.50%
2006	4.90%	1.89%	3.05%	9.84%
2007	5.20%	0.58%	2.44%	8.22%

(1) Includes foreclosures and real estate owned.

RESULTS OF OPERATIONS

Comparative information on our results of operations is provided in the tables below:

(amounts in thousands except per share information)	Year Ended December 31, 2007	2006	2005
Interest income	$ 30,778	$ 50,449	$ 74,395
Interest expense	20,095	39,362	62,506
Net interest income	$ 10,683	$ 11,087	$ 11,889
Recapture of (provision for) loan losses	1,281	15	(5,780)
Net interest income after recapture of (provision for) loan losses	11,964	11,102	6,109
Equity in earnings (loss) of joint venture	709	(852)	–
Loss on capitalization of joint venture	–	(1,194)	–
Impairment charges	–	(60)	(2,474)
Gain (loss) on sales of investments	755	(183)	9,609
Other (expense) income	(533)	617	2,022
General and administrative expenses	(3,996)	(4,521)	(5,681)
Net income	8,899	4,909	9,585
Preferred stock dividends	(4,010)	(4,044)	(5,347)
Net income to common shareholders	$ 4,889	$ 865	$ 4,238
Basic & diluted net income per common share	$ 0.40	$ 0.07	$ 0.35
Dividends declared per share:			
Common	$ –	$ –	$ –
Series D Preferred	$ 0.95	$ 0.95	$ 0.95

2007 Compared to 2006

Interest Income

Interest income includes interest earned on our investment portfolio and also reflects the amortization of any related discounts, premiums and deferred costs. The following tables present the significant components of our interest income.

(amounts in thousands)	Year ended December 31, 2007	2006

Interest income:				
Securitized mortgage loans	$	26,424	$	46,240
Securities		1,256		1,558
Cash and cash equivalents		2,611		2,015
Other loans and investments		487		636
	$	30,778	$	50,449

The change in interest income on securitized mortgage loans and securities is examined in the discussion and tables that follow.

Interest income on cash and cash equivalents increased $0.6 million in 2007 compared to 2006. This increase is primarily the result of an $11.9 million increase in the average balance of cash and cash equivalents outstanding during 2007 compared to 2006. Interest income on other loans and investments decreased $0.1 million to $0.5 million for 2007 compared to $0.6 million for 2006. This decrease was primarily related to a decrease in the average balance of other loans and investments outstanding in 2007 compared to 2006 of $3.7 million and $4.7 million, respectively.

Interest Income – Securitized Mortgage Loans

The following table summarizes the detail of the interest income earned on our securitized mortgage loans.

	Year ended December 31,					
	2007			2006		
(amounts in thousands)	Interest Income	Net Amortization	Total Interest Income	Interest Income	Net Amortization	Total Interest Income
Securitized mortgage loans:						
Commercial	$ 18,114	$ 485	$ 18,599	$ 36,048	$ 654	$ 36,702
Single-family	7,887	(62)	7,825	10,109	(571)	9,538
Total mortgage loans	$ 26,001	$ 423	$ 26,424	$ 46,157	$ 83	$ 46,240

The majority of the decrease of $18.1 million in interest income on commercial mortgage loans is primarily related to $279.0 million of commercial mortgage loans that were derecognized in September 2006. Those loans contributed $14.7 million of interest income in 2006 and none in 2007. Excluding the loans that were derecognized during 2006, the average balance of the other commercial mortgage loans outstanding during 2007 declined by approximately $33.1 million (13%) from the balance in 2006.

Interest income on securitized single-family mortgage loans declined $1.7 million to $7.8 million for the year ended December 31, 2007. The decline in interest income on single-family loans was primarily related to the decrease in the balance of the loans outstanding, which declined approximately $38.8 million, or approximately 28%, to $100.8 million for 2007. The drop in the average balance of the loans was partially offset by an increase in the average yield on our single-family loans, approximately 87% of which were variable rate at December 31, 2007. Net amortization for single-family loans also decreased $0.5 million to $0.1 million for 2007 as a result of a slow-down in the rate of prepayments on the loans as well as a reduction in the estimated future prepayment speeds.

Interest Income – Securities

The following table presents the components of interest income on securities.