NOVASTAR FINANCIAL INC
Form 10-Q
July 10, 2009

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, 2009

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

For the Transition Period From to__________ to ___________

Commission File Number 001-13533

NOVASTAR FINANCIAL, INC.

(Exact Name of Registrant as Specified in its Charter)

Maryland	**74-2830661**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
2114 Central Street, Suite 600, Kansas City, MO	**64108**
(Address of Principal Executive Office)	(Zip Code)

Registrant's Telephone Number, Including Area Code: (816) 237-7000

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No x

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 definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

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

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

The number of shares of the Registrants Common Stock outstanding on July 10, 2009 was 9,368,053.

NOVASTAR FINANCIAL, INC.
FORM 10-Q
For the Quarterly Period Ended March 31, 2009

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOVASTAR FINANCIAL, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(unaudited; dollars in thousands, except share amounts)

	March 31, 2009	December 2008
Assets		
Unrestricted cash and cash equivalents	$ 20,008	$ 24
Restricted cash	6,059	6
Mortgage loans held-in-portfolio, net of allowance of $793,679 and $776,001, respectively	1,603,659	1,772
Mortgage securities trading	3,767	7
Mortgage securities available-for-sale	11,091	12
Real estate owned	91,279	70
Accrued interest receivable	76,053	77
Other assets	5,942	5
Assets of discontinued operations	-	1
Total assets	$ 1,817,858	$ 1,978
Liabilities and Shareholders Deficit		
Liabilities:		
Asset-backed bonds secured by mortgage loans	$ 2,521,280	$ 2,599
Asset-backed bonds secured by mortgage securities	3,073	5
Junior subordinated debentures	77,446	77
Due to servicer	135,145	117
Dividends payable	22,785	19
Accounts payable and other liabilities	31,858	33
Liabilities of discontinued operations	-	2
Total liabilities	2,791,587	2,855
Commitments and contingencies (Note 7)		
Shareholders deficit :		
Capital stock, $0.01 par value, 50,000,000 shares authorized:		
Redeemable preferred stock, $25 liquidating preference per share; 2,990,000 shares, issued and outstanding	30	
Convertible participating preferred stock, $25 liquidating preference per share; 2,100,000 shares, issued and outstanding	21	
Common stock, 9,368,053, issued and outstanding	94	
Additional paid-in capital	786,253	786
Accumulated deficit	(1,767,044)	(1,671
Accumulated other comprehensive income	6,898	8
Other	(122)	
Total NovaStar Financial Inc.s shareholders deficit	(973,870)	(876
Noncontrolling interests	141	
Total shareholders deficit	(973,729)	(876
Total liabilities and shareholders deficit	$ 1,817,858	$ 1,978

See notes to condensed consolidated financial statements.

NOVASTAR FINANCIAL, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited; dollars in thousands, except per share amounts)

	For the Three Months Ended March 31,	
	2009	**2008**
Interest income	$ 40,867	$ 71,465
Interest expense	8,359	36,281
Net interest income before provision for credit losses	32,508	35,184
Provision for credit losses	(101,474)	(249,316)
Net interest expense after provision for credit losses	(68,966)	(214,132)
Other operating expense:		
Losses on derivative instruments	(4,195)	(15,587)
Fair value adjustments	(5,710)	(12,716)
Impairment on mortgage securities available-for-sale	(202)	(19,380)
Appraisal fee income	1,685	-
Appraisal fee expense	(1,159)	-
Premiums for mortgage loan insurance	(3,341)	(4,275)
Servicing fee expense	(2,991)	(3,697)
Other income, net	13	11
Total other operating expense	(15,900)	(55,644)
General and administrative expenses:		
Compensation and benefits	981	2,549
Office administration	1,984	1,911
Professional and outside services	2,046	2,268
Other appraisal management expenses	1,638	-
Other	131	145
Total general and administrative expenses	6,780	6,873
Loss from continuing operations before income tax	(91,646)	(276,649)
Income tax expense	52	650
Loss from continuing operations	(91,698)	(277,299)
Loss from discontinued operations, net of income tax	-	(5,370)
Net loss	(91,698)	(282,669)
Less: Net loss attributable to noncontrolling interests	(334)	-
Net loss available to common shareholders	$ (91,364)	$ (282,669)
Basic earnings per share:		
Loss from continuing operations available to common shareholders	$ (10.14)	$ (29.80)
Loss from discontinued operations, net of income tax	-	(0.57)
Net loss attributable to common shareholders	$ (10.14)	$ (30.37)
Diluted earnings per share:		
Loss from continuing operations attributable to common shareholders	$ (10.14)	$ (29.80)
Loss from discontinued operations, net of income tax	-	(0.57)
Net loss attributable to common shareholders	$ (10.14)	$ (30.37)
Weighted average basic shares outstanding	9,368,053	9,414,418
Weighted average diluted shares outstanding	9,368,053	9,414,418

See notes to condensed consolidated financial statements.

NOVASTAR FINANCIAL, INC.
CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS’ DEFICIT
(unaudited; dollars in thousands)

	Redeemable Preferred Stock	Convertible Participating Preferred Stock	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income	Noncontrolling Interest	Oth
Balance, January 1, 2009	$ 30	$ 21	$ 94	$ 786,279	$ (1,671,984)	$ 8,926	$ -	$ (
Other	-	-	-	(26)	-	-	-	
Accumulating dividends on preferred stock	-	-	-	-	(3,696)	-	-	
Contribution from noncontrolling interests	-	-	-	-	-	-	475	
Comprehensive loss:								
Net loss	-	-	-	-	(91,364)	-	(334)	
Other comprehensive loss	-	-	-	-	-	(2,028)	-	
Total comprehensive loss	-	-	-	-	-	-	-	
Balance, March 31, 2009	$ 30	$ 21	$ 94	$ 786,253	$ (1,767,044)	$ 6,898	$ 141	$ (

NOVASTAR FINANCIAL, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited; dollars in thousands)

	For the Three March 2009
Cash flows from operating activities:	
Net loss	$ (91,698)
Loss from discontinued operations	-
Loss from continuing operations	(91,698)
Adjustments to reconcile loss from continuing operations to net cash used in operating activities:	
Accretion of available-for-sale and trading securities	(11,439)
Interest capitalized on loans held-in-portfolio	(1,218)
Amortization of premiums on mortgage loans	1,332
Amortization of deferred debt issuance costs	(480)
Provision for credit losses	101,474
Impairments on mortgage securities – available-for-sale	202
Fair value adjustments	5,710
Losses on derivative instruments	4,195
Other	(9)
Depreciation expense	231
Changes in:	
Accrued interest receivable	1,239
Derivative instruments, net	24
Other assets	1,634
Due to servicer	17,510
Accounts payable and other liabilities	(8,155)
Net cash provided by operating activities from continuing operations	20,552
Net cash used in operating activities from discontinued operations	-

Net cash provided by (used in) operating activities	20,552
Cash flows from investing activities:	
Proceeds from paydowns on mortgage securities - available-for-sale	3,897
Proceeds from paydowns of mortgage securities - trading	2,485
Proceeds from repayments of mortgage loans held-in-portfolio	28,072
Proceeds from sales of assets acquired through foreclosure	19,003
Cash used to collateralize letter of credit	(13)
Purchases of property and equipment	(571)
Net cash provided by investing activities	52,873
Net cash provided by investing activities from discontinued operations	-
Net cash provided by investing activities	52,873

	For the Three Months Ended March 31,	
Cash flows from financing activities:	**2009**	**2008**
Payments on asset-backed bonds	(78,307)	(145,145)
Net change in short-term borrowings	-	(26,611)
Contributions from noncontrolling interests	100	-
Dividends paid on vested stock options	-	(176)
Net cash used in financing activities from continuing operations	(78,207)	(171,932)
Net cash used in financing activities from discontinued operations	-	-
Net cash used in financing activities	(78,207)	(171,932)
Net decrease in cash and cash equivalents	(4,782)	(12,840)
Cash and cash equivalents, beginning of period	24,790	25,364
Cash and cash equivalents, end of period	$ 20,008	$ 12,524

Supplemental Disclosure of Cash Flow Information
(unaudited; dollars in thousands)

	For the Three Months Ended March 31,	
	2009	**2008**
Cash paid for interest	$ 12,581	$ 36,016
Cash paid for income taxes	466	2,547
Non-cash investing and financing activities:		
Assets acquired through foreclosure	39,783	29,806
Preferred stock dividends accrued, not yet paid	3,696	3,288

See notes to condensed consolidated financial statements.

Concluded

NOVASTAR FINANCIAL, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
As of and for the quarterly period ended March 31, 2009 (Unaudited)

Note 1. Financial Statement Presentation

Description of Operations - NovaStar Financial, Inc. and its subsidiaries ("NFI" or the "Company") hold certain nonconforming residential mortgage securities. Prior to changes in its business in 2007, the Company originated, purchased, securitized, sold, invested in and serviced residential nonconforming mortgage loans and mortgage backed securities. The Company retained, through its mortgage securities investment portfolio, significant interests in the nonconforming loans it originated and purchased, and through its servicing platform, serviced all of the loans in which it retained interests.

Effective August 1, 2008, the Company acquired a 75% interest in StreetLinks National Appraisal Services, LLC (StreetLinks), a residential mortgage appraisal company, for an initial cash purchase price of $750,000 plus future payments contingent upon StreetLinks reaching certain earnings targets. Results of operations from August 1, 2008 forward are included in the consolidated statement of operations. Simultaneously with the acquisition, the Company transferred ownership of 5% of StreetLinks to the Chief Executive Officer of StreetLinks.

On April 26, 2009, the Company acquired a majority interest in Advent Financial Services, LLC, a start-up operation which will provide access to tailored banking accounts, small dollar banking products and related services to meet the needs of low and moderate income level individuals. Management is continuing to evaluate opportunities to invest excess cash as it is available.

Financial Statement Presentation - The Company's condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America ("GAAP") and prevailing practices within the financial services industry. The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of income and expense during the period. The Company uses estimates and employs the judgments of management in determining the amount of its allowance for credit losses, amortizing premiums or accreting discounts on its mortgage assets, establishing the fair value of its mortgage securities, derivative instruments, CDO debt and estimating appropriate accrual rates on mortgage securities – available-for-sale. While the condensed consolidated financial statements and footnotes reflect the best estimates and judgments of management at the time, actual results could differ significantly from those estimates.

The condensed consolidated financial statements of the Company include the accounts of all wholly-owned and majority-owned subsidiaries. Investments in entities for which the Company has significant influence are accounted for under the equity method. Intercompany accounts and transactions have been eliminated in consolidation. Interim results are not necessarily indicative of results for a full year.

As of January 1, 2009, the Company adopted SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements–an amendment of ARB No. 51" ("SFAS 160"). SFAS 160 requires that noncontrolling interests (formerly known as "minority interests") be displayed in the consolidated balance sheet as a separate component of shareholders' equity and that the consolidated net earnings attributable to the noncontrolling interests be clearly indentified and presented in the consolidated statement of earnings. The Company previously acquired StreetLinks, and as part of the acquisition certain of StreetLinks' former owners retained ownership interests in the business. At the time of purchase, StreetLinks had a net deficit, therefore the beginning noncontrolling interests balance was zero. From the acquisition date to the end of 2008, StreetLinks had a net loss so no losses were attributed to the noncontrolling interests since it was already at zero, therefore the beginning balance of the noncontrolling interests at January 1, 2009 was zero. These interests are presented on its condensed consolidated balance sheet as noncontrolling interests. In addition, earnings attributable to the noncontrolling interests are shown on its condensed consolidated statement of operations for the three months ended March 31, 2009.

On January 1, 2009, the Company adopted Financial Accounting Standards Board ("FASB") Staff Position EITF 03-6-1, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities" ("EITF 03-6-1"). EITF 03-6-1 states that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents are "participating securities" as defined in EITF 03-6, Participating Securities and the Two-Class Method under FASB Statement No. 128 (EITF 03-6), and therefore should be included in computing EPS using the two-class method. The Company's adoption of EITF 03-6-1

required us to recast previously reported EPS, and did not have a significant impact on EPS.

Going Concern Considerations - As of March 31, 2009, the Company's total liabilities exceeded its total assets under GAAP, resulting in a shareholders' deficit. The Company's losses, negative cash flows, shareholders' deficit, and lack of significant business operations raise substantial doubt about the Company's ability to continue as a going concern and, therefore, may not realize its assets and discharge its liabilities in the normal course of business. There is no assurance that cash flows will be sufficient to meet the Company's obligations. The Company's consolidated financial statements have been prepared on a going concern basis of accounting which contemplates continuity of operations, realization of assets, liabilities and commitments in the normal course of business. The Company's condensed consolidated financial statements do not reflect any adjustments relating to the recoverability and classification of recorded asset amounts or to the amounts and classification of liabilities that may be necessary should the Company be unable to continue as a going concern.

The Company's condensed consolidated financial statements as of March 31, 2009 and for the three months ended March 31, 2009 and 2008 are unaudited. In the opinion of management, all necessary adjustments have been made, which were of a normal and recurring nature, for a fair presentation of the condensed consolidated financial statements. There have been no reclassifications to prior year amounts to conform to current year presentation.

The Company's condensed consolidated financial statements should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements of the Company and the notes thereto, included in the Company's Annual Report on Form 10-K, as amended, for the fiscal year ended December 31, 2008.

Current Liquidity and Near-Term Obligations - As of July 10, 2009, the Company had approximately $20.7 million in available cash on hand (including $6.1 million in restricted cash). In addition to the Company's operating expenses, the Company has quarterly interest payments due on its trust preferred securities and intends to make payments in settlement of obligations related to its discontinued lending and servicing operations. The Company's current projections indicate sufficient available cash and cash flows from its mortgage securities to meet these payment needs during the remainder of 2009. However, the cash flow from the Company's mortgage securities is volatile and uncertain in nature, and the amounts the Company receives could vary materially from its projections. Therefore, no assurances can be given that the Company will be able to meet its cash flow needs, in which case it may seek protection of applicable bankruptcy laws.

Cash flows from mortgage loans – held-in-portfolio are used to repay the asset-backed bonds secured by mortgage loans and are not available to pay the Company's other debts, the asset-backed bonds are obligations of the securitization trusts and will be repaid using collections of the securitized assets. The trusts have no recourse to the Company's other unsecuritized assets.

Business Plan - The Company will continue to focus on minimizing losses, preserving liquidity, and exploring operating company opportunities. The Company's residual and subordinated mortgage securities are currently its only significant source of cash flows. Based on current projections, the cash flows from the mortgage securities will decrease in the next several months as the underlying mortgage loans are repaid, and could be significantly less than the current projections if losses on the underlying mortgage loans exceed the current assumptions. The Company also has significant obligations with respect to junior subordinated notes relating to the trust preferred securities. In April 2009, the Company restructured its obligations under the junior subordinated notes relating to trust preferred securities. The details of this restructuring are discussed in Note 6.

As discussed above, the Company acquired a controlling interest in an appraisal management company, StreetLinks, in August 2008 and in April 2009, the Company acquired a controlling interest in Advent Financial Services LLC.

Note 2. New Accounting Pronouncements

In June 2009, the FASB issued SFAS No. 167, "Amendments to FASB Interpretation No. 46(R)" ("SFAS 167"), which amends the consolidation guidance applicable to variable interest entities ("VIEs"). The amendments to the consolidation guidance affect all entities currently within the scope of FIN 46(R), as well as qualifying

special-purpose entities (QSPEs) that are currently excluded from the scope of FIN 46(R). SFAS 167 is effective as of the beginning of the first fiscal year that begins after November 15, 2009.The Company is continuing to evaluate the impact that SFAS 167 would have on its financial condition and results of operation upon adoption.

In June 2009, the FASB issued SFAS No. 166, Accounting for Transfers of Financial Assets an amendment of FASB Statement No. 140 (SFAS 166). SFAS 166 amends the derecognition accounting and disclosure guidance relating to SFAS 140. SFAS 166 eliminates the exemption from consolidation for QSPEs, it also requires a transferor to evaluate all existing QSPEs to determine whether it must be consolidated in accordance with SFAS 167. SFAS 166 is effective for financial asset transfers occurring after the beginning of an entitys first fiscal year that begins after November 15, 2009. The Company is continuing to evaluate the impact that SFAS 166 would have on its financial condition and results of operation upon adoption.

In May 2009, the FASB issued SFAS No. 165, Subsequent Events (SFAS 165), which establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. SFAS 165 is for interim or annual periods ending after June 15, 2009. The adoption of SFAS 165 is not expected to have a material effect on the Companys financial statements.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities (SFAS 161). The new standard is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entitys financial position, financial performance, and cash flows. It is effective for the Company as of January 1, 2009. Since SFAS No. 161 only requires certain additional disclosures, it did not have an effect on the Companys financial statements. See Note 10 for further information regarding these disclosures.

In December 2007, FASB issued Statement of Financial Accounting Standards No. 141 (R), Business Combinations (SFAS 141(R)). In summary, SFAS 141(R) requires the acquirer of a business combination to measure at fair value the assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree at the acquisition date, with limited exceptions. In addition, this standard will require acquisition costs to be expensed as incurred. The standard is effective for fiscal years beginning after December 15, 2008, and is to be applied prospectively, with no earlier adoption permitted. The Company adopted SFAS 141(R) effective January 1, 2009. The adoption of this standard may have an impact on the accounting for certain costs related to any future acquisitions.

Note 3. Mortgage Loans Held in Portfolio

Mortgage loans held-in-portfolio, all of which are secured by residential properties, consisted of the following as of March 31, 2009 and December 31, 2008 (dollars in thousands):

		March 31, 2009		December 31, 2008
Mortgage loans held-in-portfolio:				
Outstanding principal	$	2,379,622	$	2,529,791
Net unamortized deferred origination costs		17,716		19,048
Amortized cost		2,397,338		2,548,839
Allowance for credit losses		(793,679)		(776,001)
Mortgage loans held-in-portfolio	$	1,603,659	$	1,772,838
Weighted average coupon		7.73%		8.00%

Mortgage loans held-in-portfolio consist of loans that the Company has securitized in structures that are accounted for as financings. These securitizations are structured legally as sales, but for accounting purposes are treated as financings under SFAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities a replacement of FASB Statement 125 (SFAS 140). See below for details of the Companys securitization transactions structured as financings.

These securitizations are structured legally as sales, but for accounting purposes are treated as financings as defined by SFAS No. 140. The NHES 2006-1 and NHES 2006-MTA1 securitizations at inception did not meet the criteria necessary for derecognition under SFAS 140 and related interpretations because after the loans were securitized the securitization trusts may acquire derivatives relating to beneficial interests retained by the Company; additionally, the Company, had the unilateral ability to repurchase a limited number of loans back from the trust. These provisions were removed effective September 30, 2008. Since the removal of these provisions did not substantively change the transactions economics, the original accounting conclusion remains the same. The NHES 2007-1 securitization does not meet the qualifying special purpose entity criteria necessary for derecognition under SFAS 140 and related interpretations because of the excessive benefit the Company received at inception from the derivative instruments delivered into the trust to counteract interest rate risk.

Accordingly, the loans in these securitizations remain on the balance sheet as Mortgage loans - held-in-portfolio. Given this treatment, retained interests are not created, and securitization bond financing is reflected on the balance sheet as a liability. The Company records interest income on loans held-in-portfolio and interest expense on the bonds issued in the securitizations over the life of the securitizations. Deferred debt issuance costs and discounts related to the bonds are amortized on a level yield basis over the estimated life of the bonds.

At March 31, 2009 all of the loans classified as held-in-portfolio were pledged as collateral for financing purposes.

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Activity in the allowance for credit losses on mortgage loans held-in-portfolio is as follows for the three months ended March 31, 2009 and 2008, respectively (dollars in thousands):

	For the Three Months Ended March 31,	
	2009	**2008**
Balance, beginning of period	$ 776,001	$ 230,138
Provision for credit losses	101,474	249,316
Charge-offs, net of recoveries	(83,796)	(34,334)
Balance, end of period	$ 793,679	$ 445,120

FSP FAS 140-4 and FIN 46(R)-8, which were adopted by the Company on December 31, 2008, provide the disclosure requirements for transactions with variable interest entities (VIEs) or special purpose entities (SPEs) and transfers of financial assets in securitizations or asset-backed financing arrangements. Under this guidance, the Company is required to disclose information for consolidated VIEs, for VIEs in which the Company is the sponsor as defined below or is a significant variable interest holder (Sponsor/Significant VIH) and for VIEs that are established for securitizations and asset-backed financing arrangements. FSP FAS 140-4 and FIN 46(R)-8 has expanded the population of VIEs for which disclosure is required.

The Company has defined sponsor to include all transactions where the Company has transferred assets to a VIE and/or structured the VIE, regardless of whether or not the asset transfer has met the sale conditions in SFAS No. 140. The Company discloses all instances where continued involvement with the assets exposes it to potential economic gain/(loss), regardless of whether or not that continued involvement is considered to be a variable interest in the VIE.

The Companys only continued involvement, relating to these transactions, is retaining interests in the VIEs.

For the purposes of this disclosure, transactions with VIEs are categorized as follows:

Securitization transactions For the purposes of this disclosure, securitization transactions include transactions where the Company transferred mortgage loans and accounted for the transfer as a sale. This category includes both QSPEs and non-QSPEs and is reflected in the securitization section of this Note. QSPEs are commonly used by the Company in securitization transactions as described below. In accordance with SFAS No. 140 and FIN 46(R), the Company does not consolidate QSPEs.

Mortgage Loan VIEs - The Company consolidates securitization transactions that are structured legally as sales, but for accounting purposes are treated as financings as defined by SFAS 140. The NHES 2006-1 and NHES 2006-MTA1 securitizations at inception did not meet the criteria necessary for derecognition under SFAS 140 and related interpretations because after the loans were securitized the securitization trusts were able to acquire derivatives relating to beneficial interests retained by the Company. Additionally, the Company had the unilateral ability to repurchase a limited number of loans back from the trusts. These provisions were removed effective September 30, 2008. Since the removal of these provisions was not considered substantive, the original accounting conclusion remains the same. The NHES 2007-1 securitization does not meet the qualifying special purpose entity criteria necessary for derecognition under SFAS 140 and related interpretations because of the excessive benefit the Company received at inception from the derivative instruments delivered into the trust to counteract interest rate risk. These transactions continue to fail QSPE status and require consolidation and related disclosures. The Company has no control over the mortgage loans held by these VIEs due to their legal structure. Therefore, these mortgage loans have been pledged to the bondholders in the VIEs, and these assets are included in the firm-owned assets pledged balance reported within this note. In most instances, the beneficial interest holders in these VIEs have no recourse to the general credit of the Company; rather their investments are paid exclusively from the assets in the VIE. Securitization VIEs hold loan assets and are financed through the issuance of several classes of debt (i.e., tranches) with ratings that range from AAA to unrated residuals.

Collateralized Debt Obligations (CDO) - In the first quarter of 2007 the Company closed a CDO. The collateral for this securitization consisted of subordinated securities which the Company retained from its loan securitizations as well as subordinated securities purchased from other issuers. This securitization was structured legally as a sale, but for accounting purposes was accounted for as a financing under SFAS 140. This securitization did not meet the qualifying special purpose entity criteria under SFAS 140. Accordingly, the securities remain on the Company's balance sheet, retained interests were not created, and securitization bond financing replaced the short-term debt used to finance the securities.

Transactions with these VIEs are reflected in the Sponsor/Significant VIH table in instances where the Company has not transferred the assets to the VIE or in the Securitization tables where the Company has transferred assets and has accounted for the transfer as a sale.

Variable Interest Entities

FIN 46(R) requires an entity to consolidate a VIE if that entity holds a variable interest that will absorb a majority of the VIE's expected losses, receive a majority of the VIE's expected residual returns, or both. The entity required to consolidate a VIE is known as the primary beneficiary. VIEs are reassessed for consolidation when reconsideration events occur. Reconsideration events include, changes to the VIEs' governing documents that reallocate the expected losses/returns of the VIE between the primary beneficiary and other variable interest holders or sales and purchases of variable interests in the VIE.

There were no material reconsideration events during the period.

The table below provides the disclosure information required by FSP FAS 140-4 and FIN 46(R)-8 for VIEs that are consolidated by the Company (dollars in thousands):

		Assets After Intercompany Eliminations		Liabilities After Intercompany Eliminations	
Consolidated VIEs	**Total Assets**	**Unrestricted**	**Restricted (A)**		**Recourse to the Company (B)**
March 31, 2009					
Mortgage Loan VIEs(C)	$ 1,780,121	$ -	$ 1,770,813	$ 2,669,174	$ -
CDOs(D)	3,934	-	3,677	6,157	-
December 31, 2008					
Mortgage Loan VIEs(C)	$ 1,930,063	$ -	$ 1,920,610	$ 2,730,280	$ -
CDOs(D)	7,242	-	6,842	8,557	-

(A) Assets are considered restricted when they cannot be freely pledged or sold by the Company.
(B) This column reflects the extent, if any, to which investors have recourse to the Company beyond the assets held by the VIE and assumes a total loss of the assets held by the VIE.
(C) For Mortgage Loan VIEs, assets are primarily recorded in Mortgage loans held-in-portfolio. Liabilities are primarily recorded in Asset-backed bonds secured by mortgage loans.
(D) For the CDO, assets are primarily recorded in Mortgage securities trading and liabilities are recorded in Asset-backed bonds secured by mortgage securities.

Securitizations

Prior to changes in its business in 2007, the Company securitized residential nonconforming mortgage loans. The Companys involvement with VIEs that are used to securitize financial assets consists of owning securities issued by VIEs.

The following table relates to securitizations where the Company is the retained interest holder of assets issued by the entity (dollars in thousands):

	Size/Principal Outstanding (A)	Assets on Balance Sheet(B)	Liabilities on Balance Sheet(B)	Maximum Exposure to Loss(C)	Year to Date Loss on Sale	Year to Date Cash Flows
March 31, 2009						
Residential mortgage loans(D)	$ 7,818,874	$ 12,366	$ -	$ 12,366	$ -	$ 5,801
December 31, 2008						
Residential mortgage loans(D)	$ 8,121,668	$ 15,919	$ -	$ 15,919	$ -	$ 58,891

(A) Size/Principal Outstanding reflects the estimated principal of the underlying assets held by the VIE/SPEs.
(B) Assets and Liabilities on the Companys Balance Sheet reflect the effect of FIN 39 balance sheet netting, if applicable.
(C) The maximum exposure to loss includes the following: the assets held by the Company including the value of derivatives that are in an asset position and retained interests in the VIEs/SPEs; and the notional amount of liquidity and other support generally provided through total return swaps. The maximum exposure to loss for liquidity and other support assumes a total loss on the referenced assets held by the VIE.
(D) For residential mortgage loans QSPEs, assets on balance sheet are primarily securities issued by the entity and are recorded in Mortgage securities-available-for-sale and Mortgage securities-trading.

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In certain instances, the Company retains interests in the subordinated tranche and residual tranche of securities issued by VIEs that are created to securitize assets. The gain or loss on the sale of the assets is determined with reference to the previous carrying amount of the financial assets transferred, which is allocated between the assets sold and the retained interests, if any, based on their relative fair values at the date of transfer.

Generally, retained interests are recorded in the Consolidated Balance Sheets at fair value. The Company generally estimates fair value based on the present value of expected future cash flows using managements best estimates of credit losses, prepayment rates, forward yield curves, and discount rates, commensurate with the risks involved. Retained interests are either held as trading assets, with changes in fair value recorded in the Consolidated Statements of Earnings, or as securities available-for-sale, with changes in fair value included in accumulated other comprehensive loss.

Retained interests are reviewed periodically for impairment. Retained interests in securitized assets held as available-for-sale and trading were approximately $11.6 million and $13.5 million at March 31, 2009 and December 31, 2008, respectively.

The following table presents information on retained interests excluding the offsetting benefit of financial instruments used to hedge risks, held by the Company as of March 31, 2009 arising from the Companys residential mortgage-related securitization transactions. The pre-tax sensitivities of the current fair value of the retained interests to immediate 10% and 25% adverse changes in assumptions and parameters are also shown (dollars in thousands):

Carrying amount/fair value of residual interests	$	11,619
Weighted average life (in years)		3.71
Weighted average prepayment speed assumption (CPR) (percent)		18
Fair value after a 10% increase in prepayment speed	$	11,024
Fair value after a 25% increase in prepayment speed	$	10,196
Weighted average expected annual credit losses (percent of current collateral balance)		25.3
Fair value after a 10% increase in annual credit losses	$	10,142
Fair value after a 25% increase in annual credit losses	$	8,926
Weighted average residual cash flows discount rate (percent)		25.3
Fair value after a 500 basis point increase in discount rate	$	11,106
Fair value after a 1000 basis point increase in discount rate	$	10,636
Market interest rates:		
Fair value after a 100 basis point increase in market rates	$	6,870
Fair value after a 200 basis point increase in market rates	$	4,312

The preceding sensitivity analysis is hypothetical and should be used with caution. In particular, the effect of a variation in a particular assumption on the fair value of the retained interest is calculated independent of changes in any other assumption; in practice, changes in one factor may result in changes in another, which might magnify or counteract the sensitivities. Further, changes in fair value based on a 10% or 25% variation in an assumption or parameter 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 sensitivity analysis does not include the offsetting benefit of financial instruments that the Company utilizes to hedge risks, including credit, interest rate, and prepayment risk, that are inherent in the retained interests. These hedging strategies are structured to take into consideration the hypothetical stress scenarios above, such that they would be effective in principally offsetting the Companys exposure to loss in the event that these scenarios occur.

Note 4. Mortgage Securities Available-for-Sale

As of March 31, 2009, and December 31, 2008, mortgage securities available-for-sale consisted entirely of the Companys investment in the residual securities issued by securitization trusts sponsored by the Company, but did not include the NMFT Series 2007-2 residual security, which was designated as trading as a result of the Companys adoption of SFAS 155, Accounting for Certain Hybrid Financial Instruments, an amendment of SFAS 133 and SFAS 140 (SFAS 155) on January 1, 2007. As a result, the NMFT Series 2007-2, residual security qualifies for the scope exception concerning bifurcation provided by SFAS 155. Residual securities consist of interest-only, prepayment penalty and overcollateralization bonds. Management estimates the fair value of the residual securities by discounting the expected future cash flows of the collateral and bonds.

The following table presents certain information on the Companys portfolio of mortgage securities available-for-sale as of March 31, 2009 and December 31, 2008 (dollars in thousands):

	Cost Basis	Unrealized Gain	Unrealized Losses Less Than Twelve Months	Estimated Fair Value	Average Yield (A)
As of March 31, 2009	$ 4,194	$ 6,897	$ -	$ 11,091	472.9%
As of December 31, 2008	$ 3,771	$ 9,017	$ -	$ 12,788	38.2%

(A) The average yield is calculated from the cost basis of the mortgage securities and does not give effect to changes in fair value that are reflected as a component of shareholders equity. Since a number of these securities have a minimal or zero-cost basis this information is not meaningful.

During the three months ended March 31, 2009 and 2008, management concluded that the decline in value on certain securities in the Companys mortgage securities available-for-sale portfolio were other-than-temporary. As a result, the Company recognized impairments on mortgage securities available-for-sale of $0.2 million and $19.4 million during the three months ended March 31, 2009 and 2008, respectively.

Maturities of mortgage securities owned by the Company depend on repayment characteristics and experience of the underlying financial instruments.

Note 5. Mortgage Securities Trading

As of March 31, 2009 and December 31, 2008, mortgage securities trading consisted of the NMFT Series 2007-2 residual security and subordinated securities retained by the Company from securitization transactions as well as subordinated securities purchased from other issuers in the open market. Management estimates the fair value of the residual securities by discounting the expected future cash flows of the collateral and bonds. The fair value of the subordinated securities is estimated based on quoted broker prices. Refer to Note 9 for a description of the valuation methods as of March 31, 2009 and December 31, 2008.

The following table summarizes the Company's mortgage securities trading as of March 31, 2009 and December 31, 2008 (dollars in thousands):

	Original Face	Amortized Cost Basis	Fair Value	Average Yield (A)
As of March 31, 2009				
Subordinated securities pledged to CDO	$ 332,489	$ 324,847	$ 2,766	
Other subordinated securities	102,625	98,306	473	
Residual securities	-	15,247	528	
Total	$ 435,114	$ 438,400	$ 3,767	9.81%
As of December 31, 2008	$ 435,114	$ 433,968	$ 7,085	9.55%

(A) Calculated from the ending fair value of the securities.

The Company recognized net trading losses of $7.7 million and $51.6 million for the three months ended March 31, 2009 and 2008, respectively. These net trading losses are included in the fair value adjustments line on the company's condensed consolidated statements of operations.

There were no trading securities pledged as collateral as of March 31, 2009 and December 31, 2008.

Note 6. Borrowings

Junior Subordinated Debentures

NFI's wholly owned subsidiary NovaStar Mortgage, Inc. (NMI) has approximately $77.4 million in principal amount of unsecured notes (collectively, the Notes) outstanding to NovaStar Capital Trust I and NovaStar Capital Trust II (collectively, the Trusts) which secure trust preferred securities issued by the Trusts. NFI has guaranteed NMI's obligations under the Notes.

NMI failed to make quarterly interest payments that were due on March 30, April 30, June 30, July 30, September 30, October 30 and December 30, 2008, and January 30 and March 30, 2009 totaling, for all payment dates combined, approximately $6.1 million on the Notes. As a result, NMI was in default under the related indentures and NFI was in default under the related guarantees as of March 31, 2009.

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On September 12, 2008, a petition for involuntary Chapter 7 bankruptcy entitled In re NovaStar Mortgage, Inc. (Case No. 08-12125-CSS) was filed against NMI by the holders of the trust preferred securities in U.S. Bankruptcy Court for the District of Delaware in Wilmington, Delaware. The filing did not include NFI or any other subsidiary or affiliate of NFI.

On February 18, 2009, the Company, NMI, the Trusts and the trust preferred security holders entered into agreements to settle the claims of the trust preferred security holders arising from NMIs failure to make the scheduled quarterly interest payments on the Notes. As part of the settlement, the existing preferred obligations would be exchanged for new preferred obligations. The settlement and exchange were contingent upon, among other things, the dismissal of the involuntary Chapter 7 bankruptcy. On March 9, 2009, the Bankruptcy Court entered an order dismissing the involuntary proceeding. On April 24, 2009 (the Exchange Date), the parties executed the necessary documents to complete the Exchange. On the Exchange Date, the Company paid interest due through December 31, 2008, in the aggregate amount of $5.3 million. In addition, the Company paid $0.3 million in legal and administrative costs on behalf of the Trusts.

The new preferred obligations require quarterly distributions of interest to the holders at a rate equal to 1.0% per annum beginning January 1, 2009 through December 31, 2009, subject to reset to a variable rate equal to the three-month LIBOR plus 3.5% upon the occurrence of an Interest Coverage Trigger. For purposes of the new preferred obligations, an Interest Coverage Trigger occurs when the ratio of EBITDA for any quarter ending on or after December 31, 2008 and on or prior to December 31, 2009 to the product as of the last day of such quarter, of the stated liquidation value of all outstanding 2009 Preferred Securities (i) multiplied by 7.5%, (ii) multiplied by 1.5 and (iii) divided by 4, equals or exceeds 1.00 to 1.00. Beginning January 1, 2010 until the earlier of February 18, 2019 or the occurrence of an Interest Coverage Trigger, the unpaid principal amount of the new preferred obligations will bear interest at a rate of 1.0% per annum and, thereafter, at a variable rate, reset quarterly, equal to the three-month LIBOR plus 3.5% per annum.

Note 7. Commitments and Contingencies

Contingencies

Trust Preferred Settlement. See Note 6Borrowings for a detailed discussion of the settlement terms and restructuring of the Companys junior subordinated debentures, including the dismissal of the involuntary Chapter 7 bankruptcy filed against NovaStar Mortgage, Inc. (Case No. 08-12125-CSS) by the holders of the trust preferred securities in U.S. Bankruptcy Court for the District of Delaware in Wilmington, Delaware.

Litigation.

At this time, the Company cannot predict the probable outcome of the following claims and as such no amounts have been accrued in the consolidated financial statements.

In February 2007, a number of substantially similar putative class actions were filed in the United States District Court for the Western District of Missouri. The complaints name the Company and three of the Companys former and current executive officers as defendants and generally allege, among other things, that the defendants made materially false and misleading statements regarding the Companys business and financial results. The plaintiffs purport to have brought the actions on behalf of all persons who purchased or otherwise acquired the Companys common stock during the period May 4, 2006 through February 20, 2007. Following consolidation of the actions, a consolidated amended complaint was filed on October 19, 2007. On December 29, 2007, the defendants moved to dismiss all of plaintiffs claims. On June 4, 2008, the Court dismissed the plaintiffs complaints without leave to amend. The plaintiffs have filed an appeal of the Courts ruling. The Company believes that these claims are without merit and will vigorously defend against them.

In May 2007, a lawsuit entitled *National Community Reinvestment Coalition v. NovaStar Financial, Inc., et al.*, was filed against the Company in the United States District Court for the District of Columbia. Plaintiff, a non-profit organization, alleges that the Company maintains corporate policies of not making loans on Indian reservations, on dwellings used for adult foster care or on rowhouses in Baltimore, Maryland in violation of the federal Fair Housing Act. The lawsuit seeks injunctive relief and damages, including punitive damages, in connection with the lawsuit. On May 30, 2007, the Company responded to the lawsuit by filing a motion to dismiss certain of plaintiffs claims. On March 31, 2008 that motion was denied by the Court. The Company believes that these claims are without merit and will vigorously defend against them.

On January 10, 2008, the City of Cleveland, Ohio filed suit against the Company and approximately 20 other mortgage, commercial and investment bankers alleging a public nuisance had been created in the City of Cleveland by the operation of the subprime mortgage industry. The case was filed in state court and promptly removed to the United States District Court for the Northern District of Ohio. The plaintiff seeks damages for loss of property values in the City of Cleveland, and for increased costs of providing services and infrastructure, as a

result of foreclosures of subprime mortgages. On October 8, 2008, the City of Cleveland filed an amended complaint in federal court which did not include claims against the Company but made similar claims against NovaStar Mortgage, Inc., a wholly owned subsidiary of NFI. On November 24, 2008 the Company filed a motion to dismiss. On May 15, 2009 the Court granted Company's motion to dismiss. The City of Cleveland has filed a notice of intent to appeal. The Company believes that these claims are without merit and will vigorously defend against them.

On January 31, 2008, two purported shareholders filed separate derivative actions in the Circuit Court of Jackson County, Missouri against various former and current officers and directors and named the Company as a nominal defendant. The essentially identical petitions seek monetary damages alleging that the individual defendants breached fiduciary duties owed to the Company, alleging insider selling and misappropriation of information, abuse of control, gross mismanagement, waste of corporate assets, and unjust enrichment between May 2006 and December 2007. On June 24, 2008 a third, similar case was filed in United States District Court for the Western District of Missouri. The Company believes that these claims are without merit and will vigorously defend against them.

On May 6, 2008, the Company received a letter written on behalf of J.P. Morgan Mortgage Acceptance Corp. and certain affiliates ("Morgan") demanding indemnification for claims asserted against Morgan in a case entitled Plumbers & Pipefitters Local #562 Supplemental Plan and Trust v. J.P. Morgan Acceptance Corp. et al, filed in the Supreme Court of the State of New York, County of Nassau. The case seeks class action certification for alleged violations by Morgan of sections 11 and 15 of the Securities Act of 1933, on behalf of all persons who purchased certain categories of mortgage backed securities issued by Morgan in 2006 and 2007. Morgan's indemnity demand alleges that any liability it might have to plaintiffs would be based, in part, upon alleged misrepresentations made by the Company with respect to certain mortgages that make up a portion of the collateral for the securities at issue. The Company believes it has meritorious defenses to this demand and expects to defend vigorously any claims asserted.

On May 21, 2008, a purported class action case was filed in the Supreme Court of the State of New York, New York County, by the New Jersey Carpenters' Health Fund, on behalf of itself and all others similarly situated. Defendants in the case include NovaStar Mortgage Funding Corporation and its individual directors, several securitization trusts sponsored by the Company, and several unaffiliated investment banks and credit rating agencies. The case was removed to the United States District Court for the Southern District of New York. On June 16, 2009, the plaintiff filed an amended complaint. Plaintiff seeks monetary damages, alleging that the defendants violated sections 11, 12 and 15 of the Securities Act of 1933 by making allegedly false statements regarding mortgage loans that served as collateral for securities purchased by plaintiff and the purported class members. The Company believes it has meritorious defenses to the case and expects to defend the case vigorously.

On July 7, 2008, plaintiff Jennifer Jones filed a purported class action case in the United States District Court for the Western District of Missouri against the Company, certain former and current officers of the Company, and unnamed members of the Company's "Retirement Committee". Plaintiff, a former employee of the Company, seeks class action certification on behalf of all persons who were participants in or beneficiaries of the Company's 401(k) plan from May 4, 2006 until November 15, 2007 and whose accounts included investments in the Company's common stock. Plaintiff seeks monetary damages alleging that the Company's common stock was an inappropriately risky investment option for retirement savings, and that defendants breached their fiduciary duties by allowing investment of some of the assets contained in the 401(k) plan to be made in the Company's common stock. On November 12, 2008, the Company filed a motion to dismiss which was denied by the Court on February 11, 2009. On April 6, 2009 the Court granted the plaintiff's motion for class certification. The Company sought permission from the 8th Circuit Court of Appeals to appeal the order granting class certification. On May 11, 2009 the Court of Appeals granted the Company permission to appeal the class certification order. The Company believes it has meritorious defenses to the case and expects to defend the case vigorously.

On October 21, 2008, EHD Holdings, LLC ("EHD"), the purported owner of the building which leases the Company its former principal office space in Kansas City, filed an action for unpaid rent in the Circuit Court of Jackson County, Missouri. On April 24, 2009, EHD filed a motion for summary judgment seeking approximately $3.3 million, in past due rent and charges, included in the Accounts payable and other liabilities line item of the balance sheet, plus accruing rent and charges for future periods, plus attorney fees. On June 30, 2009, the Company executed a settlement agreement with EHD whereby the Company is released from all past and future

obligations under its lease agreement and paid $5 million to EHD in July 2009. EHD and the Company also agreed to take the necessary steps for the dismissal of all legal proceedings related to the lease agreement.

In addition to those matters listed above, the Company is currently a party to various other legal proceedings and claims, including, but not limited to, breach of contract claims, tort claims, and claims for violations of federal and state consumer protection laws. Furthermore, the Company has received indemnification and loan repurchase demands with respect to alleged violations of representations and warranties made in loan sale and securitization agreements. These indemnification and repurchase demands have been addressed without significant loss to the Company, but such claims can be significant when multiple loans are involved. Continued deterioration of the housing market may increase the risk of such claims.

Note 8. Comprehensive Income

The following is a rollforward of accumulated other comprehensive income for the three months ended March 31, 2009 and 2008 (dollars in thousands):

	For the Three Months Ended March 31,	
	2009	**2008**
Net loss	$ (91,698)	$ (282,669
Other comprehensive income (loss):		
Change in unrealized loss on mortgage securities available-for-sale	(2,322)	(16,128
Impairment on mortgage securities - available-for-sale reclassified to earnings	202	19,380
Change in unrealized gain on derivative instruments used in cash flow hedges	8	(1,419
Net settlements of derivative instruments used in cash flow hedges reclassified to earnings	84	757
Other comprehensive income (loss)	(2,028)	2,590
Total comprehensive loss	(93,726)	(280,079
Comprehensive loss attributable to noncontrolling interests	334	-
Total comprehensive loss attributable to NovaStar Financial, Inc.	$ (93,392)	$ (280,079

Note 9. Fair Value Accounting

Fair Value Measurements (SFAS 157)

SFAS 157 defines fair value, establishes a consistent framework for measuring fair value and expands disclosure requirements about fair value measurements. SFAS 157, among other things, requires the Company to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

These valuation techniques are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's market assumptions. These two types of inputs create the following fair value hierarchy:

- Level 1Quoted prices for identical instruments in active markets
- Level 2Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.
- Level 3Instruments whose significant value drivers are unobservable.

The Company determines fair value based upon quoted broker prices when available or through the use of alternative approaches, such as discounting the expected cash flows using market interest rates commensurate with the credit quality and duration of the investment. The methods the Company uses to determine fair value on an instrument specific basis are detailed in Valuation Methods below.

The following tables present for each of the fair value hierarchy levels, the Company's assets and liabilities related to continuing operations which are measured at fair value on a recurring basis as of March 31, 2009 and December 31, 2008 (dollars in thousands).

		Fair Value Measurements at Reporting Date Using		
Description	**Fair Value at March 31, 2009**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Assets:				
Mortgage securities -trading	$ 3,767	$ -	$ -	$ 3,767
Mortgage securities available-for-sale	11,091	-	-	11,091
Total assets	$ 14,858	$ -	$ -	$ 14,858
Liabilities:				
Asset-backed bonds secured by mortgage securities	$ 3,073	$ -	$ -	$ 3,073
Derivative instruments, net	8,564	-	8,564	-
Total liabilities	$ 11,637	$ -	$ 8,564	$ 3,073

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		Fair Value Measurements at Reporting Date Using		
Description	**Fair Value at December 31, 2008**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Assets:				
Mortgage securities -trading	$ 7,085	$ -	$ -	$ 7,085
Mortgage securities available-for-sale	12,788	-	-	12,788
Total assets	$ 19,873	$ -	$ -	$ 19,873
Liabilities:				
Asset-backed bonds secured by mortgage securities	$ 5,376	$ -	$ -	$ 5,376
Derivative instruments, net	9,102	-	9,102	-
Total liabilities	$ 14,478	$ -	$ 9,102	$ 5,376

The following tables provide a reconciliation of the beginning and ending balances for the Company's mortgage securities trading which are measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three months ended March 31, 2009 and 2008 (dollars in thousands):

	Cost Basis	Unrealized Loss	Estimated Fair Value of Mortgage Securities
As of December 31, 2008	$ 433,968	$ (426,883)	$ 7,085
Increases (decreases) to mortgage securities trading:			
Accretion of income	6,917	-	6,917
Proceeds from paydowns of securities	(2,485)	-	(2,485)
Mark-to-market value adjustment	-	(7,750)	(7,750)
Net (decrease) increase to mortgage securities - trading	4,432	(7,750)	(3,318)
As of March 31, 2009	$ 438,400	$ (434,633)	$ 3,767

	Cost Basis	Unrealized Loss	Estimated Fair Value of Mortgage Securities
As of December 31, 2007	$ 41,275	$ (16,534)	$ 24,741
Increases (decreases) to mortgage securities trading:			
Accretion of income	2,286	-	2,286
Proceeds from paydowns of securities	(12,578)	-	(12,578)
Mark-to-market value adjustment	-	2,585	2,585
Net (decrease) increase to mortgage securities - trading	(10,292)	2,585	(7,707)
As of March 31, 2008	$ 30,983	$ (13,949)	$ 17,034

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The following tables provide a reconciliation of the beginning and ending balances for the Companys mortgage securities available-for-sale which are measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three months ended March 31, 2009 and 2008 (dollars in thousands):

	Cost Basis	Unrealized Gain	Estimated Fair Value of Mortgage Securities
As of December 31, 2008	$ 3,771	$ 9,017	$ 12,788
Increases (decreases) to mortgage securities available-for-sale:			
Accretion of income (A)	4,522	-	4,522
Proceeds from paydowns of securities (A) (B)	(3,897)	-	(3,897)
Impairment on mortgage securities available-for-sale	(202)	-	(202)
Mark-to-market value adjustment	-	(2,120)	(2,120)
Net (decrease) increase to mortgage securities available-for-sale	423	(2,120)	(1,697)
As of March 31, 2009	$ 4,194	$ 6,897	$ 11,091

(A) Cash received on mortgage securities with no cost basis was $32,000 for the three months ended March 31, 2009.

(B) For mortgage securities with a remaining cost basis, the Company reduces the cost basis by the amount of cash that is contractually due from the securitization trusts. In contrast, for mortgage securities in which the cost basis has previously reached zero, the Company records in interest income the amount of cash that is contractually due from the securitization trusts. In both cases, there are instances where the Company may not receive a portion of this cash until after the balance sheet reporting date. Therefore, these amounts are recorded as receivables from the securitization trusts. As of March 31, 2009, the Company had no receivables from securitization trusts related to mortgage securities available-for-sale with a remaining cost basis.

	Cost Basis	Unrealized Gain	Estimated Fair Value of Mortgage Securities
As of December 31, 2007	$ 33,302	$ 69	$ 33,371
Increases (decreases) to mortgage securities available-for-sale:			
Accretion of income (A)	1,940	-	1,940
Proceeds from paydowns of securities (A)	(4,049)	-	(4,049)
Impairment on mortgage securities available-for-sale	(19,380)	19,380	-
Mark-to-market value adjustment	-	(16,128)	(16,128)
Net (decrease) increase to mortgage securities available-for-sale	(21,489)	3,252	(18,237)
As of March 31, 2008	$ 11,813	$ 3,321	$ 15,134

(A) For mortgage securities with a remaining cost basis, the Company reduces the cost basis by the amount of cash that is contractually due from the securitization trusts. In contrast, for mortgage securities in which the cost basis has previously reached zero, the Company records in interest income the amount of cash that is contractually due from the securitization trusts. In both cases, there are instances where the Company may not receive a portion of this cash until after the balance sheet reporting date. Therefore, these amounts are recorded as receivables from the securitization trusts. As of March 31, 2008 and December 31, 2007, the Company had receivables from securitization trusts of $2.7 million and $12.5 million, respectively, related to mortgage securities available-for-sale with a remaining cost basis.

The following table provides quantitative disclosures about the fair value measurements for the Companys assets related to continuing operations which are measured at fair value on a nonrecurring basis as of March 31, 2009 and December 31, 2008 (dollars in thousands):

		Fair Value Measurements at Reporting Date Using		
Fair Value at	Real Estate Owned	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
March 31, 2009	$ 91,279	$ -	$ -	$ 91,279
December 31, 2008	70,480	-	-	70,480

At the time a mortgage loan held-in-portfolio becomes real estate owned, the Company records the property at the lower of its carrying amount or fair value. Upon foreclosure and through liquidation, the Company evaluates the property's fair value as compared to its carrying amount and records a valuation adjustment when the carrying amount exceeds fair value. Any valuation adjustments at the time the loan becomes real estate owned is charged to the allowance for credit losses.

The following table provides a summary of the impact to earnings for the three months ended March 31, 2009 and 2008 from the Companys assets and liabilities related to continuing operations which are measured at fair value on a recurring and nonrecurring basis as of March 31, 2009 (dollars in thousands):

Asset or Liability Measured	Fair Value Measurement	Fair Value Adjustments For the Three Months Ended March 31,	Statement of Operation Line

at Fair Value	Frequency	2009	2008	Item Impacted
Mortgage securities - trading	Recurring	$ (7,750)	$ (51,604)	Fair value adjustments
Mortgage securities available-for-sale	Recurring	(202)	(19,380)	Impairment on mortgage securities available-for-sale
Derivative instruments, net	Recurring	(4,195)	(12,554)	(Losses) gains on derivative instruments
Asset-backed bonds secured by mortgage securities	Recurring	2,040	38,888	Fair value adjustments
Total fair value gains (losses)		$ (10,107)	$ (44,650)	

Valuation Methods

Mortgage securities trading. Trading securities are recorded at fair value with gains and losses, realized and unrealized, included in earnings. The Company uses the specific identification method in computing realized gains or losses. Prior to September 30, 2008, the Company estimated fair value for its subordinated securities solely from quoted market prices. Commencing September 30, 2008, the Company estimated fair value for its subordinated securities based on quoted broker prices compared to estimates based on discounting the expected future cash flows of the collateral and bonds. The Company determined this change in valuation method caused a change from Level 2 to Level 3 due to the unobservable inputs used by the Company in determining the expected future cash flows. The Company determined its valuation methodology for residual securities would also qualify as Level 3.

In addition, upon the closing of its NMFT Series 2007-2 securitization, the Company classified the residual security it retained as trading. Management estimates the fair value of its residual securities by discounting the expected future cash flows of the collateral and bonds. Due to the unobservable inputs used by the Company in determining the expected future cash flows, the Company determined its valuation methodology for residual securities would qualify as Level 3. See Mortgage securities available-for-sale" for further discussion of the Companys valuation policies relating to residual securities.

Mortgage securities available-for-sale. Mortgage securities available-for-sale represent beneficial interests the Company retains in securitization and resecuritization transactions which include residual securities. The Company had no subordinated securities included within the mortgage securities available-for-sale classification as of March 31, 2009 or December 31, 2008. Mortgage securities classified as available-for-sale are reported at their estimated fair value with unrealized gains and losses reported in accumulated other comprehensive income. To the extent that the cost basis of mortgage securities exceeds the fair value and the unrealized loss is considered to be other-than-temporary, an impairment charge is recognized and the amount recorded in accumulated other comprehensive income or loss is reclassified to earnings as a realized loss. The specific identification method is used in computing realized gains or losses.

At each reporting period subsequent to the initial valuation of the residual securities, the fair value of the residual securities is estimated based on the present value of future expected cash flows to be received. Managements best estimate of key assumptions, including credit losses, prepayment speeds, the market discount rates and forward yield curves commensurate with the risks involved, are used in estimating future cash flows.

Derivative instruments. The fair value of derivative instruments is estimated by discounting the projected future cash flows using appropriate market rates.

Asset-backed bonds secured by mortgage securities. See discussion under Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159).

Real estate owned. Real estate owned is carried at the lower of cost or fair value less estimated selling costs. The Company estimates fair value at the assets liquidation value less selling costs using managements assumptions which are based on historical loss severities for similar assets.

Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159)

The Company elected the fair value option for the asset-backed bonds issued from NovaStar ABS CDO I, which closed in the first quarter of 2007. The Company elected the fair value option for these liabilities to help reduce earnings volatility which otherwise would arise if the accounting method for this debt was not matched with the fair value accounting for the related mortgage securities - trading. The asset-backed bonds which are being carried at fair value are included in the Asset-backed bonds secured by mortgage securities line item on the condensed consolidated balance sheets. The Company recognized a fair value adjustment of $2.0 million and $38.9 million during the three months ended March 31, 2009 and 2008, respectively, which is included in the Fair value adjustments line item on the condensed consolidated statements of operations. The Company calculates interest expense for these asset-backed bonds based on the prevailing coupon rates of the specific classes of debt and records interest expense in the period incurred. Interest expense amounts are included in the Interest expense line item of the condensed consolidated statements of operations.

The Company has not elected fair value accounting for any other balance sheet items as allowed by SFAS 159.

The following table shows the difference between the unpaid principal balance and the fair value of the asset-backed bonds secured by mortgage securities for which the Company has elected fair value accounting as of March 31, 2009 and December 31, 2008 (dollars in thousands):

Unpaid Principal Balance as of	**Asset-Backed Bonds Secured by Mortgage Securities**	**Year to Date Gain Recognized**	**Fair Value**
March 31, 2009	$ 323,707	$ 2,040	$ 3,073
December 31, 2008	324,243	38,888	5,376

Substantially all of the $2.0 million change in fair value of the asset-backed bonds is considered to be related to specific credit risk as all of the bonds are floating rate.

Note 10. Derivative Instruments and Hedging Activities

The Companys objective and strategy for using derivative instruments is to mitigate the risk of increased costs on its variable rate liabilities during a period of rising rates, subject to cost and liquidity risk constraints. The Companys primary goals for managing interest rate risk are to maintain the net interest margin between its assets and liabilities and diminish the effect of changes in general interest rate levels on the market value of the Company.

The derivative instruments used by the Company to manage this risk are interest rate caps and interest rate swaps. Interest rate caps are contracts in which the Company pays either an upfront premium or monthly or quarterly premium to a counterparty. In return, the Company receives payments from the counterparty when interest rates rise above a certain rate specified in the contract. During the three months ended March 31, 2009 and 2008, premiums paid pursuant to interest rate cap agreements related to continuing operations aggregated $20,000 and $0.1 million, respectively. When premiums are financed by the Company, a liability is recorded for the premium obligation. Premiums due to counterparties as of March 31, 2009 and December 31, 2008, respectively were $40,000 and $0.1 million, respectively, and had a weighted average interest rate of 3.9% for both periods. The future contractual maturities of premiums due to counterparties as of March 31, 2009 are $40,000 due during 2009. There is no future contractual maturities premium due in 2010 or thereafter. The interest rate swap agreements to which the Company is party stipulate that the Company pay a fixed rate of interest to the counterparty and the counterparty pays the company a variable rate of interest based on the notional amount of the contract. The liabilities the Company hedges are asset-backed bonds as discussed in Note 3.

During 2007, the Company entered into several inter-related transactions involving credit default swaps (CDS) and other investments. A CDS is an agreement to provide credit event protection based on a specific security in exchange for receiving an upfront premium and a fixed-rate fee over the life of the contract. The additional investments purchased bear yields that mirror LIBOR. The result of the transaction is to create an instrument that mirrors the results of the referenced securities underlying the CDS. The CDS had a notional amount of $16.5 million and a fair value of $6.1 million at the date of purchase and are pledged as collateral against the CDO ABB. The fair value was $0.1 million and $0.2 million as of March 31, 2009 and December 31, 2008, respectively. The Company recorded losses related to fair value adjustments of $0.1 million and $1.1million for the three months ended March 31, 2009 and 2008, respectively. These losses are included in the Losses on derivative instruments line item of the Companys condensed consolidated statements of operations.

These CDS are accounted for as non-cash flow hedging derivative instruments, reported at fair value with the changes in fair value recognized through the Companys statements of operations. The value of these contracts decrease for a variety of reasons, including when the probability of the occurrence of a specific credit event increases, when the markets perceptions of default risk in general change, or when there are changes in the supply and demand of these instruments.

The Company also has derivative instruments that do not meet the requirements for hedge accounting. However, these derivative instruments do contribute to the Companys overall risk management strategy by serving to reduce interest rate risk on asset-backed bonds collateralized by the Companys loans held-in-portfolio.

The following tables present derivative instruments as of March 31, 2009 and 2008 (dollars in thousands):

	Notional Amount	Fair Value	Maximum Days to Maturity
As of March 31, 2009:			
Non-hedge derivative instruments	$ 461,500	$ (8,564)	300
As of December 31, 2008:			
Non-hedge derivative instruments	$ 461,500	$ (9,034)	390
Cash flow hedge derivative instruments	40,000	(68)	25

The Company recognized net expense of $1.4 million and $0.8 million during the three months ended March 31, 2009 and March 31, 2008, respectively, on derivative instruments qualifying as cash flow hedges, which is recorded as a component of interest expense.

During the three months ended March 31, 2009 and 2008, respectively, hedge ineffectiveness was insignificant.

The Companys derivative instruments involve, to varying degrees, elements of credit and market risk in addition to the amount recognized in the consolidated financial statements.

Credit Risk The Companys exposure to credit risk on derivative instruments is equal to the amount of deposits (margin) held by the counterparty, plus any net receivable due from the counterparty, plus the cost of replacing the contracts should the counterparty fail. The Company seeks to minimize credit risk through the use of credit approval and review processes, the selection of only the most creditworthy counterparties, continuing review and monitoring of all counterparties, exposure reduction techniques and thorough legal scrutiny of agreements. Before engaging in negotiated derivative transactions with any counterparty, the Company has in place fully executed written agreements. Agreements with counterparties also call for full two-way netting of payments. Under these agreements, on each payment exchange date all gains and losses of counterparties are netted into a single amount, limiting exposure to the counterparty to any net receivable amount due.

Market Risk The potential for financial loss due to adverse changes in market interest rates is a function of the sensitivity of each position to changes in interest rates, the degree to which each position can affect future

earnings under adverse market conditions, the source and nature of funding for the position, and the net effect due to offsetting positions. The derivative instruments utilized leave the Company in a market position that is designed to be a better position than if the derivative instrument had not been used in interest rate risk management.

Other Risk Considerations The Company is cognizant of the risks involved with derivative instruments and has policies and procedures in place to mitigate risk associated with the use of derivative instruments in ways appropriate to its business activities, considering its risk profile as a limited end-user.

Note 11. Income Taxes

Based on the evidence available as of March 31, 2009 and December 31, 2008, including the significant pre-tax losses incurred by the Company since 2007, the liquidity issues facing the Company and the decision by the Company to close all of its mortgage lending and loan servicing operations, the Company believes that it is more likely than not that the Company will not realize its deferred tax assets. Based on these conclusions, the Company recorded a valuation allowance against its entire net deferred tax assets as of March 31, 2009 and December 31, 2008.

The Company recognizes tax benefits in accordance with FIN 48, Accounting for Uncertainty in Income Taxes, an interpretation of SFAS No. 109, Accounting for Income Taxes (FIN 48). FIN 48 establishes a more-likely-than-not recognition threshold that must be met before a tax benefit can be recognized in the financial statements. As of March 31, 2009 and December 31, 2008, the total gross amount of unrecognized tax benefits was $0.5 million and $0.5 million, respectively.

Note 12. Segment Reporting

As of March 31, 2009, the Company reviews, manages and operates its business in one segment: portfolio management. Portfolio management operating results come from the income generated on the mortgage assets the Company manages less associated costs. The portfolio management segments operating results for the three months ended March 31, 2009 and 2008 are the same as the Companys condensed consolidated statements of operations.

Note 13. Loss Per Share

The computations of basic and diluted loss per share for the three months ended March 31, 2009 and 2008 (dollars in thousands, except per share amounts):

	For the Three Months Ended March 31,	
	2009	**2008**
Numerator:		
Loss from continuing operations	$ (91,698)	$ (277,299)
Less loss attributable to noncontrolling interests	(334)	-
Dividends on preferred shares	(3,696)	(3,288)
Loss from continuing operations available to common shareholders	(95,060)	(280,587)
Loss from discontinued operations, net of income tax	-	(5,370)
Loss available to common shareholders	$ (95,060)	$ (285,957)
Denominator:		
Weighted average common shares outstanding basic	9,368,053	9,414,418
Weighted average common shares outstanding dilutive:		
Weighted average common shares outstanding basic	9,368,053	9,414,418
Stock options	-	-

Restricted stock		-		-
Weighted average common shares outstanding dilutive		9,368,053		9,414,418
Basic earnings per share:				
Loss from continuing operations	$	(9.79)	$	(29.45)
Less loss attributable to noncontrolling interests		(0.04)		-
Dividends on preferred shares		(0.39)		(0.35)
Loss from continuing operations available to common shareholders		(10.14)		(29.80)
Loss from discontinued operations, net of income tax		-		