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## **FORM 10-K**

**Arlington Asset Investment Corp. - AI**

**Filed: February 29, 2008 (period: December 31, 2007)**

Annual report with a comprehensive overview of the company

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-K**

(Mark One)

☒ **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

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 000-50230

**FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**

(Exact name of registrant as specified in its charter)

Virginia  
(State or other jurisdiction of  
Incorporation or organization)

54-1873198  
(I.R.S. Employer  
Identification No.)

1001 Nineteenth Street North,  
Arlington, VA 22209

(Address of principal executive offices)(Zip Code)

(703) 312-9500

(Registrant's telephone number, including area code)

**Securities registered pursuant to section 12(b) of the act:**

Title of each class of securities	Name of each exchange on which registered
Class A Common Stock, Par Value \$0.01	New York Stock Exchange

**Securities registered pursuant to section 12(g) of the act:**

None

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

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

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 ☒ No ☐

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: ☒

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

Large Accelerated Filer ☒ Accelerated Filer ☐ Non-Accelerated Filer ☐ Smaller Reporting Company ☐

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

The aggregate market value of the registrant's Class A and Class B common stock held by non-affiliates as of June 29, 2007, based on the last sale price reported on that date on the New York Stock Exchange, which was \$5.46 per share, was approximately \$895 million. In determining this figure, the registrant has excluded all shares of Class A and Class B common stock beneficially owned on such date by its directors and executive officers and each person who beneficially owns 10% or more of the registrant's outstanding voting securities. By doing so, the registrant does not admit that such persons are affiliates within the meaning of Rule 405 of the Securities Act of 1933, as amended, or for any other purpose.

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date:

Title	Outstanding
Class A Common Stock	139,254,702 shares as of January 31, 2008
Class B Common Stock	12,616,249 shares as of January 31, 2008

**DOCUMENTS INCORPORATED BY REFERENCE**

**Document**  
Friedman, Billings, Ramsey Group, Inc. Definitive Proxy Statement for the 2008 Annual Meeting of Shareholders (to be filed with the Securities and Exchange Commission on or before April 30, 2008)

**Where Incorporated**  
Part II, Item 5  
Part III, Items 10, 11, 12, 13, 14

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## CAUTIONS ABOUT FORWARD-LOOKING INFORMATION

This Form 10-K and the information incorporated by reference in this Form 10-K include forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (Exchange Act). Some of the forward-looking statements can be identified by the use of forward-looking words such as “believes,” “expects,” “may,” “will,” “should,” “seeks,” “approximately,” “plans,” “estimates” or “anticipates” or the negative of those words or other comparable terminology. Statements concerning projections, future performance developments, events, revenues, expenses, earnings, run rates, and any other guidance on present or future periods constitute forward-looking statements. Such statements include, but are not limited to, those relating to the effects of growth, our principal investing activities, levels of assets under management and our current equity capital levels. Forward-looking statements involve risks and uncertainties. You should be aware that a number of important factors could cause our actual results to differ materially from those in the forward-looking statements. These factors include, but are not limited to:

- the factors identified under the caption entitled “Risk Factors” beginning on page 21 of this Form 10-K;
- our ability to deploy capital and grow our business through a leveraged agency mortgage-backed security, including collateralized mortgage obligations, investment strategy;
- the overall environment for interest rates;
- current conditions in the residential mortgage market and further adverse developments in that market;
- prepayment speeds within the mortgage-backed securities market;
- potential risk attributable to our mortgage-related or merchant banking investment portfolios, including changes in fair value;
- our use of leverage through and dependence on repurchase agreements and other short-term borrowings related to our mortgage investing activities;
- changes in our mortgage investing strategy, hedging strategy, use of leverage, asset allocation and operational policies without shareholder consent;
- the demand for public offerings of equity and debt securities;
- activity in the secondary securities markets;
- deterioration in the business environment in the specific sectors of the economy in which we focus or a decline in the market for securities of companies within these sectors;
- competition among financial services firms and/or mortgage banking companies for business and personnel;
- the high degree of risk associated with venture capital investments;
- mutual fund and 401(k) pension plan inflows or outflows in the securities markets;
- volatility of the securities markets;
- available technologies;
- malfunctioning or failure in our operations and infrastructure;
- the effect of government regulation and of general economic conditions on our own business and on the business in the industry areas on which we focus our investment banking activities;
- fluctuating quarterly operating results;
- the availability of capital to us;
- our ability to retain our key professionals;

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- risk from strategic investments or acquisitions and joint ventures or our entry into new business areas;
- failure to maintain effective internal controls;
- changes in laws and regulations and industry practices that may adversely affect our businesses; and
- the loss of our exemption from registration as an investment company under the Investment Company Act of 1940, as amended (1940 Act or Investment Company Act).

We will not necessarily update the information presented or incorporated by reference in this Form 10-K if any of these forward looking statements turn out to be inaccurate. Risks affecting our business are described throughout this Form 10-K. This entire Form 10-K, including the consolidated financial statements and the notes and any other documents incorporated by reference into this Form 10-K should be read for a complete understanding of our business and the risks associated with that business.

## **ITEM 1. BUSINESS**

### **Our Company**

We are a real estate investment trust (REIT), that, through our taxable REIT subsidiaries, operates investment banking, institutional brokerage, asset management and merchant banking businesses. At the parent REIT level, we invest as a principal on a leveraged basis in residential mortgage-backed securities (MBS), including collateralized mortgage obligations (CMOs), either issued by a U.S. Government agency, or guaranteed as to principal and interest by U.S. Government agencies or U.S. Government-sponsored entities. We refer to these securities as “agency-backed MBS” in this annual report on Form 10-K. We have historically invested as a principal in agency-backed MBS, and have also invested as a principal in both AAA-rated MBS issued by private organizations (private-label MBS) and net interest margin securities. As of December 31, 2007, we are no longer deploying capital into AAA-rated private-label MBS or net interest margin securities, although we continue to retain these assets in our portfolio. We also make merchant banking investments with our own capital. In addition, we have also historically originated non-conforming, including non-prime, residential mortgage loans through First NLC Financial Service, LLC (First NLC), one of our taxable REIT subsidiaries. Because of the continued deterioration of the non-prime mortgage market, on January 18, 2008, First NLC filed a voluntary petition for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code in order to effectuate an orderly liquidation of its assets. The filing was made in the United States Bankruptcy Court for the Southern District of Florida, West Palm Beach Division.

As of December 31, 2007, we beneficially owned approximately 52% of the outstanding shares of common stock of FBR Capital Markets Corporation (FBR Capital Markets), one of our taxable REIT subsidiaries, which is a publicly traded holding company (NASDAQ: FBCM) for our capital markets (investment banking, institutional brokerage), asset management and merchant banking businesses. We formed FBR Capital Markets in June 2006. On July 20, 2006, FBR Capital Markets completed a private offering of common stock to institutional investors and a concurrent private placement to two affiliates of Crestview Partners (Crestview), a New York-based private equity firm. These transactions, which we collectively refer to as the 2006 private offering, resulted in the sale of 18,000,000 shares of FBR Capital Markets common stock. In connection with the 2006 private offering, we contributed to FBR Capital Markets our investment banking, institutional brokerage and research and asset management businesses, including the subsidiaries Friedman, Billings, Ramsey & Co., Inc. (FBR & Co.), Friedman, Billings, Ramsey International, Ltd. (FBRIL), FBR Investment Management, Inc. (FBRIM) and FBR Fund Advisors, Inc. (FBR Fund Advisors). In June 2007, FBR Capital Markets completed an initial public offering of common stock in which selling shareholders, including us, sold an aggregate of 12,960,950 shares of FBR Capital Markets Common Stock.

At December 31, 2007, we had \$372 million of net operating loss carry-forwards and \$268 million of capital loss carry-forwards at the parent company REIT. The capital loss carry-forwards will expire in 2011 and the net operating loss carry-forward will expire in 2027 (see Note 9 to our consolidated financial statements).

Our investment banking, institutional brokerage and research, and asset management businesses are conducted through taxable REIT subsidiaries and pay income tax on their earnings at statutory corporate income

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tax rates. Our mortgage-related investment and other investment businesses are conducted at the parent REIT level, generating and distributing their earnings as dividends to shareholders before taxes. This structure provides shareholders a security that can pay a dividend at the parent REIT level and, at the taxable REIT subsidiary level, offers the possibility for growth through the ability to retain and reinvest after-tax earnings. On December 21, 2007, we announced that our Board of Directors had decided not to pay a cash dividend to our shareholders for the fourth quarter of 2007, concluding at that time that the repurchase of our Class A common stock represented a better use of our financial resources than the payment of cash dividends. Pursuant to our variable dividend policy, our Board of Directors, in its sole discretion, may reinstate the payment of cash dividends when appropriate in the future.

We are a Virginia corporation and our principal executive offices are located at Potomac Tower, 1001 Nineteenth Street North, Arlington, Virginia, 22209.

## **Recent Developments**

Because of the continued deterioration of the non-prime mortgage market, on January 18, 2008, First NLC, our non-conforming residential mortgage loan origination subsidiary, filed a voluntary petition for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code in order to effectuate an orderly liquidation of First NLC's assets. The filing was made in the United States Bankruptcy Court for the Southern District of Florida, West Palm Beach Division. In connection with the liquidation, we also announced that we would not close the previously disclosed recapitalization of First NLC. We do not expect to recover our remaining \$12 million investment in First NLC.

## **Available Information**

You may read and copy the definitive proxy materials and any other reports, statements or other information that we file with the United States Securities and Exchange Commission (SEC or Commission) at the SEC's public reference room at 100 F Street, N.E., Washington, DC 20549. You may call the SEC at 1-800-SEC-0330 for further information on the public reference room. Our SEC filings are also available to the public from commercial document retrieval services and at the Internet worldwide web site maintained by the SEC at <http://www.sec.gov>. These SEC filings may also be inspected at the offices of the New York Stock Exchange (NYSE), which is located at 20 Broad Street, New York, New York 10005.

Our Internet web site address is <http://www.fbr.com>. We make available free of charge through our website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act, as well as the annual report to shareholders and Section 16 reports on Forms 3, 4 and 5 as soon as reasonably practicable after such documents are electronically filed with, or furnished to, the SEC. In addition, our Articles of Incorporation, Bylaws, Statement of Business Principles (our code of ethics), Corporate Governance Guidelines, and the charters of our Audit, Compensation, Nominating and Governance and Risk Policy and Compliance Committees are available on our Internet web site and are available in print, without charge, to any shareholder upon written request in writing c/o our Secretary at 1001 Nineteenth Street North, Arlington, Virginia 22209. Information on our web site should not be deemed to be a part of this report or incorporated into any other filings we make with the SEC.

## **Employees**

As of December 31, 2007, we had 1,025 employees, of which 243 were employed at our First NLC subsidiary. Our employees are not subject to any collective bargaining agreement and we believe that we have excellent relations with our employees.

## **Financial Information by Segment**

We have historically operated in four business segments: principal investing, capital markets (which includes investment banking and institutional brokerage (sales and trading and research) operations, asset

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management and non-conforming residential mortgage loan origination. In connection with the voluntary petition for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code filed by First NLC on January 18, 2008, we will deconsolidate First NLC for financial reporting purposes and use the cost method to account for our investment in First NLC beginning in the first quarter of 2008.

Financial information concerning our company as of December 31, 2007 and 2006 and for the fiscal years ended December 31, 2007, 2006 and 2005, including the amount of net revenues contributed by each segment in such periods, is set forth in our consolidated financial statements and the notes thereto for in Part II, Item 8, of this report on Form 10-K. Information with respect to our operations by business segment is set forth in under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations—Executive Overview" in Part II, Item 7, of this report on Form 10-K and in Note 18 to our consolidated financial statements in Part II, Item 8, of this report on Form 10-K.

### **Principal Investing Business**

As of December 31, 2007, the majority of our principal investing activity consists of investing in agency-backed MBS and other mortgage assets, including CMOs, on a leveraged basis. We also invest in merchant banking opportunities, including investments in equity securities, mezzanine debt and senior loans. Some of our principal investments are in non-real estate related assets, subject to maintaining our qualification as a REIT. In 2005, we began to implement a broader strategy to expand the types of mortgage investments held in our REIT portfolio, including non-conforming residential mortgage loans, but in 2007 we returned to a mortgage investing strategy focused on agency-backed MBS ( *i.e.*, mortgages that meet the conforming loan underwriting standards of Fannie Mae, Freddie Mac and Ginnie Mae). See "—Mortgage Investing" below.

We constantly evaluate the rates of return that can be achieved in each investment category and for each individual investment in which we participate. We continue to believe that the mortgage sector offers attractive risk-adjusted returns. We continuously evaluate investment opportunities against the returns available in each of our investment alternatives and attempt to allocate our assets and capital with an emphasis toward what we believe to be the highest risk-adjusted return available, consistent with retaining our REIT status. This strategy will cause us to have different allocations of capital in different environments.

### ***Mortgage Investing***

#### *Our MBS Portfolio*

In the fourth quarter of 2007, we deployed cash into our core business of investing in agency-backed MBS, including agency CMOs. Our investments in MBS, including agency CMOs, averaged \$1.1 billion with a one-month CPR of 3.9, and an ending net premium of \$1.0 million as of December 31, 2007. The net yield on our MBS for the fourth quarter of 2007 was 5.83% with a corresponding cost of funds of 4.88%. With current spreads exceeding 175 basis points on a substantially hedged basis for certain segments of the agency-backed MBS market, we intend to continue to deploy cash and redeploy additional liquidity created from the disposition of any remaining non-agency assets into the core business.

We invest directly in residential MBS guaranteed as to principal and interest by Fannie Mae, Freddie Mac or Ginnie Mae (referred to as agency-backed MBS). The market value of these securities however is not guaranteed by these companies. These pools of mortgage loans, together with our other real estate-related assets, represent qualifying REIT assets under the federal tax code.

MBS differ from other forms of traditional fixed-income securities which normally provide for periodic payments of interest in fixed amounts with principal payments at maturity. Instead, MBS provide for a monthly

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payment that consists of both interest and principal. In effect, these payments are a “pass-through” of the monthly interest and principal payments made by borrowers on their mortgage loans, net of any fees paid to the servicer or guarantor of the MBS securities. In addition, outstanding principal on the MBS may be prepaid at any time due to prepayments on the underlying mortgage loans. These differences can result in significantly greater price and yield volatility than is the case with more traditional fixed-income securities. Whole mortgage loans and other mortgage assets share many of the characteristics of MBS.

Mortgage prepayments are affected by factors including the level of interest rates, general economic conditions, the location and age of the mortgage, and other social and demographic conditions. Generally, prepayments on MBS and other mortgage assets increase during periods of falling mortgage interest rates and decrease during periods of rising mortgage interest rates. Reinvestment of prepayments may occur at higher or lower interest rates than the original investment, thus affecting the yield on our portfolio.

We manage our portfolio of mortgage investments to provide a high risk-adjusted return on capital. Our principal investment strategy is to invest predominantly in adjustable-rate, agency-backed MBS of varying initial fixed periods and to finance these investments with short-term borrowings (generally 30 to 90 days). From time to time, we may invest in fixed-rate, agency-backed MBS financed with short-term borrowings. Although the coupon on adjustable-rate MBS will change over time, there are aspects of the security that result in the coupon being fixed for a period of time or the change in the coupon being limited. A significant portion of the adjustable-rate MBS we will purchase will be backed by mortgages that have fixed coupons for three to five years before adjusting annually thereafter (these types of securities are referred to as hybrid adjustable rate MBS). The initial fixed period results in the MBS having a longer duration than the short-term borrowings financing these investments. In addition, adjustable-rate mortgage loans typically have caps and floors that limit the maximum amount by which the mortgage coupon may be increased or decreased at periodic intervals or over the life of the security. To the extent that interest rates rise faster than mortgage rates are allowed to increase based on the interest rate caps, the change in the mortgage coupon may not fully offset increases in our funding costs. Because of the interest rate risk inherent in our investment strategy, we generally limit the leverage (debt-to-equity ratio) of our agency-backed MBS portfolio to not greater than 12:1, although, from time to time leverage may increase or decrease due to changes in the value of the underlying portfolio investments and the timing and amount of re-investments. As of December 31, 2007, the leverage ratio of our agency-backed MBS portfolio was .

The following table summarizes, as of December 31, 2007, our portfolio of MBS (including principal receivable) by issuer (dollars in thousands).

	Face Amount	Fair Value
Agency-backed:		
Fannie Mae	\$ 101	\$ 101
Freddie Mac	1,492,064	1,493,615
Total	1,492,165	1,493,716
Private-label <sup>(1)</sup>	300,297	297,764
Total	\$ 1,792,462	\$ 1,791,480

(1) As of December 31, 2007, approximately 96% of the private-label MBS held in our portfolio were rated “AAA” by Standard & Poor’s.

Our agency-backed MBS portfolio consists of pass-through certificates backed by pools of mortgage loans guaranteed as to principal and interest by Fannie Mae, Freddie Mac and Ginnie Mae. For a detailed discussion regarding the interest rate sensitivity of our MBS portfolio and how we manage interest rate risk, see “—Our Hedging & Interest Rate Risk Management” below.

- *Fannie Mae MBS*: Federal National Mortgage Association, better known as “Fannie Mae,” is a privately owned, federally chartered corporation organized and existing under the Federal National

Mortgage Association Charter Act. Fannie Mae provides funds to the mortgage market primarily by purchasing home mortgage loans from local lenders, thereby replenishing their funds for additional lending. Fannie Mae guarantees to registered holders of Fannie Mae certificates that it will distribute amounts representing scheduled principal and interest (at the rate provided by the Fannie Mae certificate) on the mortgage loans in the pool underlying the Fannie Mae certificate, whether or not received, and the full principal amount of any mortgage loan foreclosed or otherwise finally liquidated, whether or not the principal amount is actually received by Fannie Mae. The obligations of Fannie Mae under its guarantees are solely those of Fannie Mae and are not backed by the full faith and credit of the United States. If Fannie Mae were unable to satisfy its obligations, the distributions made to us would consist solely of payments and other recoveries on the underlying mortgage loans, and accordingly, monthly distributions to us would be adversely affected by delinquent payments and defaults on the mortgage loans. The securities issued by Fannie Mae have an implied “AAA” rating.

- *Freddie Mac MBS*: Federal Home Loan Mortgage Corporation, better known as “Freddie Mac,” is a privately owned government-sponsored enterprise created pursuant to Title III of the Emergency Home Finance Act of 1970. Freddie Mac’s principal activities currently consist of the purchase of mortgage loans or participation interests in mortgage loans and the resale of the loans and participations in the form of guaranteed MBS. Freddie Mac guarantees to holders of Freddie Mac certificates the timely payment of interest at the applicable pass-through rate and ultimate collection of all principal on the holder’s pro rata share of the unpaid principal balance of the underlying mortgage loans, but does not guarantee the timely payment of scheduled principal on the underlying mortgage loans. The obligations of Freddie Mac under its guarantees are solely those of Freddie Mac and are not backed by the full faith and credit of the United States. If Freddie Mac were unable to satisfy its obligations, the distributions made to us would consist solely of payments and other recoveries on the underlying mortgage loans, and accordingly, monthly distributions to us would be adversely affected by delinquent payments and defaults on those mortgage loans. The securities issued by Freddie Mac have an implied “AAA” rating.
- *Ginnie Mae MBS*: Government National Mortgage Association, better known as “Ginnie Mae,” is a wholly owned corporate instrumentality of the United States within the Department of Housing and Urban Development. Title III of the National Housing Act of 1934 (the Housing Act) authorizes Ginnie Mae to guarantee the timely payment of principal and interest on certificates that represent an interest in a pool of mortgages insured by the Federal Housing Administration under the Housing Act or partially guaranteed by the Veteran’s Administration under the Servicemen’s Readjustment Act of 1944 and other loans eligible for inclusion in mortgage pools underlying Ginnie Mae certificates. Section 306(g) of the Housing Act provides that “the full faith and credit of the United States is pledged to the payment of all amounts that may be required to be paid under any guaranty under this subsection.” An opinion, dated December 12, 1969, of an Assistant Attorney General of the United States provides that under section 306(g) of the Housing Act, Ginnie Mae certificates of the type that we may purchase are authorized to be made by Ginnie Mae and “would constitute general obligations of the United States backed by its full faith and credit.”

We also invest in agency-backed collateralized mortgage obligations, or CMOs, which are debt obligations issued by special purpose entities that are secured by mortgage loans or mortgage-backed certificates issued by government and government-related guarantors, including, Ginnie Mae, Fannie Mae and Freddie Mae, together with certain funds and other collateral. Payments of principal and interest on underlying collateral provide the funds to pay debt service on the CMO.

In a CMO, a series of bonds or certificates is issued in multiple classes. Each class of CMOs, often referred to as a “tranche,” is issued at a specific coupon rate (which, as discussed below, may be an adjustable rate subject to a cap) and has a stated maturity or final distribution date. Principal prepayments on collateral underlying a CMO may cause it to be retired substantially earlier than the stated maturity or final distribution date. Interest is paid or accrues on all classes of a CMO on a monthly, quarterly or semi-annual basis. The principal and interest on underlying mortgages may be allocated among the several classes of a series of a CMO in many ways. In a

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common structure, payments of principal, including any principal prepayments, on the underlying mortgages are applied to the classes of the series of a CMO in the order of their respective stated maturities or final distribution dates, so that no payment of principal will be made on any class of a CMO until all other classes having an earlier stated maturity or final distribution date have been paid in full.

We acquire agency CMO floaters. One or more tranches of a CMO may have coupon rates that reset periodically at a specified increment over an index such as LIBOR. These adjustable-rate tranches are sometimes known as CMO floaters and may be collateralized by fixed or adjustable-rate mortgages.

There are two main categories of indices for floaters: (1) those based on U.S. Treasury securities, and (2) those derived from calculated measures such as a cost of funds index or a moving average of mortgage rates. Commonly utilized indices include the one-year Treasury note rate, the three-month Treasury bill rate, the six-month Treasury bill rate, rates on long-term Treasury securities, the 11th District Federal Home Loan Bank Costs of Funds Index, the National Median Cost of Funds Index, one-month or three-month LIBOR, the prime rate of a specific bank, or commercial paper rates. Some indices, such as the one-year Treasury rate, closely mirror changes in market interest rate levels. Others, such as the 11th District Home Loan Bank Cost of Funds Index, tend to lag changes in market interest rate levels. We seek to diversify our investments in floaters among a variety of indices and reset periods so that we are not at any one time unduly exposed to the risk of interest rate fluctuations. In selecting floaters for investment, we will also consider the liquidity of the market for the different mortgage-backed securities

As of December 31, 2007, we held approximately \$300.3 million (face amount) of private-label MBS having an estimated fair value of approximately \$297.8 million. Private-label MBS are MBS that are not issued by a U.S. Government agency or a U.S. Government-sponsored entity, such as Fannie Mae, Freddie Mac or Ginnie Mae and that are backed by a pool of single-family residential mortgage loans. These certificates are issued by originators of, investors in, and other owners of residential mortgage loans, including savings and loan associations, savings banks, commercial banks, mortgage banks, investment banks and special purpose “conduit” subsidiaries of these institutions. While agency-backed MBS are backed by the express obligation or guarantee of Fannie Mae, Freddie Mac, or Ginnie Mae as described above, private-label MBS are generally covered by one or more forms of private ( *i.e.*, non-governmental) credit enhancement. These credit enhancements provide an extra layer of loss coverage in the event that losses are incurred upon foreclosure sales or other liquidations of underlying mortgaged properties in amounts that exceed the equity holder’s equity interest in the property. Forms of credit enhancement include limited issuer guarantees, reserve funds, private mortgage guaranty pool insurance, over-collateralization and subordination. Subordination is a form of credit enhancement frequently used and involves the issuance of classes of senior and subordinated MBS to allocate losses on the underlying mortgage loans. Typically, one or more classes of senior MBS are created which are rated in one of the two highest rating levels by one or more nationally recognized rating agencies and which are supported by one or more subordinated MBS that bear losses on the underlying mortgage loans prior to the classes of senior MBS. As of December 31, 2007, approximately 96% of the private-label MBS held in our portfolio were rated “AAA” by Standard & Poor’s.

### *Our Use of Leverage*

We may reduce the amount of equity capital we have invested in agency-backed MBS or other mortgage assets, including agency CMOs, by funding a portion of those investments with repurchase agreements, commercial paper, to the extent commercial paper is available on favorable terms or at all, or other borrowing arrangements. To the extent that revenue derived from those assets exceeds our interest expense and other costs of the financing, our net income will be greater than if we had not borrowed funds and had not invested in the assets. Conversely, if the revenue from our MBS and other mortgage assets does not sufficiently cover the interest expense and other costs of the financing, our net income will be less or our net loss will be greater than if we had not borrowed funds. Current conditions in the credit markets may make it impracticable for us to obtain short-term commercial paper financing for our agency-backed MBS portfolio, including agency CMOs.

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We borrow funds to invest in residential mortgage assets by entering into repurchase agreements or, in the case of MBS, issuing commercial paper. Under repurchase agreements, assets are sold to a third party with the commitment to repurchase the same assets at a fixed price on an agreed future date. The repurchase price reflects the purchase price plus an agreed upon market rate of interest. These repurchase agreements are accounted for as debt, secured by the underlying assets. In August 2003, we formed Georgetown Funding, LLC (Georgetown Funding), which is a special purpose Delaware limited liability company organized for the purpose of issuing extendable commercial paper notes in the asset-backed commercial paper market and entering into reverse repurchase agreements with us and our affiliates. We serve as administrator for Georgetown Funding's commercial paper program and all of Georgetown Funding's transactions are conducted with FBR. Through our administration agreement and repurchase agreements, we are the primary beneficiary of Georgetown Funding and consolidate this entity for financial reporting purposes. The commercial paper notes issued by Georgetown Funding are collateralized by the MBS we own and are rated A1+/P1 by Standard & Poor's and Moody's Investors Service, respectively. Through our master repurchase agreement with Georgetown Funding, we have capacity to finance up to \$12 billion of MBS; however, current conditions in the credit markets may make it impracticable for us to obtain short-term commercial paper financing for our agency-backed MBS portfolio including agency CMOs.

### *Our Hedging and Interest Rate Risk Management*

To the extent consistent with our election to qualify as a REIT, we follow an interest rate risk management program intended to protect our portfolio of agency-backed MBS and mortgage-related investments against the effects of major interest rate changes. Generally, our interest rate risk management program is formulated with the intent to ameliorate the potential adverse effects resulting from differences in the amount and timing of rate adjustment to our assets versus those affecting our corresponding liability. Our agency-backed MBS hedging strategy includes an element of reliance on coupon repricing of assets in addition to hedging our liability cost.

Additionally, our interest rate risk management program may encompass from time to time a number of procedures, including the following:

- structuring some borrowings to have interest rate adjustment indices and interest rate adjustment periods that, on an aggregate basis, generally correspond to the interest rate adjustment indices and interest rate adjustment periods of our adjustable-rate agency-backed MBS and other mortgage assets; and
- structuring some borrowing agreements relating to adjustable-rate agency-backed MBS and other mortgage assets to have a range of different maturities and interest rate adjustment periods (although substantially all will be less than one year).

We adjust the average maturity adjustment periods of our borrowings on an ongoing basis by changing the mix of maturities and interest rate adjustment periods as borrowings come due and are renewed. Through use of these procedures, we attempt to minimize the differences between the interest rate adjustment periods of our agency-backed MBS and other mortgage assets and related borrowings that may occur.

We purchase from time-to-time interest rate swaps, interest rate collars, interest rate caps or floors, and similar financial instruments to attempt to mitigate the risk of the cost of our variable rate liabilities increasing at a faster rate than the yield on our assets during a period of rising interest rates or to mitigate prepayment risk. It is not our policy to use derivatives to speculate on interest rates. These derivative instruments have an active secondary market and are intended to provide income and cash flow to offset potential reduced interest income and cash flow under certain interest rate environments. Certain of our interest rate management activities qualify for hedge accounting in accordance with Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended and interpreted (SFAS 133). We report the derivative financial instruments and any related margin accounts on our consolidated balance sheets at their fair value. We may hedge as much of the interest rate risk as our management determines is in our best interests,

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given the cost of the hedging transactions and the need to maintain our status as a REIT. This determination may result in our electing to bear a level of interest rate or prepayment risk that could otherwise be hedged when management believes, based on all relevant facts, that the cost of hedging exceeds the level of risk that management believes is present.

We seek to build a balance sheet and undertake an interest rate risk management program which is likely to generate positive earnings and maintain an equity liquidation value sufficient to maintain operations given a variety of potential environments. Our interest rate risk management strategies also provide support for our leverage strategies. In determining our target leverage, we monitor, among other things, our “duration.” This is the expected percentage change in market value of our assets that would be caused by a 1% change in short and long-term interest rates. To monitor duration and the related risks of fluctuations in the liquidation value of our equity, we model the impact of various economic scenarios on the market value of our agency-backed MBS and other mortgage assets and liabilities. See additional discussion of interest rate risk relative to our leveraged portfolio of agency-backed MBS and other mortgage assets included in Item 7A, “Quantitative and Qualitative Disclosures about Market Risk.” We believe that our interest rate risk management program will allow us to maintain operations throughout a wide variety of potentially adverse circumstances. Nevertheless, in order to further preserve our capital base during periods when we believe a trend of rapidly rising interest rates has been established, we may decide to enter into or increase hedging activities or to sell assets. Each of these actions may lower our earnings and dividends in the short term to further our objective of maintaining attractive levels of earnings and dividends over the long term.

We may elect to conduct a portion of our hedging operations through one or more subsidiary corporations, each of which we would elect to treat as a “taxable REIT subsidiary.” To comply with the asset tests applicable to us as a REIT, we could own 100% of the voting stock of such subsidiary, provided that the value of the stock that we own in all such taxable REIT subsidiaries does not exceed 20% of the value of our total assets at the close of any calendar quarter. A taxable subsidiary would not elect REIT status and may or may not distribute any net profit after taxes to us and its other stockholders. Any dividend income we receive from the taxable subsidiaries (combined with all other income generated from our assets, other than qualified REIT real estate assets) must not exceed 25% of our gross income.

We believe that we maintain a cost-effective asset/liability management program to provide a level of protection against interest rate and prepayment risks. However, no strategy can completely insulate us from interest rate changes and prepayment risks. Further, as noted above, the federal income tax requirements that we must satisfy to qualify as a REIT limit our ability to hedge our interest rate and prepayment risks. We monitor carefully, and may have to limit, our asset/liability management program to assure that we do not realize excessive hedging income, or hold hedging assets having excess value in relation to total assets, which could result in our disqualification as a REIT, the payment of a penalty tax for failure to satisfy certain REIT tests under the Internal Revenue Code, provided the failure was for reasonable cause. In addition, asset/liability management involves transaction costs which increase dramatically as the period covered by the hedging protection increases. Therefore, we may be unable to hedge effectively our interest rate and prepayment risks. See “Item 7—Management’s Discussion and Analysis of Financial Condition and Results of Operations—Critical Accounting Policies—Hedging Activities” below.

### *Prepayment Risk Management*

We seek to minimize the effects of faster or slower than anticipated prepayment rates through structuring a diversified portfolio with a variety of prepayment characteristics, investing in fixed-rate agency-backed MBS and other mortgage assets, investing in certain mortgage structures which have prepayment protections and balancing assets purchased at a premium with assets purchased at a discount. We monitor prepayment risk through periodic review of the impact of a variety of prepayment scenarios on our revenues, net earnings, dividends, cash flow and net balance sheet market value.

### ***Merchant Banking***

Our merchant banking investment strategy has been to invest in companies that compete in industries where we have investment expertise and a contextual understanding of industry dynamics. We rely on the investment banking group of Friedman, Billings, Ramsey & Co., Inc. (FBR & Co.), which is the principal operating subsidiary of FBR Capital Markets, to provide us with potential investment opportunities. Our merchant banking investment decisions are primarily based on a fundamental value-oriented approach. Almost all of our investments are in companies that are also investment banking clients of our affiliate. We are long-term investors but do not seek to control the companies in which we invest. In most cases, we intend to hold our merchant banking investments for greater than six months. Because of our broker-dealer affiliation, many of our investments in companies that are our investment banking clients are subject to lock-up restrictions which limit our ability to sell securities for a period of time.

Subject to maintaining our qualification as a REIT, we invest from time to time in equity securities that may or may not be related to the real estate business. We follow a fundamental value-oriented investment approach and focus on the intrinsic value of the underlying business. We also consider factors such as: strength of management; liquidity of the investment; and prices of similar or comparable securities and/or companies.

Upon completion of FBR Capital Markets' private offering in July 2006, FBR Capital Markets began evaluating merchant banking investments along with us in potential or existing investment banking clients. FBR Capital Markets and our company allocate each merchant banking investment opportunity 50% to FBR Capital Markets and 50% to our company, subject to the approval of each of our investment committees. In addition, allocations are subject, in our case, to the maintenance of our REIT qualification, and, in the case of both FBR Capital Markets and our company, the maintenance of our respective exemptions from the registration requirements of the Investment Company Act of 1940, as amended. Subject to maintaining its exemption from the registration requirements of the Investment Company Act of 1940, FBR Capital Markets expects in the near term to invest a material portion of its excess liquid capital in residential mortgage-backed securities through a mortgage investing strategy similar to our mortgage investing strategy.

As of December 31, 2007, we had invested in equity securities of various publicly-traded and privately-held companies having an estimated fair value of \$113.8 million. See, "Item 7—Management's Discussion and Analysis of Financial Condition and Results of Operations—Principal Investing—Merchant Banking" below.

Although our merchant banking investments have focused primarily on equities, we evaluate and from time to time and may invest in short to medium-term mezzanine and senior loans that may have a higher risk credit profile and yield higher returns than the typical senior loan made by a commercial bank or other traditional lending institution. In addition to the above considerations for an equity investment, we also consider the structural characteristics of mezzanine or senior loan investments. These loans may or may not be secured; may or may not be subordinated; have a variety of repayment structures and sources; and typically compensate for the higher risk profile through higher interest rates rather than equity features.

We evaluate our merchant banking portfolio to recognize as "other than temporary impairments" the amounts by which the fair value of certain of our merchant banking investments were below their respective cost bases. In 2007, we recognized a \$32.4 million non-cash write-down of equity positions, the majority of which involve companies doing business in the sub-prime mortgage sector.

### **Capital Markets Business**

Our capital markets business is conducted by our investment banking and institutional brokerage (sales and trading and research) professionals through FBR & Co. and FBRIL, our broker-dealer subsidiaries. These professionals provide investment banking services, including capital raising and financial advisory services, and institutional brokerage services including sales and trading and research services, to our institutional clients across our core industry sectors. We believe the capital markets transactions sourced by our investment banking

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professionals create the types of investment opportunities that our institutional brokerage clients seek, while our institutional brokerage clients provide demand for our investment banking clients' securities issues, thus helping to provide these corporate issuers with the ability to meet their corporate financing needs.

Our investment banking professionals, backed by their industry knowledge and our strong distribution platform, seek to establish and maintain relationships with our corporate clients and to provide them with capital raising and financial advisory services. We provide capital raising services in industry specific investment banking teams that operate across the following core industry sectors: consumer, diversified industrials, energy and natural resources, financial institutions, healthcare, insurance, real estate and technology, media, and telecommunications (TMT), and these teams work closely with our M&A investment banking group in connection with the delivery of financial advisory services. We also have a financial sponsors investment banking group that works closely with our industry-focused investment banking teams to deliver a full array of investment banking products and solutions to the private equity community and their portfolio companies. During 2007, we continued to strengthen our business by adding coverage of new industry sectors in institutional brokerage and enhancing our products and services in investment banking.

As an investment bank with a merchant banking capability, we are involved with companies early in their formation in order to establish relationships that will provide us with ongoing revenues as these companies' corporate finance and financial advisory needs grow. We seek to provide our corporate clients with the financing and advisory services that they will need at all stages of their corporate lifecycle.

We have developed a strong market presence, primarily in a lead-managing role, as a leading underwriter of equity securities in the United States. We maintain dominant market share in private institutional equity offerings pursuant to Rule 144A under the Securities Act, which we believe is a function of our institutional distribution capability and our experienced, client-focused investment bankers. During 2007, we were the lead or sole book-running manager of 25 equity offerings and co-managed 23 other equity offerings, raising proceeds of approximately \$11.6 billion.

We base our decision to underwrite an offering of a client's securities on company and industry fundamentals, management's track record, historical financial results, financial projections and other factors, all backed by extensive due diligence. We offer a wide range of financial products designed to serve the needs of our investment banking clients, including private institutional equity offerings pursuant to Rule 144A under the Securities Act, initial public offerings, follow-on and secondary equity offerings, equity-linked offerings, public and private preferred equity, and convertible debt and debt offerings.

In the first quarter of 2007, we significantly expanded our M&A advisory capability, adding a 26-person banking team with substantial experience serving middle market companies in consumer products, energy, healthcare, business services and diversified industrials. This acquisition offers our investment banking clients a more complete array of banking services, enhances our resources and advisory expertise and strengthens our middle market investment banking presence. Our financial advisory practice builds on our capital markets expertise and focuses on helping our investment banking clients to assess strategic alternatives, including advice on M&A, mutual conversions, financial restructuring, and strategic partnering transactions. In addition, we provide valuation advice, fairness opinions, market comparable valuation analysis and other corporate finance advice, including advice with respect to dividend policies and evaluations of stock repurchase programs. In 2007, we advised on 40 strategic advisory transactions representing \$4.4 billion in aggregate transaction value.

Through our institutional brokerage professionals, we provide research and institutional sales and trading services to equity and high-yield investors in North America, Europe, Australia and elsewhere. We execute securities transactions for institutional investors such as mutual funds, insurance companies, hedge funds, banks, money managers and pension and profit-sharing plans.

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We believe our institutional brokerage professionals are distinguished by their in-depth understanding of the companies and industries in which we focus. Our traders and salespeople are required to develop detailed knowledge and relationships and provide trade execution and sales and trading services to a diverse institutional client base of more than 700 institutional investor accounts as of December 31, 2007. Many of our institutional clients have been long-standing investors in transactions that our investment banking teams have brought to the capital markets and have continued a close relationship with us as they have grown in size and assets under management.

Our sales professionals work closely with our research analysts and our trading desk to provide the most up-to-date information to our institutional clients. Our sales, trading and research professionals work together to maintain regular contact with the specialized portfolio managers and buy-side analysts of each institutional client. Our trading professionals facilitate trading in equity and high-yield securities. We make markets in Nasdaq and other securities, we trade listed securities, and we service the trading desks of major institutions in the United States, Europe and elsewhere.

We understand the importance of research and the role quality research plays in the institutional brokerage process, particularly for accounts that do not maintain a large in-house research team. As of December 31, 2007, our research analysts performed independent research on over 500 companies to help our clients understand the dynamics that drive the sectors and companies they cover. We seek to differentiate ourselves through originality of perspective, depth of insight and our ability to uncover industry trends. We believe our unique viewpoint has helped us develop relationships with investor clients in both our primary distribution and secondary trading businesses.

Our research analysts operate under three guiding principles: (i) to provide objective, independent analysis of securities, their issuers, and their place in the capital markets; (ii) to identify undervalued investment opportunities in the capital markets, and (iii) to communicate effectively the fundamentals of these investment opportunities to potential investors. To achieve these objectives, we believe that industry specialization is necessary and, as a result, we organize our research staff along industry lines. Each industry team works together to identify and evaluate industry trends and developments. Within industry groups, analysts are further subdivided into specific areas of focus so that they can maintain and apply specific industry knowledge to each investment opportunity they address.

After initiating coverage on a company, our analysts seek to maintain a long-term relationship with that company and a long-term commitment to ensure that new developments are effectively communicated to our sales force and institutional investors. Our research team analyzes major trends, publishes original research on new areas of growth, provides fundamental, company-specific coverage and works with our institutional clients to identify and evaluate public equity investment opportunities.

### **Asset Management Business**

FBRIM and FBR Fund Advisers, our SEC registered investment advisers, offer our clients three main services: mutual funds, alternative asset management and private wealth advisory. We are focused on expanding our asset management business and strive, where appropriate, to utilize our intellectual capital, relationships and other resources, to achieve this goal. As of December 31, 2007, we had \$2.5 billion in assets under management.

At December 31, 2007, we managed client assets in excess of \$2.0 billion through our core equity and specialty mutual fund product lines. Our core equity funds, the FBR Pegasus Fund™, FBR Pegasus Mid Cap Fund™ and the FBR Pegasus Small Cap Fund™, provide investors with access to institutional quality exposure to the large, mid-and small-cap segments of the capital markets respectively. Our specialty funds, the FBR Large Cap Financial, FBR Small Cap Financial, FBR Large Cap Technology, FBR Small Cap Technology, FBR Gas Utility Index, and the FBR Focus Fund, allow investors to add targeted exposure to growth opportunities in specific industry sectors. We also manage a money-market fund, the FBR Funds for Government Investors.

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Regardless of market capitalization and industry sector, through strict attention to relative valuation and careful security selection, all of our actively managed mutual funds strive to participate in rising markets and more importantly, preserve capital in down markets.

Through FBRIM, our alternative asset management group currently manages hedge funds, including funds of funds, as well as private equity and venture capital funds. We seek to expand our presence in this area by using our industry knowledge to identify alternative asset strategies and managers, within our company and externally. We also intend to invest our own capital in certain of these strategies. By doing so, we believe we can grow our alternative asset management business. FBRIM has dedicated sales, compliance, investor relations and accounting personnel for its alternative asset management platform in addition to the supervisory and risk management personnel provided by us.

We provide comprehensive private wealth management services to high net worth individuals, families and foundations through FBRIM's Private Wealth group. Our professionals have accounting, legal, compliance, private banking and institutional investment management experience which we use to provide investors with customized financial solutions and access to select third party investment strategies. Brokerage products and services are provided to Private Wealth group clients through FBR & Co. and FBRIL.

The professionals in the Private Wealth group respond with specialized skills to the specific wealth management needs of each client. Addressing liquidity and financial planning issues for holders of substantial ownership interests in privately-held and public companies is an important area of specialization. Private wealth client services include: strategic, risk-managed asset allocation and implementation; access to select third party investment expertise and strategies; portfolio liquidity and income management; restricted and 144A stock sales; concentrated equity and option monetization; wealth transfer oversight; global investment performance and wealth accumulation reporting.

### **Accounting, Administration and Operations**

Our accounting, administration and operations personnel are responsible for financial controls, internal and external financial reporting, human resources and personnel services, office operations, information technology and telecommunications systems, the processing of securities transactions, and corporate communications. With the exception of payroll processing, which is performed by an outside service bureau, and customer account processing, which is performed by our clearing brokers, most data processing functions are performed internally. We believe that future growth will require implementation of new and enhanced communications and information systems and training of our personnel to operate such systems.

### **Compliance, Legal, Risk Management and Internal Audit**

Our compliance, legal and risk management personnel (together with other appropriate personnel) are responsible for our compliance procedures with regard to the legal and regulatory requirements of our holding company and our operating businesses and for our procedures with regard to our exposure to market, credit, operations, liquidity, compliance, legal, reputational and equity ownership risk. In addition, our internal audit and compliance personnel test and audit for compliance by our personnel with our policies and procedures. Our legal personnel also provide legal service throughout our company, including advice on managing legal risk. The supervisory personnel in these areas have direct access to, and meet regularly with, our executive management and with the Audit Committee and the Risk Policy and Compliance Committee of our Board of Directors to ensure their independence in performing these functions. Pursuant to its charter, the Audit Committee has oversight of the staffing, qualifications and performance of our internal audit function. In addition to our internal compliance, legal, risk management and internal audit personnel, we outsource particular functions to outside consultants and attorneys for their particular expertise.

## Competition

As a full-service investment banking, institutional brokerage and asset management firm, all aspects of our business are intensely competitive. Our competitors are other brokerage firms, investment banking firms, merchant banks and financial advisory firms. We compete with some of our competitors nationally and with others on a regional, product or business line basis. Many of our competitors have substantially greater capital and resources than we do and offer a broader range of financial products. We believe that the principal factors affecting competition in our business include client relationships, reputation, the abilities of our professionals, market focus and the relative quality and price of our services and products.

We have experienced intense price competition in some of our businesses, in particular discounts in large block trades and trading commissions and spreads. The ability to execute trades electronically, through the Internet and through other alternative trading systems, has increased the pressure on trading commissions and spreads. We believe that this trend toward alternative trading systems will continue. In addition, the trend, particularly in the equity underwriting business, toward increased focus by many larger investment banking companies on institutional equity offerings pursuant to Rule 144A, multiple book runners and co-managers has increased the competitive pressure in the investment banking industry, and may lead to lower average transaction fees. We may experience competitive pressures in these and other areas in the future as some of our competitors seek to increase market share by reducing prices.

In our asset management business, we compete with many of the same firms as we do in the investment banking and brokerage businesses as well as with venture capital firms, large mutual fund companies, commercial banks and smaller niche players including private hedge funds. We believe that our unique perspective on the industries we serve affords an opportunity to grow our assets under management and intend to invest our own capital alongside that of our fund investors.

Competition is also intense for the recruitment and retention of qualified professionals. Our ability to continue to compete effectively in our businesses will depend upon our continued ability to attract new professionals and retain and motivate our existing professionals.

In addition to competing for customers and investments, we compete with other companies in the financial services, investment and mortgage banking and brokerage industries to attract and retain experienced and productive investment professionals. See “Item 1A—Risk Factors—General Risks Related to Our Business” below.

In acquiring agency backed MBS and other mortgage assets, we compete with specialty finance companies, savings and loan associations, banks, mortgage bankers, insurance companies, mutual funds, institutional investors, investment banking firms, other lenders, governmental bodies, broker-dealers, mortgage REITs and other entities. Many of our mortgage competitors are significantly larger than us, have access to greater capital and other resources and may have other advantages over us. In addition, there are numerous mortgage REITs with asset acquisition objectives similar to ours, and other mortgage REITs with similar strategies may be organized in the future, including mortgage REITs sponsored by FBR Capital Markets or its affiliates. The effect of the existence of additional REITs may be to increase competition for the available supply of mortgage-related assets, including MBS, suitable for purchase.

For a further discussion of the competitive factors affecting our business, see “Risk Factors” in Part I, Item 1A of this report on Form 10-K.

## Risk Management

In conducting our business, we are exposed to a range of risks including, without limitation:

- *Market risk.* Market risk is the risk to our earnings or capital resulting from adverse changes in the values of assets resulting from movement in market interest rates, equity prices or foreign exchange rates, as well as market expectations concerning the underlying assets.
- *Credit risk.* Credit risk is the risk of loss due to an individual customer's or institutional counterparty's unwillingness or inability to pay its obligations.
- *Operations risk.* Operations risk is the risk of loss resulting from systems failure, inadequate controls, human error, fraud or unforeseen catastrophes.
- *Liquidity risk.* Liquidity risk is the risk that we may be unable to meet our obligations as they come due because of our inability to liquidate assets or obtain funding. Liquidity risk also includes the risk of having to sell assets at a loss to generate liquid funds.
- *Regulatory risk.* Regulatory risk is the risk of loss, including fines or penalties, from failing to comply with federal, state or local laws, rules and regulations pertaining to financial services activities, including the loss of our REIT qualification.
- *Legal risk.* Legal risk is the risk of loss, disruption or other negative effect on our operations or condition that arises from unenforceable contracts, lawsuits, adverse judgments, or adverse governmental or regulatory proceedings, or the threat thereof.
- *Reputational risk.* Reputational risk is the risk that negative publicity regarding our practices, whether true or not, will cause a decline in the customer base, resulting in costly litigation, or reduce our revenues.
- *Equity ownership risk.* Equity ownership risk arises from making equity investments that create an ownership interest in portfolio companies, and is a combination of credit, market, operational, liquidity, compliance and reputation risks.

We have a corporate-wide risk management program approved by our Board of Directors. This program sets forth various risk management policies, provides for a risk management committee and assigns risk management responsibilities. The program is designed to focus on the following:

- identifying, assessing and reporting on corporate risk exposures and trends;
- establishing and revising as necessary policies, procedures and risk limits;
- monitoring and reporting on adherence with risk policies and limits;
- developing and applying new measurement methods to the risk process as appropriate; and
- approving new product developments or business initiatives.

Although we believe that our risk management program and our internal controls are appropriately designed to address the risks to which we are exposed, we cannot provide assurance that our risk management program or our internal controls will prevent or reduce such risks.

## Regulation

### Overview

In the United States, a number of federal regulatory agencies are charged with the integrity of the securities and other financial markets and with protecting the interests of customers participating in those markets.

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We are subject to regulation by several federal agencies. The SEC is the federal agency that is primarily responsible for the regulation of broker-dealers and investment advisers doing business in the United States. The Federal Reserve Board promulgates regulations applicable to securities credit (margin) transactions involving broker-dealers and certain other institutions in the United States. Much of the regulation of broker-dealers has been delegated to self-regulatory organizations (SROs), principally the Financial Industry Regulatory Authority (FINRA), which was formed in July 2007 through the consolidation of the National Association of Securities Dealers, Inc. (NASD) and the member regulation, enforcement and arbitration functions of the NYSE, and the national securities exchanges. These organizations, which are subject to oversight by the SEC, govern the industry, monitor daily activity and conduct periodic examinations of member broker-dealers. While FBR & Co. and our other broker-dealer subsidiaries are not members of the New York Stock Exchange ("NYSE"), our business is impacted by the NYSE's rules.

Securities firms are also subject to regulation by state securities commissions in the states in which they are required to be registered. FBR & Co. is registered as a broker-dealer with the SEC and in all 50 states, Puerto Rico and the District of Columbia, and is a member of, and subject to regulation by FINRA and the Municipal Securities Rulemaking Board. FBR Investment Services, Inc., (FBRIS) is one of our SEC-registered broker-dealers and is registered in all 50 states, Puerto Rico and the District of Columbia. FBRIS is a member of FINRA.

We and our operating subsidiaries are also subject to the USA PATRIOT Act (PATRIOT Act), which requires financial institutions to adopt and implement policies and procedures designed to prevent and detect money laundering. FBR and its subsidiaries have adopted a comprehensive anti-money laundering compliance program that we believe is in compliance with the PATRIOT Act.

### ***Regulation of FBR Capital Markets' and Our Broker-Dealer Subsidiaries***

Our capital markets business, as well as the financial services industry generally, is subject to extensive regulation in the United States and elsewhere. As a matter of public policy, regulatory bodies in the United States and the rest of the world are charged with safeguarding the integrity of the securities and other financial markets and with protecting the interests of customers participating in those markets. In the United States, the SEC is the federal agency responsible for the administration of the federal securities laws. FBR Capital Markets' and our broker-dealer subsidiaries, FBR & Co. and FBRIS, are registered as broker-dealers with the SEC and FINRA and in all 50 states, Puerto Rico and the District of Columbia. Accordingly, each of FBR & Co. and FBRIS is subject to regulation and oversight by the SEC and FINRA, an SRO which is itself subject to oversight by the SEC and which adopts and enforces rules governing the conduct, and examines the activities, of its member firms, including FBR & Co. and FBRIS. State securities regulators also have regulatory or oversight authority over FBR & Co. and FBRIS. Our business may also be subject to regulation by non-U.S. governmental and regulatory bodies and self-regulatory authorities in other countries where we operate.

In general, broker-dealers are subject to regulations that cover all aspects of the securities business, including sales methods, trade practices among broker-dealers, use and safekeeping of customers' funds and securities, capital structure, record-keeping, the financing of customers' purchases and the conduct and qualifications of directors, officers and employees. In particular, as a registered broker-dealer and member of various self-regulatory organizations, FBR & Co. and FBRIS are subject to the SEC's uniform net capital rule, Rule 15c3-1. Rule 15c3-1 specifies the minimum level of net capital a broker-dealer must maintain and also requires that a significant part of its assets be kept in relatively liquid form. The SEC and various self-regulatory organizations impose rules that require notification when net capital falls below certain predefined criteria, limit the ratio of subordinated debt to equity in the regulatory capital composition of a broker-dealer and constrain the ability of a broker-dealer to expand its business under certain circumstances. Additionally, the SEC's uniform net capital rule imposes certain requirements that may have the effect of prohibiting a broker-dealer from distributing or withdrawing capital and requiring prior notice to the SEC for certain withdrawals of capital. The SEC has adopted rule amendments that establish alternative net capital requirements for broker-dealers that are part of a consolidated supervised entity. As a condition to its use of the alternative method, a broker-dealer's ultimate

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holding company and affiliates (referred to collectively as a consolidated supervised entity) must consent to group-wide supervision and examination by the SEC. If we elect to become subject to the SEC's group-wide supervision rules, we will be required to report to the SEC computations of our capital adequacy. We have not elected to become subject to the SEC's group-wide supervision rules. Compliance with regulatory net capital requirements could limit those operations that require the intensive use of capital, such as underwriting and trading activities, and also could restrict our ability to withdraw capital from our affiliated broker-dealers, which in turn could limit our ability to pay dividends, repay debt and redeem or repurchase shares of our outstanding capital stock. We believe that at all times FBR & Co. and FBRIS have been in compliance in all material respects with the applicable minimum net capital rules of the SEC and FINRA.

A failure of a U.S. broker-dealer to maintain its minimum required net capital would require it to cease executing customer transactions until it came back into compliance, and could cause it to lose its FINRA membership, its registration with the SEC or require its liquidation. Further, the decline in a broker-dealer's net capital below certain early warning levels, even though above minimum net capital requirements, could cause material adverse consequences to the broker-dealer and to us.

FBR & Co. and FBRIS are also subject to risk assessment rules imposed by the SEC which require, among other things, that certain broker-dealers maintain and preserve certain information, describe risk management policies and procedures and report on the financial condition of certain affiliates whose financial and securities activities are reasonably likely to have a material impact on the financial and operational condition of the broker-dealers. Certain material associated persons (as defined in the SEC's risk assessment rules) of the broker-dealers and the activities conducted by such material associated persons may also be subject to regulation by the SEC. In addition, the possibility exists that, on the basis of the information it obtains under the SEC's risk assessment rules, the SEC could seek authority over our unregulated subsidiaries either directly or through its existing authority over our regulated subsidiaries.

The research areas of investment banks have been and remain the subject of increased regulatory scrutiny. In 2002 and 2003, acting in part pursuant to a mandate contained in the Sarbanes-Oxley Act of 2002, the SEC, the NYSE and the NASD (now FINRA) adopted rules imposing heightened restrictions on the interaction between equity research analysts and investment banking personnel at member securities firms. In 2004, the SEC proposed amendments to Regulation M that would further affect the manner in which securities are distributed and allocated in registered public offerings, and the NYSE and the NASD (now FINRA) have proposed similar rulemaking in this area. We cannot fully predict the practical effect that such restrictions or measures will have on our business, and the SEC, the NYSE and FINRA may adopt additional and more stringent rules with respect to offering procedures and the management of conflicts of interest in the future.

The effort to combat money laundering and terrorist financing is a priority in governmental policy with respect to financial institutions. The USA PATRIOT Act of 2001, as amended, or the PATRIOT Act, contains anti-money laundering and financial transparency laws and mandates the implementation of various new regulations applicable to broker-dealers and other financial services companies, including standards for verifying client identification at account opening, and obligations to monitor client transactions and report suspicious activities. Through these and other provisions, the PATRIOT Act seeks to promote the identification of parties that may be involved in terrorism or money laundering. Anti-money laundering laws outside the United States contain some similar provisions. The obligation of financial institutions, including us, to identify their customers, watch for and report suspicious transactions, respond to requests for information by regulatory authorities and law enforcement agencies, and share information with other financial institutions, has required the implementation and maintenance of internal practices, procedures and controls which have increased, and may continue to increase, our costs, and any failure with respect to our programs in this area could subject us to serious regulatory consequences, including substantial fines, and potentially other liabilities.

Certain of our businesses are subject to compliance with laws and regulations of U.S. federal and state governments, non-U.S. governments, their respective agencies and/or various self-regulatory organizations or

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exchanges relating to the privacy of client information, and any failure to comply with these regulations could expose us to liability and/or reputational damage.

Additional legislation, changes in rules promulgated by the SEC and self-regulatory organizations or changes in the interpretation or enforcement of existing laws and rules, either in the United States or elsewhere, may directly affect the mode or our operation and profitability. The U.S. and non-U.S. government agencies and self-regulatory organizations, as well as state securities commissions in the United States, are empowered to conduct administrative proceedings that can result in censure, fine, the issuance of cease-and-desist orders or the suspension or expulsion of a broker-dealer or its directors, officers or employees. Occasionally, FBR & Co. has been subject to investigations and proceedings, and sanctions have been imposed for infractions of various regulations relating to its activities.

FBR Capital Markets' and our broker-dealer subsidiaries are also subject to regulation by various foreign governments and regulatory bodies. FBR & Co. and FBRIS are registered with and subject to regulation by the Ontario Securities Commission in Canada. FBRIL, a United Kingdom brokerage subsidiary of FBR Capital Markets, is subject to regulation by the Financial Services Authority in the United Kingdom pursuant to the United Kingdom Financial Services and Markets Act of 2000 (as amended). Foreign regulation may govern all aspects of the investment business, including regulatory capital, sales and trading practices, conflicts of interest, research, use and safekeeping of customer funds and securities, recordkeeping, margin practices and procedures, registration standards for individuals, periodic reporting and settlement procedures.

Many of the investment services that are subject to authorization and regulation by the FSA under the Financial Services and Markets Act of 2000 (as amended) are also subject to certain European Union (EU) directives covering, among other things, the organizational requirements and operating conditions for investment firms including customer protection requirements and conduct of business rules. These standards, requirements and rules are similarly implemented, under the same directives, throughout the EU and are broadly comparable in scope and purpose to the customer protection requirements imposed under SEC rules. Where such investment services fall outside the scope of these EU directives local regulation in each jurisdiction, including those in which we operate, may still apply and in some cases may be more restrictive than the requirements of such directives.

The EU Markets in Financial Instruments Directive (MiFID), a major piece of legislation that updates and expands the current framework for regulating exchanges, multilateral trading facilities and investment firms on a pan-European basis, was implemented in the U.K. and most other EU member states on November 1, 2007. MiFID facilitates cross-border business by investment firms by generally establishing the regulatory regime of the member state in which an investment firm has its registered or head office as controlling the investment business of that firm. Once a MiFID investment firm has been authorized by its home member state, it will be able to use the MiFID passport to provide services to clients in other EU member states either on a cross-border basis or by establishing a branch in another member state, activities which will be regulated by the home member state (whereas previously a service was regulated by the EU member state in which the service was provided). MiFID imposes a new set of organizational requirements and conduct of business requirements on investment firms. Ongoing efforts by EU member countries to adopt national laws and regulations under MiFID could subject us to new regulatory requirements in 2008.

In the event of non-compliance by us or one of our subsidiaries with an applicable regulation, governmental regulators and one or more of the SROs may institute administrative or judicial proceedings that may result in censure, fine, civil penalties (including treble damages in the case of insider trading violations), the issuance of cease-and-desist orders, the deregistration or suspension of the non-compliant broker-dealer, the suspension or disqualification of officers or employees or other adverse consequences. The imposition of any such penalties or orders on us or our personnel could have a material adverse effect on our operating results and financial condition.

### ***Regulation of FBR Capital Markets' and Our Asset Management Subsidiaries***

Three of our asset management subsidiaries, FBRIM and FBRFA (which are also subsidiaries of FBR Capital Markets) and Money Management Advisors, Inc. (MMA), are registered as investment advisers with the SEC. As investment advisers registered with the SEC, they are subject to the requirements of the Investment Advisers Act of 1940 (Advisers Act) and the SEC's regulations thereunder. These requirements relate to, among other things, limitations on the ability of investment advisers to charge performance-based or non-refundable fees to clients, record-keeping and reporting requirements, disclosure requirements, limitations on principal transactions between an adviser or its affiliates and advisory clients, as well as general anti-fraud prohibitions. They may also be subject to certain state securities laws and regulations. The state securities law requirements applicable to registered investment advisers are in certain cases more comprehensive than those imposed under the federal securities laws. In addition, two of our asset management subsidiaries, FBRFA, which is also a subsidiary of FBR Capital Markets and Money Management Advisors, Inc., and the mutual funds they manage, are subject to the requirements of the Investment Company Act and the SEC's regulations thereunder.

In connection with much of our asset management activities, we, and the private investment vehicles that we manage, are relying on certain exclusions and exemptions from registration under the 1940 Act, and under certain state securities laws and the laws of various foreign countries. Failure to comply with the initial and continuing requirements of any such exemptions could have a material adverse effect on the manner in which we and these vehicles carry on their activities, including penalties similar to those listed above for broker-dealers.

### ***Regulation of Our Historical Non-Conforming Residential Mortgage Loan Business***

Our business (through our subsidiary First NLC and its affiliated entities) historically included the origination, acquisition, pooling, securitization and sale of non-conforming residential mortgage loans. Consequently, we were subject to additional federal and state laws in this area of operation, including laws relating to lending, consumer protection, privacy and unfair trade practices, and any past failure to comply with these regulations could expose us to liability and/or reputational damage.

## **ITEM 1A. RISK FACTORS**

Investing in our company involves various risks, including the risk that you might lose your entire investment. Our results of operations depend upon many factors including our ability to implement our business strategy, the availability of opportunities to acquire assets and make loans, the level and volatility of interest rates, the cost and availability of short- and long-term credit, financial market conditions, and general economic conditions.

The following discussion concerns some of the risks associated with our business. These risks are interrelated, and you should treat them as a whole. Additional risks and uncertainties not presently known to us, may also materially and adversely affect the value of our common stock and our ability to pay dividends to our shareholders. In connection with the forward-looking statements that appear in Part I, Item 1A, of this report on Form 10-K and elsewhere, you should carefully review the section entitled "Cautions About Forward-Looking Information."

### **Risks Related to Adverse Market Conditions**

***In general, changes in market conditions could adversely and materially affect our businesses and the value of our common stock could be negatively impacted.***

Risk is an inherent part of our business. Our businesses are materially affected by conditions in the financial markets and economic conditions generally around the world. A favorable business environment is generally characterized by, among other factors, high global gross domestic product growth, stable geopolitical conditions,

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transparent and efficient capital markets, liquid markets with active investors, low inflation, high business and consumer confidence and strong business earnings. Slowing growth, contraction of credit, increasing energy prices, declines in business or investor confidence or risk tolerance, increases in inflation, higher unemployment, outbreaks of hostilities or other geopolitical instability, corporate, political or other scandals that reduce investor confidence in capital markets and natural disasters, among other things, can affect the global financial markets. In addition, economic or political pressures in a country or region may cause local market disruptions and currency devaluations, which may also affect markets generally. In the event of changes in market conditions, such as interest or foreign exchange rates, equity, fixed income, commodity or real estate valuations, liquidity, availability of credit or volatility, our businesses could be adversely affected in many ways.

### ***Our cash flows may decline as a result of adverse market conditions.***

Recently, the residential real estate market in the U.S. has experienced a significant downturn due to declining real estate values, substantially reducing mortgage loan originations and securitizations, and precipitating more generalized credit market dislocations and a significant contraction in available liquidity globally, which has negatively impacted our revenues. These factors have continued into the beginning of fiscal 2008 and, combined with rising oil prices, declining business and consumer confidence and increased unemployment, have precipitated an economic slowdown and fears of a possible recession. These factors could continue beyond fiscal 2008. Continued or further credit market dislocations or sustained market downturns may reduce cash flows from our clients and adversely affect the value of our common stock. Our revenues from our capital markets business and asset management businesses have been impacted by adverse market conditions and may continue to be impacted in the future. Revenues from our capital markets business are directly related to the number and size of the transactions in which we participate and therefore were adversely affected in the latter half of 2007 by the mortgage and credit market dislocations, and may be further impacted by continued or further credit market dislocations or sustained market downturns. Our results of operations could continue to be impacted in 2008 and beyond as a result of these market factors. Sustained market downturns or continued or further credit market dislocations and liquidity issues would also likely lead to a decline in the volume of capital market transactions that we execute for our institutional brokerage clients and, therefore, to a decline in the revenues we receive from commissions and spreads earned from the trades we execute for our clients. In addition, because the fees that we charge for managing our clients' portfolios are in many cases based on the value of those portfolios, a market downturn that reduces the value of our clients' portfolios would reduce the revenues we receive from our asset management business. Heightened risk aversion among investors may cause them to shift their trading activity to higher quality and more liquid products, which are generally somewhat less profitable for us.

### ***Continued adverse developments in the residential mortgage market may adversely affect the value of our portfolio agency-backed MBS and agency CMOs and our ability to finance or sell the securities that we acquire.***

Recently, the residential mortgage market in the United States has experienced a variety of difficulties and changes in economic conditions that may adversely affect the performance and market value of our agency-backed MBS and agency CMOs. Securities backed by residential mortgage loans originated in 2006 and 2007 have had a higher and earlier than expected rate of delinquencies. Many residential MBS have been downgraded by the rating agencies during the past few months and the rating agencies may in the future provide further downgrades or downgrade additional issuances of residential MBS. As a result, the market for these securities may be adversely affected for a significant period of time.

We intend to deploy capital into our core principal investing business of investing in agency-backed MBS agency CMOs. Fannie Mae, Freddie Mac or Ginnie Mae guarantee the payments on the agency-backed MBS we acquire, including the agency-backed MBS including in our agency CMOs, even if the borrowers of the underlying mortgages default on their payments. However, rising delinquencies could negatively affect the value of our agency-backed MBS and our agency CMOs or create market uncertainty about their true value. We rely on

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our agency-backed MBS and agency CMOs as collateral for our short-term financings. Any decline in their value, or perceived market uncertainty about their value, would likely make it more difficult for us to obtain financing on favorable terms or at all, or maintain our compliance with the terms of any financing arrangements already in place. At the same time, market uncertainty about residential mortgages in general could depress the market for agency-backed MBS, making it more difficult for us to sell any agency-backed MBS or agency CMOs we own on favorable terms, or at all. If market conditions result in a decline in available purchasers of agency-backed MBS or the value of our agency-backed MBS and agency CMOs, our financial position and results of operations could be adversely affected.

***The current weakness in the mortgage market may adversely affect some of our potential lenders, which may result in increases in our borrowing costs and reductions in the value of the securities in our portfolio of agency-backed MBS, including our agency CMOs.***

The current weakness in the mortgage market may adversely affect some of our potential lenders, which we believe could render some of our lenders unable or unwilling to extend credit to us when needed. This may increase our financing costs. Partially as a result of several major market participants experiencing distress, marketability of all fixed income securities recently has been negatively impaired, including agency-backed MBS. If many of our potential lenders are unwilling or unable to provide us with financing, we may be unable to leverage our portfolio or, to the extent it may already be levered, we could be forced to sell our agency-backed MBS, including our agency CMOs, at a time when prices are depressed. The combination of a lower asset base and more stringent financing terms would likely negatively impact our taxable income and cash available for distributions to shareholders.

During 2007, dislocations in the capital markets became magnified. Since June 30, 2007, several large financial institutions reported that dislocations in the non-prime mortgage market had spread to the Alt-A mortgage market and structured finance markets. Because many asset-backed collateralized debt obligations and asset-backed commercial paper programs contain non-agency securities, all sectors of the fixed income markets and financing markets have come under stress. Several holders of these assets reported difficulty maintaining financing for mortgages and mortgage-backed securities. Some were unable to meet margin calls in connection with this financing. Much of the stress in the financial markets was focused on non-agency residential mortgages and the financing of these assets. The dislocations were pronounced in the non-prime residential MBS market. Lenders demanded higher rates and greater levels of over-collateralization to finance these assets. The agency-backed MBS market experienced some effects of these dislocations as lenders' terms became more stringent generally. Lenders' capacity to finance agency-backed MBS became more limited, though to a lesser degree than in the non-agency securities markets. Financing rates for agency-backed MBS remain elevated and over-collateralization rates remain higher than those generally prevailing prior to the recent market dislocations. If such conditions persist or worsen, we may experience increased borrowing costs and reductions in our liquidity and the value of our portfolio of agency-backed MBS investments, including our agency CMOs. The combination of a lower asset base and more stringent financing terms will likely negatively impact our taxable income and cash available for distributions to shareholders.

## **General Risks Related to our Business**

***We may not be able to manage our growth efficiently, which may adversely affect our results and may, in turn, negatively affect the market price of our common stock and our ability to make distributions to our shareholders.***

We have experienced growth in our business activities. Our growth has required, and our growth will continue to require, increased investment in management and professionals, personnel, financial and management systems and controls and facilities, which could cause our operating margins to decline from historical levels, especially in the absence of revenue growth. In addition, as is common in the industry, our broker-dealer subsidiaries will continue to be highly dependent on the effective and reliable operation of communications and information systems and business continuity plans. We believe that our anticipated future

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growth will require implementation of new and enhanced communications and information systems and training of our personnel to operate these systems. In addition, the scope of procedures for assuring compliance with applicable laws and regulations and NASD (now FINRA) rules has changed as the size and complexity of our business has changed. As we continue to grow, we will continue to implement additional formal compliance procedures to reflect our growth. Any difficulty or significant delay in the implementation or operation of existing or new systems, compliance procedures or the training of personnel could adversely affect the market price of our common stock and our ability to pay dividends.

***The voting power of our principal shareholders and other executive officers, directors and nominees may result in corporate action with which you do not agree and may discourage third party acquisitions of our company and prevent our shareholders from receiving any premium above market price for their shares.***

Eric F. Billings has significant influence over our operations through his ownership of our common stock, which, as of January 31, 2008, represents approximately 13.9% of the total voting power of our common stock. In addition, Mr. Billings serves as one of our directors and as our Chief Executive Officer. Mr. Billings also serves as a member of the board of directors and as Chairman and Chief Executive Officer of FBR Capital Markets. Mr. Billings and all of our other executive officers, directors and nominees, as a group, control, as of January 31, 2008, approximately 16.1% of our total voting power. The extent of the influence that Mr. Billings and our other officers, directors and nominees have over us may have the effect of discouraging offers to acquire control of our company and may preclude holders of our common stock from receiving any premium above market price for their shares that may be offered in connection with any attempt to acquire control of our company without the approval of Mr. Billings.

***The trading prices of our Class A common stock may be adversely affected by factors outside of our control.***

Any negative changes in the public's perception of the prospects for companies in the REIT, the mortgage-backed securities, or the merchant banking industries, or in the investment banking, securities brokerage, asset management, or financial services industries could depress our stock price regardless of our results.

The following factors could contribute to the volatility of the price of our Class A common stock:

- actual or unanticipated variations in our quarterly results;
- changes in our level of dividend payments;
- new products or services offered by us and our competitors;
- changes in our financial estimates by securities analysts;
- conditions or trends in the investment or financial services industries in general;
- changes in interest rate environments and the mortgage market that cause our borrowing costs to increase, our reported yields on our mortgage-backed securities to decrease or that cause the value of our mortgage-backed securities to decrease;
- increased defaults under non-conforming residential mortgage loans originated by First NLC and held in our portfolio;
- announcements by us of significant acquisitions, strategic partnerships, investments or joint ventures;
- changes in the market valuations of the companies in which we make principal investments;
- negative changes in the public's perception of the prospects of investment or financial services companies;
- changes in the regulatory environment in which our business operates;
- general economic conditions such as a recession, or interest rate or currency rate fluctuations;

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- any obstacles in continuing to qualify as a REIT, including changes in law applicable to REITs;
- additions or departures of our key personnel; and
- additional sales of our securities.

Many of these factors are beyond our control.

***We may experience significant fluctuations in quarterly operating results due to the volatile nature of the investment banking and securities business and the sensitivity of our principal investing business to changes in interest rates and fluctuations in the stock market and we may therefore fail to meet profitability or dividend expectations, which may, in turn, affect the market price of our Class A common stock and our ability to pay dividends to our stockholders.***

Our revenues and operating results may fluctuate from quarter to quarter and from year to year due to a combination of factors, including:

- the number and size of underwriting and merger and acquisition transactions completed by our investment banking group, and the level and timing of fees received from those transactions;
- changes in the earnings from our mortgage-backed securities and other principal investments resulting from market volatility, changes in interest rates and volatility in mortgage loan prepayment rates;
- changes in the market valuations of the investments of our managed funds and of the companies in which we have made principal investments;
- access to public markets or other exit strategies for companies in which we have made an investment as principal;
- the recognition of profits or losses on principal investments or with respect to warrants or other equity-linked securities received in connection with capital-raising activities;
- the level of institutional and retail brokerage transactions and the level of commissions received from those transactions;
- the timing of recording of asset management fees and special allocations of income, if any;
- variations in expenditures for personnel, consulting and legal expenses, and expenses of establishing new business units, including technology expenses; and
- other variations in expenditures, including marketing and sponsorship.

Any one of these factors could adversely affect the market price of our common Class A stock and our ability to pay dividends to our stockholders.

***An increase in market interest rates may have an adverse effect on the market price of our common stock.***

One of the factors that investors may consider in deciding whether to buy or sell our common stock is our dividend rate as a percentage of our share price, relative to market interest rates. If market interest rates increase, prospective investors may desire a higher dividend rate on our common stock or seek securities paying higher dividends or interest. For instance, if interest rates rise without an increase in our dividend rate, the market price of our common stock could decrease because potential investors may require a higher yield on our common stock as market rates on interest-bearing securities, such as bonds, rise.

***We will not pay a cash dividend for the fourth quarter of 2007, and we cannot assure you that we will be able to pay dividends in the future.***

As a REIT, we must distribute annually at least 90% of our REIT taxable income to our shareholders, other than any net capital gain and excluding the retained earnings of our taxable REIT subsidiaries. We currently

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anticipate that our taxable REIT subsidiaries will retain most or all of their earnings and profits, which would make these earnings and profits unavailable for distribution to our shareholders. On December 21, 2007, we announced that our Board of Directors had decided not to pay a cash dividend to our shareholders for the fourth quarter of 2007, concluding at that time that the repurchase of our Class A common stock represented a better use of our financial resources than the payment of cash dividends. Pursuant to our variable dividend policy, our Board of Directors, in its sole discretion, may reinstate the payment of cash dividends when appropriate in the future, but there can be no assurances as to when it will do so, if ever.

***Loss of our 1940 Act exemption would adversely affect us and negatively affect the market price of our Class A common stock and the ability to pay dividends to our stockholders.***

We believe that we currently are not, and we intend to continue operating our company so that we will not become, regulated as an investment company under the 1940 Act, because we are “primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.” Specifically, we have invested, and intend to continue investing, at least 55% of our assets in mortgage loans or mortgage-backed securities that represent the entire ownership in a pool of mortgage loans and at least an additional 25% of our assets in mortgages, mortgage-backed securities, securities of REITs, and other real estate-related assets.

If we fail to qualify for this exclusion from regulation under the 1940 Act, we could be required to restructure our activities. For example, if the market value of our investments in equity securities were to increase by an amount that resulted in less than 55% of our assets being invested in mortgage loans or mortgage-backed securities that represent the entire ownership in a pool of mortgage loans, we might have to sell equity securities in order to qualify for exclusion from regulation under the 1940 Act. The sale could occur under adverse market conditions. Each of our subsidiaries also qualifies for an exemption from regulation as an investment company under the 1940 Act.

***Failure to procure adequate capital and funding would adversely affect our results and may, in turn, negatively affect the market price of our Class A common stock and our ability to pay dividends to our stockholders.***

We depend upon the availability of adequate funding and capital for our operations. For example, we invest in mortgage-backed securities funded by short-term borrowings. In addition, our broker-dealer and financial services subsidiaries are dependent on the availability of adequate capital to satisfy applicable regulatory capital requirements. As a REIT, we are required to distribute annually at least 90% of our taxable income, other than any net capital gain and excluding taxable REIT subsidiary earnings, to our shareholders and are therefore not able to retain our earnings for new investments. However, our taxable REIT subsidiaries are able to retain (and likely will continue to retain) earnings for investment in new capital, subject to the various REIT requirements. We have historically satisfied our capital needs from equity contributions, internally generated funds and loans from third parties. We cannot assure you that any, or sufficient, funding or capital will continue to be available to us in the future on terms that are acceptable to us. In the event that we cannot obtain sufficient funding on acceptable terms, there may be a negative impact on the market price of our Class A common stock and our ability to pay dividends.

***We face intense competition for personnel which could adversely affect our business and in turn negatively affect the market price of our common stock and our ability to pay dividends to our stockholders.***

Our businesses are dependent on the highly skilled, and often highly specialized, individuals we employ. Retention of specialists to manage our mortgage-backed securities portfolio, research analysts, private equity specialists, sales and trading personnel, investment banking personnel, asset management personnel, and technology, lending, management and administrative professionals are particularly important to our prospects. Competition for the recruiting and retention of employees may increase elements of our compensation costs. We

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cannot assure you that, in order to support our growth plans, we will be able to recruit and hire a sufficient number of new employees with the desired qualifications in a timely manner. We regularly review our compensation policies, including stock incentives. Nonetheless, our incentives may be insufficient in light of competition for experienced professionals in the investment industry, particularly if the value of our stock declines or fails to appreciate sufficiently to be a competitive source of a portion of professional compensation. Increased compensation costs could adversely affect the amount of cash available for distribution to shareholders and our failure to recruit and retain qualified employees could materially and adversely affect our future operating results.

***We are dependent on a small number of key senior professionals and loss of the professionals could adversely affect our results and may, in turn, negatively affect the market price of our Class A common stock and our ability to pay dividends.***

We generally do not have employment agreements with our senior officers and other key professionals. The loss of professionals, particularly a senior professional with a broad range of contacts in one of our businesses, could materially and adversely affect our operating results. Our investment banking strategy is to establish relationships with prospective corporate clients in advance of any transaction, and to maintain these relationships by providing advisory services to corporate clients in equity, debt and merger and acquisition transactions. These relationships depend in part upon the individual employees who represent us in our dealings with our clients. From time to time, other companies in the investment industry have experienced losses of professionals in all areas of the investment business. The level of competition for key personnel includes competition from non-brokerage U.S. and foreign financial services companies, commercial banks, other investment banks and venture capital firms, all of which may target or increase their efforts in some of the same industries that we serve. In particular, we face competition for experienced research analysts, sales and trading personnel, and investment bankers of the type on which our business is highly dependent. We cannot assure you that losses of key personnel will not occur.

***We are highly dependent on systems and third parties, and systems failures could significantly disrupt our business, which may, in turn, negatively affect the market price of our Class A common stock and our ability to pay dividends.***

Our business is highly dependent on communications and information systems, including systems provided by our clearing brokers and by and for other third parties. Any failure or interruption of our systems, the systems of our clearing brokers, or third-party trading or information systems could cause delays or other problems in our securities trading activities, including mortgage-backed securities trading activities, which could have a material adverse effect on our operating results and negatively affect the market price of our common stock and our ability to pay dividends.

In addition, our clearing brokers provide elements of our principal disaster recovery system. We cannot assure you that we or our clearing brokers will not suffer any systems failure or interruption, including one caused by a hurricane, earthquake, fire, other natural disaster, power or telecommunications failure, act of God, act of war, terrorist attack, pandemic or other emergency situation, or that we or our clearing brokers' back-up procedures and capabilities in the event of any such failure or interruption will be adequate. The occurrence of any failures or interruptions could significantly harm our business.

***We may not be able to keep up with rapid technological change, which may adversely affect the market price of our Class A common stock and our ability to pay dividends.***

There are significant technical and financial risks in the development of new services and products or enhanced versions of existing services and products. We cannot assure you that we will be able to:

- develop or obtain the necessary technologies;
- effectively use new technologies;

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- adapt our services and products to evolving industry standards;
- develop, introduce and market in a profitable manner our services and products; or
- enhance or create new services and products.

If we are unable to develop and introduce enhanced or new services or products quickly enough to respond to market or customer requirements, or if we or our services and products do not achieve market acceptance, our business, financial condition and operating results will be materially adversely affected and our cash available for distribution to stockholders may be negatively impacted.

### ***Indemnification agreements with our affiliates may increase the costs to us of litigation against our company.***

Our charter documents allow indemnification of our officers, directors and agents to the maximum extent permitted by Virginia law, as may the charter documents of our subsidiaries in their respective jurisdictions of incorporation. We have entered into indemnification agreements with these persons. We also have agreed to indemnify FBR Capital Markets against claims that relate to our capital markets businesses that we contributed to FBR Capital Markets prior to completion of the FBR Capital Markets 2006 private offering. In the future we may be the subject of indemnification assertions under these charter documents or agreements by our affiliates who are or may become defendants in litigation. Amounts paid pursuant to these indemnification agreements could adversely affect our financial results and the amount of cash available for distribution to stockholders.

### **Risks Related to Investment Banking, Institutional Brokerage, Sales and Trading, Asset Management and Other Fee-Based Financial Services Businesses Operated by us through our Taxable REIT Subsidiaries**

We may be adversely affected by the general risks of the financial services and investment banking business.

Through taxable REIT subsidiaries, including FBR & Co. (the primary broker-dealer subsidiary of FBR Capital Markets), we operate investment banking, trading, brokerage, asset management and other fee-based financial services businesses. The financial and investment business is, by its nature, subject to numerous and substantial risks, particularly in volatile or illiquid markets and in markets influenced by sustained periods of low or negative economic growth. As a financial services and investment banking firm, we and our operating results may be adversely affected by a number of factors, which include:

- the risk of losses resulting from the ownership or underwriting of securities;
- the risks of trading securities for our own account (i.e., principal activities) and for our customers;
- reduced cash inflows from investors into asset management businesses;
- the risk of losses from lending, including to small, privately-owned companies;
- counterparty failure to meet commitments;
- customer default and fraud;
- customer complaints;
- employee errors, misconduct and fraud (including unauthorized transactions by traders);
- failures in connection with the processing of securities transactions;
- litigation and arbitration;
- the risks of reduced revenues in periods of reduced demand for public offerings or reduced activity in the secondary markets; and
- the risk of reduced fees and commissions we receive for selling securities on behalf of our customers (i.e., underwriting spreads).

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Any one of these factors could adversely affect the market price of our Class A common stock and our ability to pay dividends. See “—Risks Related to Adverse Market Conditions.”

***We depend on relatively few industries to generate a significant percentage of our revenue, which may limit our revenues and net income and may adversely affect our operating results and negatively impact the market price of our common stock.***

We are dependent on revenues related to securities issued by companies in specific industry sectors. The consumer, diversified industrials, energy and natural resources, financial institutions, healthcare, insurance, real estate and TMT sectors account for the majority of our investment banking, asset management, institutional trading and research activities. Therefore, any downturn in the market for the securities of companies in these industry sectors, or factors affecting such companies, could adversely affect our operating results and financial condition. Additionally, the frequency and size of securities offerings can vary significantly from industry to industry due to economic, legislative, regulatory and political factors.

Underwriting and other capital raising transactions, strategic advisory engagements and related trading activities in our core sectors represent a significant portion of our businesses. This concentration of activity exposes us to the risk of substantial declines in revenues in the event of downturns in our core sectors. Any future downturns in our core sectors could result in a decrease in the size or number of transactions we complete, which would reduce our investment banking revenues.

We also derive a significant portion of our revenues from institutional sales and trading transactions related to the securities of companies in these sectors. Our revenues from such institutional sales and trading transactions may decline when underwriting activities in these industry sectors decline, the volume of trading on Nasdaq, the NYSE or any other securities exchange or market declines, or when industry sectors or individual companies report results below investors' expectations.

***Our financial results may fluctuate substantially from quarter to quarter, which may impair our stock price.***

We have experienced, and expect to experience in the future, significant quarterly variations in our revenues and results of operations. These variations may be attributed in part to the fact that our investment banking revenues are typically earned upon the successful completion of a transaction, the timing of which is uncertain and beyond our control. In most cases, we receive little or no payment for investment banking engagements that do not result in the successful completion of a transaction. As a result, our business is highly dependent on market conditions as well as the decisions and actions of our clients and interested third parties. In addition, a client's securities offering may be delayed or terminated because of adverse market conditions, failure to obtain necessary regulatory approvals or unexpected financial or other problems in the client's business. If the parties fail to complete an offering in which we are participating as an underwriter or placement agent, we will earn little or no revenue from the transaction. This risk may be intensified by our focus on early-stage companies in certain sectors, as the market for securities of these companies may experience significant variations in the number and size of equity offerings as well as the after-market trading volume and prices of newly issued securities. Recently, more companies initiating the process of an initial public offering are simultaneously exploring M&A exit opportunities. Our investment banking revenues would be adversely affected in the event that an initial public offering for which we are acting as an underwriter is preempted by the company's sale if we are not engaged as a strategic advisor in such sale.

As a result, we are unlikely to achieve steady and predictable earnings on a quarterly basis, which could in turn adversely affect the price of our common stock. See “Management's Discussion and Analysis of Financial Condition and Results of Operation – Executive Summary.”

***Our failure to acquire or internally develop the infrastructure needed to offer a complete range of M&A services and other advisory services or to grow our asset management business could negatively affect the growth of our business.***

Our ability to expand our M&A business depends upon expanding and enhancing the investment banking services we presently offer. We intend to incur increased costs to expand this business. Our failure to acquire or hire additional M&A professionals to offer additional M&A services or our failure to successfully integrate such M&A services into our existing business could have an adverse impact on our business. Furthermore, our failure to expand our M&A services capabilities to satisfy anticipated near-term demand in our core sectors may harm our growth prospects.

Our ability to expand our asset management business depends on a variety of factors, including but not limited to our ability to identify traditional and/or alternative asset managers and strategies, within our company and externally, and our ability to deploy capital into investments in this area. We cannot guarantee that we will be able to successfully identify alternative asset managers and strategies or invest our own capital in alternative asset managers or strategies. Our inability to expand our asset management business could harm our growth prospects and could negatively impact the value of our common stock.

***Pricing and other competitive pressures may impair the revenues and profitability of our institutional brokerage business.***

We derive a significant portion of our revenues from our institutional brokerage business. Along with other firms, we have experienced intense price competition in this business in recent years. In particular, the ability to execute trades electronically and through alternative trading systems has increased the pressure on trading commissions and spreads. We expect pricing pressures in the business to continue. Decimalization in securities trading, introduced in 2000, has also reduced revenues and lowered margins within the equity sales and trading divisions of many firms, including ours. We believe we may experience competitive pressures in these and other areas in the future as some of our competitors seek to obtain market share by competing on the basis of price or use their own capital to facilitate client trading activities. In addition, we face pressure from our larger competitors, which may be better able to offer a broader range of complementary products and services to clients in order to win their trading business. If we are unable to compete effectively in these areas, the revenues from our sales and trading business may decline, and our business and results of operations may be adversely affected. Our research and institutional brokerage business may be adversely affected by changes in laws and regulations and industry practices.

Changes in laws and regulations governing our institutional brokerage and research activities could also adversely affect our institutional brokerage and research business.

Changes in industry practices may also adversely affect our results of operations. Historically, our clients have paid us for research through commissions on trades. Recently, Fidelity Investments has entered into arrangements with certain financial institutions of which it is a client, pursuant to which Fidelity Investments agreed to pay separately for trading and research services, a process known as “unbundling.” Previously, Fidelity Investments had, like other fund managers, paid for research from those financial institutions through the commissions that it had paid to those financial institutions for trading services. As a result, the financial institutions that have entered into unbundling arrangements with Fidelity Investments will charge lower commissions per trade but will receive separate compensation for research that they provide to Fidelity Investments. Currently, we are not a party to any unbundling arrangements. However, we cannot assure you that we will not be a party to any unbundling arrangements in the future. It is uncertain whether unbundling arrangements will become an industry trend, and if so, to what extent. Furthermore, we cannot predict the consequences on our business of these arrangements, nor can we predict the impact on our business if unbundling develops as an industry trend. If unbundling becomes prevalent, we cannot assure you that our institutional brokerage clients will also pay us separately for our research, or if they do, that our revenues from these clients will remain the same. If our clients wish to purchase sales and trading and research services separately, we

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cannot assure you that we will be able to market our services on that basis as effectively as some of our competitors, and our business consequently could be adversely affected.

***We face strong competition from larger firms, some of which have greater resources and name recognition, which may impede our ability to grow our business.***

The brokerage and investment banking industries are intensely competitive and we expect them to remain so. We compete on the basis of a number of factors, including client relationships, reputation, the abilities of our professionals, market focus and the relative quality and price of our services and products. We have experienced intense price competition in some of our businesses, in particular discounts in large block trades and trading commissions and spreads. In addition, pricing and other competitive pressures in investment banking, including the trends toward increased focus by many larger investment banking companies on institutional equity offerings pursuant to Rule 144A, multiple book runners, co-managers and multiple financial advisors handling transactions, have continued and could adversely affect our revenues, even as the volume and number of investment banking transactions have started to increase. We believe we may experience competitive pressures in these and other areas in the future as some of our competitors seek to obtain market share by competing on the basis of price.

Many of our competitors in the brokerage and investment banking industries have a broader range of products and services, greater financial and marketing resources, larger customer bases, greater name recognition, more senior professionals to serve their clients' needs, greater global reach and more established relationships with clients than we have. These larger and better capitalized competitors may be better able to respond to changes in the brokerage and investment banking industries, to compete for skilled professionals, to finance acquisitions, to fund internal growth and to compete for market share generally.

The scale of our competitors has increased in recent years as a result of substantial consolidation among companies in the brokerage and investment banking industries. In addition, a number of large commercial banks, insurance companies and other broad-based financial services firms have established or acquired underwriting or financial advisory practices and broker-dealers or have merged with other financial institutions. These firms have the ability to offer a wider range of products than we do, which may enhance their competitive position. They also have the ability to support investment banking with commercial banking, insurance and other financial services in an effort to gain market share, which has resulted, and could further result, in pricing pressure in our businesses. In particular, the ability to provide financing has become an important advantage for some of our larger competitors and, because we do not provide such financing, we may be unable to compete as effectively for clients in a significant part of the brokerage and investment banking market.

If we are unable to compete effectively with our competitors, our business, financial condition and results of operations will be adversely affected.

***Our capital markets and strategic advisory engagements are singular in nature and our failure to capture repeat business from existing clients may harm our operating results.***

Our investment banking clients generally retain us on a short-term, engagement-by-engagement basis in connection with specific capital markets or mergers and acquisitions transactions, rather than on a recurring basis under long-term contracts. As these transactions are typically singular in nature and our engagements with these clients may not recur, we must continuously seek out new engagements when our current engagements are successfully completed or are terminated. As a result, high activity levels in any period are not necessarily indicative of continued high levels of activity in any subsequent period. If we are unable to generate a substantial number of new engagements that generate fees from the successful completion of transactions, our business and results of operations would likely be adversely affected.

***Larger and more frequent capital commitments in our trading, underwriting and merchant banking businesses increases the potential for us to incur significant losses.***

There is a trend toward larger and more frequent commitments of capital by financial services firms in many of their activities. For example, in order to win business, investment banks are increasingly committing to purchase large blocks of stock from publicly traded issuers or significant shareholders, instead of the more traditional marketed underwriting process, in which marketing is typically completed before an investment bank commits to purchase securities for resale. With the increased capital available to us from our 2006 private offering, we may undertake more block trades in the future. As a result, we will be subject to increased risk as we commit greater amounts of capital to facilitate primarily client-driven business and, therefore, may suffer losses even when economic and market conditions are generally favorable for others in the industry.

Although we have historically not engaged in proprietary trading, we may engage in proprietary trading in the future to maintain trading positions in the fixed income and equity markets. We may enter into large transactions in which we commit our own capital as part of our client trading activities. The number and size of these large transactions may materially affect our results of operations in a given period. We may also incur significant losses from our trading activities due to market fluctuations and volatility in our results of operations. To the extent that we own assets, *i.e.*, have long positions, in any of those markets, a downturn in the value of those assets or in those markets could result in losses. Conversely, to the extent we have sold assets we do not own, *i.e.*, have short positions, in any of those markets, an upturn in those markets could expose us to potentially large losses as we attempt to cover our short positions by acquiring assets in a rising market.

***Limitations on our access to capital could impair our liquidity and our ability to conduct our businesses.***

Liquidity, or ready access to funds, is essential to financial services firms. Failures of financial institutions have often been attributable in large part to insufficient liquidity. Liquidity is of particular importance to our trading business and perceived liquidity issues may affect our clients' and counterparties' willingness to engage in brokerage transactions with us. Our liquidity could be impaired due to circumstances that we may be unable to control, such as a general market disruption or an operational problem that affects our trading clients, third parties or us. Further, our ability to sell assets may be impaired if other market participants are seeking to sell similar assets at the same time.

FBR & Co., which is a domestic registered broker-dealer, is subject to the net capital requirements of the SEC and various self-regulatory organizations of which it is a member. These requirements typically specify the minimum level of net capital a broker-dealer must maintain and also mandate that a significant part of its assets be kept in relatively liquid form. FBRIL, which is a registered broker-dealer in the United Kingdom, is also subject to the capital requirements of the United Kingdom Financial Services Authority, or FSA. Any failure to comply with these net capital requirements could impair our ability to conduct our core business as a brokerage firm.

Furthermore, FBR & Co. and FBRIL are subject to laws that authorize regulatory bodies to block or reduce the flow of funds from them to us. As a holding company, we will depend on dividends, distributions and other payments from our subsidiaries to fund our obligations, including debt obligations. As a result, regulatory actions could impede access to funds that we need to make payments on our obligations, including debt obligations.

***Our risk management policies and procedures may leave us exposed to unidentified or unanticipated risk, which could harm our business.***

We have devoted significant resources to develop our risk management strategies and techniques and expect to continue to do so in the future. However, our risk management strategies and techniques may not be fully effective in mitigating our risk exposure in all market environments or against all types of risk.

We are exposed to the risk that third parties that owe us money, securities or other assets will not perform their obligations. These parties may default on their obligations to us due to bankruptcy, lack of liquidity,

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operational failure, breach of contract or other reasons. We are also subject to the risk that our rights against third parties may not be enforceable in all circumstances. Although we regularly review credit exposures to specific clients and counterparties and to specific industries and regions that we believe may present credit concerns, default risk may arise from events or circumstances that are difficult to detect or foresee. In addition, concerns about, or a default by, one institution could lead to significant liquidity problems, losses or defaults by other institutions, which in turn could adversely affect us. If any of the variety of instruments, processes and strategies we utilize to manage our exposure to various types of risk are not effective, we may incur losses.

### ***Strategic investments or acquisitions and joint ventures may result in additional risks and uncertainties in our business.***

We intend to grow our core businesses through both internal expansion and through strategic investments, acquisitions or joint ventures. To the extent we make strategic investments or acquisitions or enter into joint ventures, we face numerous risks and uncertainties combining or integrating the relevant businesses and systems, including the need to combine accounting and data processing systems and management controls and to integrate relationships with customers and business partners. In the case of joint ventures, we are subject to additional risks and uncertainties in that we may be dependent upon, and subject to liability, losses or reputational damage relating to, systems, controls and personnel that are not under our control. In addition, conflicts or disagreements between us and our joint venture partners may negatively impact our businesses.

To the extent that we pursue business opportunities outside the United States, we will be subject to political, economic, legal, operational and other risks that are inherent in operating in a foreign country, including risks of possible nationalization, expropriation, price controls, capital controls, exchange controls and other restrictive governmental actions, as well as the outbreak of hostilities. In many countries, the laws and regulations applicable to the securities and financial services industries are uncertain and evolving, and it may be difficult for us to determine the exact requirements of local laws in every market. Our inability to remain in compliance with local laws in a particular foreign market could have a significant and negative effect not only on our businesses in that market but also on our reputation generally. We are also subject to the enhanced risk that transactions we structure might not be legally enforceable in the relevant jurisdictions.

### ***We may have potential conflicts of interest with our executive officers and employees which could result in decisions that are not in your best interests.***

From time to time, our executive officers and employees may invest in private or public companies in which we, or one of our affiliates, is or could potentially be an investor or for which we carry out investment banking assignments, publish research or act as a market maker. In addition, we have in the past and will likely in the future organize businesses, such as our hedge, private equity and venture capital funds, in which our executive officers or employees may acquire minority interests or profit interests. There are risks that, as a result of such investment or profit interest, an executive officer or employee may have incentives to take actions that would conflict with our best interests. Our board of directors has adopted a code of business conduct and ethics which contains a policy with respect to conflicts of interest. We also have in place compliance procedures and practices designed to monitor the activities of our executive officers and employees, including their investing activities. While we believe that our code of business conduct and ethics and these procedures and practices will be effective; we cannot guarantee that they will prevent material adverse effects in all conflict of interest situations that might arise.

### ***Our capital markets business is dependent on cash inflows to mutual funds and other pooled investment vehicles, which could result in our experiencing operating losses if cash flows slow, and negatively impact cash available for distribution to shareholders.***

A slowdown or reversal of cash inflows to mutual funds and other pooled investment vehicles could lead to lower underwriting and brokerage revenues for us since mutual funds and other pooled investment vehicles

purchase a significant portion of the securities offered in public offerings underwritten by FBR & Co. and subsequently traded in the secondary markets. Demand for new equity offerings has been driven in part by institutional investors, particularly large mutual funds and hedge funds, seeking to invest on behalf of their investors. Our brokerage business is particularly dependent on the institutional market. The public may redeem mutual funds as a result of a decline in the market generally or as a result of a decline in mutual fund net asset values. To the extent that a decline in cash inflows into mutual funds reduces demand by fund managers for initial public or secondary offerings, our business and results of operations could be materially adversely affected. Moreover, a slowdown in investment activity by mutual funds may have an adverse effect on the securities markets generally. Such environments may adversely affect the market price of our Class A common stock and our ability to pay dividends.

***Significantly expanded corporate governance and public disclosure requirements may result in fewer initial public offerings and distract existing public companies from engaging in capital market transactions which may reduce the number of investment banking opportunities available to pursue.***

Highly-publicized financial scandals in recent years have led to investor concerns over the integrity of the U.S. financial markets, and have prompted Congress, the SEC, the NYSE and Nasdaq to significantly expand corporate governance and public disclosure requirements. To the extent that private companies, in order to avoid becoming subject to these new requirements, decide to forgo initial public offerings, our equity underwriting business may be adversely affected. In addition, provisions of the Sarbanes-Oxley Act of 2002 and the corporate governance rules imposed by self-regulatory organizations have diverted many companies' attention away from capital market transactions, including securities offerings and acquisition and disposition transactions. In particular, companies that are or are planning to be public are incurring significant expenses in complying with the SEC and accounting standards relating to internal control over financial reporting, and companies that disclose material weaknesses in such controls under the new standards may have greater difficulty accessing the capital markets. These factors, in addition to adopted or proposed accounting and disclosure changes, may have an adverse effect on our business.

***Financial services firms have been subject to increased scrutiny over the last several years, increasing the risk of financial liability and reputational harm resulting from adverse regulatory actions.***

As a participant in the financial services industry, we are subject to extensive regulation under federal and state laws in the U.S. and under the laws of other countries in which we do business. We are also regulated by a number of self-regulatory organizations. The industry has experienced increased scrutiny from a variety of regulators, including the SEC, the NYSE, FINRA and state attorneys general. Penalties and fines sought by regulatory authorities have increased substantially over the last several years. This regulatory and enforcement environment has created uncertainty with respect to a number of transactions that had historically been entered into by financial services firms and that were generally believed to be permissible and appropriate. We may be adversely affected by changes in the interpretation or enforcement of existing laws and rules by these governmental authorities and self-regulatory organizations. We also may be adversely affected as a result of new or revised legislation or regulations imposed by the SEC, other United States or foreign governmental regulatory authorities or self-regulatory organizations that supervise the financial markets, including FINRA. Among other things, we could be fined, prohibited from engaging in some of our business activities or subject to limitations or conditions on our business activities. Substantial legal liability or significant regulatory action against us could have material adverse financial effects or cause significant reputational harm to us, which could seriously harm our business prospects.

In addition, financial services firms are subject to numerous conflicts of interests or perceived conflicts. The SEC and other federal and state regulators have increased their scrutiny of potential conflicts of interest. We have adopted various policies, controls and procedures to address or limit actual or perceived conflicts and regularly seek to review and update our policies, controls and procedures. However, appropriately dealing with conflicts of interest is complex and difficult and our reputation could be damaged if we fail, or appear to fail, to deal

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appropriately with conflicts of interest. Our policies and procedures to address or limit actual or perceived conflicts may also result in increased costs, additional operational personnel and increased regulatory risk. Failure to adhere to these policies and procedures may result in regulatory sanctions or client litigation. For example, the research areas of investment banks have been and remain the subject of heightened regulatory scrutiny which has led to increased restrictions on the interaction between equity research analysts and investment banking personnel at securities firms.

***Our exposure to legal liability is significant, and damages that we may be required to pay and the reputational harm that could result from legal action against us could materially adversely affect our businesses.***

We face significant legal risks in our businesses and, in recent years, the volume of claims and amount of damages sought in litigation and regulatory proceedings against financial institutions have been increasing. These risks include potential liability under securities or other laws for materially false or misleading statements made in connection with securities offerings and other transactions, potential liability for “fairness opinions” and other advice we provide to participants in strategic transactions and disputes over the terms and conditions of complex trading arrangements. We are also subject to claims arising from disputes with employees for alleged discrimination or harassment, among other things.

As a brokerage and investment banking firm, we depend to a large extent on our reputation for integrity and high-caliber professional services to attract and retain clients. As a result, if a client is not satisfied with our services, it may be more damaging in our business than in other businesses. Moreover, our role as advisor to our clients on important underwriting or mergers and acquisitions transactions involves complex analysis and the exercise of professional judgment, including rendering “fairness opinions” in connection with mergers and other transactions. Therefore, our activities may subject us to the risk of significant legal liabilities to our clients and aggrieved third parties, including shareholders of our clients who could bring securities class actions against us. Our investment banking engagements typically include broad indemnities from our clients and provisions to limit our exposure to legal claims relating to our services, but these provisions may not protect us or may not be enforceable in all cases. As a result, we may incur significant legal and other expenses in defending against litigation and may be required to pay substantial damages for settlements and adverse judgments. Substantial legal liability or significant regulatory action against us could have a material adverse effect on our results of operations or cause significant reputational harm to us, which could seriously harm our business and prospects.

***Employee misconduct could harm us and is difficult to detect and deter.***

Our reputation is critical in maintaining our relationship with clients, investors, regulators and the general public and is a key focus in our risk management efforts. In recent years, there have been a number of highly publicized cases involving fraud, conflicts of interest or other misconduct by employees in the financial services industry in recent years, and we run the risk that employee misconduct could occur at our company. For example, misconduct by employees could involve the improper use or disclosure of confidential information, which could result in regulatory sanctions and serious reputational or financial harm. Misconduct by employees could include binding us to transactions that exceed authorized limits or present unacceptable risks, or hiding from us unauthorized or unsuccessful activities, which, in either case, may result in unknown and unmanaged risks or losses. Employee misconduct could also involve the improper use or disclosure of confidential information, which could result in regulatory sanctions and serious reputational or financial harm. It is not always possible to deter employee misconduct, and the precautions we take to detect and prevent this activity may not be effective in all cases. As a result, we could suffer significant reputational harm for any misconduct by our employees. In addition, in certain circumstances our reputation could be damaged by activities of our clients or of hedge funds or other entities in which we invest, over which we have little or no control.

## **Risks Related to our Principal Investing Activities**

***Declines in the market values of our agency-backed MBS and agency CMOs may adversely affect periodic reported results and credit availability, which may reduce earnings and, in turn, cash available for distribution to our stockholders.***

A substantial portion of our assets are classified for accounting purposes either as “trading securities” or as “available-for-sale.” Changes in the market values of those assets will be directly charged or credited to stockholders’ equity. As a result, a decline in value may reduce the book value of our assets. Moreover, if the decline in value of an available-for-sale security is other than temporary, such decline will reduce earnings, as will a decline in the value of our securities classified as trading securities for accounting purposes.

A decline in the market value of our agency-backed MBS and agency CMOs may adversely affect us particularly in instances where we have borrowed money based on the market value of those assets. If the market value of those assets declines, the lender may require us to post additional collateral to support the loan. If we were unable to post the additional collateral, we would have to sell the assets at a time when we might not otherwise choose to do so. A reduction in credit available may reduce our earnings and, in turn, cash available for distribution to shareholders.

The sale of our agency-backed MBS and agency CMOs may jeopardize our REIT status. To continue to qualify as a REIT, we must comply with requirements regarding our assets and our sources of income. If we are required to liquidate our agency-backed MBS and our agency CMOs as a result of margin calls, we may be unable to comply with these requirements, ultimately jeopardizing our status as a REIT and our failure to qualify as a REIT will have adverse tax consequences.

***Our mortgage investing strategy involves leverage, which could adversely affect our operations and negatively affect cash available for distribution to our shareholders.***

Using debt to finance the purchase of our agency-backed MBS and agency CMOs will expose us to the risk that margin calls will be made and that we will not be able to meet those margin calls. To meet margin calls, we may sell the applicable mortgage-related securities and such sales could result in realized losses, and negatively affect cash available for distribution to our shareholders.

While it is not our current policy to leverage the equity securities or loan investments in our merchant banking portfolio, if we were to leverage these investments, this leverage could expose us to the risk that margin calls will be made and that we will not be able to meet them. A leveraged company’s income and net assets will tend to increase or decrease at a greater rate than if borrowed money were not used.

We enter into repurchase agreements to finance our agency-backed MBS and agency CMOs, which can amplify the effect of a decline in value resulting from an interest rate increase. For example, assume that we finance \$96 million of MBS through repurchase agreements to acquire \$100 million of 8% mortgage-backed securities. If prevailing interest rates were to increase sufficiently, the value of the mortgage-backed securities may decline to a level below the amount required to be maintained under the terms of the repurchase agreements. If the mortgage-backed securities were then sold, we would have to transfer additional assets to secure the borrowings.

***Changes in interest rates could negatively affect the value of our mortgage-backed securities, which could result in reduced earnings or losses and negatively affect the cash available for distribution to our stockholders.***

We invest indirectly in mortgage loans by purchasing mortgage-backed securities and we currently intend to continue this investment strategy. Under a normal yield curve, an investment in mortgage-backed securities will decline in value if long-term interest rates increase. Despite Fannie Mae, Freddie Mac or Ginnie Mae guarantees

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of the agency-backed mortgage-backed securities we own, those guarantees do not protect us from declines in market value caused by changes in interest rates. Declines in market value may ultimately reduce earnings or result in losses to us, which may negatively affect cash available for distribution to our stockholders.

A significant risk associated with our portfolio of mortgage-related assets is the risk that both long-term and short-term interest rates will increase significantly. If long-term rates were to increase significantly, the market value of these mortgage-backed securities would decline and the weighted average life of the investments would increase. We have realized losses in two of the last three years, and could realize a loss in the future if the mortgage-backed securities were sold. At the same time, an increase in short-term interest rates would increase the amount of interest owed on the repurchase agreements we enter into in order to finance the purchase of mortgage-backed securities.

Market values of mortgage-backed securities may decline without any general increase in interest rates for a number of reasons, such as increases in defaults, increases in voluntary prepayments and widening of credit spreads.

In addition, changes in interest rates may impact some of our merchant banking equity investments in non-conforming mortgage loan originators and other companies whose business models are sensitive to interest rates.

***An increase in our borrowing costs relative to the interest we receive on our mortgage-related assets may adversely affect our profitability, which may negatively affect cash available for distribution to our stockholders.***

As our repurchase agreements and other short-term borrowing instruments mature, we will be required either to enter into new repurchase agreements or to sell a portion of our mortgage-related assets or other investment securities. Current conditions in the credit markets may make it impracticable to enter into new repurchase agreements or other short-term facilities “—Risks Related to Adverse Market Conditions.”

An increase in short-term interest rates at the time that we seek to enter into new repurchase agreements would reduce the spread between our returns on our mortgage-related assets and the cost of our borrowings. This change in interest rates would adversely affect our returns on our mortgage-related assets portfolio, which might reduce earnings and, in turn, cash available for distribution to our stockholders.

***Prepayment rates could negatively affect the value of our mortgage-backed securities, which could result in reduced earnings or losses and negatively affect the cash available for distribution to our stockholders.***

In the case of residential mortgage loans, there are seldom any restrictions on borrowers’ abilities to prepay their loans. Homeowners tend to prepay mortgage loans faster when interest rates decline. Consequently, owners of the loans have to reinvest the money received from the prepayments at the lower prevailing interest rates. Conversely, homeowners tend not to prepay mortgage loans when interest rates increase. Consequently, owners of the loans are unable to reinvest money that would have otherwise been received from prepayments at the higher prevailing interest rates. This volatility in prepayment rates may affect our ability to maintain targeted amounts of leverage on our mortgage-based securities portfolio and may result in reduced earnings or losses for us and negatively affect the cash available for distribution to our shareholders.

Despite Fannie Mae, Freddie Mac or Ginnie Mae guarantees of principal and interest related to the agency-backed MBS we own, those guarantees do not protect us against prepayment risks.

***Rapid changes in the values of our mortgage-backed securities and other real estate assets may make it more difficult for us to maintain our REIT status or exemption from the 1940 Act.***

If the market value or income potential of our mortgage-backed securities and mezzanine loans declines as a result of increased interest rates, prepayment rates or other factors, we may need to increase our real estate

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investments and income and/or liquidate our non-qualifying assets in order to maintain our REIT status or exemption from the 1940 Act. If the decline in real estate asset values and/or income occurs quickly, this may be especially difficult to accomplish. This difficulty may be exacerbated by the illiquid nature of many of our non-real estate assets. We may have to make investment decisions that we otherwise would not make absent the REIT and 1940 Act considerations.

***Hedging against interest rate exposure may adversely affect our earnings, which could adversely affect cash available for distribution to our shareholders.***

We have entered into and may enter into interest rate swap agreements or pursue other hedging strategies. Our hedging activity will vary in scope based on the level and volatility of interest rates and principal prepayments, the type of mortgage-backed securities held, and other changing market conditions. Interest rate hedging may fail to protect or could adversely affect us because, among other things:

- interest rate hedging can be expensive, particularly during periods of rising and volatile interest rates;
- 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 amount of income that a REIT may earn from hedging transactions to offset interest rate losses is limited by federal tax provisions governing REITs;
- 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 party owing money in the hedging transaction may default on its obligation to pay.

Our hedging activity may adversely affect our earnings, which could adversely affect cash available for distribution to our shareholders.

***Our assets may include mezzanine or senior unsecured loans that may have greater risks of loss than secured senior loans and if those losses are realized, it could adversely affect our earnings, which could adversely affect our cash available for distribution to our shareholders.***

Our assets may include mezzanine or senior unsecured loans that involve a higher degree of risk than long-term senior secured loans. First, the loans may not be secured by mortgages or liens on assets. Even if secured, these loans may have higher loan-to-value ratios than a senior secured loan. Furthermore, our right to payment and the security interest may be subordinated to the payment rights and security interests of the senior lender. Therefore, we may be limited in our ability to enforce our rights to collect these loans and to recover any of the loan balance through a foreclosure of collateral.

Our loans may have an interest only payment schedule, with the principal amount remaining outstanding and at risk until the maturity of the loan. In this case, a borrower's ability to repay its loan may be dependent upon a liquidity event that will enable the repayment of the loan.

In addition to the above, numerous other factors may affect a company's ability to repay its loan, including the failure to meet its business plan, a downturn in its industry or negative economic conditions. A deterioration in a company's financial condition and prospects may be accompanied by deterioration in the collateral for the loan. Losses in our loans could adversely affect our earnings, which could adversely affect cash available for distribution to our shareholders.

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***We may change our mortgage investment strategy, hedging strategy, asset allocation and operational policies without shareholder consent, which may result in riskier investments and adversely affect the market value of our common stock and our ability to make distributions to our shareholders.***

We may change our mortgage investment strategy, hedging strategy, asset allocation and operational policies at any time without the consent of our shareholders, which could result in our making investments or hedges that are different from, and possibly riskier than, the investments and hedges described in this report on Form 10-K. A change in our investment or hedging strategy may increase our exposure to interest rate, and real estate market fluctuations. A change in our asset allocation could result in us making investments in instrument categories different from those described in this report on Form 10-K. Our Board of Directors determines our operational policies and may amend or revise our policies, including those with respect to our acquisitions, growth, operations, indebtedness, capitalization and distributions or approve transactions that deviate from these policies without a vote of, or notice to, our shareholders. Operational policy changes could adversely affect the market value of our common stock and our ability to make distributions to our shareholders.

***Loans that we may make to highly leveraged companies may have a greater risk of loss which, in turn, could adversely affect our earnings and cash available for distribution to our shareholders.***

Leverage may have material adverse consequences to the companies to which we may make loans in connection with our merchant banking business and to us as an investor in these companies. These companies may be subject to restrictive financial and operating covenants. The leverage may impair these companies' ability to finance their future operations and capital needs. As a result, these companies' flexibility to respond to changing business and economic conditions and to business opportunities may be limited. A leveraged company's income and net assets will tend to increase or decrease at a greater rate than if borrowed money were not used. As a result, leveraged companies have a greater risk of loss. Losses on such loans could adversely affect our earnings, which could adversely affect cash available for distribution to our shareholders.

***Our due diligence may not reveal all of a portfolio company's liabilities and may not reveal other weaknesses in a portfolio company's business.***

Before making an investment in a business entity, we assess the strength and skills of the entity's management and other factors that we believe will determine the success of the investment. In making the assessment and otherwise conducting customary due diligence, we rely on the resources available to us and, in some cases, an investigation by third parties. This process is particularly important and subjective with respect to newly-organized entities because there may be little or no information publicly available about the companies. We cannot assure you that our due diligence processes will uncover all relevant facts or risks about a company or investment that we make, or that any investment will be successful. Any unsuccessful investment may have a material adverse effect on our financial condition and results of operations.

***We depend on management and have limited ability to influence management of portfolio companies.***

We generally do not control the management, investment decisions or operations of the enterprises in which we have investments. Management of those enterprises may decide to change the nature of their assets or business plan, or management may otherwise change in a manner that is not satisfactory to us. We typically have no ability to affect these management decisions, and as noted below, may have only limited ability to dispose of these investments.

***We may make merchant banking investments that have limited liquidity, which may reduce the return on those investments to our stockholders.***

The equity securities of a new publicly-held or privately-held entity in which we invest are likely to be restricted as to resale and may otherwise be highly illiquid. We expect that there will be restrictions on our ability to resell the securities of any private or newly-public company that we acquire for a period of at least one year

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after we acquire those securities. In addition, applicable REIT tax provisions may cause sales of certain assets to be disadvantageous. Thereafter, a public market sale may be subject to volume limitations or dependent upon securing a registration statement for a secondary offering of the securities.

The securities of newly-public entities may trade less frequently and in smaller volume than securities of companies that are more widely held and have more established trading patterns. Sales of these securities may cause their values to fluctuate more sharply. Because we will make investments through an affiliate of FBR & Co., a registered broker-dealer in the U.S., and FBRIL, a registered broker-dealer in the United Kingdom, our ability to invest in companies may be constrained by applicable securities laws and regulations and the rules of FINRA and similar self-regulatory organizations. FBR & Co.'s investment and trading activities are regulated by the SEC, FINRA and other governmental authorities, and FBRIL's investment and trading activities are regulated by similar regulatory authorities in the United Kingdom, including the FSA. As a result, the rules of the SEC, FINRA and other governmental authorities may limit our ability to invest in the securities of companies whose securities are underwritten or privately placed by our broker-dealer affiliates.

Prices of the equity securities of new entities in which we invest may be volatile. We may make investments that are significant relative to the portfolio company's overall capitalization, and resales of significant amounts of these securities might adversely affect the market and the sales price for the securities.

The short- and medium-term loans we make are based, in part, upon our knowledge of the borrower and its industry. In addition, we do not yet nor may we ever have a significant enough portfolio of loans to easily sell them to a third party. As a result, these loans are and may continue to be highly illiquid.

Disposition value of our merchant banking investments is dependent upon general and specific market conditions which could result in a decline of the value of the investments.

Even if we make an appropriate investment decision based on the intrinsic value of an enterprise, we cannot assure you that the trading market value of the investment will not decline, perhaps materially, as a result of general market conditions. For example, an increase in interest rates, a general decline in the stock markets, or other market conditions adverse to companies of the type in which we invest could result in a decline in the value of our investments.

***The market for investment opportunities is competitive, which could make it difficult for us to purchase or originate investments at attractive yields, which could have an adverse effect on cash available for distribution to our stockholders.***

We gain access to investment opportunities only to the extent that they become known to us. Gaining access to investment opportunities is highly competitive. We compete with other companies that have greater capital, more long-standing relationships, broader product offerings and other advantages. Competitors include, but are not limited to, business development companies, small business investment companies, commercial lenders and mezzanine funds and other broker-dealers. Increased competition would make it more difficult for us to purchase or originate investments at attractive yields, which could have an adverse effect on cash available for distribution to our stockholders.

***We may incur losses as a result of our sector investment activities, which could negatively affect the market price of our common stock and our ability to make distributions to our stockholders.***

Our investments are made primarily through funds which we manage and funds which a third party acts as a manager. These funds may invest in companies in the early stages of their development or in industry sectors that are historically volatile, such as technology or sub-prime mortgage issuers. Our business and prospects must be considered in light of the risks, expenses and difficulties frequently encountered by companies in early stages of development, particularly companies in new and rapidly evolving markets. Moreover, these funds may invest in

privately held companies as to which little public information is available. Accordingly, we depend on these fund managers to obtain adequate information to evaluate the potential returns from investing in these companies. Fund managers may or may not be successful in this task. Also, these companies frequently have less diverse product lines and smaller market presence than large competitors. They are thus generally more vulnerable to economic downturns and may experience substantial variations in operating results.

Moreover, many of these portfolio companies will require additional equity funding to satisfy their continuing working capital requirements. Because of the circumstances of those companies or market conditions, it is possible that one or more of these portfolio companies will not be able to raise additional financing or may be able to do so only at a price or on terms that are unfavorable to them. Adverse returns with respect to these technology sector investment activities could adversely affect us and our operating results, which could negatively affect the market price of our Class A common stock and our ability to pay dividends.

#### **Risks Related to the Sale or Securitization of Non-Conforming Residential Mortgage Loans We Historically Originated or Acquired**

***We may be required to repurchase mortgage loans that we have sold or securitized, as the case may be, or to indemnify holders of our asset-backed securities, which could have a material adverse effect on our results of operations, financial condition and business.***

We historically originated non-conforming residential mortgage loans through First NLC. In addition, we historically acquired non-conforming residential mortgage loans through MHC I, Inc. (MHC), one of our qualified REIT subsidiaries. When we originated or acquired and included these mortgage loans in a securitization transaction or whole loan sale, we made certain representations and warranties regarding certain characteristics of these loans, the borrowers and the underlying properties. If we are found to have breached any of these representations and warranties, we may be required to repurchase those loans or indemnify the holders of the asset-backed securities we issued. If this occurs, we may have to bear any associated losses directly. In addition, in the case of loans that we sold, we may be required to indemnify the purchasers of the loans for losses or expenses incurred as a result of a breach of a representation or warranty. Repurchased loans typically require a significant allocation of working capital to carry on our books. Furthermore, repurchased mortgage loans typically can be sold only at a significant discount to the unpaid principal balance. Any repurchases or indemnification payments with respect to loans that we have securitized or sold could significantly harm our results of operations.

***We may be subject to losses due to fraudulent and negligent acts on the part of loan applicants, mortgage brokers, other vendors and our employees.***

When we originated mortgage loans through First NLC, we relied heavily upon information supplied by third parties, including the information contained in the loan application made by the applicant, property appraisal, title information and employment and income documentation. If a third party misrepresented any of this information and if we did not discover the misrepresentation prior to funding the loan, the value of the loan may be significantly lower than anticipated. As a practical matter, we generally bear the risk of loss associated with the misrepresentation whether it is made by the loan applicant, the mortgage broker, another third party or one of our employees. A loan with respect to which a material misrepresentation has been made is subject to repurchase if it was sold prior to detection of the misrepresentation. In addition, the persons and entities that made such material misrepresentations, are often difficult to locate, and it is nearly impossible to recoup any monetary losses that we may have suffered, as a result of such material misrepresentations from those who have made them.

For a portion of the mortgage loans we originated, we required no or limited documentation of the borrowers' income and bank account information. Instead, we based our credit decisions largely on the borrowers' credit score and credit history, the collateral value of the property securing the loan and the effect of the loan on the borrowers' debt service. There is a higher risk of default on loans where there is little or no documentation of the borrowers' income.

## **Tax Risks of our Business and Structure**

### ***Our ownership limitation may restrict change of control or business combination opportunities in which our shareholders might receive a premium for their shares.***

In order for us to qualify as a REIT, no more than 50% in value of our outstanding capital stock may be owned, directly or indirectly, by five or fewer individuals during the last half of any calendar year. "Individuals" include natural persons, private foundations, some employee benefit plans and trusts, and some charitable trusts. In order to preserve our REIT status, our amended and restated articles of incorporation generally prohibit any shareholder from directly or indirectly owning more than 9.9% of any class or series of our outstanding common stock or preferred stock.

The ownership limitation could have the effect of discouraging a takeover or other transaction in which holders of our common stock might receive a premium for their shares over the then prevailing market price or which holders might believe to be otherwise in their best interests.

### ***U.S. federal income tax requirements may restrict our operations, which could restrict our ability to take advantage of attractive investment opportunities, which could negatively affect the cash available for distribution to our shareholders.***

We intend to continue to operate in a manner that is intended to cause us to qualify as a REIT for U.S. federal income tax purposes. However, the U.S. federal income tax laws governing REITs are extremely complex, and interpretations of the U.S. federal income tax laws governing qualification as a REIT are limited. Qualifying as a REIT requires us to meet various tests regarding the nature of our assets and our income, the ownership of our outstanding stock, and the amount of our distributions on an ongoing basis. In some instances, compliance with these tests may not be completely within our control. For example, some of our investments are in equity securities of other REITs, which generally are qualifying assets and produce qualifying income for purposes of the REIT qualification tests. The failure of the REITs in which we invest to maintain their REIT status, however, could jeopardize our REIT status. Accordingly, we cannot be certain that we will be successful in operating so as to qualify as a REIT.

At any time, new laws, interpretations, or court decisions may change the federal tax laws regarding, or the U.S. federal income tax consequences of, qualification as a REIT. In addition, compliance with the REIT qualification tests could restrict our ability to take advantage of attractive investment opportunities in non-qualifying assets, which would negatively affect the cash available for distribution to our shareholders. For example, we may be required to limit our investment in non-REIT equity securities and mezzanine loans to the extent that such loans are not secured by real property.

### ***Our ownership of and relationship with our taxable REIT subsidiaries will be limited and a failure to comply with the limits would jeopardize our REIT status and may result in the application of a 100% excise tax.***

A REIT may own up to 100% of the stock of one or more taxable REIT subsidiaries. A taxable REIT subsidiary may earn income that would not be qualifying income if earned directly by the parent REIT. Both the subsidiary and the REIT must jointly elect to treat the subsidiary as a taxable REIT subsidiary. A corporation of which a taxable REIT subsidiary directly or indirectly owns more than 35% of the voting power or value of the stock will automatically be treated as a taxable REIT subsidiary. Overall, no more than 20% of the value of a REIT's assets may consist of stock or securities of one or more taxable REIT subsidiaries. A taxable REIT subsidiary will pay income tax at regular corporate rates on any income that it earns. In addition, the taxable REIT subsidiary rules limit the deductibility of interest paid or accrued by a taxable REIT subsidiary to its parent REIT to assure that the taxable REIT subsidiary is subject to an appropriate level of corporate taxation. The rules also impose a 100% excise tax on certain transactions between a taxable REIT subsidiary and its parent REIT that are not conducted on an arm's-length basis.

All of our operating businesses are conducted through taxable REIT subsidiaries. Our taxable REIT subsidiaries pay corporate income tax on their taxable income, and their after-tax net income is available for distribution to us but is not required to be distributed to us.

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The aggregate value of the taxable REIT subsidiary stock and securities currently owned by us is significantly less than 20% of the value of our total assets (including the taxable REIT subsidiary stock and securities). Furthermore, we will monitor the value of our investments in our taxable REIT subsidiaries for the purpose of ensuring compliance with the rule that no more than 20% of the value of our assets may consist of taxable REIT subsidiary stock and securities (which is applied at the end of each calendar quarter). In addition, we will scrutinize all of our transactions with our taxable REIT subsidiaries for the purpose of ensuring that they are entered into on arm's-length terms in order to avoid incurring the 100% excise tax described above. There can be no complete assurance, however, that we will be able to comply with the 20% limitation on ownership of taxable REIT subsidiary stock and securities on an ongoing basis so as to maintain REIT status or to avoid application of the 100% excise tax imposed on certain non-arm's-length transactions.

### ***Failure to make required distributions would subject us to tax, which would reduce the cash available for distribution to our shareholders.***

In order to qualify as a REIT, an entity must distribute to its shareholders, each calendar year, at least 90% of its taxable income, other than any net capital gain and excluding any retained earnings of taxable REIT subsidiaries. To the extent that a REIT satisfies the 90% distribution requirement, but distributes less than 100% of its taxable income, it will be subject to federal corporate income tax on its undistributed income. In addition, the REIT will incur a 4% nondeductible excise tax on the amount, if any, by which its distributions in any calendar year are less than the sum of:

- 85% of its ordinary income for that year;
- 95% of its capital gain net income for that year; and
- 100% of its undistributed taxable income from prior years.

We intend to continue to pay out our REIT taxable income to our shareholders in a manner intended to satisfy the 90% distribution requirement and to avoid both corporate income tax and the 4% excise tax. However, there is no requirement that taxable REIT subsidiaries distribute their after-tax net income to their parent REIT or their shareholders and our taxable REIT subsidiaries may elect not to make any distributions to us.

Our taxable income may substantially exceed our net income as determined based on generally accepted accounting principles because, for example, capital losses will be deducted in determining our GAAP income, but may not be deductible in computing our taxable income. In addition, we may invest in assets that generate taxable income in excess of economic income or in advance of the corresponding cash flow from the assets, referred to as phantom income. Although some types of phantom income are excluded in determining the 90% distribution requirement, we will incur corporate income tax and the 4% excise tax with respect to any phantom income items if we do not distribute those items on an annual basis. As a result of the foregoing, we may generate less cash flow than taxable income in a particular year. In that event, we may be required to use cash reserves, incur debt, or liquidate non-cash assets at rates or times that we regard as unfavorable in order to satisfy the distribution requirement and to avoid corporate income tax and the 4% excise tax in that year.

### ***Failure to qualify as a REIT would subject us to U.S. federal income tax, which would reduce the cash available for distribution to our shareholders.***

If we fail to qualify as a REIT in any calendar year, we would be required to pay U.S. federal income tax on our taxable income. We might need to borrow money or sell assets in order to pay that tax. Our payment of income tax would decrease the amount of our income available for distribution to our shareholders. Furthermore, if we cease to be a REIT, we no longer would be required to distribute substantially all of our taxable income to our shareholders. Unless our failure to qualify as a REIT were excused under federal tax laws, we could not re-elect REIT status until the fifth calendar year following the year in which we failed to qualify.

***The requirement that we distribute at least 90% of our taxable income to our shareholders, other than net capital gains and excluding the retained earnings of our taxable REIT subsidiaries, each year will result in our shareholders receiving periodic taxable distributions.***

In order to qualify as a REIT, we must distribute to our shareholders, each calendar year, at least 90% of our taxable income; other than net capital gains and excluding the taxable income of our taxable REIT subsidiaries. As a result, our shareholders receive periodic distributions from us. These distributions generally are taxable as ordinary income to the extent that they are made out of our current or accumulated earnings and profits. Our ordinary REIT dividends generally are not eligible for the reduced tax rates applicable to dividends paid by regular C corporations.

***A sale of assets acquired as part of the 2003 merger between pre-merger Friedman, Billings, Ramsey Group, Inc. and FBR Asset Investment Corp. within ten years after the merger would result in corporate income tax, which would reduce the cash available for distribution to our shareholders.***

If we sell any asset that we acquired as part of the 2003 merger between pre-merger Friedman, Billings, Ramsey Group, Inc. and FBR Asset Investment Corp., including the stock and securities of certain of our taxable REIT subsidiaries, within ten years after the merger and recognize a taxable gain on the sale, we will be taxed at the highest corporate rate on an amount equal to the lesser of:

- the amount of gain that we recognize at the time of the sale; or
- the amount of gain that we would have recognized if we had sold the asset at the time of the merger for its then fair market value.

This rule potentially could inhibit us from selling assets acquired as part of the 2003 merger within ten years after the merger.

***We may be subject to adverse legislative or regulatory tax changes that could reduce the market price of our common stock.***

The federal income tax laws governing REITs or the administrative interpretations of those laws may be amended at any time. Any of those new laws or interpretations may take effect retroactively and could adversely affect us or you as a shareholder.

## **ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

## **ITEM 2. PROPERTIES**

Our principal executive offices are located at Potomac Tower, 1001 Nineteenth Street North, Arlington, Virginia 22209. We carry out all aspects of our operations related to our capital markets, asset management and principal investing segments at that location. We lease with our affiliates more than nine floors of our headquarters building and at an adjacent property in Arlington, Virginia. We also lease office space with our affiliates in the following locations where we conduct certain portions of our operations as indicated: Boston, Massachusetts (capital markets and asset management); Dallas, Texas (capital markets); Houston, Texas (capital markets); Irvine, California (capital markets); New York, New York (capital markets); San Francisco, California (capital markets); Sydney, Australia (capital markets) and London, England (capital markets). We believe that the present facilities, together with current options to extend lease terms and occupy additional space, are adequate for our current and presently projected needs.

Our First NLC subsidiary, which filed a voluntary petition for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code on January 18, 2008 in order to effectuate an orderly liquidation of its assets, leases executive offices in Deerfield Beach, Florida and also leases office space in approximately 78 other locations throughout the United States. All such leases likely will be rejected in First NLC's bankruptcy case.

## ITEM 3. LEGAL PROCEEDINGS

### Overview

Except as described below, as of December 31, 2007, we were neither a defendant nor a plaintiff in any lawsuits or arbitrations nor involved in any governmental or SRO matters that are expected to have a material adverse effect on our financial condition, results of operations or liquidity. We are defendant in a small number of civil lawsuits and arbitrations (together, litigation) relating to our various businesses. In addition, we are subject to various reviews, examinations, investigations and other inquiries by governmental agencies and SROs. There can be no assurance that these matters individually or in aggregate will not have a material adverse effect on our financial condition or results of operations in a future period. However, based on management's review with counsel, resolution of these matters is not expected to have a material adverse effect on our financial condition, results of operations or liquidity.

Many aspects of our business involve substantial risks of liability and litigation. Underwriters, broker-dealers and investment advisers are exposed to liability under federal and state securities laws, other federal and state laws and court decisions, including decisions with respect to underwriters' liability and limitations on indemnification, as well as with respect to the handling of customer accounts. For example, underwriters may be held liable for material misstatements or omissions of fact in a prospectus used in connection with the securities being offered and broker-dealers may be held liable for statements made by their securities analysts or other personnel. FBR & Co., FBR Capital Markets' and our U.S. broker-dealer subsidiary, has been named as a defendant in a small number of securities claims involving investment banking clients of FBR & Co. as a result of FBR & Co.'s role as an underwriter. In these cases, the underwriting agreement provides, subject to certain conditions, that the investment banking client is required to indemnify FBR & Co. against certain claims or liabilities, including claims or liabilities under the Securities Act or contribute to payments which FBR & Co. is required to make as a result of the litigation. Although these cases involving FBR & Co. are at a preliminary stage, based on management's review with counsel and present information currently known by management, resolution of such matters is not expected to have a material effect on our financial condition or results of operations. In certain circumstances, broker-dealers and asset managers may also be held liable by customers and clients for losses sustained on investments. In recent years, there has been an increasing incidence of litigation and actions by government agencies and SROs involving the securities industry, including class actions that seek substantial damages. We are also subject to the risk of litigation, including litigation that may be without merit. As we intend to actively defend such litigation, significant legal expenses could be incurred. An adverse resolution of any future litigation against us could materially affect our financial condition, results of operations and liquidity.

Our business (through our subsidiary First NLC and its affiliated entities) historically included the origination, acquisition, pooling, securitization and sale of non-conforming residential mortgage loans. Consequently, we were subject to additional federal and state laws in this area of operation, including laws relating to lending, consumer protection, privacy and unfair trade practices.

### Putative Class Action Securities Lawsuits

FBR Group and certain of its current (including certain officers and directors of our Company) and former senior officers and directors have been named in a series of putative class action securities lawsuits filed in the second quarter of 2005, all of which are currently pending in the United States District Court for the Southern District of New York. These cases have been consolidated under the name *In re FBR Inc. Securities Litig.* A consolidated amended complaint has been filed asserting claims under the Securities Exchange Act of 1934 and alleging misstatements and omissions concerning (i) the SEC and NASD (now FINRA) investigations relating to FBR & Co.'s involvement in a private investment in public equity on behalf of CompuDyne, Inc. in October 2001 and (ii) the alleged conduct of FBR Group and certain current and former FBR Group officers and employees in allegedly facilitating certain sales of CompuDyne shares. FBR Group has filed a motion to dismiss the plaintiffs' consolidated amended complaint, which is pending before the court. We cannot predict the likely outcome of these lawsuits or their likely impact on us, if any, at this time.

### Shareholders' Derivative Action

We have been named a nominal defendant, and certain current and former senior officers and directors have been named as defendants, in three shareholders' derivative actions. Two of these actions, brought by Lemon Bay Partners LLC and Walter Boyle, are pending in the United States District Court for the Southern District of New York and have been consolidated, for pre-trial purposes only, with the pending putative class action securities lawsuits under the name *In re FBR Inc. Securities and Derivative Litig.* The third, brought by Gary Walter and Harry Goodstadt, has been filed in the Circuit Court for Arlington County, Virginia. All three cases claim that certain of our current and former officers and directors breached their duties to us based on allegations substantially similar to those in the *In re FBR Inc. Securities Litig. et al.* putative class action lawsuits described above. We have not responded to any of these complaints and no discovery has commenced. We cannot predict the likely outcome of this action or its likely impact on us at this time. Our Board of Directors has established a special committee whose jurisdiction includes the *In re FBR Inc. Securities and Derivative Litig.* and the Walter/Goodstadt matters as well as consideration of shareholder demand letters which contain similar allegations, and the special committee has been authorized to make final decisions whether such litigation is in our best interests.

### Other Litigation

As previously reported in our Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2007 and the quarterly period ended September 30, 2007, First NLC and the plaintiffs in the previously reported putative class actions pending in the U.S. District Court for the Northern District of California alleging violations of the Fair Labor Standards Act and violations of California wage and hour laws reached an agreement in June 2007 resolving all disputes (*Stanfield, et al. v. First NLC Financial Services, LLC*, Case No. C 06-3892 SBA; *Sparrow-Milrot, et al. v. First NLC Financial Services, LLC*, Case No. SA CV 07-0119 AHS RCX). First NLC has agreed to pay \$14 million in exchange for a full release of asserted claims against it. In September 2007, the federal district court granted preliminary approval of the settlement. In December 2007 the federal district court judge granted final approval of the settlement and the case was dismissed with prejudice.

As previously reported by the Company, on January 18, 2007, First NLC, our non-conforming residential mortgage loan origination subsidiary, filed a voluntary petition for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code in order to effectuate an orderly liquidation of First NLC's assets. The filing was made in the United States Bankruptcy Court for the Southern District of Florida, West Palm Beach Division.

### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITIES HOLDERS

None.

## PART II

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

Our Class A common stock is listed on the NYSE under the symbol "FBR." The following table shows the high and low sales prices of our Class A common stock during each fiscal quarter during the years ended December 31, 2007 and 2006, and the cash dividend per share declared during those periods.

	Price Range of Class A Common Stock		Cash Dividends Per Share
	High	Low	
Year Ended December 31, 2007			
Fourth Quarter	\$ 4.90	\$ 2.49	\$ —
Third Quarter	5.59	3.81	0.05
Second Quarter	6.67	5.30	0.05
First Quarter	8.39	4.50	0.05
Year Ended December 31, 2006			
Fourth Quarter	\$ 8.58	\$ 6.95	\$ 0.05
Third Quarter	11.39	7.70	0.05
Second Quarter	12.07	8.70	0.20
First Quarter	11.99	8.95	0.20

On January 31, 2008, there were approximately 323 record holders of our Class A common stock.

There is no established public trading market for our Class B common stock and on January 31, 2008, there were approximately 27 record holders of our Class B common stock. Class B shares receive dividends in the same amounts and on the same dates as Class A shares.

Information regarding securities authorized for issuance under our equity compensation plans as of December 31, 2007 will be incorporated by reference from our Definitive Proxy Statement from 2008 annual meeting of shareholders, which be filed with the SEC no later than 120 days after the end of our fiscal year ended December 31, 2007 (2008 Proxy Statement).

In order to qualify as a REIT for federal income tax purposes, we must distribute to our stockholders with respect to each year at least 90% of our taxable income. Although we generally intend to distribute to our shareholders each year an amount equal to our taxable income for that year, distributions paid by us will be at the discretion of our board of directors and will depend on our actual cash flow, our financial condition, capital requirements, the annual distribution requirements under the REIT provisions of the Internal Revenue Code and other factors our board of directors deems relevant. On December 21, 2007, we announced that our Board of Directors had decided not to pay a cash dividend to our shareholders for the fourth quarter of 2007, concluding at that time that the repurchase of our Class A common stock represented a better use of our financial resources than the payment of cash dividends. Pursuant to our variable dividend policy, our Board of Directors, in its sole discretion, may reinstate the payment of cash dividends when appropriate in the future.

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The following table provides information on the Company's share repurchases during the fourth quarter of 2007:

<u>Period</u>	<u>Total Number of Shares Purchased</u>	<u>Average Price Paid per Share</u>	<u>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</u>	<u>Maximum Number of (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs<sup>(1)</sup></u>
October 1 to October 31, 2007	8,146,528	\$ 4.65	8,146,528	76,356,572
November 1 to November 30, 2007	—	—	—	76,356,572
December 1 to December 31, 2007	—	—	—	76,356,572
Total	<u>8,146,528</u>	<u>\$ 4.65</u>	<u>8,146,528</u>	<u>76,356,572</u>

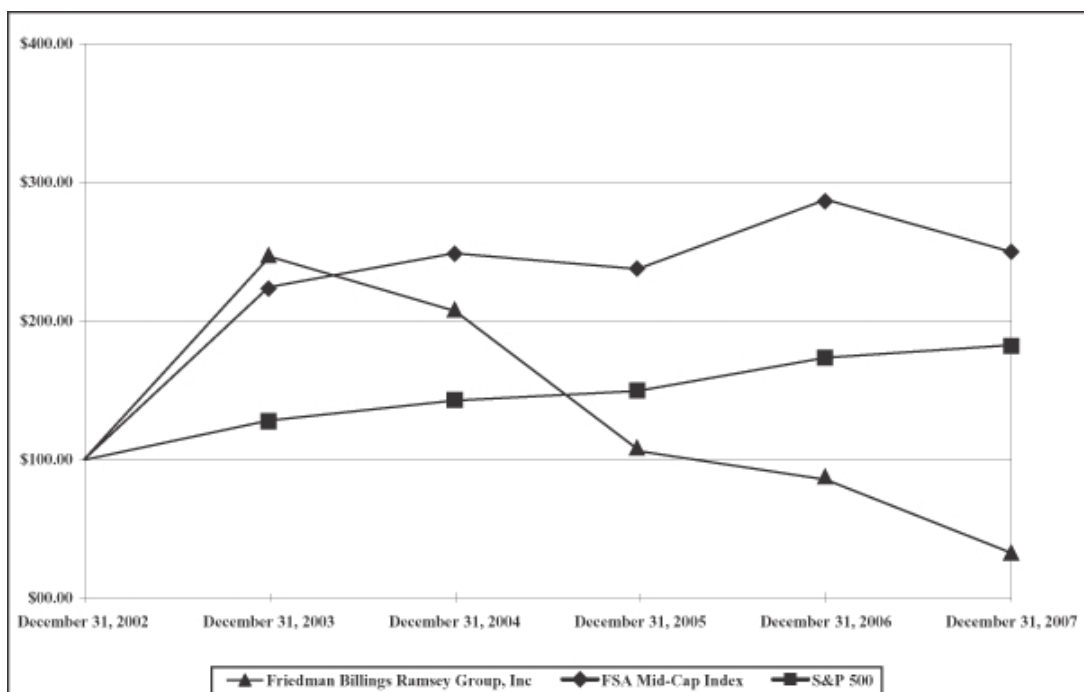
- (1) In April 2003, our board of directors authorized a share repurchase program in which we could repurchase up to 14,000,000 shares of Class A common stock from time to time. In March 2007, we announced that we would begin repurchasing shares in accordance with this share repurchase program. In July 2007, our Board of Directors authorized an increase in the number of shares of Class A common stock we could repurchase in accordance with this share repurchase program from 14,000,000 shares to 50,000,000 shares. In December 2007, our Board of Directors authorized a further increase in the number of shares of Class A common stock that we are authorized to repurchase in accordance with this repurchase program from 50,000,000 shares to 100,000,000 shares.

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The following graph compares the change in the cumulative total shareholder return for our Class A common stock from December 31, 2002 to December 31, 2007 with the comparable cumulative return of two indexes: the Standard & Poors (S&P) 500 Stock Index and the FSA Mid-Cap Index published by Financial Service Analytics, Inc.

Our Class A common stock trades on the NYSE. The graph assumes \$100 invested on December 31, 2002 in our Class A common stock and \$100 invested at the same time in each of the above mentioned indexes. The comparison assumes that all dividends are reinvested.

**Comparison of 5 Year Cumulative Total Return Among Friedman, Billings, Ramsey Group, Inc., the S&P 500 Index and the FSA Mid-Cap Index**



	FBR Prices <sup>(1)</sup>	FBR Indexed	FSA Mid-Cap	S&P 500 Indexed
December 31, 2002	\$ 9.36	\$ 100	\$ 100	\$ 100
December 31, 2003	23.08	247	225	129
December 31, 2004	19.39	207	249	143
December 31, 2005	9.90	106	238	150
December 31, 2006	8.00	85	288	173
December 31, 2007	3.04	32	251	183

(1) Closing price of our Class A common stock on the NYSE on December 31 of the indicated year.

**ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA**
**SELECTED CONSOLIDATED FINANCIAL INFORMATION**  
(Dollars in thousands, except per share amounts)

	Year Ended December 31,				
	2007	2006	2005	2004	2003
<b>Consolidated Statements of Operations</b>					
Revenues:					
Investment banking:					
Capital raising	\$ 282,619	\$ 190,187	\$ 356,753	\$ 398,183	\$ 246,567
Advisory	34,063	24,148	17,759	30,115	14,815
	<u>316,682</u>	<u>214,335</u>	<u>374,512</u>	<u>428,298</u>	<u>261,382</u>
Institutional brokerage:					
Principal transactions	10,152	5,814	17,950	20,444	23,965
Agency commissions	104,792	101,009	82,778	89,650	50,178
Mortgage trading interest	—	51,147	30,859	—	—
Mortgage trading net investment loss	—	(3,301)	(3,820)	—	—
	<u>114,944</u>	<u>154,669</u>	<u>127,767</u>	<u>110,094</u>	<u>74,143</u>
Asset management:					
Base management fees	23,549	20,093	30,348	28,307	24,782
Incentive allocations and fees	401	1,327	1,929	10,940	13,959
	<u>23,950</u>	<u>21,420</u>	<u>32,277</u>	<u>39,247</u>	<u>38,741</u>
Principal investment:					
Interest	501,130	594,879	549,832	350,691	168,393
Net investment (loss) income	(221,956)	(184,552)	(239,754)	101,973	70,619
Dividends	3,173	14,551	36,622	14,644	4,078
	<u>282,347</u>	<u>424,878</u>	<u>346,700</u>	<u>467,308</u>	<u>243,090</u>
Mortgage banking:					
Interest	51,245	88,662	78,007	—	—
Net investment (loss) income	(222,032)	83,786	13,741	—	—
	<u>(170,787)</u>	<u>172,448</u>	<u>91,748</u>	<u>—</u>	<u>—</u>
Other	15,808	20,154	22,302	7,155	11,169
Total revenues	<u>582,944</u>	<u>1,007,904</u>	<u>995,306</u>	<u>1,052,102</u>	<u>628,525</u>
Interest expense	477,437	611,800	546,313	164,156	68,995
Provision for loan losses	—	15,740	14,291	—	—
Revenues, net of interest expense and provision for loan losses	<u>105,507</u>	<u>380,364</u>	<u>434,702</u>	<u>887,946</u>	<u>559,530</u>
Non-Interest Expenses:					
Compensation and benefits	361,355	309,065	331,492	323,524	226,389
Professional services	55,741	59,722	66,550	50,467	21,628
Business development	43,518	42,150	46,648	44,955	21,416
Clearing and brokerage fees	12,514	11,820	8,882	9,123	7,014
Occupancy and equipment	52,302	50,051	34,044	14,458	9,585
Communications	28,690	24,398	20,634	13,959	10,574
Other operating expenses	82,246	89,377	70,679	22,740	16,919
Impairment of goodwill	162,765	—	—	—	—
Restructuring charges	46,985	—	—	—	—
Total non-interest expenses	<u>846,116</u>	<u>586,583</u>	<u>578,929</u>	<u>479,226</u>	<u>313,525</u>
Operating (loss) income	(740,609)	(206,219)	(144,227)	408,720	246,005
Other Income:					
Gain on sale of subsidiary shares	104,062	121,511	—	—	—
(Loss) income before taxes and minority interest	(636,547)	(84,708)	(144,227)	408,720	246,005
Income tax provision (benefit)	22,932	(14,682)	26,683	59,161	44,591
Minority interest in earnings (losses) of consolidated subsidiary	774	(2,751)	—	—	—
Net (loss) income	<u>\$ (660,253)</u>	<u>\$ (67,275)</u>	<u>\$ (170,910)</u>	<u>\$ 349,559</u>	<u>\$ 201,414</u>

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	Year Ended December 31,				
	2007	2006	2005	2004	2003
<b>Consolidated Balance Sheet Data</b>					
<b>Assets:</b>					
Cash and cash equivalents	\$ 692,360	\$ 189,956	\$ 238,615	\$ 224,371	\$ 92,688
Restricted cash	14,166	132	6,101	7,156	—
Mortgage-backed securities, at fair value	1,791,480	6,870,661	8,002,561	11,726,689	10,551,570
Loans held for investment, net	—	—	6,841,266	—	—
Loans held for sale, net	65,074	5,367,934	963,807	—	—
Long-term investments	169,274	185,492	347,644	441,499	379,002
Reverse repurchase agreements	—	—	283,824	183,375	—
Trading securities, at fair value	19,057	18,180	1,032,638	7,744	4,932
Goodwill and intangible assets, net	9,837	184,590	189,250	122,417	124,103
Other	183,707	535,573	530,084	215,037	176,790
<b>Total assets</b>	<b>\$2,944,955</b>	<b>\$13,352,518</b>	<b>\$18,435,790</b>	<b>\$12,928,288</b>	<b>\$11,329,085</b>
<b>Liabilities:</b>					
Trading account securities sold but not yet purchased, at fair value	\$ 206	\$ 202	\$ 150,547	\$ 17,176	\$ 9,525
Commercial paper	—	3,971,389	6,996,950	7,294,949	4,392,965
Repurchase agreements	1,744,377	3,059,330	2,698,619	3,467,569	5,095,676
Dividends payable	—	8,743	34,588	65,870	56,744
Accounts payable and other liabilities	240,045	195,867	284,032	375,830	165,647
Securitization financing, net	—	4,486,046	6,642,198	—	—
Long-term debt	323,575	324,453	324,686	128,370	54,189
<b>Total liabilities</b>	<b>2,308,203</b>	<b>12,046,030</b>	<b>17,131,620</b>	<b>11,349,764</b>	<b>9,774,746</b>
Minority interest	243,061	135,443	—	—	—
<b>Shareholders Equity:</b>					
Common Stock and Additional Paid in Capital	1,470,320	1,564,244	1,529,237	1,463,576	1,434,417
Accumulated other comprehensive (loss) income, net of taxes	(12,846)	(15,136)	(977)	(38,162)	60,505
(Accumulated deficit) retained earnings	(1,063,783)	(378,063)	(224,090)	153,110	59,417
	393,691	1,171,045	1,304,170	1,578,524	1,554,339
<b>Total liabilities and shareholders' equity</b>	<b>\$2,944,955</b>	<b>\$13,352,518</b>	<b>\$18,435,790</b>	<b>\$12,928,288</b>	<b>\$11,329,085</b>
<b>Statistical Data</b>					
Basic (loss) earnings per share	\$ (3.95)	\$ (0.39)	\$ (1.01)	\$ 2.09	\$ 1.68
Diluted (loss) earnings per share	\$ (3.95)	\$ (0.39)	\$ (1.01)	\$ 2.07	\$ 1.63
Book value per share <sup>(1)</sup>	\$ 2.61 <sup>(2)</sup>	\$ 6.78 <sup>(2)</sup>	\$ 7.66 <sup>(2)</sup>	\$ 9.46 <sup>(2)</sup>	\$ 9.41 <sup>(2)</sup>
Total employees <sup>(1)</sup>	1,025	3,019	2,499	698	494
Pre-tax return on average equity	(81)%	(7)%	(10)%	26%	27%
Compensation and benefits expense as a percentage of net revenues	343%	81%	76%	36%	40%
Basic weighted average shares outstanding (in thousands)	166,975	171,667	169,333	167,099	119,801
Diluted weighted average shares outstanding (in thousands)	166,975	171,667	169,333	168,490	123,307
Cash dividends per common share	\$ 0.15	\$ 0.50	\$ 1.22	\$ 1.53	\$ 1.36

(1) As of end of the period reported.

(2) Excludes employee stock and purchase loan receivable shares of 1.6 thousand shares, 1.6 thousand shares, 0.6 million shares, 0.7 million shares, and 1.3 million shares, pledged as collateral as of December 31, 2007, 2006, 2005, 2004, and 2003, respectively.

## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### Overview

Friedman, Billings, Ramsey Group, Inc. is a leading investment banking firm that provides investment banking, institutional brokerage and asset management services through its publicly traded, majority-owned subsidiary, FBR Capital Markets (NASDAQ: FBCM), and invests as a principal in agency-backed MBS and makes merchant banking investments with its own capital. Historically, we have invested in other mortgage-related investments, including non-conforming residential mortgage loans and securities backed by non-conforming residential mortgage loans. Additionally, the Company owns First NLC Financial Services, LLC (First NLC), a non-conforming, including non-prime residential mortgage loan originator. When we use the terms "FBR," "we" "us" "our" and "the Company," we mean Friedman, Billings, Ramsey Group, Inc. and its consolidated subsidiaries. We historically have conducted most of our principal investing activities at the parent company level and through a qualified REIT subsidiary (QRS) (principal investing). We have elected and believe that we are organized and have been operated in a manner that qualifies us to be taxed as a real estate investment trust (REIT) for U.S. federal income tax purposes. We conduct our investment banking and institutional brokerage activities (capital markets), investment management and advisory activities (asset management) and loan origination and mortgage banking activities (mortgage banking) in taxable REIT subsidiaries. Our Company operates primarily in the United States and Europe.

Because of the continued deterioration of the non-prime mortgage market, on January 18, 2008, First NLC filed a voluntary petition for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code in order to effectuate an orderly liquidation of First NLC's assets. The filing was made in the United States Bankruptcy Court for the Southern District of Florida, West Palm Beach Division. In connection with the voluntary bankruptcy petition filed by First NLC, beginning in the first quarter of 2008, we will deconsolidate First NLC for financial reporting purposes and use the cost method to account for our investment in First NLC.

### Business Environment

#### *Mortgage-Related Investing*

In recent months, the mortgage industry has come under continued pressure due to numerous factors, which include industry-wide disclosures regarding the continued deterioration of the value of mortgage assets held by banks and broker-dealers, the deterioration of mortgage credit among mortgage lenders, the downgrades of mortgage securities by the rating agencies and a reluctance on the part of banks and broker-dealers to finance mortgage securities in the reverse repurchase agreement and other mortgage financing markets. Despite the contraction in market liquidity that began in August 2007, we believe financing for agency securities remains available due to the credit quality of agency securities. Much of the stress in the financial markets has been focused on non-agency securities and the financing of these securities has suffered as a result. However, we believe repurchase financing remains available at favorable rates for agency securities due to the guarantees in principal and interest by U.S. government agencies or U.S. Government-sponsored entities.

Beginning on September 18, 2007, the U.S. Federal Reserve has lowered the target for the Federal Funds Rate five times to 3.0%. These reductions have significantly improved the financing spreads and net interest margins on agency securities that we intend to purchase. Additionally, rates on interest rate swap contracts that we intend to use to hedge against interest rate risks have also declined allowing for improvement in net interest margins. We anticipate taking advantage of the current favorable financing environment for agency securities by deploying our capital into a leveraged portfolio of agency-backed MBS backed predominantly by current-reset and longer-to-reset ARMs.

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The supply of agency securities on the secondary mortgage market continues to increase as non-agency securitization channels have been significantly reduced due to the contraction in market liquidity that began in August 2007. Over the past several months, the non-agency MBS market has experienced significant dislocation and a substantial decline in asset values, causing a slowdown in the issuance of these securities. According to the Office of Federal Housing Enterprise Oversight, for the fourth quarter of 2007, agency-backed MBS accounted for 84.8% of total MBS issuance compared to 71.3% in the third quarter of 2007 and 53.8% in the second quarter of 2007.

### ***Capital Markets***

Our businesses are materially affected by conditions in the U.S. financial markets and general U.S. economic conditions. The market environment was generally favorable for our businesses in the first half of the 2007 fiscal year. These favorable conditions resulted from a number of factors, including strong equity markets, continued strength in the economy, tightening credit spreads, active trading volumes, and strong underwriting activities. During the second half of the 2007 fiscal year, the economy was affected by the deterioration within the subprime residential mortgage asset category, weakness in the housing sector became worse than most observers expected, and dislocations began to occur beyond the residential mortgage component of credit markets. Also during the latter part of 2007, risk aversion escalated following rating downgrades of certain structured assets which, in part, led to many market participants re-pricing assets and taking large write-downs. Central banks sought to prevent a more serious downturn through interest rate and liquidity actions. The year ended with dislocated inter-bank markets, constrained bank balance sheets and credit uncertainty regarding monoline issuers and structured investment vehicles.

U.S. equity markets rose over the first three quarters of the year, but experienced high volatility in the second half of the year. Equity underwriting activity fell off in the second half of the year, and the fourth quarter slowdown in capital markets activity following the August dislocation in credit markets was particularly severe. Finally, corporate activity levels in completed and announced M&A transactions were up compared to the prior year.

U.S. economic growth was approximately 2.2% for 2007 and is forecasted to be lower for 2008. During 2007, the housing market weakened, business confidence declined, and in the last six months of the year, consumer confidence dropped. The labor market followed the same trajectory, showing signs of deterioration in the second half of the year as unemployment levels increased modestly and payroll data showed some signs of weakness. Responding to concerns over liquidity in the financial markets, the U.S. Federal Reserve reduced rates three times during the year and made additional rate cuts in January 2008, and most observers anticipate additional reductions will occur in the early part of 2008. Long-term bond yields declined, with the 10-year Treasury note ending the year down 63 basis points at 4.03%. The S&P 500 Index, Dow Jones Industrial Average and NASDAQ composites were up 5.49%, 8.88% and 9.81%, respectively from year-end 2006 levels. The current high levels of U.S. home inventories suggest that an extended period of construction declines and housing price cuts will combine with tighter credit conditions and increasing oil prices to slow down consumer spending. We believe those conditions will continue to strain the capital markets and will decrease the U.S. growth rate, resulting in what we believe will be lower levels of capital markets activity in 2008.

We believe 2008 is going to be a low growth year with continued dampened capital markets activity across the industry, both here and overseas. Our growth outlook is dependent on how extended and severe the credit dislocation may be, results from fiscal and monetary policy actions, accessibility of liquidity and the direction of oil prices. The underpinnings of these growth assumptions also form our view on prospective investment banking, institutional sales, trading and research and asset management activity.

## Executive Summary

For the year ended December 31, 2007, our total revenues, net of interest expense and loan loss provisions, were \$105.5 million compared to \$380.4 million in 2006. The 2007 net loss of \$660.3 million, or \$3.95 loss per share, compares to a net loss of \$67.3 million, or \$0.39 loss per share in 2006. The components of the net losses by segment are as follows:

	For the year ended December 31,	
	2007	2006
Capital Markets, net of intersegment elimination	\$ 23,192	\$ (34,376)
Asset Management	(7,016)	(11,080)
Principal Investment	(330,411)	(142,594)
Mortgage Banking	(426,374)	(18,169)
Operating loss	(740,609)	(206,219)
Gain on sale of subsidiary shares	104,062	121,511
Loss before income taxes and minority interest	(636,547)	(84,708)
Income tax provision (benefit)	22,932	(14,682)
Minority interest in earnings (losses) of consolidated subsidiary	774	(2,751)
Net loss	<u>\$(660,253)</u>	<u>\$ (67,275)</u>

For the year ended December 31, 2007, the Company declared a total of \$0.15 per share in dividends, down from \$0.50 per share for the year ended December 31, 2006. The Company's book value per share decreased to \$2.61 as of December 31, 2007 compared to \$6.78 as of December 31, 2006. The reduction in book value per share reflects the impact from the net loss and dividends declared in 2007.

The following provides analysis of our operating segments and their activities.

## Capital Markets

Our capital markets segment includes investment banking and institutional sales, trading and research.

The pre-tax income from our capital markets segment increased to \$28.7 million (\$23.2 million, net of intersegment eliminations) for the year ended December 31, 2007 from a loss of \$34.4 million for the year ended December 31, 2006. This increase was primarily attributable to a \$102.3 million increase in investment banking revenues during 2007, reflecting a higher volume of capital raising activity, primarily in the first six months of 2007, in our real estate, financial services and TMT sectors. Through June 30, 2007, we had generated \$219.9 million in investment banking revenues. However, due to the disruption in the credit markets in August 2007, market conditions deteriorated significantly during the last five months of 2007. As a result of these conditions, we were unable to maintain the level of investment banking revenue growth achieved in the first six months of 2007, and for the year, we generated \$316.7 million of investment banking revenues. Of this total investment banking revenue in 2007, we recognized \$195.5 million related to sole-managed private placement transactions. This compared to total investment banking revenues of \$214.3 million in 2006, of which \$130.4 million related to sole-managed private placement transactions. Our institutional brokerage sales and trading net revenues increased \$4.8 million, or 4.4%, for the year ended December 31, 2007 compared to the prior year. Compensation and benefits costs within our capital markets segment increased 26.0%, or \$56.1 million, during 2007 as a result of the increased variable compensation due to increased capital raising revenues.

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*Investment Banking*

Our investment banking activities consist of a broad range of services, including underwritings, public and private capital raising transactions that include a wide variety of securities, and financial advisory services in merger, acquisition, restructuring and strategic partnering transactions. Revenues from our investment banking operations totaled \$316.7 million for the year, representing an increase of 47.8% from the prior year. In 2007, our investment banking team executed 91 banking assignments with a total transaction value of over \$16.0 billion, including \$5.0 billion in lead-managed equity capital raising transactions. Highlights for lead-managed capital raises include:

- \$1.1 billion in six IPOs;
- \$2.5 billion in 11 private placements; and
- \$1.4 billion in eight follow-on, secondary and preferred public equity offerings

In addition, during 2007 our M&A group completed 40 successful mergers, acquisitions and advisory assignments, representing \$4.4 billion in aggregate transaction value.

The following table shows details of our investment banking revenues for the years indicated (dollars in thousands):

	2007	2006	2005
<b>Capital raising:</b>			
Institutional private equity offerings and private placements	\$ 197,219	\$ 139,276	\$ 225,489
Initial public offerings	32,233	13,763	69,677
Follow-on, secondary and preferred public equity offerings	52,419	35,132	53,180
Asset-backed securities and high yield debt offerings	748	2,016	8,407
Total capital raising	282,619	190,187	356,753
<b>Advisory</b>	34,063	24,148	17,759
<b>Total investment banking</b>	<b>\$ 316,682</b>	<b>\$ 214,335</b>	<b>\$ 374,512</b>

*Institutional Brokerage*

In addition to our investment banking activities, we also offer institutional brokerage services to customers. In a rapidly changing trading environment characterized by continuing pressure on commission rates, revenue from institutional brokerage (principal transactions and agency commissions) was up 7.6% on a year-to-year basis, increasing from \$106.8 million in 2006 to \$114.9 million in 2007. The increase in revenue is due to our expansion of sales and trading personnel and a reduction in trading losses.

In May 2005, we initiated certain fixed income trading activities, primarily related to mortgage-backed, asset-backed and other structured securities. These fixed income trading activities continued through October 2006. During the third quarter 2006, we made a decision to sell our trading positions. At present, we do not expect to redeploy capital to fixed income trading activities. Revenues, net of related interest expense, related to institutional brokerage activities for the years indicated are (dollars in thousands):

	2007	2006	2005
Principal transactions	\$ 10,152	\$ 5,814	\$ 17,950
Agency commissions	104,792	101,009	82,778
Mortgage trading interest and net investment loss	—	47,846	27,039
	114,944	154,669	127,767
Interest expense	—	44,472	23,743
<b>Institutional brokerage revenues, net of interest expense</b>	<b>\$ 114,944</b>	<b>\$ 110,197</b>	<b>\$ 104,024</b>

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Our investment banking and institutional brokerage businesses are focused in the consumer, diversified industrials, energy and natural resources, financial institutions, healthcare, insurance, real estate and technology, media and telecommunications sectors. Historically, we have focused on small and mid-cap stocks, although our research coverage and associated brokerage activities increasingly involve larger-cap stocks. By their nature, our business activities are highly competitive and are not only subject to general market conditions, volatile trading markets, and fluctuations in the volume of market activity, but also to the conditions affecting the companies and markets in our areas of focus. As a result, our capital markets revenues and profits can be subject to significant volatility from period to period.

### ***Asset Management***

Our asset management segment consists of managing a broad range of pooled investment vehicles, including mutual funds, hedge funds, venture capital and private equity funds and separate accounts. Our total net assets under management were \$2.5 billion at December 31, 2007, compared to \$2.4 billion at December 31, 2006. Net assets under management increased 4.4%, or \$103.5 million, during 2007 as a result of mutual fund inflows, primarily related to the FBR Focus Fund.

The operating loss from our asset management activities decreased from an operating loss of \$11.1 million in 2006 to an operating loss of \$7.0 million in 2007. The decrease in operating loss was primarily attributable to an increase in net revenues of 13.7% or \$3.7 million during 2007 as a result of an increase in average assets under management during 2007 as compared to 2006 and the fees earned from those assets.

We generate fees from our asset management activity for services provided in the management of investment vehicles or accounts and administration of mutual funds. Base management fees are earned on our net assets under management and are determined based on a percentage of actual or committed capital, excluding, in some cases, our own direct investments and certain other affiliated capital. The percentages used to determine our base fee vary from vehicle to vehicle.

We recorded \$23.5 million in base management fees (including mutual fund administrative fees) for the year ended December 31, 2007. Our annualized effective fee during the fourth quarter of 2007 on the year end net assets under management was 87 basis points.

The incentive allocations and gains (losses) in our managed investment partnerships are determined, in part, by the value of securities held by those partnerships. To the extent that these partnerships hold securities of public companies that are restricted as to resale due to contractual lock-ups, regulatory requirements (including Rule 144 holding periods), or for other reasons, these securities are generally valued by reference to the public market price, subject to discounts to reflect the restrictions on liquidity. These discounts are sometimes referred to as haircuts. As the restriction period runs, the amount of the discount is generally reduced. We review these valuations and discounts quarterly.

The following provides details relating to our assets under management (dollars in millions):

	December 31, 2007	
	Gross(1)	Net(2)
Managed accounts	\$ 347.1	\$ 347.1
Hedge and offshore funds	52.1	50.7
Mutual funds:		
Equity	1,870.5	1,859.3
Fixed income and money market	176.0	175.3
Private equity funds	23.8	22.6
Total	<u>\$2,469.5</u>	<u>\$ 2,455.0</u>

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	December 31, 2006	
	Gross(1)	Net(2)
Managed accounts	\$ 259.9	\$ 259.9
Hedge and offshore funds	97.5	96.4
Mutual funds:		
Equity	1,749.6	1,743.4
Fixed income and money market	212.3	211.3
Private equity funds	42.2	40.5
Total	<u>\$2,361.5</u>	<u>\$2,351.5</u>

- (1) Gross assets under management represent the amount of actual gross assets of our proprietary investment partnerships and mutual funds including leverage.
- (2) Net assets under management represent gross assets under management, net of any repurchase agreement debt, margin loans, securities sold but not yet purchased, lines of credit, and any other liabilities.

Our asset management revenues and net income (loss) are subject to fluctuations due to a variety of factors that cannot be predicted with great certainty. These factors include the overall condition of the economy and the securities markets as a whole and the sectors on which we focus. This condition can in turn influence inflows and outflows of assets under management, and the performance of our asset management funds. For example, a significant portion of the performance-based or incentive revenues that we recognize from our hedge fund, venture capital and private equity activities is based on the value of securities held in the funds we manage. The value of these securities includes unrealized gains or losses that may change from one period to another.

### ***Mortgage Banking***

We historically conducted our mortgage banking activities primarily through our taxable REIT subsidiary First NLC, a residential mortgage banking company originating and acquiring primarily non-conforming mortgage loans in the United States. We acquired First NLC during the first quarter of 2005 with the expectation that the acquisition would assist in expanding and adding flexibility to our mortgage loan business by providing the ability to originate, price, portfolio and sell non-conforming mortgage loans based on market conditions.

However, market conditions and continued deterioration of the non-prime mortgage market during 2006 and 2007 prevented us from achieving expected returns from our investment in the mortgage banking segment (which consists primarily of First NLC operations). During 2006 and 2007, we took various steps to limit our exposure to losses in our mortgage banking segment. On July 25, 2007, we entered into a recapitalization agreement with an affiliate of Sun Capital Partners (Sun Capital). The recapitalization agreement resulted in the investment by Sun Capital of \$60 million, and an additional investment by us of \$15 million, in First NLC. Pursuant to the terms and conditions of the recapitalization agreement and the other related agreements, each of Sun Capital's and our investment in First NLC was treated as convertible debt of First NLC. Prior to conversion of any of this debt to equity, First NLC continued to be a wholly-owned subsidiary of our company, was governed by a board of directors controlled by us and operated under state mortgage licenses based on this governance structure. Accordingly, Sun Capital has been treated as a senior lender of First NLC and its convertible debt investment in First NLC is non-recourse to us. Upon satisfaction of various conditions, the convertible debt was expected to convert into equity interests in First NLC, which would have resulted in First NLC being owned 80% by Sun Capital and 20% by us. As a result of the First NLC bankruptcy proceedings discussed below, the recapitalization of First NLC will not close. Pursuant to the terms of a loan agreement entered into in connection with the recapitalization agreement, any recovery from First NLC or its assets in respect of the convertible debt investments in First NLC made by Sun Capital and us in the third quarter of 2007 will be shared 80% by Sun Capital and 20% by us, notwithstanding whether Sun Capital's or our convertible debt investment has been converted into equity of First NLC. As of December 31, 2007, we have continued to consolidate First NLC for financial reporting purposes.

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As a result of continued deterioration of the non-prime mortgage market, on January 18, 2008, First NLC filed a voluntary petition for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code in order to effectuate an orderly liquidation of First NLC's assets. The filing was made in the United States Bankruptcy Court for the Southern District of Florida, West Palm Beach Division.

In connection with the voluntary petition for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code filed by First NLC, beginning in the first quarter of 2008, we will deconsolidate First NLC for financial reporting purposes and use the cost method to account for our investment in First NLC.

Operating losses incurred by the mortgage banking segment, consisting primarily of First NLC, increased from an operating loss of \$18.2 million in 2006 to an operating loss of \$426.4 million in 2007. The operating losses in 2007 were primarily attributable to the continued decline in value of the loans held and originated during 2007 due to the continued deterioration in the market for non-prime residential mortgage loans which reflects the effects of industry-wide increases in early payment default requests from loan investors as well as the surplus of non-prime loans in the market. The 2006 operating loss was primarily attributable to the compression on loan sales premiums and an industry-wide increase in the numbers of loans required to be repurchased by originators due to early payment defaults during 2006.

In response to the deterioration in the non-prime mortgage industry, First NLC initiated various restructuring activities in 2007. As a result, for the twelve months ended December 31, 2007, the Company recorded charges of \$101.7 million related to these restructuring activities and a decline in the fair value of First NLC's origination platform, including write-downs of \$65.0 million related to the impairment of goodwill and other intangible assets. There were no comparable restructuring charges incurred by First NLC in 2006.

For the year ended December 31, 2007, the Company's provision for repurchase and premium recapture obligations was \$47.3 million. This provision reflects the effects of industry-wide increases in requests for loan repurchases related to early payment defaults and significantly increased loss severities on repurchased non-prime residential mortgage loans due to deteriorating market conditions in 2007. Of the total loss provision recorded during 2007, \$18.0 million represents a change in estimate relating to prior year sales due to the changes in market conditions noted above. As a result of First NLC's bankruptcy proceedings, the Company's on-going exposure to First NLC and related repurchase and premium recapture obligations will be eliminated.

As noted above, we continued to consolidate First NLC for financial reporting based on our equity ownership; however, based on the fact that Sun Capital's convertible debt and various other First NLC obligations, reflected on our balance sheet at December 31, 2007, are non-recourse to us, since entering into the July recapitalization transaction, we have recorded losses in excess of our investment exposure. As a result, upon the confirmation of Chapter 11 plans in the First NLC bankruptcy proceedings, which is expected to occur in the first six months of 2008, we estimate that approximately \$70.0 million of the operating losses incurred by First NLC will ultimately be recovered; however, no assurance can be given that we will recover these operating losses in the first six months of 2008.

### ***Principal Investing***

As of December 31, 2007, our principal investing activity consisted primarily of investments in a leveraged portfolio of agency-backed MBS, merchant banking investments and investments in hedge and venture funds.

We constantly evaluate the rates of return that can be achieved in each investment category and for each individual investment in which we participate. Historically, based on market conditions, our mortgage-backed securities investments have provided us with higher relative risk-adjusted rates of return than most other investment opportunities we have evaluated. Consequently, we have maintained a high allocation of our assets and capital in this sector.

We intend to continue to evaluate investment opportunities against the returns available in each of our investment alternatives and endeavor to allocate our assets and capital with an emphasis toward the highest risk-

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adjusted return available. This strategy may cause us to have different allocations of capital in different environments.

*Non-Conforming Mortgage Loans*

Revenues from the non-conforming mortgage loan portfolio were historically generated primarily from net interest income. The Company recorded net interest income of \$40.0 million from the non-conforming mortgage loans held at the REIT during 2007.

During the fourth quarter of 2007 the Company completed the sale of its on-balance sheet securitized loans. Pursuant to this sale agreement, the Company sold its financial interests in the securitized loans and surrendered control over the loans and all of its rights under the various securitization agreements, eliminating any continuing involvement in the securitized loans. As a result of this sale transaction, \$2.9 billion of loans and related assets and \$2.9 billion of securitization borrowings and related liabilities were transferred from the Company's balance sheet. Accordingly, as of December 31, 2007, the Company's investment in securitized mortgage loans was reduced to zero. The Company recognized a gain from the sale of the securitized mortgage loans of \$9.7 million in 2007 that is included in principal investing net investment loss, however, this gain was substantially offset by other costs associated with the securitization trusts.

As of December 31, 2007, the loans held for sale, net, invested at the REIT was comprised of the following (dollars in thousands):

Principal balance	\$ 841
Valuation allowance for lower of cost or market value	(789)
Loans held for sale, net	<u>\$ 52</u>

*Mortgage-Backed Securities*

We also invest in agency-backed and, to a lesser extent, private-label MBS. Our MBS investment strategy is based on investing predominantly in hybrid-ARM mortgage-backed securities financed by repurchase agreement borrowings and short-term commercial paper. However, current conditions in the credit markets may make it impracticable for us to obtain short-term commercial paper financing for our agency-backed MBS portfolio. The Company recorded net interest income of \$39.6 million from MBS held in our principal investment portfolio during 2007 compared to \$35.7 million during 2006.

During the third quarter of 2007, the Company liquidated approximately \$5.8 billion of agency MBS at a loss of approximately \$57.7 million to reduce leverage during the unprecedented credit market disruption and uncertainty in the asset-backed financing market and increase liquidity.

Subsequent to these sales, the Company began to reinvest capital in the MBS portfolio and as of December 31, 2007, the fair value of our investments in mortgage-backed securities totaled \$1.8 billion. These investments were primarily comprised of securities guaranteed as to principal and interest by Fannie Mae and Freddie Mac. The following table summarizes, as of December 31, 2007, our portfolio of mortgage-backed securities (including principal receivable) by issuer (dollars in thousands).

	<u>Face Amount</u>	<u>Fair Value</u>
Agency-backed:		
Fannie Mae	\$ 101	\$ 101
Freddie Mac	1,492,064	1,493,615
Total	1,492,165	1,493,716
Private-label <sup>(1)</sup>	300,297	297,764
Total	<u>\$ 1,792,462</u>	<u>\$ 1,791,480</u>

(1) As of December 31, 2007, approximately 96% of the private-label MBS held in our portfolio were rated "AAA" by Standard & Poor's.

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*Merchant Banking and Other Long-Term Investments*

The total value of FBR's merchant banking portfolio and other long-term investments was \$169.3 million as of December 31, 2007. Of this total, \$113.8 million was held in the merchant banking portfolio, \$30.6 million was held in alternative asset funds, and \$24.9 million was held in other long-term investments. Net unrealized gains in the merchant banking portfolio included in Accumulated Other Comprehensive Income (AOCI) totaled \$3.4 million as of December 31, 2007.

In 2007, we recorded \$32.4 million in other than temporary impairment write-downs on certain merchant banking investments. These write-downs were recorded as part of the Company's quarterly assessments of unrealized losses in its portfolio of marketable equity securities for potential other than temporary impairments and its related assessment of cost method investments. The Company also recognized other-than-temporary write downs of \$3.6 million in a residual interest in a non-prime mortgage loan securitization. We also recognized \$25.6 million in realized gains and earned \$3.2 million in dividend income. These amounts compared to \$79.7 million of other than temporary impairment charges, \$34.7 million of realized gains and \$14.6 million dividend income in 2006.

The following table provides additional detail regarding the Company's merchant banking investments and other long-term investments as of December 31, 2007 (dollars in thousands):

	December 31, 2007		
	Shares	Cost/Adjusted Basis	Fair Value/Carrying Value
<b>Merchant Banking Investments</b>			
Asset Capital Corporation, Inc. <sup>(1)(2)</sup>	948,766	\$ 4,507	\$ 4,507
Castlepoint Holdings Ltd.	500,000	4,650	6,000
Cohen Finacial <sup>(1)(2)</sup>	112,892	1,129	1,129
Cypress Financial Holdings, Inc. <sup>(1)</sup>	537,604	5,000	5,000
Ellington Financial LLC <sup>(1)</sup>	1,938,750	36,449	36,449
FSI Realty Trust <sup>(1)(2)</sup>	752,688	1,505	1,505
Grubb & Ellis Co	473,116	3,038	3,033
Muni Funding of America, LLC <sup>(1)</sup>	750,000	6,975	6,975
Orion Marine Group, Inc	796,494	10,000	11,947
Star Asia Financial, Limited <sup>(1)</sup>	800,000	7,440	7,440
Thornburg Mortgage Inc. (Preferred Series F) <sup>(2)</sup>	289,952	6,886	6,958
Thunderbird Resorts Inc <sup>(1)</sup>	1,194,743	10,000	10,000
Vintage Wine Trust, Inc. <sup>(1)(2)</sup>	1,075,269	8,602	8,602
Other		1,734	1,724
Preferred equity investment <sup>(1)(2)</sup>		2,500	2,500
Total merchant banking investments		\$ 110,415	\$ 113,769
Investment funds			30,620
Other investments			1,239
Residual interest in securitization			15,903
Investment securities—marked to market			7,743
Total long-term investments			\$ 169,274

(1) As of December 31, 2007 these shares cannot be traded in a public market (e.g., NYSE or Nasdaq) but may be sold in private transactions.

(2) Cost/Adjusted basis reflects the effects of other than temporary impairment charges.

## Results of Operations

### Revenues

Our revenues consist primarily of capital raising and advisory fees in investment banking; agency commissions, principal transactions and mortgage trading interest and net investment income in institutional brokerage; base management fees and incentive allocations and fees in asset management; net interest income, net investment income, including realized gains or losses and other-than-temporary impairments, dividends from merchant banking investments and investment fund earnings from principal investing activities; and net interest income and net investment income, including gain or loss on sale of loans from mortgage banking activities.

Revenue from capital raising transactions is substantially dependent on the market for public and private offerings of equity and debt securities within the sectors in which we focus. Agency commissions are dependent on the level of overall market trading volume and penetration of our institutional client base by our research, sales and trading staff. Principal brokerage transactions are dependent on these same factors and on NASDAQ trading volume and spreads in the securities of such companies; net trading gains and losses are dependent on the market performance of securities held, as well as our decisions as to the level of market exposure we accept in these securities. Asset management revenues are dependent on the level of the capital on which our base management fees are calculated and the amount and performance of capital on which we have the potential to generate incentive income. Our asset management vehicles are subject to market risk caused by illiquidity and volatility in the markets in which they would seek to sell financial instruments. Revenue earned from these activities, including unrealized gains that are included in the incentive income portion of our asset management revenues and in net investment income, may fluctuate as a result. Accordingly, our revenues in these areas have fluctuated in the past, and are likely to continue to fluctuate, based on these factors.

In our principal investing and mortgage banking activities, we invest in mortgage-backed securities and mortgage loans that are financed by repurchase agreement, commercial paper and securitization borrowings all of which are interest sensitive financial instruments. We are exposed to interest rate risk that fluctuates based on changes in the level or volatility of interest rates and mortgage prepayments and in the shape and slope of the yield curve. The Company attempts to hedge a portion of its exposure to rising interest rates through the use of various derivative instruments.

#### *Investment Banking*

Capital raising revenue consists of underwriting discounts, selling concessions, management fees and reimbursed expenses associated with underwriting activities and 144A institutional equity placements. We act in varying capacities in our underwriting activities, which, based on the underlying economics of each transaction, determine our ultimate revenues from these activities. When we are engaged as lead-manager of an underwriting, we generally bear more risk and earn higher revenues than if engaged as a co-manager, an underwriter (syndicate member) or a broker-dealer included in the selling group.

Advisory revenue consists primarily of advisory fees and reimbursed expenses associated with such activities. Advisory fees have fluctuated in the past, and are likely to continue to fluctuate, based on the number and size of our completed transactions.

#### *Institutional Brokerage*

Principal transactions consist of a portion of dealer spreads attributed to the securities trading activities of FBR & Co. as principal in listed and other securities, and are primarily derived from FBR & Co.'s activities as a market-maker. Trading gains and losses on equity securities are combined and reported on a net basis as part of

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principal transactions. Gains and losses result primarily from market price fluctuations that occur while holding positions in FBR & Co.'s trading security inventory.

Agency commissions consist of revenue resulting from executing stock exchange-listed securities and other transactions as agent.

Mortgage trading activities include buying and selling mortgage-backed securities and other structured securities in various financial transactions (which may include forward trades, dollar rolls and reverse repurchase transactions). We have managed market risk associated with these securities positions primarily through forward purchases and sales of such securities. These transactions result in interest income and net investment gain/loss.

#### *Asset Management*

We receive asset management revenue in our capacity as the investment manager to advisory clients, including our mutual funds, as general partner of several hedge, private equity and venture capital investment partnerships and as administrator to mutual funds. Management fees and incentive income on investment partnerships have been earned from entities that have invested primarily in the securities of companies engaged in the financial services, real estate and technology sectors. Incentive income is likely to fluctuate with the performance of securities in these sectors.

#### *Principal Investing*

Principal investing interest income has historically related to interest earned on our portfolio of mortgage-backed securities and mortgage loans. Net investment income has historically included net realized gains on sale of equity securities and mortgage-backed securities, income from investments funds and derivative activities as well as lower of cost or market value adjustments on securitized mortgage loans held for sale and other than temporary write-downs of equity securities. Principal investing dividends relate to our portfolio of merchant banking investments.

As of December 31, 2007, we had \$3.4 million of net unrealized gains related to merchant banking equity investments recorded in AOCI. If we liquidate these securities or determine that a decline in value of these investments below our cost basis is other-than-temporary, a portion or all of the gains or losses will be recognized as a gain or loss in the statement of operations during the period in which the liquidation or determination is made. Our investment portfolio is exposed to potential future downturns in the markets and private debt and equity securities are exposed to deterioration of credit quality, defaults, and downward valuations.

We record allocations for our proportionate share of the earnings or losses of the hedge, private equity and venture funds and other partnerships in which we have made investments. Income or loss allocations are recorded in net investment income in our statements of operations.

Net investment income also includes unrealized gains and losses on investments held at FBR & Co. In connection with certain capital raising transactions, we have received and hold warrants for the stock of the issuing companies, which are generally exercisable at the respective offering price of the transaction. Similarly, we may receive and hold shares of the issuing companies. For restricted warrants and shares, including private Company warrants and shares, we carry the securities at fair value based on internal valuation models and estimates made by management. Due to the restrictions on the warrants and the underlying securities, and the subjectivity of these valuations, these warrants may have nominal values. We value warrants to purchase publicly traded stocks, where the restriction periods have lapsed, using an option valuation model.

#### *Mortgage Banking*

Mortgage banking revenue have historically included net interest income on loans held for sale at First NLC as well as net investment income, consisting primarily of net gains and losses on sales of mortgage loans by First

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NLC. Our mortgage banking revenue was highly dependent on conditions in the residential mortgage market. Recent industry-wide increases in delinquencies and losses with respect to residential mortgage loans, particularly in the non-prime sector, have negatively impacted our mortgage banking revenue and have adversely affected our operating results for 2007 and 2006.

*Other Revenue*

Other revenue primarily includes miscellaneous interest, dividends and fees.

**Expenses**

Interest expense includes the costs of our repurchase agreement borrowings, commercial paper borrowings, and securitization financing as well as long-term debt securities we have issued. Interest expense also includes costs of subordinated credit lines, bank deposits and other financing.

Compensation and benefits expense includes base salaries as well as incentive compensation. Incentive compensation varies primarily based on revenue production and net income. Salaries, payroll taxes and employee benefits are relatively fixed in nature. In addition, compensation and benefits includes non-cash expenses associated with all stock-based awards granted to employees.

Professional services expenses includes legal and consulting fees, recruiting fees and asset management sub-advisory fees. Many of these expenses, such as legal fees associated with investment banking transactions and sub-advisory fees, are to a large extent variable with revenue.

Business development expenses includes travel and entertainment expenses related to investment banking transactions, costs of conferences and advertising, and the Company's sponsorship of the PGA TOUR's FBR Open. Expenses that are directly related to investment banking transactions are variable with revenue.

Clearing and brokerage fees include trade processing expense that we pay to our clearing brokers, and execution fees that we pay to floor brokers and electronic communication networks. These expenses are almost entirely variable with revenue.

Occupancy and equipment includes rental costs for our facilities, depreciation and amortization of equipment, software and leasehold improvements and expenses. These expenses are largely fixed in nature.

Communications expenses include voice, data and Internet service fees, and data processing costs. While variable in nature, these do not tend to vary with revenue.

Other operating expenses include mortgage insurance premium, loan servicing costs, amortization of certain intangible assets, professional liability and property insurance, printing and copying, business licenses and taxes, offices supplies, interest related to taxes, penalties and fees, charitable contributions and other miscellaneous office expenses.

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The following table sets forth financial data as a percentage of net revenues for the years presented:

	Year Ended December 31,		
	2007	2006	2005
Revenues:			
Investment banking:			
Capital raising	267.9%	50.0%	82.1%
Advisory	32.3%	6.3%	4.1%
	<u>300.2%</u>	<u>56.3%</u>	<u>86.2%</u>
Institutional brokerage:			
Principal transactions	9.6%	1.5%	4.1%
Agency commissions	99.3%	26.6%	19.0%
Mortgage trading interest	—	13.4%	7.1%
Mortgage trading net investment loss	—	(0.9)%	(0.9)%
	<u>108.9%</u>	<u>40.6%</u>	<u>29.3%</u>
Asset management:			
Base management fees	22.3%	5.3%	7.0%
Incentive allocations and fees	0.4%	0.3%	0.4%
	<u>22.7%</u>	<u>5.6%</u>	<u>7.4%</u>
Principal investment:			
Interest	475.0%	156.4%	126.5%
Net investment loss	(210.4)%	(48.5)%	(55.2)%
Dividends	3.0%	3.8%	8.4%
	<u>267.6%</u>	<u>111.7%</u>	<u>79.7%</u>
Mortgage banking:			
Interest	48.6%	23.3%	17.9%
Net investment (loss) income	(210.4)%	22.0%	3.2%
	<u>(161.8)%</u>	<u>45.3%</u>	<u>21.1%</u>
Other	14.9%	5.3%	5.1%
Total revenues	552.5%	264.8%	228.8%
Interest expense	452.5%	160.8%	125.7%
Provision for loan losses	—	4.0%	3.1%
Revenues, net of interest expense and provision for loan losses	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>
Non-interest expenses:			
Compensation and benefits	342.5%	81.3%	76.3%
Professional services	52.8%	15.7%	15.3%
Business development	41.2%	11.1%	10.7%
Clearing and brokerage fees	11.9%	3.1%	2.0%
Occupancy and equipment	49.6%	13.2%	7.8%
Communications	27.2%	6.4%	4.8%
Other operating expenses	78.0%	23.5%	16.3%
Impairment of goodwill	154.3%	—	—
Restructuring charges	44.5%	—	—
Total non-interest expenses	<u>802.0%</u>	<u>154.3%</u>	<u>133.2%</u>
Operating loss	<u>(702.0)%</u>	<u>(54.3)%</u>	<u>(33.2)%</u>

## Comparison of the Years Ended December 31, 2007 and 2006

We reported a net loss of \$660.3 million for the year ended December 31, 2007 compared to a net loss of \$67.3 million for the year ended December 31, 2006. Net loss included the following results of operations by segment (in thousands):

	For the year ended December 31,	
	2007	2006
Capital Markets, net of intersegment elimination	\$ 23,192	\$ (34,376)
Asset Management	(7,016)	(11,080)
Principal Investment	(330,411)	(142,594)
Mortgage Banking	(426,374)	(18,169)
Operating loss	(740,609)	(206,219)
Gain on sale of subsidiary shares	104,062	121,511
Loss before income taxes and minority interest	(636,547)	(84,708)
Income tax provision (benefit)	22,932	(14,682)
Minority interest in earnings (losses) of consolidated subsidiary	774	(2,751)
Net loss	<u>\$(660,253)</u>	<u>\$ (67,275)</u>

The increase in net loss was primarily attributed to an increase in operating losses of our mortgage banking and principal investment segments. The results of our mortgage banking segment included an increase in provisions for repurchase obligation and lower of cost or market valuation adjustment on non-securitized mortgage loans of \$189.3 million, decrease in gross gains on sale of mortgage loans of \$143.0 million, impairment of goodwill and costs associated with a reduction in workforce and termination of certain leases. The results of our principal investment segment included losses of \$52.7 million for the year ended December 31, 2007, which is primarily related to losses incurred in the sale of \$5.8 billion of MBS in the third quarter of 2007. We recognized \$119.9 million in lower of cost or market adjustments prior to sale of the securitized mortgage loan portfolio. In addition, we recorded an impairment of goodwill of associated with our principal investment segment of \$108.0 million during the year ended December 31, 2007. Operating results from the mortgage banking and principal investment segments was partially offset by the operating results of our capital markets segment and a gain on a sale of 12.7 million shares of FBR Capital Markets of \$104.1 million. Our capital markets segment increased its profitability by \$57.6 million which is primarily attributable to increases investment banking revenues and principal transactions and agency commissions from institutional brokerage. The increase in net loss was also attributable to the change in income taxes from a \$14.7 million tax benefit in 2006 to a \$22.9 million tax provision in 2007 as a result of higher profitability in our capital markets segment.

The Company's net revenues decreased 72.3% from \$380.4 million in 2006 to \$105.5 million in 2007 due to the following changes in revenues and interest expense:

Capital raising revenue increased 48.6% from \$190.2 million in 2006 to \$282.6 million in 2007. The increase was attributable to an increase in amounts raised in sole-managed private placement transactions completed in 2007 as compared to 2006. The higher volume of capital raising activity related primarily to our real estate, financial services and TMT sectors. We completed 12 private placements during 2007 generating \$197.2 million in revenues as compared to 17 private placements during 2006 generating \$139.3 million in revenues. In addition, we completed eight public transactions as lead manager raising capital of \$1.4 billion in 2007 compared to eight public transactions as lead manager raising capital of \$600 million in 2006.

Advisory revenue increased 41.5% from \$24.1 million in 2006 to \$34.1 million in 2007 as a result of the transaction during the first quarter of 2007, with Legacy Partners in which we acquired a team of more than two dozen investment banking professionals and a pipeline of certain advisory transactions.

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Institutional brokerage revenue from agency commissions and principal transactions increased 7.6% from \$106.8 million in 2006 to \$114.9 million in 2007 as a result of increases in trading volume due to our expansion of sales and trading personnel in 2007 and a reduction in trading losses. In addition, during 2006, our mortgage sales and trading activities contributed revenues net of interest expense of \$3.3 million, reflecting \$51.1 million in interest income, a net investment loss of \$3.3 million and \$44.5 million of interest expense. There was no comparable activity during 2007 as we sold our mortgage trading positions during the third quarter of 2006 and made a decision not to redeploy capital to this trading activity.

Asset management base management fees increased 16.9% from \$20.1 million in 2006 to \$23.5 million in 2007. The increase was primarily attributable to the increase in average net assets under management in 2007 due in large part to an increase in average mutual fund assets, primarily as a result of inflows to the FBR Focus Fund. Asset management incentive allocations and fees decreased 69.2% from \$1.3 million in 2006 to \$0.4 million in 2007 as a result of fund performance during the period.

Revenues from our principal investment, mortgage banking and warehouse financing activities, net of related interest expense, totaled \$(332.7) million for 2007 compared to \$68.0 million for 2006. The decrease in net revenues is primarily the result of a decrease in the interest spread and a decrease in net investment income from mortgage banking activities, as summarized below (dollars in thousands).

	For the year ended December 31,	
	2007	2006
Net interest income	\$ 108,153	\$ 154,198
Net investment loss—principal investing	(221,956)	(184,552)
Dividend income	3,173	14,551
Net investment (loss) income—mortgage banking	(222,032)	83,786
	<u>\$ (332,662)</u>	<u>\$ 67,983</u>

The components of net interest income from mortgage investments are summarized in the following table (dollars in thousands):

	For the year ended December 31, 2007			For the year ended December 31, 2006		
	Average Balance	Income / (Expense)	Yield / Cost	Average Balance	Income / (Expense)	Yield / Cost
Mortgage-backed securities	\$ 4,482,460	\$ 261,619	5.84%	\$ 3,727,748	\$ 208,444	5.59%
Mortgage loans	4,098,342	275,186	6.72%	6,734,153	469,192	6.97%
Reverse repurchase agreements	—	—	—	151,950	8,442	5.48%
	<u>\$ 8,580,802</u>	<u>536,805</u>	<u>6.26%</u>	<u>\$ 10,613,851</u>	<u>686,078</u>	<u>6.46%</u>
Other <sup>(1)</sup>		<u>15,569</u>			<u>6,542</u>	
		552,374			692,620	
Repurchase agreements	\$ 1,741,603	(93,067)	(5.27)%	\$ 839,446	(43,867)	(5.15)%
Commercial paper	2,329,105	(127,070)	(5.38)%	2,610,719	(136,738)	(5.17)%
Mortgage financing credit facilities	594,555	(36,901)	(6.12)%	1,043,776	(61,221)	(5.79)%
Securitization	3,434,187	(208,615)	(5.99)%	5,593,131	(319,980)	(5.64)%
Derivative contracts <sup>(2)</sup>	—	21,432		—	23,384	
	<u>\$ 8,099,450</u>	<u>(444,221)</u>	<u>(5.48)%</u>	<u>\$ 10,087,072</u>	<u>(538,422)</u>	<u>(5.34)%</u>
Net interest income/spread		<u>\$ 108,153</u>	<u>0.78%</u>		<u>\$ 154,198</u>	<u>1.12%</u>

(1) Includes interest income on cash and other miscellaneous interest-earning assets.

(2) Includes the effect of derivative instruments accounted for as cash flow hedges.

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The change in the composition of the Company's principal investment portfolio from 2006 to 2007 was due to the reduction in mortgage loan originations throughout the year as a result of the deterioration of the non-prime mortgage origination industry and a combination of principal repayments and the sale of securitized mortgage loan portfolio with no reinvestment in similar assets. As a result of the principal repayments and sale, the related securitization borrowings used to fund these investments likewise decreased significantly during the year, ending the year without such debt on our balance sheet.

As shown in the table above, net interest income decreased by \$46.0 million from 2006 to 2007. This decrease was due to an decrease in the average balance of mortgage loans which have higher yields than those earned on our MBS portfolio offset by increased borrowing costs due to continued increases in short term interest rates. Amortization expense totaled \$7.3 million in 2007 compared to \$35.9 million in 2006. This decrease in amortization expense was a result of both the repositioning of the MBS portfolio during 2006 and 2007 and the reclassification of the mortgage loans held at the REIT from held for investment to held for sale during 2006.

Net interest income from the MBS portfolio increased by \$3.9 million from \$35.7 million in 2006 to \$39.6 million in 2007 due to an increase in the net interest spread earned on the portfolio from 0.43% in 2006 to 0.46% in 2007.

Mortgage loan portfolio, mortgage banking and warehouse financing related interest income was \$275.2 million with related interest expense of \$222.2 million, resulting in net interest income of \$53.0 million for the year ended December 31, 2007. This compared to mortgage loan portfolio, mortgage banking and warehouse financing related interest income of \$477.6 million with related interest expense of \$365.7 million, resulting in net interest income of \$111.9 million for the year ended December 31, 2006. The decrease in net interest income in 2007 was the result of the decrease in average mortgage loans during 2007 reflecting the effects of principal repayments and the sale of securitized mortgage loan portfolio and the decrease in mortgage loan originations.

In addition to net interest income, the Company recorded \$3.2 million in dividend income from its merchant banking equity investment portfolio in 2007 compared to \$14.6 million during 2006. The decrease in dividend income was primarily due to the decrease in the number of and amount of capital invested in dividend paying companies in the merchant banking portfolio as well as reduced dividend rates.

The Company realized a net investment loss of \$222.0 million during 2007 compared to net investment loss of \$184.6 million in 2006. The following table summarizes the components of net investment loss (dollars in thousands):

	For the year ended December 31,	
	2007	2006
Securitized mortgage loans held-for-sale—lower of cost or market adjustments	\$ (119,900)	\$ (149,823)
Available for sale and cost method securities—other-than-temporary impairments	(52,928)	(79,665)
Realized (losses)gains on sale of equity investments and mortgage-backed securities	(27,126)	39,164
Income from investments funds	2,789	3,244
(Losses)gains on investment securities—marked-to-market, net	(1,376)	4,994
Residual investment write-down	(3,602)	—
Other, net	(19,813)	(2,466)
	<u>\$ (221,956)</u>	<u>\$ (184,552)</u>

In determining the lower-of-cost or market value of the securitized mortgage loans, the Company considered various factors affecting the overall value of the portfolio, including but not limited to factors such as

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prepayment speeds, default rates, loss assumption, geographic locations, collateral values and mortgage insurance coverage. Based on such factors, the Company assessed the present value of expected loan cash flows considering the specific characters of each individual loan. Significant assumptions used by the Company in determining this value were supported by comparison to market date for similar portfolio and transaction, when available. During the fourth quarter of 2007 the Company completed the sale of the securitized mortgage loans. Pursuant to this sale agreement, the Company sold its financial interests in the securitized loans and surrendered control over the loans and all of its rights under the various securitization agreements, eliminating any continuing involvement in the securitized loans. As a result of this sale transaction, \$2.9 billion of loans and related assets and \$2.9 billion of securitization borrowings and related liabilities were transferred from the Company's balance sheet. The Company recognized a gain from the sale of the securitized mortgage loans of \$9.7 million in the fourth quarter of 2007 that is included in principal investing net investment loss. Considering other costs associated with the securitization trusts recognized during the fourth quarter of 2007, the sale did not have material impact on the Company's operating results for the fourth quarter of 2007.

As part of our quarterly assessments of unrealized losses in our MBS portfolio for potential other-than-temporary impairment, we recognized \$20.5 million of other-than-temporary impairment charges in 2007 related to deterioration in credit quality on certain MBS investments during the second half of 2007. We recognized no comparable other-than-temporary impairments during 2006.

As part of our quarterly assessments of unrealized losses in our portfolio of marketable equity securities for other-than-temporary impairments and our assessment of cost method investments, we recognized other-than-temporary impairment charges of \$32.4 million relating to marketable equity securities and cost method investments in 2007. In comparison, we recognized other-than-temporary impairment charges of \$79.7 million relating to marketable equity securities and cost method investments in 2006.

The realized losses recognized in 2007 were primarily the result of the liquidation of \$5.8 billion of agency-backed MBS during the third quarter of 2007 and additional sales during 2007 at a loss of \$52.7 million offset by net realized gains from the sale and exchange of merchant banking investments of \$25.6 million. The realized gains of \$39.2 million in 2006 related primarily to the sale of merchant banking investments.

Other net investment income primarily includes net gains and losses from derivatives not designated as cash flow hedges under SFAS 133. These derivatives primarily include hedges relating to the financing for certain MBS positions and the mortgage loan portfolio.

Income from investment funds reflects the Company's earnings from investments in proprietary investment partnerships and other managed investments. See Note 4 to the financial statements for further information on investment funds, other gains and losses, as well as realized gains on sales of equity investments and mortgage-backed securities.

During the year ended December 31, 2007 and 2006, the Company sold \$2.8 billion and \$7.5 billion of loans, respectively. During 2007, the provision for losses increased significantly as compared to the prior year reflecting the effects of an industry-wide increase in requests for buy-backs of loans related to early pay defaults. The components of net investment income from mortgage banking activities are as follows (dollars in thousands):

	For the year ended December 31,	
	2007	2006
Gross gain from loan sale transactions, including hedge activities	\$ 15,518	\$ 158,501
Provision for losses, including repurchase and premium recapture and lower of cost or market valuation allowances	(239,321)	(50,069)
Direct loan origination costs, net of fees earned	1,771	(24,646)
	<u>\$ (222,032)</u>	<u>\$ 83,786</u>

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Other revenues decreased 21.8% from \$20.2 million in 2006 to \$15.8 million in 2007 primarily due to a decrease in interest income related to warehouse financing as the Company did not engage in these activities in 2007.

Interest expense unrelated to our principal investing, mortgage banking, warehouse financing and brokerage activities primarily relates to long-term debt issued through FBR TRS Holdings and short-term financing. These costs increased from \$28.9 million in 2006 to \$33.2 million in 2007, reflecting an increase in interest expense associated with the \$60.0 million in short-term borrowings from Sun Capital in accordance with the Recapitalization Agreement.

Total non-interest expenses increased 44.2% from \$586.6 million in 2006 to \$846.1 million in 2007. This increase was caused by the following fluctuations in non-interest expenses:

Compensation and benefits expense increased 16.9% from \$309.1 million in 2006 to \$361.4 million in 2007. The increase in compensation expense was primarily attributable to the increase in variable compensation of \$52.2 million as a result of increased investment banking revenues and commissions on institutional brokerage revenues, stock-based award compensation of \$3.6 million for new issuances of FBR Capital Markets stock-based awards, and compensation costs associated with the expansion of our M&A and international capital markets businesses. These increases were offset by a decrease in compensation due to the reduction in head count at First NLC.

Professional services decreased 6.7% from \$59.7 million in 2006 to \$55.7 million in 2007 primarily due to a \$9.9 million reduction in consulting and corporate legal costs offset by increases of \$3.3 million in subadvisory fees and \$2.9 million in investment banking deal expenses corresponding to increased investment banking revenues.

Business development expenses increased 3.1% from \$42.2 million in 2006 to \$43.5 million in 2007. This increase is primarily due to increased costs associated with capital raising activities consistent with the increase in investment banking revenue.

Clearing and brokerage fees increased 5.9% from \$11.8 million in 2006 to \$12.5 million in 2007. The increase is due to increased equity trading volumes.

Occupancy and equipment expense increased 4.4% from \$50.1 million in 2006 to \$52.3 million in 2007, including an increase of \$0.9 million in depreciation expense from \$13.5 million in 2006 to \$14.4 million in 2007. This increase in depreciation was primarily attributable to upgrades of software for compliance initiatives.

Communications expense increased 17.6% from \$24.4 million in 2006 to \$28.7 million in 2007 primarily due to increased costs related to market data and customer trading services. In addition, the increase reflected the Company's investment in its technology infrastructure including its data center and disaster recovery systems.

Other operating expenses decreased 8.1% from \$89.4 million in 2006 to \$82.2 million in 2007. This change was primarily due to the reduction of \$20.5 million in servicing, administrative, and mortgage insurance costs as a result of the decrease in the average balance of our mortgage loan portfolio offset partially by \$11.0 million in First NLC settlement costs related to the resolution of certain litigation.

In response to the deterioration in the non-prime mortgage industry, First NLC initiated various restructuring activities during the year ended December 31, 2007. For the year ended December 31, 2007, the Company recorded a charge of \$101.7 million related to these restructuring activities and a decline in the fair value of First NLC's origination platform. This charge included a write-down of \$65.0 million related to the impairment of goodwill and purchased intangible assets, measured as the amount by which the carrying amount

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exceeded estimated fair value of these assets. The remaining charge of \$36.7 million primarily relates to the termination of employees and certain facility and equipment leases.

We recognized an impairment of goodwill associated with our principal investment segment of \$108.0 million. This impairment was the result of continued losses generated by this segment over recent years as well as current market conditions affecting the activities of this segment. These factors have had a significant impact on the decline in fair value of the Company attributed to the principal investment segment resulting in a writedown of the goodwill balance to zero.

The total income tax provision changed from a \$14.7 million tax benefit in 2006 to a \$22.9 million tax expense in 2007 due to the current year income at the Company's taxable REIT subsidiaries. Our tax provision relates to income generated by our taxable REIT subsidiaries, and our effective tax rate relating to this income was 8.5% in 2007 as compared to 20% in 2006. The effective tax rate for the year ended December 31, 2007, represents adjustments to statutory tax rates primarily due to valuation allowances recognized on deferred tax assets and liabilities, differential in the book losses of a subsidiary compared to the tax loss, and differential in the book gain on sale of subsidiary stock compared to the tax gain. The effective tax rate for the year ended December 31, 2006, represents adjustments to statutory tax rates related to the gain on sale of subsidiary stock which is not taxable for federal purposes.

Minority interest in earnings (losses) of consolidated subsidiary of \$0.8 million represents minority interest holder's share of earning of FBR Capital Markets for the year ended December 31, 2007 as compared to \$(2.8) million of minority interest associated with losses of a consolidated subsidiary for the year ended December 31, 2006.

#### **Comparison of the Years Ended December 31, 2006 and 2005**

Net loss decreased from a loss of \$170.9 million in 2005 to a \$67.3 million loss in 2006. The 2006 loss is primarily due to our decision as of September 30, 2006, to reclassify the mortgage loan portfolio held at the REIT from held for investment to held for sale. As a result of this change, we recorded our investment in this portfolio at the lower of cost or market, and consequently recognized a \$149.8 million write-down in 2006. In addition, in 2006 we recognized other-than-temporary impairment write-downs of \$79.7 million relating to certain investments in our merchant banking investment portfolio. The decrease in net loss from 2005 was also impacted by the gain recorded on the share issuance by FBR Capital Markets (described below), a decrease in principal investment write-downs and an increase in net interest income from principal investments. Conversely, the 2006 net loss reflected a significant reduction in capital raising revenues as compared to 2005 as well as reductions in dividends from principal investing activities and asset management fees.

These write-downs, reduced investment banking activities, asset management and returns were partially offset by a \$121.5 million gain recorded as a result of the July 2006 share issuance by FBR Capital Markets, a holding company for the Company's capital markets operations formed in the second quarter 2006. This gain represented the increase in value of the Company's investment in FBR Capital Markets as a result of the share issuance and, based on the structure of the transaction, this gain was not taxable. Subsequent to the share issuance and as of December 31, 2006, the Company retained a 71.9% beneficial ownership interest in FBR Capital Markets.

In addition to the above, effective January 1, 2006, the Company adopted SFAS 123R. Pursuant to the provisions of SFAS 123R, we recorded \$5.0 million of compensation expense related to share-based payments during 2006. The net loss in 2006 also included a \$14.7 million tax benefit as compared to a \$26.7 million income tax provision recorded in 2005.

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The Company's net revenues decreased 12.5% from \$434.7 million in 2005 to \$380.4 million in 2006 due to the following changes in revenues and interest expense:

Capital raising revenue decreased 46.7% from \$356.8 million in 2005 to \$190.2 million in 2006. The decrease is attributable to a decrease in amounts raised in private placement transactions as well as fewer lead or co-lead managed transactions completed in 2006 as compared to 2005. The lower volume of capital raising activity related primarily to our financial institutions and real estate sections which were adversely affected by the continued inverted yield curve during 2006. During 2006, the Company completed 17 private equity placements generating \$139.3 million in revenues compared to 16 private equity placements in 2005 generating \$225.5 million. The average capital raised on sole-managed private equity placements decreased from \$237.4 million per transaction in 2005 on 15 transactions to \$209.7 million per transaction in 2006 on 15 transactions. In addition, during 2006, the Company managed 35 public equity offerings raising \$7.7 billion, compared to 60 public equity offerings raising \$15.5 billion in 2005.

Advisory revenue increased 35.4% from \$17.8 million in 2005 to \$24.1 million in 2006 primarily due to an increase in the average revenues generated from each transaction.

Institutional brokerage revenue from agency commissions and principal transactions increased 6.1% from \$100.7 million in 2005 to \$106.8 million in 2006 as a result of increases in trading volume offset by a decrease in trading gains. In addition, the Company's mortgage sales and trading operations contributed revenues net of interest expense of \$3.3 million, reflecting \$51.1 million in interest income, a net investment loss of \$3.3 million and \$44.5 million of interest expense compared to revenues net of interest expense of \$3.4 million in 2005.

Asset management base management fees decreased 33.7% from \$30.3 million in 2005 to \$20.1 million in 2006. The decrease was primarily attributable to the decrease in average net assets under management in 2006 as compared to 2005, due in large part to the closure and liquidation of certain hedge and offshore funds during the third and fourth quarters of 2005, as well as a decrease in mutual fund administrative fees. Asset management incentive allocations and fees decreased 31.6% from \$1.9 million in 2005 to \$1.3 million in 2006 as a result of fund performance during the period.

Revenues from our principal investment, mortgage banking and warehouse financing activities, net of related interest expense, totaled \$68.0 million for 2006 compared to \$(57.8) million for 2005. The increase in net revenues was primarily the result of a decrease in impairment charges, an increase in the interest spread and an increase in net investment income from mortgage banking activities, as summarized below (dollars in thousands).

	For the year ended December 31,	
	2006	2005
Net interest income	\$ 154,198	\$ 131,567
Net investment loss—principal investing	(184,552)	(239,754)
Dividend income	14,551	36,622
Net investment income—mortgage banking	83,786	13,741
	<u>\$ 67,983</u>	<u>\$ (57,824)</u>

In 2006, the Company made a determination in evaluating its investment strategy and its intent related to its held-for investment mortgage loan portfolio to reclassify these loans to held-for-sale. As a result of this change, the Company recorded its investment in this loan portfolio at the lower of cost or market and recognized a \$149.8 million write-down in the value of these loans. The change in intent was primarily based on the strategy to redeploy the capital invested in that portfolio more rapidly to investments with higher earnings potential than if the portfolio were held to maturity. In addition, during 2006 we recognized other-than-temporary impairment losses of \$79.7 million relating to merchant banking investments. The effects of these write-downs on the operating results for 2006 compared to operating results for 2005 which included a write-down in our mortgage-

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backed securities portfolio of \$180.1 million, net of hedging gains, and a separate write-down of \$74.5 million relating to the Company's merchant banking portfolio. The 2005 MBS portfolio write-down reflected the Company's decision to reposition the portfolio to eliminate a negative spread on much of the portfolio.

The components of net interest income from mortgage investments are summarized in the following table (dollars in thousands):

	For the year ended December 31, 2006			For the year ended December 31, 2005		
	Average Balance	Income / (Expense)	Yield / Cost	Average Balance	Income / (Expense)	Yield / Cost
Mortgage-backed securities	\$ 3,727,748	\$ 208,444	5.59%	\$ 10,237,443	\$ 338,044	3.30%
Mortgage loans	6,734,153	469,192	6.97%	4,179,939	289,437	6.92%
Reverse repurchase agreements	151,950	8,442	5.48%	253,680	10,208	4.02%
	<u>\$10,613,851</u>	<u>686,078</u>	<u>6.46%</u>	<u>\$14,671,062</u>	<u>637,689</u>	<u>4.35%</u>
Other(1)		6,542			101	
		692,620			637,790	
Repurchase agreements	\$ 839,446	(43,867)	(5.15)%	\$ 2,401,180	(72,271)	(3.01)%
Commercial paper	2,610,719	(136,738)	(5.17)%	7,923,351	(263,958)	(3.33)%
Mortgage financing credit facilities	1,043,776	(61,221)	(5.79)%	2,286,890	(100,672)	(4.40)%
Securitization	5,593,131	(319,980)	(5.64)%	1,667,578	(77,796)	(4.67)%
Derivative contracts(2)	—	23,384		—	8,474	
	<u>\$ 10,087,072</u>	<u>(538,422)</u>	<u>(5.34)%</u>	<u>\$14,278,999</u>	<u>(506,223)</u>	<u>(3.55)%</u>
Net interest income/spread		<u>\$ 154,198</u>	<u>1.12%</u>		<u>\$ 131,567</u>	<u>0.80%</u>

(1) Includes interest income on cash and other miscellaneous interest-earning assets.

(2) Includes the effect of derivative instruments accounted for as cash flow hedges.

As a result of the First NLC acquisition in February 2005, the increase in the mortgage loan portfolio and the repositioning of the MBS portfolio to eliminate a negative spread on much of the portfolio, the Company's 2006 principal investment portfolio composition shifted significantly from that of the same period in 2005. In 2006, in connection with the repositioning of the mortgage-backed securities portfolio, the Company sold \$7.6 billion of securities from the MBS portfolio held at December 31, 2005. As a result of these sales, the related repurchase agreement and commercial paper borrowings used to fund these investments likewise decreased significantly.

As shown in the table above, net interest income increased by \$22.6 million from 2005 to 2006. This increase was due to an increase in the average balance of mortgage loans which have higher yields than those earned on our MBS portfolio offset by increased borrowing costs due to continued increases in short term interest rates. Amortization expense totaled \$35.9 million in 2006 compared to \$85.5 million in 2005. This decrease in amortization expense was a result of both the repositioning of the MBS portfolio during 2006 and the reclassification of the mortgage loans held at the REIT from held for investment to held for sale.

Net interest income from the MBS portfolio increased by \$9.6 million from \$26.1 million in 2005 to \$35.7 million in 2006 due to a increase in the net interest spread earned on the portfolio from 0.13% in 2005 to 0.43% in 2006.

Mortgage loan portfolio, mortgage banking and warehouse financing related interest income was \$477.6 million with related interest expense of \$365.7 million, resulting in net interest income of \$111.9 million for the

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year ended December 31, 2006. This compared to mortgage loan portfolio, mortgage banking and warehouse financing related interest income of \$299.6 million with related interest expense of \$194.2 million, resulting in net interest income of \$105.4 million for the year ended December 31, 2005.

In addition to net interest income, the Company recorded \$14.6 million in dividend income from its merchant banking equity investment portfolio in 2006, compared to \$36.6 million during 2005. The decrease in dividend income was primarily due to the decrease in the number of and amount of capital invested in dividend paying companies in the merchant banking portfolio as well as reduced dividend rates. Also, the Company realized a net investment loss of \$184.6 million during 2006 compared to net investment loss of \$239.8 million in 2005. The following table summarizes the components of net investment loss (dollars in thousands):

	For the year ended December 31,	
	2006	2005
Securitized mortgage loans held-for-sale—lower of cost or market adjustments	\$ (149,823)	\$ —
Available for sale and cost method securities—other-than-temporary impairments	(79,665)	(74,452)
MBS portfolio—other-than-temporary impairments, net of hedging gains	—	(180,087)
Realized gains on sale of equity investments and mortgage-backed securities	39,164	12,286
Income from investments funds	3,244	62
Gains on investment securities—marked-to-market, net	4,994	1,362
Other, net	(2,466)	1,075
	<u>\$ (184,552)</u>	<u>\$ (239,754)</u>

The 2006 net investment loss was due primarily to the effects of reclassifying the portfolio of securitized loans held-for-investment to held-for-sale as of September 30, 2006, as well as other than temporary impairment losses relating to merchant banking investments. In determining the lower-of-cost or market value of the securitized mortgage loans, the Company considered various factors effecting the overall value of the portfolio, including but not limited, to factors such as prepayment speeds, default rates, loss assumptions, geographic locations, collateral values, and mortgage insurance coverage. The Company utilized the present value of expected cash flows considering the specific characteristics of each individual loan, aggregating the loans by specific securitization issuance, in determining the value of the portfolio. The Company also considered that these loans are collateral for securitization borrowings; therefore, taking into consideration the impact of any sale of the loan portfolio on the securitization borrowings, the related cash flows and the overall value of the residual interests in the securitization transactions that have been retained by the Company. Significant assumptions used by the Company in determining this value were supported by comparison to available market data for similar portfolios and transactions as well as a third party valuation of the residual interests in the securitization transactions.

Although the Company considers its valuation methodology to be appropriate, the realized value from a market transaction may differ given the inherently subjective nature of the valuation, including uncertainties related to the various market assumptions and other data used in the calculation and that difference could be material. The actual value from a market transaction will be subject to, among other things, changes in both short- and long-term interest rates, prepayment rates, housing prices, credit loss experience and the shape and slope of the yield curve. The Company will continue to monitor and assess the significant assumptions underlying this value in the future.

As part of the Company's quarterly assessments of unrealized losses in its portfolio of marketable equity securities for potential other-than-temporary impairments and its assessment of cost method investments, the Company recorded other-than-temporary impairment charges of \$79.7 million relating to marketable equity securities and cost method investments in 2006. This compares to \$74.5 million of impairment charges during 2005.

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Other net investment income primarily includes net gains and losses from derivatives not designated as cash flow hedges under SFAS 133. These derivatives primarily include hedges relating to the financing for certain MBS positions and the mortgage loan portfolio.

Income from investment funds reflects the Company's earnings from investments in proprietary investment partnerships and other managed investments. See Note 4 to the financial statements for further information on investment funds, other gains and losses, as well as realized gains on sales of equity investments and mortgage-backed securities.

During the year ended December 31, 2006 and 2005, the Company sold \$7.5 billion and \$4.4 billion of loans, respectively, and earned a gross premium of 1.44% and 1.99%, respectively. During the third quarter of 2006, the provision for losses increased significantly as compared to the prior year and prior 2006 quarters reflecting the effects of an industry-wide increase in requests for buy-backs of loans related to early pay defaults. The components of net investment income from mortgage banking activities are as follows (dollars in thousands):

	For the year ended December 31,	
	2006	2005
Gross gain from loan sale transactions, including hedge activities	\$ 158,501	\$ 89,310
Provision for losses, including repurchase and premium recapture and lower of cost or market valuation allowances	(50,069)	(31,863)
Direct loan origination costs, net of fees earned	(24,646)	(43,706)
	<u>\$ 83,786</u>	<u>\$ 13,741</u>

Other revenues decreased 9.4% from \$22.3 million in 2005 to \$20.2 million in 2006 primarily due to a decrease in interest income related to warehouse financing.

The Company's mortgage loan portfolio is comprised of loans predominately originated in 2005 and purchased by the Company in the second half of 2005 and therefore had a limited history. For the year ended December 31, 2006 and 2005, the Company's average loans held for investment balance was \$5.7 billion and \$3.1 billion, respectively. For the year ended December 31, 2006 and 2005, the Company recorded provisions for loan losses relating to its portfolio of loans held for investment \$15.7 million and \$14.3 million, respectively. As discussed previously, the Company reclassified these loans to a held for sale category as of September 30, 2006.

Interest expense unrelated to our principal investing, mortgage banking, warehouse financing and brokerage activities primarily relates to long-term debt issued through FBR TRS Holdings. These costs increased from \$14.9 million in 2005 to \$26.2 million in 2006 due to increased interest rates associated with these floating rate borrowings and the increase in the average balance outstanding for the year.

Total non-interest expenses increased 1.3% from \$578.9 million in 2005 to \$586.6 million in 2006. This increase was caused by the following fluctuations in non-interest expenses:

Compensation and benefits expense decreased 6.8% from \$331.5 million in 2005 to \$309.1 million in 2006. This decrease is primarily due to a \$52.7 million decrease in variable compensation associated with the decrease in investment banking revenue offset by \$5.0 million of stock compensation recorded pursuant to SFAS 123R and an increase of \$27.1 million in First NLC compensation. The increase related to First NLC is attributable to the inclusion of its activities for the entire 2006 period as compared to its inclusion in 2005 results from the date of acquisition, as well as net increase in its headcount of 635 related to expansion of its origination platform.

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Professional services decreased 10.4% from \$66.6 million in 2005 to \$59.7 million in 2006 primarily due to reductions in legal, corporate accounting and consulting costs in 2006 in part due to 2005 results including non-recurring costs associated with the integration of First NLC's operations into the Company's control structure. In addition, the change reflected decreased costs associated with capital raising activities consistent with the decrease in investment banking revenue.

Business development expenses decreased 9.4% from \$46.6 million in 2005 to \$42.2 million in 2006. This decrease is primarily due to a decrease in corporate business development costs, including advertising costs and costs associated with the Company's sponsorship of the PGA TOUR's FBR Open, as well as costs associated with investor conferences. In addition, the change reflected decreased costs associated with capital raising activities consistent with the decrease in investment banking revenue.

Clearing and brokerage fees increased 32.6% from \$8.9 million in 2005 to \$11.8 million in 2006. The increase was due to increased equity trading volumes as well as mortgage trading activity.

Occupancy and equipment expense increased 47.4% from \$34.0 million in 2005 to \$50.1 million in 2006, including an increase of \$3.7 million in depreciation expense from \$9.8 million in 2005 to \$13.5 million in 2006. This overall increase was primarily due to the investments made in expanding and upgrading office space at our Arlington facilities, upgrades of technology, as well as an increase in costs associated with First NLC, reflecting the inclusion of its activities for the entire 2006 period as compared to its inclusion in 2005 results from the date of acquisition and an increase in First NLC's office space to accommodate their increase in headcount related to expansion of its loan origination platform.

Communications expense increased 18.4% from \$20.6 million in 2005 to \$24.4 million in 2006 primarily due to increased costs related to market data and customer trading services as well as increased costs associated with First NLC, reflecting the inclusion of its activities for the entire 2006 period as compared to its inclusion in 2005 results from the date of acquisition.

Other operating expenses increased 26.4% from \$70.7 million in 2005 to \$89.4 million in 2006. This change was primarily due to an increase of approximately \$20.4 million in servicing fees and insurance related to the mortgage loan portfolios.

The total income tax provision changed from a \$26.7 million tax expense in 2005 to a \$14.7 million tax benefit in 2006 due to the current year losses at the Company's taxable REIT subsidiaries. Our tax provision related to income generated by our taxable REIT subsidiaries, and our effective tax rate relating to this income was 20% in 2006 as compared to 48% in 2005. The change in the effective tax rates was due primarily to the gain on sale of subsidiary stock which is not taxable for federal purposes (see Note 9 to the consolidated financial statements).

## **Liquidity and Capital Resources**

Liquidity is a measurement of our ability to meet potential cash requirements including ongoing commitments to repay borrowings, fund investments, loan acquisition and lending activities, and for other general business purposes. In addition, regulatory requirements applicable to our broker-dealer subsidiaries require minimum capital levels for these entities. Our primary sources of funds for liquidity have historically consisted of borrowings under repurchase agreements, commercial paper borrowings, securitization financings, principal and interest payments on mortgage-backed securities and mortgage loans, dividends on equity securities, proceeds from sales of securities and mortgage loans, internally generated funds, equity capital contributions, and credit provided by banks, clearing brokers, and affiliates of our principal clearing broker. Potential future sources of liquidity for us include existing cash balances, internally generated funds, borrowing capacity through margin accounts and under repurchase agreements, and future issuances of common stock, preferred stock, or debt. Due to the crisis in the sub-prime mortgage market, the liquidity and credit market experienced unprecedented disruptions in 2007. As a result, the availability of third-party sources of liquidity, including short-term commercial paper borrowings, was limited as of December 31, 2007.

### ***Cash Flows***

As of December 31, 2007, the Company's cash and cash equivalents totaled \$692.4 million representing a net increase in the balance of \$502.4 million for the year ended December 31, 2007. The increase was primarily attributable to the sale of mortgaged-backed securities at FBR Capital Markets with the proceeds being reinvested in money market funds as well as sales of MBS at the REIT. Of the \$692.4 million of cash and cash equivalents, \$383.6 million was held by FBR Capital markets and \$9.9 million was held at First NLC. The Company's use of the funds held by FBR Capital markets would be subject to approval by a majority of the disinterested directors serving on the FBR Capital Markets Board of Directors.

Cash used in operating activities during 2007 was offset by net cash inflows of \$6.6 billion from investing activities and net cash outflows of \$6.9 billion from financing activities. Cash provided by operating activity was attributable to the reduction in the non-securitized mortgage loans originated by First NLC and cash provided by operating activities from FBR Capital Markets. Furthermore, cash provided by investing activities and used in financing activities reflect reductions in the MBS with respect to this portfolio during 2007.

Specifically, our investing activities during 2007, included proceeds from sales of, and receipt of principal payments from, mortgage-backed securities totaling \$10.0 billion. These cash inflows were offset by \$5.0 billion of mortgage-backed securities purchases. The Company's 2007 investing activities did not include any new investments in mortgage loans to be held for investment. Similarly, the Company's financing activities reflected net repayments of commercial paper and repurchase agreement borrowings of \$5.3 billion and \$1.5 billion of securitization financing repayments.

As of December 31, 2006, the Company's cash and cash equivalents totaled \$190.0 million representing a net decrease in the balance of \$48.7 million for the year then ended. The decrease was primarily attributable to the \$143.0 million of cash used in operating activities during the year. The cash used in operating activities was primarily driven by an increase in First NLC's mortgage loan inventory of \$340 million during 2006. This use of cash in mortgage banking was offset by operating net cash inflows from capital markets related to the sale of fixed income trading positions and cash inflows related to operating assets of our principal investment segment.

### ***Sources of Funding***

We believe that our existing cash balances, cash flows from operations, borrowing capacity, other sources of liquidity and execution of our financing strategies should be sufficient to meet our cash requirements. We have obtained, and believe we will be able to continue to obtain, short-term financing in amounts and at interest rates consistent with our financing objectives. We may, however, seek debt or equity financings, in public or private transactions, to provide capital for corporate purposes and/or strategic business opportunities, including possible acquisitions, joint ventures, alliances, or other business arrangements which could require substantial capital outlays. Our policy is to evaluate strategic business opportunities, including acquisitions and divestitures, as they arise. There can be no assurance that we will be able to generate sufficient funds from future operations, or raise sufficient debt or equity on acceptable terms, to take advantage of investment opportunities that become available. Should our needs ever exceed our ready sources of liquidity, we believe that most of our investments could be sold, in most circumstances, to provide cash. As discussed above, due to the crisis in the sub-prime mortgage market, the liquidity and credit market experienced unprecedented disruptions in 2007. As a result, availability in third-party sources of liquidity was limited as of December 31, 2007.

In April 2007, we terminated a \$180 million, 364-day senior secured credit agreement with various financial institutions that we entered into in October 2006. There were no borrowings outstanding under this facility at any time during 2007. We were not required to pay any termination fee or penalty as a result of the termination.

As of December 31, 2007, the Company's indebtedness totaled \$2.3 billion, which resulted in a leverage ratio (debt to equity) of 6 to 1. In addition to trading account securities sold short and other payables and accrued

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expenses, our indebtedness consisted of repurchase agreements borrowings with several financial institutions and long term debentures issued through our taxable REIT subsidiary, FBR TRS Holdings, Inc. (TRS Holdings). Such long-term debt issuances have totaled \$317.5 million. These long term debt securities accrue and require payments of interest quarterly at annual rates of three-month LIBOR plus 2.25%-3.25%, mature in thirty years, and are redeemable, in whole or in part, without penalty after five years. As of December 31, 2007, we had \$323.6 million of long-term corporate debt.

On July 25, 2007, the Company entered into a recapitalization agreement with an affiliate of Sun Capital. The recapitalization agreement resulted in the investment by Sun Capital and the Company of \$60 million and \$15 million, respectively, on a *pari passu* basis, subject to terms and conditions set forth in the recapitalization agreement and other related agreements. These investments are treated as convertible debt of First NLC. As of December 31, 2007, the outstanding short term borrowing balance was \$64.0 million, including accrued interest of \$3,981. This debt has an interest rate of 15% per annum and is non-recourse to the Company. As a result of the First NLC bankruptcy proceedings commenced on January 18, 2008 and discussed elsewhere in this report on Form 10-K, the recapitalization of First NLC will not close. Pursuant to the terms of a loan agreement entered into in connection with the recapitalization agreement, any recovery from First NLC or its assets in respect of the convertible debt investments in First NLC made by Sun Capital and us in the third quarter of 2007 will be shared 80% by Sun Capital and 20% by us, notwithstanding whether Sun Capital's or our convertible debt investment has been converted into equity of First NLC.

Georgetown Funding is, a special purpose Delaware limited liability company, organized for the purpose of issuing extendable commercial paper notes in the asset-backed commercial paper market and entering into reverse repurchase agreements with us and our affiliates. We serve as administrator for Georgetown Funding's commercial paper program. All of Georgetown Funding's transactions are conducted with the Company. Through our administration agreement, and repurchase agreements we are the primary beneficiary of Georgetown Funding and consolidate this entity for financial reporting purposes. The extendable commercial paper notes issued by Georgetown Funding are rated A1+/P1 by Standard & Poor's and Moody's Investors Service, respectively. Our Master Repurchase Agreement with Georgetown Funding enables us to finance up to \$12 billion of mortgage-backed securities. There were no short-term commercial paper borrowings issued by Georgetown Funding and outstanding as of December 31, 2007. In addition, current conditions in the credit markets may make it impracticable for us to obtain short-term commercial paper financing for our MBS portfolio in the future.

The Company also has short-term financing facilities that are structured as repurchase agreements with various financial institutions to fund its portfolio of agency-backed MBS and agency CMOs. The interest rates under these agreements are based on LIBOR plus a spread that ranges between 1.00% to 1.40% based on the nature of the mortgage collateral.

Our mortgage financing repurchase agreements include provisions contained in the standard master repurchase agreement as published by the Bond Market Association and may be amended and supplemented in accordance with industry standards for repurchase facilities. Our mortgage financing repurchase agreements include financial covenants, with which the failure to comply would represent an event of default under the applicable repurchase agreement. Similarly, each repurchase agreement includes events of default for failures to qualify as a REIT, events of insolvency and events of default on other indebtedness. As provided in the standard master repurchase agreement as typically amended, upon the occurrence of an event of default or termination event the applicable counterparty has the option to terminate all repurchase transactions under such counterparty's repurchase agreement and to demand immediate payment of any amount due from us to the counterparty.

Under our repurchase agreements, we may be required to pledge additional assets to our repurchase agreement counterparties in the event the estimated fair value of the existing pledged collateral under such agreements declines and such lenders demand additional collateral (i.e., a margin call), which may take the form of additional securities or cash. Margin calls on repurchase agreements collateralized by our MBS investments primarily result from events such as declines in the value of the underlying mortgage collateral caused by factors such as rising interest rates or prepayments. Margin calls on repurchase agreements collateralized by our

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mortgage loans primarily result from events such as declines in the value of the underlying mortgage collateral caused by interest rates, prepayments, and/or the deterioration in the credit quality of the underlying loans.

To date, we have not had any margin calls on our repurchase agreements that we were not able to satisfy with either cash or additional pledged collateral. However, should we encounter increases in interest rates or prepayments, margin calls on our repurchase agreements could result in a manner that could cause an adverse change in our liquidity position.

The following table provides information regarding the Company's outstanding commercial paper, repurchase agreement borrowings, and mortgage financing facilities (dollars in thousands).

	December 31, 2007			December 31, 2006		
	Commercial Paper	Repurchase Agreements	Short-Term Mortgage Financing Facilities <sup>(1)</sup>	Commercial Paper	Repurchase Agreements	Short-Term Mortgage Financing Facilities <sup>(1)</sup>
Outstanding balance	\$ —	\$ 1,681,822	\$ 62,555	\$ 3,971,389	\$ 2,116,813	\$ 942,517
Weighted-average rate	—	5.00%	6.16%	5.41%	5.34%	6.05%
Weighted-average term to maturity	—	20.0 days	NA	18.3 days	21.9 days	NA

(1) Under these mortgage financing agreements, which expire or may be terminated by the Company or the counterparty within one year, the Company may finance mortgage loans for up to 180 days. The interest rates on these borrowings reset daily.

### Assets

Our principal assets have historically consisted of MBS, non-conforming mortgage loans, cash and cash equivalents, receivables, and long-term investments, and securities held for trading purposes. As of December 31, 2007, liquid assets consisted primarily of cash and cash equivalents of \$692.4 million. Cash equivalents consisted primarily of money market funds invested in debt obligations of the U.S. government. In addition, we held \$1.8 billion in MBS, \$65.1 million in non-conforming mortgage loans, \$169.3 million in long-term investments, \$19.1 million in trading securities, a receivable due from servicer of \$1.4 million at December 31, 2007. The Company's total assets decreased from \$13.4 billion at December 31, 2006 to \$2.9 billion as of December 31, 2007. The decline in total assets reflects the effects of the sale of the securitized mortgage loan portfolio and net sales of available-for-sale MBS during 2007.

Long-term investments have primarily consisted of investments in marketable equity and non-public equity securities, managed partnerships (including hedge, private equity, and venture capital funds), in which we serve as managing partner and our investment in RNR II (QP), LP (a partnership we do not manage). Although our investments in hedge, private equity and venture capital funds are mostly illiquid, the underlying investments of such entities are, in the aggregate, mostly publicly-traded, liquid equity and debt securities, some of which may be restricted due to contractual "lock-up" requirements.

As of December 31, 2007, our mortgage-backed securities portfolio was comprised primarily of fixed-rate agency-backed MBS as compared to adjustable-rate mortgages and hybrid-ARM securities in 2006. The total par and fair value of the portfolio was \$1.8 billion. As of December 31, 2007, the weighted average coupon of the portfolio was 5.77%. Our non-conforming mortgage loans were comprised substantially of hybrid-ARMs. As of December 31, 2007, the principal balance of the non-conforming mortgage loan portfolio was \$109.3 million and the weighted average coupon was 8.46%. Substantially all of these loans were held by the First NLC and were sold subsequent to year end 2007 at amounts that approximated their December 31, 2007 book value.

The actual yield on the MBS is affected by the price paid to acquire the investment. Our cost basis in MBS is normally greater than the par value (i.e., a premium), resulting in the yield being less than the stated coupon. The MBS portfolio had a premium of \$1.0 million (0.06% of the unpaid par value) as of December 31, 2007.

Net unrealized gains related to our merchant banking investments that was included in accumulated other comprehensive gain in our balance sheet totaled \$3.4 million as of December 31, 2007. If and when we liquidate

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these or determine that a decline in value of these investments below our cost basis is other than temporary, a portion or all of the gains or losses will be recognized as a gain or loss in the statement of operations during the period in which the liquidation or determination is made. Our investment portfolio is exposed to potential future downturns in the markets and private equity securities are exposed to deterioration of credit quality, defaults, and downward valuations. On a quarterly basis, we review the valuations of our private equity investments. If and when we determine that the net realizable value of these investments is less than our carrying value, we will reflect the reduction as an investment loss.

#### *Regulatory Capital*

FBR & Co. and FBRIS, as U.S. broker-dealers, are registered with the SEC and are members of FINRA (formerly the National Association of Securities Dealers, Inc.). Additionally, FBRIL, our U.K. broker-dealer, is registered with the Financial Services Authority (FSA) of the United Kingdom. As such, they are subject to the minimum net capital requirements promulgated by the SEC and FSA, respectively. As of December 31, 2007, FBR & Co. had total regulatory net capital of \$102.4 million, which exceeded its required net capital of \$5.0 million by \$97.4 million. In addition, FBRIS and FBRIL had regulatory capital as defined in excess of required amounts. Regulatory net capital requirements increase when the broker-dealers are involved in underwriting activities based upon a percentage of the amount being underwritten.

#### *Dividends*

During 2007, we declared dividends as specified in the following table.

<u>Declaration Date</u>	<u>Record Date</u>	<u>Payment Date</u>	<u>Dividends Per Share</u>
September 17, 2007	September 28, 2007	October 31, 2007	\$0.05
June 19, 2007	June 29, 2007	July 31, 2007	\$0.05
March 21, 2007	March 30, 2007	April 30, 2007	\$0.05

On December 21, 2007, we announced that our Board of Directors had decided not to pay a cash dividend to our shareholders for the fourth quarter of 2007, concluding at that time that the repurchase of our Class A common stock represented a better use of our financial resources than the payment of cash dividends. Pursuant to our variable dividend policy, our Board of Directors, in its sole discretion, may reinstate the payment of cash dividends when appropriate in the future.

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### *Contractual Obligations*

We have contractual obligations to make future payments in connection with long-term debt and non-cancelable lease agreements and other contractual commitments as well as uncalled capital commitments to various investment partnerships that may be called over the next ten years. The following table sets forth these contractual obligations by fiscal year (in thousands):

	2008	2009	2010	2011	2012	Thereafter	Total
Long-term debt <sup>(1)</sup>	\$ 970	\$ 970	\$ 970	\$ 970	\$ —	\$ 319,695	\$ 323,575
Minimum rental and other contractual commitments	24,508	24,611	21,042	23,039	20,235	41,992	155,427
Capital commitments <sup>(2)</sup>	—	—	—	—	—	—	—
	<u>\$ 25,478</u>	<u>\$ 25,581</u>	<u>\$ 22,012</u>	<u>\$ 24,009</u>	<u>\$ 20,235</u>	<u>\$ 361,687</u>	<u>\$ 479,002</u>

- (1) This table excludes interest payments to be made on the Company's long-term debt securities issued through FBR TRS Holdings. Based on the 3-month LIBOR of 5.00% as of December 31, 2007, plus a weighted average margin of 2.63%, estimated annualized interest on the current outstanding principal of \$317.5 million of long-term debt securities would be approximately \$24.2 million for the year ending December 31, 2008. These long-term debt securities mature in thirty years beginning in March 2033 through October 2035. Note that interest on this long-term debt floats based on 3-month LIBOR, therefore, actual coupon interest will differ from this estimate.
- (2) The table above excludes \$3.8 million of uncalled capital commitments as of December 31, 2007 to various investment partnerships that may be called over the next ten years. This commitment was \$6.0 million at December 31, 2006. This amount was excluded because we cannot currently determine when, if ever, the commitments will be called.

The Company also has short term repurchase agreement liabilities of \$1.7 billion as of December 31, 2007. See Note 7 to the financial statements for further information.

### **Quantitative and Qualitative Disclosures about Market Risk**

Market risk generally represents the risk of loss through a change in realizable value that can result from a change in the prices of equity securities, a change in the value of financial instruments as a result of changes in interest rates, a change in the volatility of interest rates or a change in the credit rating of an issuer. We are exposed to the following market risks as a result of our investments in mortgage-backed securities and equity investments. Except for trading securities held by FBR & Co., none of these investments is held for trading purposes.

#### ***Interest Rate Risk***

##### *Leveraged MBS and Mortgage Loans*

The Company is primarily subject to interest-rate risk as a result of its principal investment activities. Historically, the Company also was subject to interest rate risk as a result of its mortgage banking activities. Through its principal investment activities, the Company invests in agency-backed MBS and agency CMOs and finances those investments with repurchase agreement and commercial paper borrowings, both of which are interest rate sensitive financial instruments. Current conditions in the credit markets may make it impracticable for us to obtain short-term commercial paper financing for our agency-backed MBS and agency CMOs. The Company is exposed to interest rate risk that fluctuates based on changes in the level or volatility of interest rates and mortgage prepayments and in the shape and slope of the yield curve. The Company attempts to hedge a

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portion of its exposure to interest rate fluctuations primarily through the use of interest rate swaps, interest rate caps, and Eurodollar futures and put option contracts. The counterparties to the Company's derivative agreements at December 31, 2007 are U.S. financial institutions.

The Company's primary risk is related to changes in both short and long term interest rates, which affect the Company in several ways. As interest rates increase, the market value of the mortgage-backed securities may be expected to decline, prepayment rates may be expected to go down, and duration may be expected to extend. An increase in interest rates is beneficial to the market value of the Company's derivative instruments, including economic hedges and instruments designated as cash flow hedges. For example, for interest rate swap positions, the cash flows from receiving the floating rate portion increase and the fixed rate paid remains the same under this scenario. If interest rates decline, the reverse is true for mortgage-backed securities, paying fixed and receiving floating interest rate swaps, interest rate caps, and Eurodollar futures and put option contracts.

The Company records its derivatives at fair value. The differential between amounts paid and received for derivative instruments designated as cash flow hedges is recorded as an adjustment to interest expense. In addition, the Company records the ineffectiveness of its cash flows hedges, if any, in net investment income. In general (i.e., presuming the hedged risk is still probable of occurring), in the event of early termination of these derivatives, the Company receives or makes a payment based on the fair value of the instrument, and the related deferred gain or loss recorded in other comprehensive income is amortized into income or expense over the original hedge period.

The table that follows shows the expected change in fair value for the Company's current mortgage-backed securities (primarily agency-backed MBS and, to a lesser extent, private-label MBS at December 31, 2007), remaining mortgage loans held by First NLC, and derivatives related to the Company's principal investing activities under several hypothetical interest-rate scenarios. Interest rates are defined by the U.S. Treasury yield curve. The changes in rates are assumed to occur instantaneously. It is further assumed that the changes in rates occur uniformly across the yield curve and that the level of LIBOR changes by the same amount as the yield curve. Actual changes in market conditions are likely to be different from these assumptions.

Changes in value are measured as percentage changes from their respective values presented in the column labeled "Value at December 31, 2007." Management's estimate of change in value for mortgage loans and mortgage-backed securities are based on the same assumptions it uses to manage the impact of interest rates on the portfolio. Actual results could differ significantly from these estimates. For mortgage-backed securities, the estimated change in value is based on an assumed duration of 0.35.

The effective durations are based on observed market value changes, as well as management's own estimate of the effect of interest rate changes on the fair value of the investments including assumptions regarding prepayments based, in part, on age of and interest rate on the mortgages and the mortgages underlying the mortgage-backed securities, prior exposure to refinancing opportunities, and an overall analysis of historical prepayment patterns under a variety of past interest rate conditions (dollars in thousands, except per share amounts).

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	Value at December 31, 2007	Value at December 31, 2007 with 100 basis point increase in interest rates	Percent Change	Value at December 31, 2007 with 100 basis point decrease in interest rates	Percent Change
<b>Assets</b>					
Mortgage-backed securities	\$ 1,791,480	\$ 1,784,314	(0.40)%	\$ 1,796,854	0.30%
Mortgage loans	65,074	65,074	—	65,074	—
Derivative assets	3,514	13,231	276.53%	850	(75.81)%
Other	1,084,887	1,084,887	—	1,084,887	—
<b>Total assets</b>	<b>2,944,955</b>	<b>\$2,947,506</b>	<b>0.09%</b>	<b>\$2,947,665</b>	<b>0.09%</b>
<b>Liabilities</b>					
Repurchase agreements and commercial paper	\$ 1,744,377	\$ 1,744,377	—	\$ 1,744,377	—
Derivative liabilities	3,558	541	(84.80)%	8,836	148.35%
Other	560,268	560,268	—	560,268	—
<b>Total liabilities</b>	<b>2,308,203</b>	<b>2,305,186</b>	<b>(0.13)%</b>	<b>2,313,481</b>	<b>0.23%</b>
<b>Minority interest</b>	<b>243,061</b>	<b>243,061</b>	<b>—</b>	<b>243,061</b>	<b>—</b>
<b>Shareholders' equity</b>	<b>393,691</b>	<b>399,259</b>	<b>1.41%</b>	<b>391,123</b>	<b>(0.65)%</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$2,944,955</b>	<b>\$2,947,506</b>	<b>0.09%</b>	<b>\$2,947,665</b>	<b>0.09%</b>
<b>Book value per share</b>	<b>\$ 2.61</b>	<b>\$ 2.65</b>	<b>1.41%</b>	<b>\$ 2.60</b>	<b>(0.65)%</b>

As shown above, the Company's portfolio of mortgage-backed securities generally will benefit less from a decline in interest rates than it will be adversely affected by a same scale increase in interest rates.

#### Other

The value of our direct investments in other companies is also likely to be affected by significant changes in interest rates. For example, certain of the companies are exposed to risks similar to those identified above as being applicable to our own investments in mortgage-backed securities. Additionally, changes in interest rates often affect market prices of equity securities. Because each of the companies in which we invest has its own interest rate risk management process, it is not feasible for us to quantify the potential impact that interest rate changes would have on the stock price or the future dividend payments by any of the companies in which we have invested.

#### Equity Price Risk

The Company is exposed to equity price risk as a result of its investments in marketable equity securities, investment partnerships, and trading securities. Equity price risk changes as the volatility of equity prices changes or the values of corresponding equity indices change.

While it is impossible to exactly project what factors may affect the prices of equity sectors and how much the effect might be, the table below illustrates the impact a ten percent increase and a ten percent decrease in the price of the equities held by the Company would have on the value of the total assets and the book value of the Company as of December 31, 2007 (dollars in thousands, except per share amounts).

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	Value at December 31, 2007	Value of Equity at December 31, 2007 with 10% Increase in Price	Percent Change	Value of Equity at December 31, 2007 with 10% Decrease in Price	Percent Change
<b>Assets</b>					
Marketable equity securities	\$ 28,688	\$ 31,557	10.00%	\$ 25,819	(10.00)%
Equity method investments	30,620	33,682	10.00%	27,558	(10.00)%
Investment securities-marked to market	7,743	8,517	10.00%	6,969	(10.00)%
Other long-term investments	1,239	1,363	—	1,115	—
Trading securities-equities	19,057	20,963	10.00%	17,151	(10.00)%
Other	2,857,608	2,857,608	—	2,857,608	—
<b>Total assets</b>	<b>\$ 2,944,955</b>	<b>\$ 2,953,690</b>	<b>0.30%</b>	<b>\$ 2,936,220</b>	<b>(0.30)%</b>
<b>Liabilities</b>	<b>\$ 2,308,203</b>	<b>\$ 2,308,203</b>	<b>—</b>	<b>\$ 2,308,203</b>	<b>—</b>
<b>Minority Interest</b>	<b>\$ 243,061</b>	<b>\$ 245,766</b>	<b>1.11%</b>	<b>\$ 240,356</b>	<b>(1.11)%</b>
<b>Shareholders' Equity</b>					
Common stock	1,519	1,519	—	1,519	—
Paid-in-capital	1,468,801	1,468,801	—	1,468,801	—
Accumulated other comprehensive income	(12,846)	(9,977)	22.33%	(15,715)	(22.33)%
Accumulated retained deficit	(1,063,783)	(1,060,622)	0.30%	(1,066,944)	(0.30)%
<b>Total shareholders' equity</b>	<b>393,691</b>	<b>399,721</b>	<b>1.53%</b>	<b>387,661</b>	<b>(1.53)%</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 2,944,955</b>	<b>\$ 2,953,690</b>	<b>0.30%</b>	<b>\$ 2,936,220</b>	<b>(0.30)%</b>
<b>Book value per share</b>	<b>\$ 2.61</b>	<b>\$ 2.65</b>	<b>1.53%</b>	<b>\$ 2.57</b>	<b>(1.53)%</b>

Except to the extent that the Company sells its marketable equity securities or other long term investments, or a decrease in their fair value is deemed to be other than temporary, an increase or decrease in the fair value of those assets will not directly affect the Company's earnings, however an increase or decrease in the value of equity method investments, investment securities-marked to market, as well as trading securities will directly effect the Company's earnings.

#### High Yield and Non-Investment Grade Debt and Preferred Securities

We may from time-to-time underwrite, trade, invest in, and make markets in high-yield corporate debt securities and preferred stock of below investment grade-rated companies. For purposes of this discussion, non-investment grade securities are defined as preferred securities or debt rated BB+ or lower, or equivalent ratings, by recognized credit rating agencies, as well as non-rated securities or debt. Investments in non-investment grade securities generally involve greater risks than investment grade securities due to the issuer's creditworthiness and the comparative illiquidity of the market for such securities. As of December 31, 2007, we have not underwritten, traded in or made a market in a material amount of these securities.

#### Off-Balance Sheet Arrangements

##### Loan Sales and Securitizations

We have historically been a party to various transactions that have an off-balance sheet component. In connection with whole loan sales to unaffiliated third parties, and in connection with mortgage loans securitized in off balance sheet transactions, our subsidiaries involved in originating or acquiring mortgage loans have made representations and warranties about certain characteristics of the loans, the borrowers, and the underlying

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properties. Generally, while neither the bondholders in the securitization transactions nor the purchasers of whole loans have recourse to us in the event that the transferred loans do not perform as expected, such parties do have recourse to us in the event of a breach of any such representations and warranties, and in the case of whole loan sales, if a borrower fails to make one or more of the first loan payments due on the loan. Specifically, we are required to repurchase certain mortgage loans that fail to meet the standard representations and warranties included in the documents evidencing the transfer of the mortgage loans and such defaulted loans. Additionally, in the context of whole loan sales, our subsidiaries are subject to premium recapture expenses. Premium recapture expenses represent repayment of a portion of certain loan sale premiums to purchasers of previously sold loans that are repaid within a specified period subsequent to sale. From time to time, we have been required to repurchase loans that we sold.

The Company maintains a liability reserve for its repurchase agreement and premium recapture obligations. The reserve is increased through charges to the gain (loss) recorded at the time of sale. The reserve is reduced by charge-offs when loans are repurchased or premiums are repaid. As of December 31, 2007, this reserve balance was \$9.6 million. During 2007, we recorded provisions of \$47.3 million and charge-offs of \$61.1 million to this reserve.

### **Critical Accounting Policies**

The Company's financial statements are prepared in conformity with U.S. Generally Accepted Accounting Principles (GAAP) and follow general practices within the industries in which it operates. The preparation of the Company's financial statements requires us to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although we base our estimates and assumptions on historical experience, when available, and on various other factors that we believe to be reasonable under the circumstances, management exercises significant judgment in the final determination of our estimates. Actual results may differ from these estimates.

Our significant accounting policies are presented in Note 2 to the consolidated financial statements. Our most critical policies that are both very important to the portrayal of our financial condition and results of operations and require management's most difficult, subjective or complex judgments or estimates are discussed below.

### ***Principal Investing Segment Marketable Securities***

The Company accounts for its long-term investments in mortgage-backed securities and marketable equity securities under SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities" (SFAS 115). SFAS 115 requires that investments in debt securities be designated at the time of acquisition as "held-to-maturity," "available-for-sale" or "trading," and investments in equity securities be designated as either "available-for-sale" or "trading." Nearly all of the Company's long-term mortgage-backed securities and marketable equity securities are designated as available-for-sale and are carried at their estimated fair values with unrealized gains and losses excluded from earnings and reported in other comprehensive income or loss, a component of stockholders' equity. Long-term investments in equity securities of non-public companies that are held in non-broker dealer entities are carried at cost.

Although the Company generally intends to hold its mortgage-backed securities until maturity, it may, from time to time, sell any of its MBS as part of the overall management of its business. The available-for-sale designation provides the Company with the flexibility to sell its MBS in order to act on potential market opportunities or changes in economic conditions to ensure future liquidity and to meet other general corporate purposes as they arise.

The Company evaluates available-for-sale securities and equity securities of non-public companies carried at cost for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or

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market concerns warrant such evaluation. The value of our mortgage-backed securities and our long-term investments in marketable equity securities can fluctuate significantly. In evaluating these investments for other than temporary impairment consideration is given to (1) the length of time and the extent to which the fair value has been lower than carrying value, (2) the severity of the decline in fair value, (3) the financial condition and near-term prospects of the issuer, and (4) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value, which for MBS may be maturity. If it is determined that an investment impairment is other than temporary then the amount that the fair value is below its current basis is recorded as an impairment charge and recorded through earnings (as opposed to through other comprehensive income in the case of marketable equity securities, as such temporary changes in fair value would be).

For unrealized losses that are determined to be temporary, we continue to evaluate these at each reporting date. If we determine at a future date that an impairment is other than temporary, the applicable unrealized loss will be reclassified from accumulated other comprehensive income and recorded as a realized loss at the time the determination is made.

For the year ended December 31, 2007, the Company recorded other-than-temporary impairment write downs of \$20.5 million in the MBS portfolio. The fair value of investments in the mortgage-backed securities portfolio totaled \$1.8 billion and the net unrealized loss with respect to these investments was \$2.3 million as of December 31, 2007.

Regarding the Company's investments in marketable equity securities, as part the assessments performed at each reporting period during 2007, the Company recorded other than temporary impairment write downs of \$10.4 million. The equity security write downs related primarily to investments in the non-prime mortgage sector. As of December 31, 2007, the Company's investments in marketable equity securities totaled \$28.7 million and the net unrealized gain recorded in other comprehensive income and gain with respect to these investments was \$3.4 million.

### ***Accounting for Mortgage Loans Held-for-Sale***

Mortgage loans originated by First NLC and other purchased loans that the Company intends to sell to third parties are classified as held for sale and are carried at the lower of cost or market value.

For mortgage loans held for sale, the Company determines fair value based on third party pricing quotes when available, current investor commitments and/or requirements for loans of similar terms and credit quality or is estimated based on the same pricing models used by the Company to bid on whole loans in the open market. Such models incorporate aggregated characteristics of groups of loans including, collateral type, index, interest rate, margin, length of fixed interest rate period, life cap, periodic cap, underwriting standards, age and credit.

As of December 31, 2007, the principal balance of non-conforming mortgage loans held for sale was \$109.3 million. Substantially all of these loans were sold subsequent to year end 2007 at amounts that approximated their December 31, 2007 book value.

### ***Accounting for Securitization Activities***

Historically, the Company issued asset-backed securities through securitization trusts to fund a portion of the Company's non-conforming residential mortgage loan portfolio. Although these securitizations were structured legally as sales, the Company accounted for the securitizations as either "sales" or "financing" transactions depending on the structure of the securitization, in accordance with SFAS 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (SFAS 140). The transfers of loans are accounted for as sales, when control over the assets has been surrendered. Control over the transferred assets is deemed to be surrendered when (1) the loan has been isolated from the Company, (2) the transferee has the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred loan, and (3) the Company does not maintain effective control over the transferred loan through either

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(a) an agreement that both entitles and obligates the Company to repurchase or redeem them before their maturity or (b) the ability to unilaterally cause the holder to return the specific loan. For the sales securitizations, the Company derecognized the loans transferred into the securitization and recorded retained financial and servicing assets or liabilities, if any, and recognized gain or loss on sale from the transaction. For financing securitizations, the trusts did not meet the various qualifying special purpose entity criteria under SFAS 140 and the Company had a continuing interest. Accordingly, the Company recorded the loans held as collateral as assets and the asset-backed securities as debt liabilities.

When the Company sold mortgage loans in securitizations, it may have retained one or more interests in the securitization receivables. Gain or loss on sale of the receivables depends in part on the previous carrying amount of the financial assets involved in the transfer, allocated between the assets sold and the retained interests based on their relative fair value at the date of transfer. To obtain fair value, quoted market prices were used, if available. However, quotes are generally not available for retained interests, so the Company generally estimated fair value based on the present value of future expected cash flows estimated using management's best estimates of the key assumptions—credit losses, prepayment speeds, forward yield curves, and discount rates commensurate with the risks involved.

The Company completed one securitization in 2007 and accounted for the securitization as a sale. The Company also retained certain residual interests in the securitization. Prospectively, at the present time, the Company does not intend to issue asset-backed securities through securitizations.

### ***Valuation of Private and Restricted Public Company Investments***

The private investment funds that we manage record their investments in securities at fair value. Certain investments consist of equity investments in securities of development-stage and early-stage privately and publicly held companies. The disposition of these investments may be restricted due to the lack of a ready market (in the case of privately held companies) or due to contractual or regulatory restrictions on disposition (in the case of publicly held companies). In addition, these securities may represent significant portions of the issuer's equity and carry special contractual privileges not available to other security holders. As a result of these factors, precise valuation for the restricted public securities and private Company securities is a matter of judgment, and the determination of fair value must be considered only an approximation and may vary significantly from the amounts that could be realized if the investment were sold.

The Company evaluates its investments in equity securities of non-public companies and its restricted investments in publicly traded securities at each reporting date or more frequently when economic or market concerns warrant such evaluation. In evaluating these investments for other than temporary impairment consideration is given to the financial condition and near-term prospects of the issuer and the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. As part of the assessments performed at each reporting period during 2007, for investments carried at cost, the Company recorded other than temporary impairment write downs of \$22.1 million. These write downs related primarily to investments in the non-prime mortgage sector. As of December 31, 2007, the Company's investments in equity securities accounted for under the cost method investments totaled \$82.6 million.

### ***Goodwill and Other Intangible Assets***

We account for our intangible assets related to acquired mutual fund management contracts (\$9.8 million) (see Note 6 to the consolidated financial statements) as well as our previous intangible assets which had consisted of goodwill recorded as a result of the merger with FBR Asset (\$108 million as of December 31, 2006) and acquisition of First NLC (\$54.7 million as of December 31, 2006) and a broker relationship intangible (\$10.8 million as of December 31, 2006) in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets" (SFAS 142). Under SFAS 142, goodwill recorded is not amortized but is tested at least annually for impairment. The values of acquired management contracts and broker relationships are amortized in proportion to their

expected economic benefit of 15 years and 10 years, respectively, and tested for impairment by comparing expected future gross cash flows to the asset's carrying amount. If the expected gross cash flows are less than the carrying amount, the asset is impaired and is written-down to its fair value.

During 2007, as a result of the deterioration in the non-prime industry, we recorded impairment charges relating to the goodwill and broker relationship intangible, both recorded as part of our acquisition of First NLC, which reduced these balances to zero. In addition, in performing our impairment assessment of the goodwill recorded in our principal investing segment as a result of the merger with FBR Asset, we determined based on the continued losses recorded in this segment, the significance of these losses as well as current market conditions affecting these activities, that this goodwill balance should be reduced to zero as of December 31, 2007.

### ***Interest Income***

Interest income includes contractual interest payments adjusted for the amortization of premiums and discounts and other deferred costs in accordance with SFAS No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases" (SFAS 91). Interest on loans from borrowers not expected to service the debt and interest on loans that are contractually past due 90 or more days is charged-off, or an allowance is established based upon management's periodic evaluation. The allowance is established by a charge to interest income equal to all interest previously accrued and unpaid, and income is subsequently recognized only to the extent that cash payments are received until the borrower's ability to make periodic interest and principal payments is adequate, in which case the loan is returned to accrual status.

### ***Hedging Activities***

In the normal course of the Company's operations and to hedge the interest rate risk associated with its short-and long-term borrowings, the Company is a party to various financial instruments that are accounted for as derivatives in accordance with SFAS 133. These instruments include interest rate caps, Eurodollar futures contracts, and interest rate swaps. In general, certain of these derivatives have qualified for hedge accounting treatment, and are accounted for as cash flow or fair value hedges. These derivatives are intended to provide income and cash flow to offset potential for reduced net interest income and cash flow under certain interest rate environments.

A key element to qualify for hedge accounting is the maintenance of adequate documentation of the hedging relationship and the Company's risk management objective and strategy for undertaking the hedge. To qualify, on the date a derivative instrument agreement is entered into, the derivative and its hedging relationship are identified, designated and documented.

In accounting for such derivatives as cash flow hedges, the fair values of the Company's derivative instruments are included on the consolidated balance sheets. To the extent these hedges are effective, changes in the fair value of derivative instruments are reported in accumulated other comprehensive income and reclassified to earnings in the periods in which the earnings are affected by the hedged cash flows. Changes in the fair value of derivative instruments related to hedge ineffectiveness and activity not qualifying for hedge treatment are recorded in current period earnings. As of December 31, 2007, the Company recorded deferred losses of \$14.1 million related to cash flow hedges in other comprehensive income and loss. If these derivatives failed to qualify as cash flow hedges, the total amount deferred would be recorded to earnings.

The Company documents the relationships between hedging instruments and hedged items, as well as the Company's risk-management objective and strategy for undertaking various hedge transactions. This process includes linking derivatives to specific liabilities on the balance sheet or related exposures. The Company also assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives used in hedging transactions are highly effective in offsetting changes in the variability of cash flows of the hedged items. When it is determined that a derivative is not highly effective as a hedge or that it has ceased to be a highly effective hedge, the Company discontinues hedge accounting prospectively, as discussed below.

When hedge accounting is discontinued, the derivative will continue to be recorded on the balance sheet at its fair value, until terminated. The effective position previously recorded remains in accumulated other comprehensive income and continues to be reclassified to earnings in the periods in which the earnings are affected by the hedged cash flows; however, changes in the fair value of an ineffective hedge subsequent to the date it was determined to be ineffective is recognized in the current period earnings.

If the hedged risk is extinguished or is not probable of occurring, the Company typically terminates any applicable hedges and recognizes any remaining related accumulated other comprehensive income balance to income or expense. However, if the Company continues to hold the derivatives, they continue to be recorded on the balance sheet at fair value with any changes being recorded to current period earnings.

#### ***Accounting for Taxes Including REIT Compliance Related Matters***

The parent Company, FBR Group, has elected to be treated as a REIT under the Internal Revenue Code. As a REIT, FBR Group is not subject to Federal income tax at the parent Company level to the extent that it distributes its taxable income to shareholders and complies with certain other requirements. Other requirements include distribution of at least 90% of the REIT's taxable income, and meeting certain percentage requirements for assets and income that effectively serve to focus FBR Group's investments into real estate, including mortgage-backed securities, and other portfolio investments. Holdings of non-real estate and portfolio investments is limited, including no more than 20% of the value of FBR Group's total assets may consist of securities of one or more taxable REIT subsidiaries, discussed below. FBR Group intends to distribute 100% of its REIT taxable income, so we have provided no income taxes on the REIT's book income.

The non-REIT subsidiaries of FBR Group elected to be treated as taxable REIT subsidiaries, and are subject to normal corporate income taxes. The financial statements include a provision for current and deferred taxes on the book income of our taxable REIT subsidiaries. The taxable REIT subsidiaries, including FBR TRS Holdings, Inc. and FBR Capital Markets, elected to file consolidated Federal income tax returns. We have endeavored to treat all transactions and shared expenses between the REIT and our taxable REIT subsidiaries at arms-length. There are no distribution requirements applicable to the taxable REIT subsidiaries, and after-tax earnings may be retained.

Deferred tax assets and liabilities for our taxable REIT subsidiaries represent the differences between the financial statement and income tax bases of assets and liabilities using enacted tax rates. The measurement of net deferred tax assets is adjusted by a valuation allowance if, based on our evaluation, it is more likely than not that they will not be realized. As of December 31, 2007, the Company had net deferred tax assets of \$14.9 million. Based on our evaluation, we are currently maintaining a \$54.2 million valuation allowance for deferred tax assets, primarily relating to losses recorded at First NLC.

#### **Recently Issued Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157, "Fair Value Measurements" (SFAS 157). This statement clarifies the definition of fair value, establishes a framework and hierarchy of fair value measurements, and expands disclosures about fair value measurements. This statement emphasizes that companies should use a market-based approach using similar assumptions that market participants would use in their assessment of the fair value of an asset or liability. These assumptions should include, but are not limited to, risks associated with the asset or liability and restrictions on the sale or use of the asset. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently assessing the impact of adoption of SFAS 157 on our consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities, Including an Amendment of FASB Statement No. 115" (SFAS 159). Under SFAS 159, entities will be permitted to measure many financial instruments and certain other assets and liabilities at fair

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value on an instrument-by-instrument basis (the fair value option). This Statement is effective for the fiscal years that beginning after November 15, 2007 with early adoption permitted. The Company did not elect the fair value option for any existing assets or liabilities as of January 1, 2008.

In December 2007, the FASB issued SFAS No. 141(R), "Business Combinations" (SFAS 141R). SFAS 141(R) expands the definition of transactions and events that qualify as business combinations; requires that the acquired assets and liabilities, including contingencies, be recorded at the fair value determined on the acquisition date and changes thereafter reflected in revenue, not goodwill; changes the recognition timing for restructuring costs; and requires acquisition costs to be expensed as incurred. Adoption of SFAS 141(R) is required for business combinations after December 15, 2008. Early adoption and retroactive application of SFAS 141(R) to fiscal years preceding the effective date are not permitted. We are evaluating the impact of adoption of SFAS 141(R) on our consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interest in Consolidated Financial Statements" (SFAS 160). SFAS 160 re-characterizes minority interests in consolidated subsidiaries as non-controlling interests and requires the classification of minority interests as a component of equity. Under SFAS 160, a change in control will be measured at fair value, with any gain or loss recognized in earnings. The effective date for SFAS 160 is for annual periods beginning on or after December 15, 2008. Early adoption and retroactive application of SFAS 160 to fiscal years preceding the effective date are not permitted. We are evaluating the impact of adoption of SFAS 160 on our consolidated financial statements.

In June, 2007, the AICPA issued Statement of Position (SOP) No. 07-1, Clarification of the Scope of the Audit and Accounting Guide to Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies (SOP 07-1). SOP 07-1 addresses when the accounting principles of the AICPA Audit and Accounting Guide Investment Companies must be applied by an entity and whether those accounting principles must be retained by a parent company in consolidation or by an investor in the application of the equity method of accounting. SOP 07-1 was expected to be effective for the fiscal years beginning on or after December 15 2007. However, the FASB issued a proposal to delay the effective date indefinitely.

#### **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

See Item 7 of this Form 10-K—"Management's Discussion and Analysis of Financial Condition and Results of Operations."

#### **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

The information required by this item appears in a subsequent section of this report. See "Index to Consolidated Financial Statements of Friedman, Billings, Ramsey Group, Inc." on page F-1.

#### **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

#### **ITEM 9A. DISCLOSURE CONTROLS AND PROCEDURES**

##### **Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures**

As of the end of the period covered by this report on Form 10-K, our management carried out an evaluation, with the participation of our Chief Executive Officer, Eric F. Billings, and our Chief Financial Officer, Kurt R. Harrington, of the effectiveness of our disclosure controls and procedures (as defined under Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended) pursuant to Rule 13a-15(b) of the Exchange Act. Based upon

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that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures, as of December 31, 2007, are effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding disclosure.

#### **Management's Report on Internal Control over Financial Reporting**

The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934, as amended). The Company's internal control over financial reporting is designed under the supervision of the firm's Chief Executive Officer and Chief Financial Officer to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's financial statements for external purposes in accordance with generally accepted accounting principles.

The Company's internal control over financial reporting includes policies and procedures that pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets; provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures are being made only in accordance with authorizations of management and the directors; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisitions, use or disposition of the Company's assets that could have a material effect on our financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

As of December 31, 2007, management conducted an assessment of the effectiveness of the Company's internal control over financial reporting based on the framework established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, management has concluded that the Company maintained effective internal control over financial reporting as of December 31, 2007.

The effectiveness of the Company's internal control over financial reporting as of December 31, 2007 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report appearing on page F-2, which expresses an unqualified opinion on the effectiveness of the Company's internal control over financial reporting as of December 31, 2007.

#### **Changes In Internal Control Over Financial Reporting**

There has been no change in our company's internal control over financial reporting during the quarter ended December 31, 2007 that has materially affected, or is reasonably likely to materially affect, our company's internal control over financial reporting.

#### **ITEM 9B. OTHER INFORMATION**

None.

## **PART III**

### **ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

The information required by Part III, Item 10, of this report on Form 10-K will be provided in our 2008 Proxy Statement and is hereby incorporated by reference.

### **ITEM 11. EXECUTIVE COMPENSATION**

The information required by Part III, Item 11, of this report on Form 10-K, will be provided in our 2008 Proxy Statement and is hereby incorporated by reference.

### **ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED SHAREHOLDER MATTERS**

The information required by Part III, Item 12, of this report on Form 10-K, will be provided in our 2008 Proxy Statement and is hereby incorporated by reference.

### **ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE**

The information required by Part III, Item 13, of this report on Form 10-K will be provided in our 2008 Proxy Statement and is hereby incorporated by reference.

### **ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

The information required by Part III, Item 14, of this report on Form 10-K will be provided in our 2008 Proxy Statement and is hereby incorporated by reference.

**PART IV****ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

(a) (1) *Financial Statements*. The Friedman Billings Ramsey Group, Inc. consolidated financial statements for the year ended December 31, 2007, filed as part of this Form 10-K, are incorporated by reference into this Item 15:

- Report of Independent Registered Public Accounting Firm (page F-2)
- Consolidated Balance Sheets—Years ended 2007 and 2006 (page F-4)
- Consolidated Statements of Operations—Years ended 2007, 2006 and 2005 (page F-5)
- Consolidated Statements of Changes in Shareholder's Equity—Years ended 2007, 2006 and 2005 (page F-6)
- Consolidated Statements of Cash Flows—Years ended 2007, 2006 and 2005 (page F-7)
- Notes to Consolidated Financial Statements (page F-8)

(2) *Financial Statement Schedules*. All schedules are omitted because they are not required or because the information is shown in the financial statements or notes thereto.

(3) *Exhibits*

Exhibit Number	Exhibit Title
2.01	Agreement and Plan of Merger dated as of November 14, 2002, by and among the Registrant, FBR Asset Investment Corporation and Forest Merger Corporation (incorporated by reference to Annex A to the joint proxy statement/prospectus which is a part of Amendment No. 4 to the Registration Statement on Form S-4 (File No. 333-101703))
3.01	Amended and Restated Articles of Incorporation (incorporated by reference to Exhibit 2.1 to the Current Report on Form 8-K filed on March 31, 2003, as amended May 15, 2003).
3.02	Bylaws, amended as of March 20, 2007 (incorporated by reference to Exhibit 3.02 to the Quarterly Report on Form 10-Q filed on May 10, 2007).
4.01	Form of Specimen Certificate for Class A Common Stock (incorporated by reference to Exhibit 4.1 to the Amendment No. 1 to the Registration Statement on Form S-3 (File No. 333-107731)).
4.02	Form of Senior Indenture (incorporated by reference to Exhibit 4.2 to the Registration Statement on Form S-3 (File No. 333-107731)).
4.03	Form of Senior Debt Security (incorporated by reference to Exhibit 4.3 to the Registration Statement on Form S-3 (File No. 333-107731)).
4.04	Form of Subordinated Indenture (incorporated by reference to Exhibit 4.4 to the Registration Statement on Form S-3 (File No. 333-107731)).
4.05	Form of Subordinated Debt Security (incorporated by reference to Exhibit 4.5 to the Registration Statement on Form S-3 (File No. 333-107731)).
10.01	Friedman, Billings, Ramsey Group, Inc. 2004 Long-Term Incentive Plan (incorporated by reference to Appendix A to the Definitive Proxy Statement filed on April 29, 2004).*
10.02	1997 Employee Stock Purchase Plan (incorporated by reference to Exhibit 10.05 to Amendment No. 2 to the Registration Statement on Form S-1 (File No. 333-39107)).*

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Exhibit Number	Exhibit Title
10.03	FBR Stock and Annual Incentive Plan (incorporated by reference to Exhibit 10.03 to the Annual Report on Form 10-K for the fiscal year ended December 31, 1999).*
10.04	Non-Employee Director Stock Compensation Plan (incorporated by reference to Exhibit 10.07 to Amendment No. 2 to the Registration Statement on Form S-1 (File No. 333-39107)).*
10.05	Key Employee Incentive Plan (incorporated by reference to Exhibit 10.08 to Amendment No. 2 to the Registration Statement on Form S-1 (File No. 333-39107)).*
10.06	Agreement between Friedman Billings Ramsey Group, Inc., FBR Capital Management, Inc., Orkney Holdings, Inc., Friedman, Billings, Ramsey Investment Management, Inc. and Chevy Chase Bank, F.S.B. (incorporated by reference to Exhibit 10.09 to the Annual Report on Form 10-K for the fiscal year ended December 31, 2002).
10.07	Securities Purchase Agreement, dated as of January 10, 2005, by and among Friedman, Billings, Ramsey Group, Inc., FNLC Financial Services, Inc., NLC Financial Services, LLC, Neal S. Henschel, Jeffrey M. Henschel, Benjamin Henschel, Andrew Henschel and Sun Mortgage Partners, L.P. (incorporated by reference to Exhibit 10.08 to the Annual Report on Form 10-K for the fiscal year ended December 31, 2004).
10.8	Letter Agreement, dated as of June 22, 2006, by and among the Registrant, FBR TRS Holdings, Inc., FBR Capital Markets Corporation, Forest Holdings LLC and Forest Holdings (ERISA) LLC (incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on June 22, 2006).
10.9	Contribution Agreement, dated July 20, 2006, by and between FBR TRS Holdings, Inc. and FBR Capital Markets Corporation (incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on July 26, 2006).
10.10	Corporate Agreement, dated July 20, 2006, by and between FBR Capital Markets Corporation and the Registrant (incorporated by reference to Exhibit 10.2 to the Current Report on Form 8-K filed on July 26, 2006).
10.11	Management Services Agreement, dated as of July 20, 2006, by and between the Registrant and FBR Capital Markets Corporation (incorporated by reference to Exhibit 10.3 to the Current Report on Form 8-K filed on July 26, 2006).
10.12	Services Agreement, dated as of July 20, 2006, by and between Friedman, Billings, Ramsey Group, Inc. and FBR Capital Markets Corporation (incorporated by reference to Exhibit 10.4 to the Current Report on Form 8-K filed on July 26, 2006).
10.13	Tax Sharing Agreement, dated as of July 20, 2006, by and between the FBR TRS Holdings, Inc. and FBR Capital Markets Corporation (incorporated by reference to Exhibit 10.5 to the Current Report on Form 8-K filed on July 26, 2006).
10.14	Trademark License Agreement, dated as of July 20, 2006, by and between Friedman, Billings, Ramsey Group, Inc. and FBR Capital Markets Corporation (incorporated by reference to Exhibit 10.6 to the Current Report on Form 8-K filed on July 26, 2006).
10.15	Investment Agreement, dated as of July 19, 2006, by and among Forest Holdings LLC, Forest Holdings (ERISA) LLC and FBR Capital Markets Corporation and Friedman, Billings, Ramsey Group, Inc. (incorporated by reference to Exhibit 10.7 to the Current Report on Form 8-K filed on July 26, 2006).
10.16	Governance Agreement, dated as of July 20, 2006, by and among Forest Holdings LLC, Forest Holdings (ERISA) LLC, FBR TRS Holdings, Inc. and Friedman, Billings, Ramsey Group, Inc. (incorporated by reference to Exhibit 10.8 to the Current Report on Form 8-K filed on July 26, 2006).

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Exhibit Number	Exhibit Title
10.17	Voting Agreement, dated as of July 20, 2006, by and among by and among Forest Holdings LLC, Forest Holdings (ERISA) LLC, FBR Capital Markets Corporation, FBR TRS Holdings and Friedman, Billings, Ramsey Group, Inc. (incorporated by reference to Exhibit 10.9 to the Current Report on Form 8-K filed on July 26, 2006).
10.18	Professional Services Agreement, dated as of July 20, 2006, by and between Crestview Advisors L.L.C. and FBR Capital Markets Corporation (incorporated by reference to Exhibit 10.10 to the Current Report on Form 8-K filed on July 26, 2006).
10.19	Registration Rights Agreement, dated as of July 20, 2006, by and among Forest Holdings LLC, Forest Holdings (ERISA) LLC and FBR Capital Markets Corporation (incorporated by reference to Exhibit 10.11 to the Current Report on Form 8-K filed on July 26, 2006).
10.20	Stock Option Agreement, dated as of July 20, 2006, by and between FBR Capital Markets Corporation and Forest Holdings LLC (incorporated by reference to Exhibit 10.12 to the Current Report on Form 8-K filed on July 26, 2006).
10.21	Stock Option Agreement, dated as of July 20, 2006, between FBR Capital Markets Corporation and Forest Holdings (ERISA) LLC (incorporated by reference to Exhibit 10.13 to the Current Report on Form 8-K filed on July 26, 2006).
10.22	FBR Capital Markets Corporation 2006 Long-Term Incentive Plan (incorporated by reference to Exhibit 10.14 to the Current Report on Form 8-K filed on July 26, 2006).*
10.23	Form of FBR Capital Markets Corporation Incentive Stock Option Agreement (incorporated by reference to Exhibit 10.15 to the Current Report on Form 8-K filed on July 26, 2006).*
10.24	Form of FBR Capital Markets Corporation Non-Qualified Stock Option Agreement (incorporated by reference to Exhibit 10.16 to the Current Report on Form 8-K filed on July 26, 2006).*
10.25	FBR Capital Markets Corporation 2007 Employee Stock Purchase Plan (incorporated by reference to Exhibit 10.27 to the Annual Report on Form 10-K filed on March 1, 2007).*
10.26	Amendment No. 1 to Corporate Agreement, dated April 5, 2007, between the FBR Capital Markets Corporation and Friedman, Billings Ramsey Group, Inc.†
10.27	Amendment No. 1 to Management Services Agreement, dated April 5, 2007, between FBR Capital Markets Corporation and Friedman Billings Ramsey Group, Inc.†
10.28	2007 Employee Stock Purchase Plan, amended as of April 23, 2007.*†
10.29	Recapitalization Agreement, dated as of July 25, 2007, by and among Friedman, Billings, Ramsey Group, Inc., FNLC Financial Services, Inc., NLC Holding Corp. and First NLC Financial Services, LLC (incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on July 31, 2007).
10.30	Loan and Security Agreement, dated as of July 25, 2007, by and among First NLC Financial Services, LLC, as Borrower, NLC Holding Corp., as Lender, FNLC Financial Services, Inc., as Lender, Friedman, Billings, Ramsey Group, Inc., for the limited purpose of any fraud claims, and NLC Holding Corp., as Administrative Agent for the Lenders (incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on July 31, 2007).
10.31	Amendment No. 1 to FBR Capital Markets Corporation 2006 Long-Term Incentive Plan.*†
11.01	Statement regarding Computation of Per Share Earnings (included in Part II, Item 8 and Note 2 to the Registrant's Consolidated Financial Statements on page F-19).
12.01	Statement regarding Computation of Ratio of Earnings to Fixed Charges.†

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<u>Exhibit Number</u>	<u>Exhibit Title</u>
21.01	List of Subsidiaries of the Registrant.†
23.01	Consent of PricewaterhouseCoopers LLP.†
24.01	Power of Attorney (included on the signature page to this report on Form 10-K and incorporated by reference herein)†
31.01	Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.†
31.02	Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.†
32.01	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.†
32.02	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.†
99.01	Form of resolution of the Board of Directors of FBR Capital Markets Corporation with respect to the FBR Capital Markets Director Stock Purchase Plan.†
99.02	Form of Subscription Agreement with respect to the FBR Capital Markets Director Stock Purchase Plan.†

\* Management agreement or compensatory plan or arrangement.

† Filed herewith.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**FRIEDMAN BILLINGS RAMSEY GROUP, INC.**

Date: February 29, 2008

By: /s/ ERIC F. BILLINGS

Eric F. Billings  
Chief Executive Officer

**POWER OF ATTORNEY**

KNOW ALL MEN BY THESE PRESENTS, that each person whose signature appears below hereby constitutes and appoints **Eric F. Billings** and **Kurt R. Harrington** and each of them as his true and lawful attorney-in-fact and agent, with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to sign any and all amendments to this Annual Report on Form 10-K for the fiscal year ended December 31, 2007, and to file the same, with all exhibits thereto, and any other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents full power and authority to do and perform each and every act and thing requisite and necessary to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact and agents or any of them, or their substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ ERIC F. BILLINGS</u> ERIC F. BILLINGS	Chairman, Chief Executive Officer and Director (Principal Executive Officer)	February 29, 2008
<u>/s/ J. ROCK TONKEL, JR.</u> J. ROCK TONKEL, JR.	President, Chief Operating Officer and, Director	February 29, 2008
<u>/s/ KURT R. HARRINGTON</u> KURT R. HARRINGTON	Executive Vice President and Chief Financial Officer (Principal Financial Officer)	February 29, 2008
<u>/s/ ROBERT J. KIERNAN</u> ROBERT J. KIERNAN	Senior Vice President, Controller and Chief Accounting Officer (Principal Accounting Officer)	February 29, 2008
<u>/s/ DANIEL J. ALTOBELLO</u> DANIEL J. ALTOBELLO	Director	February 29, 2008
<u>/s/ PETER A. GALLAGHER</u> PETER A. GALLAGHER	Director	February 29, 2008
<u>/s/ STEPHEN D. HARLAN</u> STEPHEN D. HARLAN	Director	February 29, 2008
<u>/s/ RUSSELL C. LINDNER</u> RUSSELL C. LINDNER	Director	February 29, 2008
<u>/s/ RALPH S. MICHAEL III</u> RALPH S. MICHAEL III	Director	February 29, 2008
<u>/s/ WALLACE L. TIMMENY</u> WALLACE L. TIMMENY	Director	February 29, 2008
<u>/s/ JOHN T. WALL</u> JOHN T. WALL	Director	February 29, 2008

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**FINANCIAL STATEMENTS OF FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**

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**Report of Independent Registered Public Accounting Firm**

To The Board of Directors and Shareholders of  
Friedman, Billings, Ramsey Group, Inc.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, of changes in shareholders' equity and of cash flows present fairly, in all material respects, the financial position of Friedman, Billings, Ramsey Group, Inc. and its subsidiaries (the "Company") at December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2007 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the Management's Report on Internal Control over Financial Reporting. Our responsibility is to express opinions on these financial statements and on the Company's internal control over financial reporting based on our integrated audit. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP  
McLean, Virginia  
February 29, 2008

**FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(Dollars in thousands, except per share amounts)

	December 31,	
	2007	2006
<b>ASSETS</b>		
Cash and cash equivalents	\$ 692,360	\$ 189,956
Restricted cash	14,166	132
Receivables:		
Due from servicer	1,434	64,740
Interest	7,060	68,981
Other	66,863	83,528
Investments:		
Mortgage-backed securities, at fair value	1,791,480	6,870,661
Loans held for sale, net	65,074	5,367,934
Long-term investments	169,274	185,492
Trading securities, at fair value	19,057	18,180
Due from clearing broker	—	28,999
Derivative assets, at fair value	3,514	36,875
Goodwill	—	162,765
Intangible assets, net	9,837	21,825
Furniture, equipment, software and leasehold improvements, net of accumulated depreciation and amortization of \$34,014 and \$36,841, respectively	30,451	44,111
Prepaid expenses and other assets	74,385	208,339
<b>Total assets</b>	<b>\$2,944,955</b>	<b>\$13,352,518</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Liabilities:</b>		
Trading account securities sold short but not yet purchased, at fair value	\$ 206	\$ 202
Commercial paper	—	3,971,389
Repurchase agreements	1,744,377	3,059,330
Derivative liabilities, at fair value	3,558	44,582
Dividends payable	—	8,743
Interest payable	2,991	12,239
Accrued compensation and benefits	57,000	57,227
Due to clearing broker	7,059	—
Accounts payable, accrued expenses and other liabilities	105,456	81,819
Short term-loan borrowing	63,981	—
Securitization financing, net	—	4,486,046
Long-term debt	323,575	324,453
<b>Total liabilities</b>	<b>2,308,203</b>	<b>12,046,030</b>
<b>Minority Interest</b>	<b>243,061</b>	<b>135,443</b>
<b>Commitments and Contingencies (Note 11)</b>		
<b>Shareholders' Equity:</b>		
Preferred Stock, \$0.01 par value, 25,000,000 shares authorized, none issued and outstanding	—	—
Class A Common Stock, \$0.01 par value, 450,000,000 shares authorized, 139,266,465 and 161,487,096 shares issued, respectively	1,393	1,615
Class B Common Stock \$0.01 par value, 100,000,000 shares authorized 12,616,249 and 13,225,249 shares issued and outstanding, respectively	126	132
Additional paid-in capital	1,468,801	1,562,485
Accumulated other comprehensive loss, net of taxes	(12,846)	(15,136)
Accumulated deficit	(1,063,783)	(378,051)
<b>Total shareholders' equity</b>	<b>393,691</b>	<b>1,171,045</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$2,944,955</b>	<b>\$13,352,518</b>

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

**FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Dollars in thousands except per share amounts)

	Year Ended December 31,		
	2007	2006	2005
<b>Revenues:</b>			
Investment banking:			
Capital raising	\$ 282,619	\$ 190,187	\$ 356,753
Advisory	34,063	24,148	17,759
Institutional brokerage:			
Principal transactions	10,152	5,814	17,950
Agency commissions	104,792	101,009	82,778
Mortgage trading interest	—	51,147	30,859
Mortgage trading net investment loss	—	(3,301)	(3,820)
Asset management:			
Base management fees	23,549	20,093	30,348
Incentive allocations and fees	401	1,327	1,929
Principal investment:			
Interest	501,130	594,879	549,832
Net investment loss	(221,956)	(184,552)	(239,754)
Dividends	3,173	14,551	36,622
Mortgage banking:			
Interest	51,245	88,662	78,007
Net investment (loss) income	(222,032)	83,786	13,741
Other	15,808	20,154	22,302
Total revenues	582,944	1,007,904	995,306
Interest expense	477,437	611,800	546,313
Provision for loan losses	—	15,740	14,291
Revenues, net of interest expense and provision for loan losses	105,507	380,364	434,702
<b>Non-interest expenses:</b>			
Compensation and benefits	361,355	309,065	331,492
Professional services	55,741	59,722	66,550
Business development	43,518	42,150	46,648
Clearing and brokerage fees	12,514	11,820	8,882
Occupancy and equipment	52,302	50,051	34,044
Communications	28,690	24,398	20,634
Other operating expenses	82,246	89,377	70,679
Impairment of goodwill	162,765	—	—
Restructuring charges	46,985	—	—
Total non-interest expenses	846,116	586,583	578,929
Operating loss	(740,609)	(206,219)	(144,227)
<b>Other income:</b>			
Gain on sale of subsidiary shares	104,062	121,511	—
Loss before taxes and minority interest	(636,547)	(84,708)	(144,227)
Income tax provision (benefit)	22,932	(14,682)	26,683
Minority interest in earning (loss) of consolidated subsidiary	774	(2,751)	—
<b>Net loss</b>	<b>\$ (660,253)</b>	<b>\$ (67,275)</b>	<b>\$ (170,910)</b>
Basic and diluted loss per share	<b>\$ (3.95)</b>	<b>\$ (0.39)</b>	<b>\$ (1.01)</b>
Dividends declared per share	<b>\$ 0.15</b>	<b>\$ 0.50</b>	<b>\$ 1.22</b>
Basic and diluted weighted average shares outstanding	<b>166,974,997</b>	<b>171,667,179</b>	<b>169,333,013</b>

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

**FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**  
(Dollars in thousands)

	Class A Number of Shares	Class A Amount	Class B Number of Shares	Class B Amount	Additional Paid-In Capital	Employee Stock Loan Receivable	Deferred Compensation, net	Accumulated Other Comprehensive Loss	Retained Earnings (Accumulated Deficit)	Total	Comprehensive Loss
<b>Balances, December 31, 2004</b>	<u>143,967,205</u>	<u>\$ 1,440</u>	<u>24,929,599</u>	<u>\$ 249</u>	<u>\$ 1,483,640</u>	<u>\$ (4,890)</u>	<u>\$ (16,863)</u>	<u>\$ (38,162)</u>	<u>\$ 153,110</u>	<u>\$1,578,524</u>	
Net loss	—	—	—	—	—	—	—	—	(170,910)	(170,910)	\$ (170,910)
Conversion of Class B shares to Class A shares	11,449,350	114	(11,449,350)	(114)	—	—	—	—	—	—	—
Issuance of Class A common stock	3,956,928	40	—	—	63,211	—	1,261	—	—	64,512	—
Repayment on employee stock purchase and loan plan receivable	—	—	—	—	—	1,149	—	—	—	1,149	—
Interest on employee stock purchase and loan plan	—	—	—	—	277	(277)	—	—	—	—	—
Other comprehensive income:											
Net change in unrealized gain (loss) on available-for-sale investment securities (net of taxes of \$1,978)	—	—	—	—	—	—	—	39,481	—	39,481	39,481
Net change in unrealized gain (loss) on cash flow hedges	—	—	—	—	—	—	—	(2,296)	—	(2,296)	(2,296)
Comprehensive loss											<u>\$ (133,725)</u>
Dividends	—	—	—	—	—	—	—	—	(206,290)	(206,290)	—
<b>Balances, December 31, 2005</b>	<u>159,373,483</u>	<u>\$ 1,594</u>	<u>13,480,249</u>	<u>\$ 135</u>	<u>\$1,547,128</u>	<u>\$ (4,018)</u>	<u>\$ (15,602)</u>	<u>\$ (977)</u>	<u>\$ (224,090)</u>	<u>\$ 1,304,170</u>	
Net loss	—	—	—	—	—	—	—	—	(67,275)	(67,275)	\$ (67,275)
Reclassification of deferred compensation to additional paid-in capital	—	—	—	—	(15,602)	—	15,602	—	—	—	—
Conversion of Class B shares to Class A shares	255,000	3	(255,000)	(3)	—	—	—	—	—	—	—
Issuance of Class A common stock	1,858,613	18	—	—	20,793	—	—	—	—	20,811	—
Repayment on employee stock purchase and loan plan receivable	—	—	—	—	—	4,203	—	—	—	4,203	—
Interest on employee stock purchase and loan plan	—	—	—	—	197	(197)	—	—	—	—	—
Stock compensation expense for stock options and employee stock purchase plan	—	—	—	—	4,976	—	—	—	—	4,976	—
Other comprehensive income:											
Net change in unrealized gain (loss) on available-for-sale investment securities (net of taxes of \$458)	—	—	—	—	—	—	—	10,463	—	10,463	10,463
Net change in unrealized gain (loss) on cash flow hedges	—	—	—	—	—	—	—	(24,622)	—	(24,622)	(24,622)
Comprehensive loss											<u>\$ (81,434)</u>
Other	—	—	—	—	5,005	—	—	—	—	5,005	—
Dividends	—	—	—	—	—	—	—	—	(86,686)	(86,686)	—
<b>Balances, December 31, 2006</b>	<u>161,487,096</u>	<u>\$ 1,615</u>	<u>13,225,249</u>	<u>\$ 132</u>	<u>\$1,562,497</u>	<u>\$ (12)</u>	<u>\$ —</u>	<u>\$ (15,136)</u>	<u>\$ (378,051)</u>	<u>\$ 1,171,045</u>	

**FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY—(Continued)**  
(Dollars in thousands)

	Class A Number of Shares	Class A Amount	Class B Number of Shares	Class B Amount	Additional Paid-In Capital	Employee Stock Loan Receivable	Accumulated Other Comprehensive Loss	Retained Accumulated Deficit	Total	Comprehensive Loss
<b>Balances, December 31, 2006</b>	<u>161,487,096</u>	<u>\$ 1,615</u>	<u>13,225,249</u>	<u>\$ 132</u>	<u>\$1,562,497</u>	<u>\$ (12)</u>	<u>\$ (15,136)</u>	<u>\$ (378,051)</u>	<u>\$1,171,045</u>	
Net loss	—	—	—	—	—	—	—	(660,253)	(660,253)	(660,253)
Reclassification of employee stock loan receivable to additional paid-in-capital	—	—	—	—	(12)	12	—	—	—	—
Conversion of Class B shares to Class A shares	609,000	6	(609,000)	(6)	—	—	—	—	—	—
Issuance of Class A common stock	1,143,608	11	—	—	1,259	—	—	—	1,270	—
Forfeitures of Class A common stock	(329,811)	(3)	—	—	(2,020)	—	—	—	(2,023)	—
Repurchase of Class A common	(23,643,428)	(236)	—	—	(109,541)	—	—	—	(109,777)	—
Stock compensation expense for stock options and employee stock purchase plan	—	—	—	—	1,052	—	—	—	1,052	—
Amortization of Class A common shares issued as stock-based awards	—	—	—	—	7,055	—	—	—	7,055	—
Equity in issuance of subsidiary common shares to employees	—	—	—	—	8,511	—	—	—	8,511	—
Other comprehensive income:										
Net change in unrealized gain (loss) on available-for-sale investment securities (net of taxes of \$(206))	—	—	—	—	—	—	(12,169)	—	(12,169)	(12,169)
Net change in unrealized gain (loss) on cash flow hedges (net of taxes of \$ 1,257)	—	—	—	—	—	—	14,459	—	14,459	14,459
Comprehensive loss	—	—	—	—	—	—	—	—	—	<u>\$ (657,963)</u>
Dividends	—	—	—	—	—	—	—	(25,479)	(25,479)	—
<b>Balances, December 31, 2007</b>	<u>139,266,465</u>	<u>\$ 1,393</u>	<u>12,616,249</u>	<u>\$ 126</u>	<u>\$1,468,801</u>	<u>\$ —</u>	<u>\$ (12,846)</u>	<u>\$ (1,063,783)</u>	<u>\$ 393,691</u>	

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

**FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Dollars in thousands)

	Year Ended December 31,		
	2007	2006	2005
<b>Cash flows from operating activities:</b>			
Net loss	\$ (660,253)	\$ (67,275)	\$ (170,910)
Non-cash items included in net loss—			
Impairment of goodwill and intangible assets	173,014	—	—
Provisions for loan losses, including loss provisions on loan sales and lower of cost or market valuation adjustments on held for sale mortgage loans	319,620	209,237	33,202
Gain on sale of subsidiary stock	(104,061)	(121,511)	—
Incentive allocations and fees and net investment loss from long-term investments and mortgage portfolios	61,519	40,263	256,706
Depreciation and amortization	17,177	18,116	14,163
Other	85,075	57,075	66,001
Changes in operating assets:			
Receivables—			
Due from servicer	70,006	64,838	(128,745)
Interest receivable	61,327	14,634	(33,770)
Other	16,547	(25,447)	(22,756)
Due from clearing broker	36,058	42,065	24,182
Origination and purchases of loans held for sale, net of fees	(2,195,782)	(7,604,602)	(5,020,507)
Cost basis on sale and principal repayments of loans held for sale	2,926,495	7,233,744	4,451,045
Trading securities	(2,363)	995,123	(1,024,894)
Prepaid expenses and other assets	19,512	(15,971)	11,765
Reverse repurchase agreements related to broker-dealer activities	—	147,918	(147,918)
Changes in operating liabilities:			
Trading account securities sold but not yet purchased	4	(150,345)	133,371
Repurchase agreements related to broker-dealer activities, net	—	(929,363)	929,363
Accounts payable and accrued expenses	(34,320)	(29,003)	(35,527)
Accrued compensation and benefits	11,798	(22,457)	(31,470)
Net cash provided by (used in) operating activities	801,373	(142,961)	(696,699)
<b>Cash flows from investing activities:</b>			
Purchases of mortgage-backed securities	(4,989,056)	(7,924,138)	(1,971,957)
Proceeds from sales of mortgage-backed securities	9,212,338	8,165,979	1,394,261
Receipt of principal payments on mortgage-backed securities	766,132	892,101	3,965,138
Proceeds of reverse repurchase agreements, net	—	135,902	47,469
Purchases of long-term investments	(133,220)	(49,479)	(72,145)
Proceeds from sales of long-term investments	133,650	208,648	94,602
Purchases and originations of loans held for investment, including loans reclassified to held for sale	—	(1,289)	(7,646,625)
Receipt of principal payments from loans held for investment, including loans reclassified to held for sale	1,302,896	2,108,137	751,506
Proceeds from sales of loans held for investment reclassified to held for sale	—	351,662	99,159
Proceeds from sales of real estate owned	153,431	36,155	—
Proceeds from residual interest in securitization	6,154	—	—
Purchases of fixed assets	(15,910)	(11,571)	(32,025)
Proceeds from sale of subsidiary stock	205,643	—	—
Purchase of First NLC Financial Services, LLC, net of cash	—	—	(64,912)
Other	(500)	—	—
Net cash provided by (used in) investing activities	6,641,558	3,912,107	(3,435,529)

**FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS—(Continued)**  
(Dollars in thousands)

	Year Ended December 31,		
	2007	2006	2005
<b>Cash flows from financing activities:</b>			
Proceeds from issuance of long-term debt	—	—	195,000
Repayments of long-term debt	(970)	(970)	(970)
(Repayments of) proceeds from repurchase agreements, net	(1,314,952)	1,290,432	(2,181,478)
Repayments of commercial paper, net	(3,971,390)	(3,025,561)	(297,999)
Proceeds from short-term borrowings	60,000	—	—
Repayments of temporary subordinated loan	—	(75,000)	(200,000)
Proceeds from temporary subordinated loan	—	—	275,000
Proceeds from sale of subsidiary stock, net of issuance costs	4,326	259,738	—
Dividends paid	(34,218)	(112,774)	(237,333)
Proceeds from issuance of common stock	483	4,700	5,632
Repurchase of common stock and subsidiary stock	(122,794)	—	—
Proceeds from securitization financing, net	—	34,782	7,140,458
Repayments of securitization financing	(1,545,417)	(2,197,355)	(512,376)
Payments for purchases of derivatives with financing element	(15,595)	—	(62,371)
Proceeds from the issuance of derivatives with financing element	—	—	21,760
Proceeds from repayment of employee stock loan receivable	—	4,203	1,149
Net cash (used in) provided by financing activities	(6,940,527)	(3,817,805)	4,146,472
Net increase (decrease) in cash and cash equivalents	502,404	(48,659)	14,244
Cash and cash equivalents, beginning of year	189,956	238,615	224,371
Cash and cash equivalents, end of year	<u>\$ 692,360</u>	<u>\$ 189,956</u>	<u>\$ 238,615</u>
<b>Supplemental Cash Flow Information:</b>			
Cash payments for interest	\$ 505,558	\$ 632,048	\$ 543,185
Cash payments for taxes	\$ 44,710	\$ 7,897	\$ 50,622

Note: See Note 16 for supplemental cash flow information, non-cash transactions.

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

**FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Dollars in thousands, except per share amounts)**

**Note 1. Organization and Nature of Operations:**

***Organization***

On March 31, 2003, Friedman, Billings, Ramsey Group, Inc., a Virginia Corporation (the Company or FBR Group) merged with FBR Asset Investment Corporation (FBR Asset). The merger was accounted for as a purchase of FBR Asset by FBR Group using the purchase method of accounting. Upon completion of the merger, the parent Company, FBR Group, elected Real Estate Investment Trust (REIT) status for U.S. federal income tax purposes. Also upon completion of the merger, the Company created FBR TRS Holdings, Inc. (FBR TRS Holdings), a taxable REIT subsidiary holding Company, under which the Company conducts its investment banking, institutional brokerage, asset management and mortgage banking business in taxable REIT subsidiaries.

The Company conducts mortgage-backed securities (MBS) and merchant banking investment business at the parent company REIT level. Through its qualified REIT subsidiary, MHC I, Inc. (MHC), a wholly owned subsidiary of FBR Group, the Company invested in non-conforming mortgage loans. In December 2007, the Company sold its securitized non-conforming mortgage loan portfolio. As of December 31, 2007, MHC did not hold mortgage loans financed by asset-backed securities.

FBR TRS Holdings, a Virginia corporation, is a holding Company of which the principal operating subsidiaries are FBR Capital Markets Corporation (FBR Capital Markets), FBR Investment Services, Inc. (FBRIS), Money Management Advisors, Inc. (MMA), FBR Bancorp, Inc. (FBR Bank) and FNLC Financial Services, Inc. (FNLC). FBR Capital Markets, a Virginia corporation formed in 2006, is a holding Company of which the principal operating companies are Friedman, Billings, Ramsey & Co., Inc. (FBR & Co.), Friedman, Billings, Ramsey International, Ltd. (FBRIL), FBR Investment Management, Inc. (FBRIM) and FBR Fund Advisers, Inc. (FBRFA). As a result of a July 2006 private equity offering (see Note 3), FBR Capital Markets is a majority-owned subsidiary of FBR TRS Holdings.

FBR & Co. and FBRIS are registered broker-dealers and members of the National Association of Securities Dealers, Inc. They act as introducing brokers and forward all transactions to clearing brokers on a fully disclosed basis. FBR & Co. and FBRIS do not hold funds or securities for, nor owe funds or securities to, customers. During the periods presented, FBR & Co.'s capital raising and advisory activities were concentrated primarily on consumer, diversified industrials, energy and natural resources, financial institutions, healthcare, insurance, real estate and technology, media and telecommunications sectors.

FBRIM is a registered investment adviser that manages and acts as general partner, managing member or manager of various proprietary hedge and private equity funds. FBRIM also manages separate investment accounts. FBRFA is a registered investment adviser that manages The FBR Family of Funds.

In December 2004, FBR formed FNLC to assist in the acquisition of First NLC Financial Services, LLC (First NLC). In February 2005, the Company consummated the acquisition of First NLC (see Note 12). First NLC originates, acquires, underwrites and funds non-conforming mortgage loans secured primarily by single-family residences, then sells those loans to institutional loan purchasers or to MHC for retention in the Company's mortgage loan portfolio. On January 18, 2008, First NLC filed a voluntary petition for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code in order to effectuate an orderly liquidation of First NLC's assets. The filing was made in the United States Bankruptcy Court for the Southern District of Florida, West Palm Beach Division (see Note 19).

**FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**(Dollars in thousands, except per share amounts)**

***Nature of Operations***

The Company's principal business activities, including investing as principal in MBS, merchant banking opportunities, capital raising, securities sales and trading, merger and acquisition and advisory services, proprietary investments, and venture capital and other asset management services, are all linked to the capital markets.

Through First NLC and MHC, the Company conducted investment activities in non-conforming mortgage loans. Historically, the Company originated, acquired, financed and sold non-conforming mortgage loans. Non-conforming mortgage loans include loans to borrowers who do not meet the conforming underwriting guidelines of Fannie Mae, Freddie Mac or Ginnie Mae because of higher loan-to-value ratios, the nature or absence of income documentation, limited credit histories, high levels of consumer debt, past credit difficulties or other factors. Non-conforming loans also include loans to more creditworthy borrowers where the size of the loan exceeds conforming underwriting guidelines. The Company financed these investments through warehouse repurchase agreements and issuance of long-term asset-backed securities.

The Company has historically invested in MBS and mortgage loans that, together with the Company's other real estate-related assets represent qualifying REIT assets under the U.S. federal tax code. The portfolio of residential mortgage-backed assets is managed to provide a risk-adjusted return on capital. The Company principally invested in fixed-rate MBS as of December 31, 2007 as compared to adjustable-rate and hybrid-ARM MBS as of December 31, 2006. The Company financed these investments primarily by entering into repurchase agreements with broker dealers and through Georgetown Funding, LLC, an asset-backed commercial paper program that it administers. The Company also invested in merchant banking opportunities, including equity securities, mezzanine debt and senior loans.

The Company's investment banking and institutional brokerage business activities are primarily focused on small- and mid-cap stocks in the consumer, diversified industrials, energy and natural resources, financial institutions, healthcare, insurance, real estate and technology, media and telecommunications sectors. By their nature, the Company's business activities are conducted in markets which are highly competitive and are not only subject to general market conditions, volatile trading markets and fluctuations in the volume of market activity but to the conditions affecting the companies and markets in the Company's areas of focus.

The Company's revenues from investment banking, incentive allocations or fees from asset management, and principal investment activities, are subject to substantial fluctuations due to a variety of factors that cannot be predicted with great certainty, including the overall condition of the economy and the securities markets as a whole and of the sectors on which the Company focuses. Fluctuations also occur due to the level of market activity, which, among other things, affects the flow of investment dollars and the size, number and timing of transactions. As a result, net income (loss) and revenues in any particular period may vary significantly from period to period and year to year.

***Concentration of Risk***

A substantial portion of the Company's investment banking revenues in a year may be derived from a small number of transactions or issues or may be concentrated in a particular industry. For the years ended December 31, 2007, 2006, and 2005, investment banking revenue accounted for 300.2%, 56.3%, and 86.2%, respectively, of the Company's revenue net of interest expense.

**FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**(Dollars in thousands, except per share amounts)**

**Note 2. Summary of Significant Accounting Policies:**

***Principles of Consolidation***

The consolidated financial statements include the accounts of the Company and its wholly-owned and majority-owned subsidiaries as well as variable interest entities where the Company is determined to be the primary beneficiary in accordance with Financial Accounting Standards Board Interpretation No. 46R, "Consolidation of Variable Interest Entities an Interpretation of ARB No. 51" (FIN 46R). All significant intercompany accounts and transactions have been eliminated in consolidation. Certain amounts in the consolidated financial statements and notes for prior periods have been reclassified to conform to the current year's presentation.

***Use of Estimates***

The preparation of the Company's financial statements, in conformity with accounting principles generally accepted in the United States of America, requires us to make estimates and assumptions affecting the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although, we base our estimates and assumptions on historical experience, when available, market information, and on various other factors that we believe to be reasonable under the circumstances, management exercises significant judgment in the final determination of our estimates. Actual results may differ from these estimates.

***Cash Equivalents***

Cash equivalents include demand deposits with banks, money market accounts and highly liquid investments with original maturities of three months or less that are not held for sale in the ordinary course of business. As of December 31, 2007 and 2006, approximately 91% and 58%, respectively, of the Company's cash equivalents were invested in money market funds that invest primarily in U.S. Treasuries and other securities backed by the U.S. government.

***Restricted Cash***

Restricted cash includes amounts required to be held in escrow accounts for future settlement of certain First NLC related liabilities of the Company.

***Mortgage Loans Held-for-Sale***

Mortgage loans originated by First NLC and other purchased loans that the Company intends to sell to third parties are classified as held for sale and are carried at the lower of cost or market value.

For mortgage loans held for sale, the Company determines fair value based on third party pricing quotes when available, current investor commitments and/or requirements for loans of similar terms and credit quality or is estimated based on the same pricing models used by the Company to bid on whole loans in the open market. Such models incorporate aggregated characteristics of groups of loans including, collateral type, index, interest rate, margin, length of fixed interest rate period, life cap, periodic cap, underwriting standards, age and credit.

***Securitizations***

Historically, the Company issued asset-backed securities through securitization trusts to fund a portion of the Company's mortgage loan portfolio. Although these securitizations were structured legally as sales, the

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Company accounted for the securitizations as either “sales” or “financing” transactions, depending on the structure of the securitization, in accordance with Statement of Financial Accounting Standards (SFAS) No. 140, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities” (SFAS 140). The transfers of loans are accounted for as sales, when control over the assets has been surrendered. Control over the transferred assets is deemed to be surrendered when (1) the loan has been isolated from the Company, (2) the transferee has the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred loan, and (3) the Company does not maintain effective control over the transferred loan through either (a) an agreement that both entitles and obligates the Company to repurchase or redeem them before their maturity or (b) the ability to unilaterally cause the holder to return the specific loan. For the sales securitizations, the Company derecognized the loans transferred into the securitization and recorded retained financial and servicing assets or liabilities, if any, and recognized gain or loss on sale from the transaction. For financing securitizations, the trusts did not meet the various qualifying special purpose entity criteria under SFAS 140 and the Company had a continuing interest. Accordingly, the Company recorded the loans held as collateral as assets and the asset-backed securities as debt liabilities.

When the Company sold mortgage loans in securitizations, it may have retained one or more interests in the securitization receivables. Gain or loss on sale of the receivables depends in part on the previous carrying amount of the financial assets involved in the transfer, allocated between the assets sold and the retained interests based on their relative fair value at the date of transfer. Fair value was determined based on quoted market prices, if available. However, quotes are generally not available for retained interests, so the Company generally estimated fair value on the present value of future expected cash flows estimated using management’s best estimates of the key assumptions—credit losses, prepayment speeds, forward yield curves, and discount rates commensurate with the risks involved.

***Securities and Principal Investments***

Mortgage-backed security transactions are recorded as purchases and sales on the date the securities are settled unless the transaction qualifies as a regular-way trade, in which case the transactions are accounted for as purchases or sales on a trade date basis. Any amounts payable or receivable for unsettled trades are recorded as “securities sold” or “securities purchased” in the consolidated balance sheets.

Long-term investments in marketable equity securities and MBS are held in non-broker-dealer entities and are classified as either available-for-sale or trading investments pursuant to SFAS No. 115, “Accounting for Certain Investments in Debt and Equity Securities” (SFAS 115). These investments are carried at fair value with resulting unrealized gains and losses on available-for-sale securities reflected in accumulated other comprehensive income (loss) in the consolidated balance sheets and unrealized gains and losses on trading securities reflected in net investment income in the consolidated statements of operations. Long-term investments in equity securities of non-public companies that are held in non-broker dealer entities are carried at cost.

Although, the Company generally intends to hold its mortgage-backed securities until maturity, it may, from time to time, sell any of its MBS as part of the overall management of its business. The available-for-sale designation provides the Company with the flexibility to sell its MBS in order to act on potential market opportunities or changes in economic conditions to ensure future liquidity and to meet other general corporate purposes as they arise.

The Company evaluates available-for-sale securities and investments in equity securities of non-public companies carried at cost for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. The value of our long-term investments in

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marketable equity securities designated as available for sale can fluctuate significantly. In evaluating these investments for other than temporary impairment, consideration is given to (1) the length of time and the extent to which the fair value has been lower than carrying value, (2) the severity of the decline in fair value, (3) the financial condition and near-term prospects of the issuer, and (4) the intent and our ability to retain our investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. If it is determined that an investment impairment is other than temporary then the amount that the fair value is below its current basis is recorded as an impairment charge and recorded through earnings.

For unrealized losses that are determined to be temporary, we continue to evaluate these at each reporting date. If we determine at a future date that an impairment of a marketable equity security is other than temporary, the applicable unrealized loss will be reclassified from accumulated other comprehensive income and recorded as a realized loss at the time the determination is made.

Investments in proprietary investment funds including hedge, private equity and venture funds, in which the Company is the general partner or has a significant limited partner interest, managing member or manager, are included in long-term investments and accounted for using the equity method and the Company's proportionate share of income or loss (including realized and unrealized gains and losses) is reflected in net investment income on principal investments in the statements of operations.

Trading securities and long term investments owned by the Company's broker-dealer subsidiaries and securities sold but not yet purchased are recorded on a trade-date basis and carried at fair value. Realized and unrealized gains and losses from trading securities are reflected in principal transactions in the consolidated statements of operations. Realized and unrealized losses from such long term investments are reflected in net investment income on principal investments in the statements of operations.

Realized gains and losses on sales of non-mortgage-backed securities are determined using the specific identification method. Realized gains and losses on mortgage-backed securities transactions are determined based on average cost. Declines in the value of available-for-sale investments below the Company's cost basis that are determined to be other than temporary are reclassified from accumulated other comprehensive income (loss) and included in net investment income (loss) on principal investments in the consolidated statements of operations. Declines in the value of cost method investments below the Company's basis that are determined to be other than temporary are included in net investment income (loss) on principal investments in the consolidated statement of operations.

Substantially all financial instruments used in the Company's trading and investing activities are carried at fair value. Fair value is based generally on listed market prices or broker-dealer price quotations. The fair value of the Company's mortgage-backed securities is based on market prices provided by certain independent dealers who make markets in these financial instruments. The fair values reported reflect estimates and may not necessarily be indicative of the amounts the Company could realize in a current market transaction. To the extent that prices are not readily available, fair value is based on internal valuation models and estimates made by management, as discussed below. These fair value amounts and estimates are subject to change based on changes in market conditions. Accordingly, it is reasonably possible that such fair values will change in the near term based on market conditions.

In connection with certain capital raising transactions, the Company has received and holds warrants for the stock of the issuing companies, which are generally exercisable at the respective offering price of the transaction. These instruments are accounted for as derivatives with changes in fair value recorded to net investment income under SFAS No. 133, "Accounting for Derivative Instruments and for Hedging Activities," as amended

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(SFAS 133). Similarly, the Company may receive and hold shares of the issuing companies. For restricted warrants and shares, including private company warrants and shares, these investments by their nature, have limited or no price transparency. Such investments are initially carried at cost as an approximation of fair value. Adjustments to carrying value may be made if there are third-party transactions evidencing a change in value. Downward adjustments also may be made, in the absence of third-party transactions, if the Company determines based on valuation models and estimates that the expected realizable value of the investment is less than the carrying value. In reaching that determination, the Company may consider factors such as, but not limited to, the financial performance of the companies relative to projections, trends within sectors, underlying business models and expected exit timing and strategy. Due to the restrictions on the warrants and the underlying securities, and the subjectivity of these valuations, these warrants may have nominal values. The Company values warrants to purchase publicly traded stocks, where the restriction periods have lapsed, using an option valuation model.

***Receivable/Payable with Clearing Broker***

The Company clears all of its proprietary and customer transactions through another broker-dealer on a fully disclosed basis. Based on the terms and conditions of the Company's agreements with its clearing broker, the amount of the receivable/payable from the clearing broker represents cash on hand with the clearing broker plus proceeds from unsettled securities sold less amounts payable for unsettled securities purchased by the Company. The amounts payable are collateralized by securities owned by the Company.

***Hedging Activities***

In the normal course of the Company's operations, the Company is a party to various financial instruments that are accounted for as derivatives in accordance with SFAS 133. The Company utilizes derivative financial instruments to hedge the interest rate risk associated with its short- and long-term borrowings. The Company also uses derivatives to economically hedge certain positions in mortgage-backed securities and mortgage loans. These derivative instruments include interest rate caps, Eurodollar futures contracts, and interest rate swaps. Certain of these derivatives have qualified for hedge accounting treatment, and are accounted for as cash flow or fair value hedges. These derivatives are intended to provide income and cash flow to offset the potential for reduced net interest income and cash flow under certain interest rate environments.

A key element to qualify for hedge accounting is the maintenance of adequate documentation of the hedging relationship and the Company's risk management objective and strategy for undertaking the hedge. To qualify, on the date a derivative instrument agreement is entered into, the derivative and its hedging relationship are identified, designated and documented.

The Company's derivative instruments are recorded on the consolidated balance sheets at fair value. For derivative instruments designated as cash flow hedges, the changes in the fair value of the derivative instruments are reported in accumulated other comprehensive income (loss) to the extent the hedges are effective and reclassified to earnings in the periods in which the earnings are affected by the hedged cash flows. For derivative instruments designated as fair value hedges, the changes in the fair value of the derivative instruments are reported in current period earnings and the hedged item is adjusted for changes in the fair value attributable to the hedged risk which are also reported in current period earnings. Changes in the fair value of derivative instruments related to hedge ineffectiveness and activity not qualifying for hedge treatment are recorded in current period earnings.

The Company documents the relationships between hedging instruments and hedged items, as well as the Company's risk-management objective and strategy for undertaking various hedge transactions. This process includes linking derivatives to specific assets and liabilities on the balance sheet or related exposures. The

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Company also assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives used in hedging transactions are highly effective. When it is determined that a derivative is not highly effective as a hedge or that it has ceased to be a highly effective hedge, the Company discontinues hedge accounting prospectively, as discussed below.

When hedge accounting is discontinued for cash flow hedges, the derivative will continue to be recorded on the consolidated balance sheet at its fair value, until terminated. The effective position previously recorded remains in accumulated other comprehensive income and continues to be reclassified to earnings in the periods in which the earnings are affected by the hedged cash flows; however, changes in the fair value of an ineffective hedge subsequent to the date it was determined to be ineffective are recognized in the current period earnings.

If the hedged risk is extinguished or is not probable of occurring, the Company typically terminates any applicable hedges and recognizes any remaining unrealized gain (loss) included in the accumulated other comprehensive income (loss) balance to income or expense. However, if the Company continues to hold the derivatives, they continue to be recorded on the consolidated balance sheet at fair value with any changes being recorded to current period earnings.

***Intangible Assets***

The Company accounts for its intangible assets consisting of goodwill recorded as a result of the merger with FBR Asset and acquisition of First NLC (see Note 12), acquired mutual fund management contracts and broker relationships acquired in connection with the First NLC acquisition (see Note 12) in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets" (SFAS 142). Under SFAS 142, goodwill recorded is not amortized but is tested at least annually for impairment. The values of acquired management contracts and broker relationships are amortized in proportion to their expected economic benefit of 15 years and 10 years, respectively, and tested for impairment by comparing expected future gross cash flows to the asset's carrying amount. If the expected gross cash flows are less than the carrying amount, the asset is impaired and is written-down to its fair value.

***Furniture, Equipment, Software and Leasehold Improvements***

Furniture and equipment are depreciated using the straight-line method over their estimated useful lives of three to five years. Leasehold improvements are amortized using the straight-line method over the shorter of the useful life or lease term. Amortization of purchased software is recorded over the estimated useful lives of three to five years.

***Repurchase Agreements***

Securities sold under agreements to repurchase, which are treated as financing transactions for financial reporting purposes, are collateralized primarily by government agency securities and are carried net by counterparty, when permitted, at the amounts at which the securities subsequently will be repurchased plus accrued interest.

***Investment Banking Revenues***

Capital raising revenues represent fees earned from private placements and from public offerings of securities in which the Company acts as underwriter. These revenues are comprised of selling concessions, underwriting fees, and management fees. Advisory revenues represent fees earned from mergers and acquisitions, mutual conversions, financial restructuring and other advisory services provided to clients. Capital raising revenues are recorded as revenue at the time the underwriting or private placement is completed. Advisory fees are recorded as revenue when the related service has been rendered and the client is contractually obligated to pay. Certain fees received in advance of services rendered are recognized as revenue over the service period.

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***Institutional Brokerage Agency and Principal Revenues***

Agency commissions consist of commissions earned from executing the trade of stock exchange-listed securities and other transactions as an agent and principal transactions consist of sales credits and trading gains or losses from equity security transactions. Revenues generated from securities transactions and related commission income and expenses are recorded on a trade date basis.

***Asset Management Revenues***

The Company records two types of asset management revenue:

(1) Certain of the Company's subsidiaries act as investment advisers and receive management fees for the management of proprietary investment funds and mutual funds, based upon the amount of capital committed or assets under management. This revenue is recognized over the period in which services are performed and is recorded in base management fees in the Company's consolidated statements of operations.

(2) The Company also receives incentive income based upon the operating results of the funds. Incentive income represents a share of the gains in the investment, and is recorded in incentive allocations and fees in the consolidated statements of operations. The Company recognizes incentive income from the funds based on what would be due to the Company if the fund terminated on the balance sheet date. Incentive allocations may be based on unrealized gains and losses, and could vary significantly based on the ultimate realization of the gains or losses. The Company may therefore reverse previously recorded incentive allocation in future periods.

***Interest Income***

Interest income includes contractual interest payments adjusted for the amortization of premiums and discounts and other deferred costs in accordance with SFAS No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Directs Costs of Leasing" (SFAS No. 91). Interest on loans from borrowers not expected to service the debt and interest on loans that are contractually past due 90 or more days is charged-off, or an allowance is established based upon management's periodic evaluation. The allowance is established by a charge to interest income equal to all interest previously accrued and unpaid, and income is subsequently recognized only to the extent that cash payments are received until the borrower's ability to make periodic interest and principal payments is adequate, in which case the loan is returned to accrual status.

***Gain (Loss) on Sale of Loans, Net***

Gain (loss) on sale of loans is the difference between the sale proceeds and the net carrying amount of the loans less a provision for repurchase and premium recapture obligations and is recorded in mortgage banking net investment income in the consolidated statements of operations. Gain on sale of loans is recognized when the Company transfers ownership of the loan to the purchaser and the funds are collected. Loan sales are on a servicing-released basis. The Company reduces its gain on sale of loans to record liabilities (1) for loans sold which may be required to be repurchased due to breaches of representations and warranties or if a borrower fails to make one or more of the first loan payments due on the loan and (2) for premium recapture in instances where the sold loan is repaid within a specified period subsequent to sale.

Transfers of financial assets (mortgage loans) are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the loan has been isolated from the Company, (2) the transferee has the right (free of conditions that constrain it from taking advantage of

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that right) to pledge or exchange the transferred loan, and (3) the Company does not maintain effective control over the transferred loan through either (a) an agreement that both entitles and obligates the Company to repurchase or redeem them before their maturity or (b) the ability to unilaterally cause the holder to return the specific loan.

***Investment Funds***

The Company's subsidiary FBRIM, through various wholly-owned limited liability corporations, is the general partner, managing member, or manager of various hedge and private equity funds. Under the terms of the funds' applicable governance agreements, FBRIM can be removed as the general partner, managing member, or manager of these entities by a simple majority vote of the unaffiliated limited partners or non-managing members. Accordingly, the Company accounts for its investments in these entities using the equity method of accounting.

The Company records allocations for its proportionate share of the earnings or losses of certain hedge and private equity funds. Income or loss allocations are recorded in net investment income on principal investments in the consolidated statements of operations. The funds record their investments at fair value with changes in fair value reported in the funds' earnings at each reporting date. Accordingly, capital accounts at each reporting date include all applicable allocations of the funds' realized and unrealized gains and losses.

The private investment funds are non-registered investment companies that record their investments in securities at fair value. Certain investments consist of equity investments in securities of development-stage and early-stage privately and publicly held companies. The disposition of these investments may be restricted due to the lack of a ready market or due to contractual or regulatory restrictions on disposition. In addition, these securities may represent significant portions of the issuer's equity and carry special contractual privileges not available to other security holders. As a result of these factors, precise valuation for the restricted public securities and private company securities is a matter of judgment, and the determination of fair value must be considered only an approximation and may vary significantly from the amounts that could be realized if the investment were sold or from the value that would have been used had a ready market existed for the securities and those differences could be material.

***Compensation***

A significant component of compensation expense relates to incentive bonuses. Incentive bonuses are accrued based on the contribution of key business units using certain pre-defined formulas. The Company's compensation accruals are reviewed and evaluated on a quarterly basis.

***Stock-Based Compensation***

The Company accounts for stock-based compensation in accordance with SFAS No. 123 (revised 2004), "Share-Based Payment" (SFAS 123R). The Company adopted SFAS 123R on January 1, 2006 using the modified-prospective transition method. SFAS 123R requires companies to recognize expense in the income statement for the grant-date fair value of awards of equity instruments to employees. Pursuant to SFAS 123R, expense is recognized over the period during which employees are required to provide service. The expense is recorded using an estimated forfeiture of awards on the date of grant, rather than recognizing forfeitures as incurred as was permitted by SFAS No. 123, "Accounting for Stock-Based Compensation" (SFAS 123). Under the modified prospective transition method, compensation cost is recognized after the date of adoption for the portion of outstanding awards granted prior to the adoption of SFAS 123 for which service has not yet been rendered. In addition, under the modified prospective transition method, results for year ended December 31, 2005 were not restated.

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Prior to adopting SFAS 123R we presented the cash flows related to income tax deductions in excess of compensation cost recognized on stock issued under restricted stock vesting and stock options exercised during the period as operating cash flows in the Consolidated Statement of Cash Flows. SFAS 123R requires excess benefits to be classified as financing cash flows.

In addition, as a result of adopting SFAS 123R, certain balance sheet amounts associated with share-based compensation costs have been reclassified within the equity section of the balance sheet. This change in presentation had no effect on our total equity. Effective January 1, 2006, deferred compensation (representing unearned costs of restricted stock awards) and Common stock issuable are presented on a net basis as a component of Additional paid-in capital.

Prior to the adoption of SFAS 123R, the Company accounted for stock-based compensation in accordance with SFAS 123. Pursuant to SFAS 123, the Company continued to apply the provisions of Accounting Principles Board Opinion (APB) No. 25, "Accounting for Stock Issued to Employees" (APB 25). Under APB 25, compensation expense was recorded for the difference, if any, between the fair market value of the common stock on the date of grant and the exercise price of the option.

***Sales of Subsidiary Shares***

The Company accounts for sales of stock by its subsidiaries in accordance with Staff Accounting Bulletin No. 51, "Accounting for Sales of Stock of a Subsidiary" (SAB 51). Pursuant to SAB 51, the Company recognizes gains and losses on issuances of subsidiary stock in the statement of operations.

***Income Taxes***

The parent company, FBR Group, has elected to be taxed as a REIT under the Internal Revenue Code. To qualify for tax treatment as a REIT, the parent company must meet certain income and asset tests and distribution requirements. The parent company generally will not be subject to federal income tax at the parent level to the extent that it distributes its taxable income to its shareholders and complies with certain other requirements.

Income generated by the Company's taxable REIT subsidiaries will generally be taxed at normal corporate income tax rates. Deferred tax assets and liabilities represent the differences between the financial statement and income tax bases of assets and liabilities at the Company's taxable REIT subsidiaries, using enacted tax rates. The measurement of net deferred tax assets is adjusted by a valuation allowance if, based on management's evaluation, it is more likely than not that they will not be realized.

***Other Comprehensive Income***

Comprehensive income includes net income as currently reported by the Company on the consolidated statements of operations adjusted for other comprehensive income. Other comprehensive income for the Company represents (1) changes in unrealized gains and losses related to the Company's mortgage-backed and equity securities accounted for as available-for-sale with changes in fair value recorded through shareholders' equity and (2) changes in unrealized gains and losses related to cash flow hedges with changes in fair value recorded through shareholders' equity to the extent the hedges are effective.

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***Earnings Per Share***

Basic earnings per share includes no dilution and is computed by dividing net income or loss available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted earnings per share includes the impact of dilutive securities such as stock options. The following table presents the computations of basic and diluted earnings per share for the years ended December 31, 2007, 2006 and 2005:

	Year Ended December 31, 2007		Year Ended December 31, 2006		Year Ended December 31, 2005	
	Basic	Diluted	Basic	Diluted	Basic	Diluted
Weighted average shares outstanding:						
Common stock (in thousands)	166,975	166,975	171,667	171,667	169,333	169,333
Stock options (in thousands)	—	—	—	—	—	—
Weighted average common and common equivalent shares outstanding	166,975	166,975	171,667	171,667	169,333	169,333
Net loss applicable to common stock	<u>\$ (660,253)</u>	<u>\$ (660,253)</u>	<u>\$ (67,275)</u>	<u>\$ (67,275)</u>	<u>\$ (170,910)</u>	<u>\$ (170,910)</u>
Loss per common share	<u>\$ (3.95)</u>	<u>\$ (3.95)</u>	<u>\$ (0.39)</u>	<u>\$ (0.39)</u>	<u>\$ (1.01)</u>	<u>\$ (1.01)</u>

As of December 31, 2007, 2006 and 2005, respectively, 1,001,637, 2,925,643 and 3,740,068 options to purchase shares of common stock were outstanding. See Note 13 for detail of total stock options outstanding.

***Recent Accounting Pronouncements***

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157, “Fair Value Measurements” (SFAS 157). This statement clarifies the definition of fair value, establishes a framework and hierarchy of fair value measurements, and expands disclosures about fair value measurements. This statement emphasizes that companies should use a market-based approach using similar assumptions that market participants would use in their assessment of the fair value of an asset or liability. These assumptions should include, but are not limited to, risks associated with the asset or liability and restrictions on the sale or use of the asset. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently assessing the impact of adoption of SFAS 157.

In February 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities, Including an Amendment of FASB Statement No. 115” (SFAS 159). Under SFAS 159, entities will be permitted to measure many financial instruments and certain other assets and liabilities at fair value on an instrument-by-instrument basis (the fair value option). This Statement is effective for the fiscal years that beginning after November 15, 2007 with early adoption permitted. The Company did not elect the fair value option on any existing assets and liabilities as of January 1, 2008.

In December 2007, the FASB issued SFAS No. 141(R), “Business Combinations” (SFAS 141 (R)). SFAS 141(R) expands the definition of transactions and events that qualify as business combinations; requires that the acquired assets and liabilities, including contingencies, be recorded at the fair value determined on the acquisition date and changes thereafter reflected in revenue, not goodwill; changes the recognition timing for restructuring costs; and requires acquisition costs to be expensed as incurred. Adoption of SFAS 141(R) is

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required for business combinations after December 15, 2008. Early adoption and retroactive application of SFAS 141(R) to fiscal years preceding the effective date are not permitted. We are evaluating the impact of adoption of SFAS 141(R) on our consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interest in Consolidated Financial Statements" (SFAS 160). SFAS 160 re-characterizes minority interests in consolidated subsidiaries as non-controlling interests and requires the classification of minority interests as a component of equity. Under SFAS 160, a change in control will be measured at fair value, with any gain or loss recognized in earnings. The effective date for SFAS 160 is for annual periods beginning on or after December 15, 2008. Early adoption and retroactive application of SFAS 160 to fiscal years preceding the effective date are not permitted. We are evaluating the impact of adoption of SFAS 160 on our consolidated financial statements.

In June 2007, the AICPA issued Statement of Position No. 07-1, "Clarification of the Scope of the Audit and Accounting Guide to Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies" (SOP 07-1). SOP 07-1 addresses when the accounting principles of the AICPA Audit and Accounting Guide Investment Companies must be applied by an entity and whether those accounting principles must be retained by a parent company in consolidation or by an investor in the application of the equity method of accounting. SOP 07-1 was expected to be effective for the fiscal years beginning on or after December 15, 2007. However, the FASB issued a proposal to delay the effective date indefinitely.

**Note 3. FBR Capital Markets Corporation Offering and Sale of FBR Capital Markets Shares:**

On July 20, 2006, the Company closed a private offering to institutional investors by its newly formed taxable REIT subsidiary, FBR Capital Markets, and a concurrent private placement by FBR Capital Markets to two affiliates of Crestview Partners, a New York-based private equity firm (Crestview). These transactions in the aggregate resulted in the sale of 18,000,000 shares of common equity for \$270,000 by FBR Capital Markets. Cash proceeds to FBR Capital Markets, after deducting a placement fee payable to an affiliate of Crestview with respect to the shares purchased by the Crestview affiliates and other costs, were \$259,738. In connection with the transactions, the Company contributed to FBR Capital Markets the subsidiaries which had historically operated its capital markets business, including investment banking and institutional brokerage, and its asset management business. These subsidiaries include FBR & Co., FBRIL, FBRIM and FBR Fund Advisors. As a result of these transactions, the Company retained a beneficial 71.9% ownership interest in FBR Capital Markets, and will continue to consolidate FBR Capital Markets for financial reporting purposes.

In addition, in connection with this private placement, pursuant to the guidance in SAB 51, the Company adopted an accounting policy to recognize gains and losses on issuances of subsidiary stock in the consolidated statements of operations. Accordingly, in July 2006, the Company recognized a net gain of \$121,511 related to the sale of the FBR Capital Markets shares. The gain represents the increase in the value of the Company's investment in FBR Capital Markets as a result of the share issuance. Based on the structure of the transaction, this gain was not taxable.

As part of these transactions, the Company and FBR Capital Markets entered into a series of agreements, including a contribution agreement, a corporate agreement, a services agreement, a management services agreement, a trademark license agreement and a tax sharing agreement. In addition, FBR Capital Markets and the Company entered into a series of agreements with affiliates of Crestview, including an investment agreement, a governance agreement, a voting agreement, a registration rights agreement, a professional services agreement

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and option agreements to purchase additional shares. Pursuant to the option agreements, affiliates of Crestview may purchase up to 2,600,000 shares of FBR Capital Markets stock. Based on the provisions of EITF 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's own Stock," and the terms and conditions of these options, they have been accounted for as permanent equity.

Minority interest represents shares of common stock of FBR Capital Markets issued to outside investors. As of December 31, 2007 and December 31, 2006, 30,725,926 shares and 18,000,000 shares, respectively, of the total number of outstanding shares of FBR Capital Markets common stock, of 64,058,975 and 64,000,000 shares, respectively, were issued to outside investors and not subject to forfeiture under share-based award agreements.

In June 2007, FBR TRS Holdings, a wholly-owned taxable REIT subsidiary of the Company, sold 12,666,951 shares of FBR Capital Markets common stock through an initial public offering. The Company received \$205,643 in net proceeds from the transaction based on a per share price of \$15.81. As a result of this transaction, the Company's ownership in FBR Capital Markets was reduced to 33,333,049 shares. As of December 31, 2007, the Company, through FBR TRS Holdings, owned approximately 52% of FBR Capital Markets' outstanding common stock.

During the twelve months ended December 31, 2007, FBR Capital Markets repurchased 1,000,000 shares of its outstanding shares for a total of \$13,017. See also Note 13 for additional information on FBR Capital Markets' share repurchase program.

**Note 4. Investments:**

**Institutional Brokerage Trading Account Securities**

Trading securities owned and trading account securities sold, but not yet purchased, consisted of securities at fair value as of the dates indicated:

	December 31,			
	2007		2006	
	<u>Owned</u>	<u>Sold But Not Yet Purchased</u>	<u>Owned</u>	<u>Sold But Not Yet Purchased</u>
Corporate equity securities	\$ 18,787	\$ 154	\$ 17,567	\$ 200
Corporate bond securities	270	52	613	2
	<u>\$ 19,057</u>	<u>\$ 206</u>	<u>\$ 18,180</u>	<u>\$ 202</u>

Trading account securities sold but not yet purchased represent obligations of the Company to deliver the specified security at the contracted price, and thereby, create a liability to purchase the security in the market at prevailing prices. These transactions result in off-balance-sheet risk as the Company's ultimate obligation to satisfy the sale of securities sold but not yet purchased may exceed the current value recorded in the consolidated balance sheets.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
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**Principal Investments**

Mortgage-related securities and long-term investments consisted of the following as of the dates indicated:

	December 31, 2007	December 31, 2006
Mortgage-related investments:		
Available for sale securities:		
Fannie Mae	\$ 101	\$ 3,343,756
Freddie Mac	1,493,615	2,543,311
Ginnie Mae	—	35,949
	<u>1,493,716</u>	<u>5,923,016</u>
Private-label securities <sup>(1)</sup>	297,764	944,955
Total available for sale securities <sup>(2)</sup>	<u>1,791,480</u>	<u>6,867,971</u>
Trading securities:		
Freddie Mac	—	2,690
Total mortgage-backed securities	<u>1,791,480</u>	<u>6,870,661</u>
Loan held for sale, net:		
Securitized	—	4,416,338
Non-securitized (financed through short-term mortgage financing facilities)	65,074	951,596
Total loans held for sale, net <sup>(3)</sup>	<u>65,074</u>	<u>5,367,934</u>
Total mortgage-related investments	<u>1,856,554</u>	<u>12,238,595</u>
Long-term investments		
Merchant banking:		
Marketable equity securities	28,688	90,655
Non-public equity securities	82,581	50,233
Preferred equity investment	2,500	2,500
Investments funds	30,620	26,121
Residual interest in securitization	15,903	—
Investment securities—marked to market	7,743	12,623
Other investments	<u>1,239</u>	<u>3,360</u>
Total long-term investments	<u>169,274</u>	<u>185,492</u>
Total mortgage-related and long-term investments	<u>\$ 2,025,828</u>	<u>\$ 12,424,087</u>

- (1) Private-label mortgage-backed securities held by the Company as of December 31, 2007 and December 31, 2006 were primarily rated A- or higher by Standard & Poors. As of December 31, 2007, private-label mortgage-backed securities rated AAA accounted for 96% of the balance.
- (2) The Company's MBS portfolio was primarily comprised of fixed-rate MBS as of December 31, 2007 as compared to primarily adjustable-rate MBS as of December 31, 2006. The weighted-average coupon of the available-for-sale portfolio at December 31, 2007 and 2006 was 5.77% and 6.05%, respectively.
- (3) The weighted-average coupon of the Company's mortgage loan portfolio held for sale at December 31, 2007 and 2006 was 8.46% and 7.46%, respectively.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
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***Mortgage-Backed Securities and Long Term Investments***

The Company's available-for-sale securities consist primarily of mortgage-backed securities and equity investments in publicly traded companies. In accordance with SFAS 115, the securities are carried at fair value with resulting unrealized gains and losses reflected as other comprehensive income or loss. Gross unrealized gains and losses on these securities as of December 31, 2007 and 2006 were:

	Amortized Cost/Cost Basis	2007 Unrealized		Fair Value
		Gains	Losses	
Mortgage-backed securities <sup>(1)</sup> :				
Available-for-sale	\$ 1,793,742	\$ 1,316	\$(3,578)	\$ 1,791,480
Marketable equity securities	25,333	3,370	(15)	28,688
	<u>\$1,819,075</u>	<u>\$4,686</u>	<u>\$(3,593)</u>	<u>\$1,820,168</u>

(1) The amortized cost of MBS includes a net premium of \$1,025 at December 31, 2007.

	Amortized Cost/Cost Basis	2006 Unrealized		Fair Value
		Gains	Losses	
Mortgage-backed securities <sup>(2)</sup> :				
Available-for-sale	\$ 6,863,356	\$ 12,805	\$(8,190)	\$ 6,867,971
Trading	2,690	—	—	2,690
Marketable equity securities	82,905	10,050	(2,300)	90,655
	<u>\$6,948,951</u>	<u>\$22,855</u>	<u>\$(10,490)</u>	<u>\$6,961,316</u>

(2) The amortized cost of MBS includes a net premium of \$57,499 at December 31, 2006.

The following table provides further information regarding the duration of unrealized losses as of December 31, 2007:

	Continuous Unrealized Loss Position for					
	Less Than 12 Months			12 Months or More		
	Amortized Cost	Unrealized Losses	Fair Value	Amortized Cost	Unrealized Losses	Fair Value
Mortgage-backed securities	\$ 288,488	\$(3,578)	\$ 284,910	\$ —	\$ —	\$ —
Marketable equity securities	3,101	(15)	3,086	—	—	—
	<u>\$ 291,589</u>	<u>\$(3,593)</u>	<u>\$ 287,996</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>

During 2007, the Company evaluated its portfolio of mortgage-backed securities for impairment. The securities in the Company's mortgage-backed securities portfolio are primarily the mortgage-backed securities guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae. The Company does not deem these investments to be other-than-temporarily impaired because of the limited severity and duration of the impairments and the Company has the intent and ability to hold these investments until a recovery of fair value occurs, which may be maturity. The value of the remaining non-agency mortgage-backed securities rated below AAA have been impacted severely as a result of the liquidity and non-prime mortgage market crisis during the year. The Company deemed these declines in the value of the non-agency mortgage-backed securities to be other-than-temporary; therefore, the Company recognized \$20,481 in impairment losses in principal investing net investment loss in the consolidated statements of operations.

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The Company also evaluated its portfolio of marketable equity securities for impairment. For each of the securities with unrealized losses, at each reporting period the Company reviewed the underlying cause for the impairments, as well as the severity and durations of the impairments. The Company evaluated the near term prospects for each of the investments in unrealized loss positions in relation to the severity and duration of the impairment. Based on the severity and duration of certain of these unrealized losses, the Company recognized impairment losses on these investments because they are considered other-than-temporarily impaired. During the years ended December 31, 2007, 2006 and 2005, the Company recorded \$10,357, \$63,252 and \$57,290 of such other-than-temporary impairment losses in the consolidated statements of operations relating to marketable equity securities with a basis of \$14,981, \$114,129, and \$132,818, respectively. Regarding the remaining marketable equity securities in unrealized loss positions as of December 31, 2007 and 2006, based on the Company's evaluation, considering the limited severity and duration of these unrealized losses and the Company's ability and intent to hold these investments for a reasonable period of time sufficient for a forecasted recovery of the cost basis, the Company does not consider these investments to be other-than-temporarily impaired.

The Company will continue to evaluate these investments at each reporting period end. If the Company determines at a future date that an impairment is other-than-temporary, the applicable unrealized loss will be reclassified from accumulated other comprehensive loss and recognized as a loss in the consolidated statement of operations at the time the determination is made.

For investments carried at cost, at each reporting date, the Company evaluates its portfolio for such investments for impairment including consideration of the severity and duration of factors affecting the fair value of these investments. During the years ended December 31, 2007, 2006 and 2005, the Company recorded impairment losses of \$22,090, \$13,913 and \$17,162, respectively, in the consolidated statements of operations reflecting the Company's evaluation of the estimated fair value of private equity investments with a cost basis of \$39,447, \$32,388, and \$39,050, respectively. The Company also recorded \$-0-, \$2,500 and \$-0- impairment losses during 2007, 2006, and 2005 respectively, reflecting the Company's evaluation of the estimated fair value of a preferred equity investment. These impairment losses were due to circumstances arising during the respective years that had an adverse effect on the fair values of these securities.

During 2007 the Company received \$9,578,168 from sales of mortgage-backed securities resulting in gross gains and losses of \$9,005 and \$(61,717), respectively, and received \$122,436 from sales of marketable equity securities resulting in gross gains and losses of \$40,265 and \$(12,661), respectively. Included in MBS sold and the related gains and losses are \$503,258 of MBS purchases and classified as trading during the year ended December 31, 2007. The Company recognized losses of \$94 on these trading securities during the year ended December 31, 2007. During 2006, the Company received \$10,977,609 from sales of mortgage-backed securities resulting in gross gains and losses of \$31,855 and \$(8,618), respectively, and received \$133,564 from sales of marketable equity securities resulting in gross gains and losses of \$26,434 and \$(12), respectively. Included in MBS sold in 2006 and the related gains and losses are \$2,456,185 of MBS purchased and classified as trading during the year. The Company recognized realized gain of \$13,733 on trading securities during 2006.

As of December 31, 2007 and 2006, \$1,778,524 and \$6,441,886 (each representing fair value excluding principal receivable), respectively, of the mortgage-backed securities were pledged as collateral for repurchase agreements and commercial paper borrowings. In addition, \$-0- and \$36,475, of principal and interest receivables related to the securities collateralizing commercial paper borrowings have also been pledged as collateral for those borrowings as of December 31, 2007 and 2006, respectively.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
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*Accumulated Other Comprehensive Income (Loss)*

The following provides detail of the amounts included in accumulated other comprehensive loss and reclassified to earnings during the specified periods.

	Year ended December 31,		
	2007	2006	2005
Beginning balance	\$ (15,137)	\$ (977)	\$ (38,162)
Net unrealized investment losses during the period:			
Net unrealized holding losses, net of taxes	(37,843)	(17,128)	(221,296)
Reclassification adjustment for recognized losses included in net income, net of taxes	25,673	27,591	260,777
Net change in fair value related to cash flow hedging activities	34,703	1,418	20,152
Net reclassifications to earnings—cash flow hedging activities	(20,242)	(26,040)	(22,448)
Ending balance	<u>\$ (12,846)</u>	<u>\$ (15,136)</u>	<u>\$ (977)</u>

***Mortgage Loans***

During the year ended December 31, 2006, the Company made a determination in evaluating its investment strategy and its intent related to its held-for-investment securitized mortgage loan portfolio held at the parent REIT, that it no longer intended to hold this portfolio for investment. Accordingly, these loans were reclassified to held for sale. As a result of this change, in accordance with SFAS No. 65, "Accounting for Certain Mortgage Banking Activities," the Company recorded its investment in this loan portfolio at the lower of cost or market and for the years ended December 31, 2007 and 2006, recognized write downs of \$119,900 and \$149,823, respectively, in the value of these loans.

During the fourth quarter of 2007 the Company completed the sale of its on-balance sheet securitized loans. Pursuant to this sale agreement, the Company sold its financial interests in the securitized loans and surrendered control over the loans and all of its rights under the various securitization agreements, eliminating any continuing involvement in the securitized loans. As a result of this sale transaction, \$2,938,670 of loans and related assets and \$2,947,893 of securitization borrowings and related liabilities were transferred from the Company's balance sheet. Accordingly, as of December 31, 2007, the Company's investment in securitized mortgage loans was reduced to zero. The Company recognized a gain from the sale of the securitized mortgage loans of \$9,723 in 2007. The remaining loans held for sale as of December 31, 2007, consist of non-securitized loans.

Loans held for sale, net, was comprised of the following:

	December 31, 2007	December 31, 2006
Principal balance:		
Securitized	\$ —	\$ 4,452,708
Non-securitized (financing through short-term mortgage financing facilities)	109,304	958,274
Total principal balance	109,304	5,410,982
Deferred origination costs, net and unamortized premiums	(307)	2,847
Allowance for lower of cost or market value	(43,923)	(45,895)
Loans held for sale, net	<u>\$ 65,074</u>	<u>\$ 5,367,934</u>

Mortgage loans 90 or more days past due totaled \$4,235 and \$557,136 as of December 31, 2007 and December 31, 2006, respectively. As of December 31, 2007, the Company has reserved \$152 for past due interest on such delinquent loans.

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***Investment Funds***

The private investment funds, from which the Company earns management, incentive and investment income are non-registered investment companies that record their investments in securities at fair value. Certain investments consist of equity investments in securities of development-stage and early-stage privately and publicly held companies. The disposition of these investments may be restricted due to the lack of a ready market or due to contractual or regulatory restrictions on disposition. In addition, these securities may represent significant portions of the issuer's equity and carry special contractual privileges not available to other security holders. As a result of these factors, precise valuation for the restricted public securities and private company securities is a matter of judgment, and the determination of fair value must be considered only an approximation and may vary significantly from the amounts that could be realized if the investment were sold or from the value that would have been used had a ready market existed for the securities and those differences could be material.

FBRIM, through various wholly-owned limited liability corporations, is the general partner, managing member, or manager of various hedge and private equity funds. All of these entities were formed for the purpose of investing in public and private securities; therefore, their assets principally consist of investment securities accounted for at fair value. Under the terms of the funds' applicable governance agreements, FBRIM can be removed as the general partner, managing member, or manager of these entities by a simple majority vote of the unaffiliated limited partners or non-managing members. The Company accounts for its investments in these entities under the equity method of accounting and the Company's proportionate share of income or loss (income allocation including realized and unrealized gains or losses) is reflected in net investment income in the statement of operations.

In addition, as a significant investor in certain other investment funds, although we do not manage these funds, we also account for these investments under the equity method. The following table specifies the Company's investments in such investment funds:

	<b>December 31,</b>	
	<b>2007</b>	<b>2006</b>
Hedge funds	\$ 14,988	\$ 15,994
Private equity funds	2,017	3,737
Other	13,523	6,390
	<u>\$ 30,528</u>	<u>\$ 26,121</u>

The following table summarizes certain financial information regarding the Company's investments in these investment funds.

	<b>December 31,</b>		
	<b>2007</b>	<b>2006</b>	<b>2005</b>
Total assets	\$ 714,452	\$ 739,296	\$ 417,905
Total liabilities	148,636	150,960	50,874
Total equity	565,816	588,336	367,031
Total revenue	12,198	14,144	24,797
Total expenses	15,674	26,523	12,352
Realized gains	17,229	30,166	30,821
Unrealized gains (losses)	116,615	192,717	(73,056)
Net income (losses)	130,368	210,504	(29,790)
FBR Group's share of total equity	30,528	26,121	41,977
FBR Group's share of net income-net investment income	2,372	2,993	62
FBR Group's share of net income-incentive allocations and fees	409	839	1,851

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As of December 31, 2007 and 2006, the Company had receivables of \$492 and \$408, respectively, due from these affiliates.

***Investment Securities—Marked to Market***

Investment securities—marked to market include equity securities and warrants to purchase equity securities that were received in connection with investment banking transactions. For the years ended December 31, 2007, 2006, and 2005, the Company recorded net (losses) gains of \$(1,474), \$1,845, and \$1,351, respectively, relating to such equity securities (see Note 8 for additional detail regarding stock warrants).

**Note 5. Furniture, Equipment, Software and Leasehold Improvements:**

Furniture, equipment, software and leasehold improvements, summarized by major classification, were:

	<b>December 31,</b>	
	<b>2007</b>	<b>2006</b>
Furniture and equipment	\$ 22,210	\$ 30,539
Software	13,639	20,888
Leasehold improvements	28,616	29,525
	64,465	80,952
Less-accumulated depreciation and amortization	(34,014)	(36,841)
	<u>\$ 30,451</u>	<u>\$ 44,111</u>

For the years ended December 31, 2007, 2006, and 2005, depreciation expense was \$14,449, \$13,538, and \$9,753, respectively.

During the year ended December 31, 2007, the Company recognized impairment charges of \$13,930 on furniture, equipment, software and leasehold improvements related to its mortgage banking segment due to the reduction in origination volumes as a result of the deterioration in the non-prime mortgage origination industry. These impairment charges are recorded in restructuring charges on the consolidated statements of operations. See Note 12 for additional information on the restructuring activities associated with First NLC. No impairment charges were recognized during the years ended December 31, 2006 and 2005.

**Note 6. Intangible Assets and Goodwill**

The following table reflects the components of intangible assets as of the dates indicated:

	<b>December 31, 2007</b>	<b>December 31, 2006</b>
<b>Management contracts:</b>		
Cost	\$ 18,465	\$ 18,465
Accumulated amortization	(8,628)	(7,465)
Net	<u>\$ 9,837</u>	<u>\$ 11,000</u>
<b>Broker relationships:</b>		
Cost	\$ —	\$ 16,500
Accumulated amortization	—	(5,675)
Net	<u>\$ —</u>	<u>\$ 10,825</u>
<b>Intangible assets, net</b>	<u><b>\$ 9,837</b></u>	<u><b>\$ 21,825</b></u>

For the years ended December 31, 2007, 2006, and 2005, amortization expense recognized was \$1,739, \$3,978, and \$4,170, respectively.

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Estimated amortization expense for each of the next five years is as follows:

	<u>Amount</u>
2007	\$1,163
2008	1,163
2009	1,163
2010	1,163
2011	1,163

In accordance with SFAS 142, the Company recognized impairment charges of \$162,765 on goodwill during the year ended December 31, 2007. These impairment charges representing the amount by which the carrying amount exceeded estimated fair value were comprised of \$108,013 related to the principal investment segment and \$54,752 related to the mortgage banking segment. The impairment on the principal investment segment was in response to the tightening of the credit markets on the mortgage industry during the second half of 2007 and the continued deterioration of the non-prime mortgage industry. The declines in these industries and the number of companies competing in these industries that have declared bankruptcy have put significant pressure on the fair value of the Company. The impairment on the mortgage banking segment reflects the continued deterioration of the non-prime mortgage origination industry during 2007. See Note 12 for additional information on the restructuring activities associated with First NLC. As of December 31, 2007 and 2006, the carrying value of goodwill is \$-0- and \$162,765, respectively.

During the year ended December 31, 2005, the Company recorded impairment charges of \$249, relating to the acquired management contracts related to the asset management segment that are included in other operating expenses. The impairment charge was recorded in response to agreements to sell specific mutual funds below carrying value.

During the year ended December 31, 2007, the Company recognized impairment charges of \$10,249 related to the broker relationships intangible assets acquired through the purchase of First NLC. These impairment charges were recorded in response to operating losses and reductions in wholesale loan origination volumes.

**Note 7. Borrowings:**

***Commercial Paper and Repurchase Agreements***

The Company has historically issued commercial paper and entered into repurchase agreements to fund its investments in mortgage-backed securities and mortgage loans, as well as its warehouse lending and fixed income trading activities. Commercial paper issuances are conducted through Georgetown Funding Company, LLC (Georgetown Funding).

Georgetown Funding is a special purpose Delaware limited liability company organized for the purpose of issuing extendable commercial paper notes collateralized by mortgage-backed securities and entering into reverse repurchase agreements with the Company and its affiliates. The Company serves as administrator for Georgetown Funding's commercial paper program and all of Georgetown Funding's transactions are conducted with the Company. Through the Company's administration agreement and repurchase agreements, the Company is the primary beneficiary of Georgetown Funding and consolidates this entity for financial reporting purposes. The commercial paper notes issued by Georgetown Funding are rated A1+/P1 by Standard & Poor's and Moody's Investors Service, respectively. The Company's Master Repurchase Agreement with Georgetown Funding enables the Company to finance up to \$12,000,000 of mortgage-backed securities.

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The Company also has short-term financing facilities that are structured as repurchase agreements with various financial institutions to fund its portfolio of mortgage loans. The interest rates under these agreements are based on LIBOR plus a spread that ranges between 1.00% to 1.40% based on the nature of the mortgage collateral. As of December 31, 2007, the amount at risk related to \$1,493,614 billion of repurchase agreements with Barclays Capital Inc. was \$74,828, representing 18.8% of the Company shareholders' equity with a weighted average maturity of 20 days.

The following tables provide information regarding the Company's outstanding commercial paper, repurchase agreement borrowings, and mortgage financing facilities.

	December 31, 2007			December 31, 2006		
	Commercial Paper	Repurchase Agreements	Short-Term Mortgage Financing Facilities <sup>(1)</sup>	Commercial Paper	Repurchase Agreements	Short-Term Mortgage Financing Facilities <sup>(1)</sup>
Outstanding balance	\$ —	\$1,681,822	\$62,555	\$3,971,389	\$2,116,813	\$ 942,517
Value of assets pledged as collateral:						
Agency mortgage-backed securities	—	1,493,614	—	4,209,851	1,844,447	—
Non-agency mortgage-backed securities	—	284,910	—	—	424,063	—
Mortgage loans	—	—	65,022	—	—	950,191
Weighted-average rate	—	5.00%	6.16%	5.41%	5.34%	6.05%
Weighted-average term to maturity	—	20.0 days	NA	18.3 days	21.9 days	NA

- (1) Under these mortgage financing agreements, which expire or may be terminated by the Company or the counterparty within one year, the Company may finance mortgage loans for up to 180 days. The interest rates on these borrowings reset daily.

	December 31, 2007			December 31, 2006		
	Commercial Paper	Repurchase Agreements	Short-Term Mortgage Financing Facilities	Commercial Paper	Repurchase Agreements	Short-Term Mortgage Financing Facilities
Weighted-average outstanding balance during the year ended	\$2,329,105	\$1,741,603	\$594,555	\$2,610,719	\$839,446	\$1,043,776
Weighted-average rate during the year ended	5.38%	5.27%	6.12%	5.17%	5.15%	5.79%

See also Note 8 for information regarding the effects of derivative instruments on the Company's borrowing costs.

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**Securitization Financing**

The Company has issued asset-backed securities through securitization trusts to finance a portion of the Company's portfolio of mortgage loans. The asset-backed securities are secured solely by the mortgages transferred to the trusts and are non-recourse to the Company. The principal and interest payments on the mortgages provide the funds to pay debt service on the securities. This securitization activity was accounted for as financings since the securitization trusts did not meet the qualifying special purpose entity criteria under SFAS 140, and because the Company maintained continuing involvement in the securitized mortgages through its ownership of certain interests issued by the trust. As a result of the completion of the sale of the Company's securitized mortgage loan portfolio in the fourth quarter of 2007 (see Note 4), the Company also transferred the related securitization financings from its consolidated balance sheets. Accordingly, the Company had no outstanding securitization borrowings as of December 31, 2007. The outstanding balances of the securities as of December 31, 2006 were as follows:

	December 31, 2006
Security balance	\$ 4,501,619
Discount on bonds, net	(15,573)
Balance of securitization financing, net	\$ 4,486,046
Current balance of loans and other assets collateralizing the securities	\$4,552,898

See also Note 8 for information regarding the effects of derivative instruments on the Company's borrowing costs.

**Long Term Debt**

As of December 31, 2007 and 2006, the Company had issued a total of \$317,500 of long term debentures through FBR TRS Holdings. The long-term debentures accrue and require payments of interest quarterly at an annual rate of three-month LIBOR plus 2.25% to 3.25%. The weighted average interest rate on these long term debentures was 7.63% as of December 31, 2007. All of these borrowings mature between 2033 and 2035. The Company had incurred costs related to the issuance of these debentures. These costs will be amortized over the five year period through the redemption date. As of December 31, 2007 and 2006, the unamortized balance of these issuance costs was \$2,422 and \$3,459, respectively. During the year ended December 31, 2007, the Company did not issue additional long-term debentures.

As of December 31, 2007 and 2006, the Company had additional outstanding long-term debt of \$3,409 and \$4,086, respectively associated with the Company's 2001 acquisition of Money Management Associates, LP and Rushmore Trust and Savings. This note is collateralized by the capital stock of FBR Fund Advisors, Inc. and matures on January 2, 2011. Interest on this note is imputed at 9%.

**Short Term Borrowings**

On July 25, 2007, the Company entered into a recapitalization agreement with an affiliate of Sun Capital. The recapitalization agreement resulted in the investment by Sun Capital and the Company of \$60,000 and \$15,000, respectively, on a pari passu basis, subject to terms and conditions set forth in the recapitalization agreement and other related agreements. These investments have been treated as convertible debt of First NLC. As of December 31, 2007, the Company's outstanding short term borrowing balance was \$63,981, including accrued interest of \$3,981. This debt has an interest rate of 15% per annum and is non-recourse to the Company. See Note 19 for additional information regarding First NLC.

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**Note 8. Derivatives and Hedging Activities:**

In the normal course of its operations, the Company is a party to financial instruments that are accounted for as derivative financial instruments in accordance with SFAS 133. These instruments include interest rate caps, interest rate swaps, Eurodollar futures contracts, U.S. Treasury futures contracts, swaptions, certain borrower interest rate lock agreements, certain commitments to purchase and sell mortgage loans and mortgaged-backed securities, and warrants to purchase common stock.

***Derivative Instruments***

The Company utilizes derivative financial instruments to hedge the interest rate risk associated with its borrowings. The Company also uses derivatives to economically hedge certain positions in mortgage-backed securities and mortgage loans. The derivative financial instruments include interest rate caps, interest rate swaps and Eurodollar futures contracts. As discussed below, certain of these derivatives are designated as cash flow or fair value hedges under SFAS 133 and others are not designated as hedges for accounting purposes. The counterparties to these derivative instruments are U.S. financial institutions.

Interest rate caps and interest rate swaps are primarily used to hedge the Company's exposure to future cash flows associated with debt repricings. For interest rate caps, in exchange for a fee paid at inception of the agreement, the Company receives a floating rate based on one-month LIBOR whenever one-month LIBOR exceeds a specified rate (the "strike" rate). The Company is the fixed rate payer for the interest rate swaps where the Company pays based on fixed rate and receives based on floating rate, therefore, locking-in the cost of borrowing. Eurodollar futures contracts are a proxy for the forward AA/AAA LIBOR-based credit curve and allow the Company the ability to lock in three-month LIBOR forward rates for its short-term borrowings based on the maturity dates of the contracts. The following table summarizes these derivative positions as of December 31, 2007 and 2006:

	December 31, 2007		December 31, 2006	
	Notional Amount	Fair Value	Notional Amount	Fair Value
Cash flow hedges:				
Interest rate cap agreements <sup>(1)</sup>	\$ 3,063,000	\$ 1,336	\$ —	\$ —
Interest rate swap agreements <sup>(2)</sup>	135,000	(2,958)	—	—
Eurodollar futures contracts <sup>(3)</sup>	—	—	25,790,000	(34,526)
Fair value hedge:				
Interest rate cap agreement <sup>(4)</sup>	789,238	2,177	—	—
No hedge designation:				
Interest rate cap agreements <sup>(5)</sup>	1,021,612	(668)	4,115,751	21,266

(1) Comprised of four interest rate caps which mature between 2008 and 2010 with strike rates between 5.37% and 5.50%.

(2) Comprised of three interest rate swaps which mature in 2012 with interest rates between 4.58% and 5.59%.

(3) The \$25,790,000 total notional amount of Eurodollar futures contracts as of December 31, 2006 represents the accumulation of Eurodollar futures contracts that mature on a quarterly basis between 2007 and 2011 and hedge borrowings of between \$2,685,000 and \$100,000. The Company closed and de-designated these contracts in June 2007.

(4) Comprised of one interest rate cap which matures in 2012 with a strike rate of 6.36%.

(5) Comprised of one interest rate cap maturing 2010 with a strike rates between 5.40% and 5.56%.

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During the year, the Company had designated certain interest rate caps and interest rate swaps as cash flow hedges of the variability in interest payments associated with the Company's borrowings. The notional amount and terms of each of these derivative instruments were matched against a like amount of current and/or anticipated borrowings and terms under the Company's forecasted financings. These instruments were highly effective hedges and qualified as cash flow hedges under SFAS 133. Accordingly, changes in the fair value of these derivatives were reported in other comprehensive income to the extent the hedge was effective, while changes in fair value attributable to hedge ineffectiveness are reported in earnings. The net effect of the Company's cash flow hedges on the variability in interest payments was to decrease interest expense by \$21,501 for the year ended December 31, 2007. These hedging activities decreased interest expense by \$23,384 during 2006. The total net loss deferred in accumulated other comprehensive income relating to these derivatives was \$14,115 at December 31, 2007. Of this amount, a net expense of \$4,580 is expected to flow through the Company's statement of operations over the next twelve months. The Company recognized a loss of \$2,479 related to the ineffectiveness portion of these hedges.

During the fourth quarter of 2007, the Company designated an interest rate cap as a fair value hedge of the Company's exposure to a decrease in the fair value of a MBS attributable to changes in LIBOR. Accordingly pursuant to SFAS 133, the gains and losses on the interest rate cap are recognized in earnings and the changes in fair value of the hedged item attributable to the hedged risk are adjusted from the carrying amount of the hedged item and recognized in earnings in the same period. During the year ended December 31, 2007, the ineffective portion of this hedge was not material.

The Company also uses derivative instruments, including certain interest rate caps, Eurodollar futures contracts, U.S. Treasury futures contracts and swaptions, to hedge certain mortgage-backed security and mortgage loan positions and related borrowings that are not designated as hedges under SFAS 133. For example, Eurodollar futures contracts have been used to hedge the financing for certain mortgage-backed security positions and commitments to purchase certain mortgage-backed securities. The Company also uses Eurodollar futures contracts to hedge its exposure on loan commitments. The changes in fair value on these derivatives are recorded to net investment income in the statement of operations. For the year ended December 31, 2007, the Company recorded net losses of \$21,988 on these derivatives.

***Stock Warrants***

In connection with its capital raising activities, the Company may receive warrants to acquire equity securities. These instruments are accounted for as derivatives with changes in the fair value recorded to net investment income under SFAS 133. For the years ended December 31, 2007, 2006 and 2005, the Company recorded net gains (losses) of \$413, \$(249) and \$2,651, respectively, related to these securities. As of December 31, 2007 and 2006, the Company held stock warrants with a fair value of \$1,763 and \$1,350, respectively. Furthermore, during 2005, the Company exercised warrants and sold the resulting stock realizing a gain of \$287.

**Note 9. Income Taxes:**

The parent company, FBR Group, elected REIT status under the Internal Revenue Code. As a REIT, FBR Group is not subject to Federal income tax on earnings distributed to its shareholders. Most states recognize REIT status as well. Since FBR Group intends to distribute 100% of its REIT taxable income to shareholders, the Company has recognized no income tax expense on its REIT income.

**FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**  
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To maintain tax qualification as a REIT, FBR Group must meet certain income and asset tests and distribution requirements. The REIT must distribute to shareholders at least 90% of its (parent company) taxable income. A predominance of the REIT's gross income must come from real estate sources and other portfolio-type income. A significant portion of the REIT's assets must consist of real estate and similar portfolio investments, including mortgage-backed securities. Beginning in 2001, the tax law changed to allow REITs to hold a certain percentage of their assets in taxable REIT subsidiaries. The income generated from the Company's taxable REIT subsidiaries is taxed at normal corporate rates and will generally not be distributed to the Company's shareholders. Failure to maintain REIT qualification would subject FBR Group to Federal and state corporate income taxes at regular corporate rates. The taxable REIT subsidiaries, including FBR TRS Holdings and FBR Capital Markets have elected to file a consolidated Federal income tax return.

During the year ended December 31, 2007, 2006 and 2005 the Company recorded \$22,932, \$(14,682), and \$26,683 respectively of income tax expense (benefit) for income and losses generated that was attributable to taxable REIT subsidiaries, net of tax effect on intercompany profits eliminated. The Company had taxable book income (losses) before income taxes of \$(269,619), \$73,857, \$55,966 respectively in 2007, 2006, and 2005.

The provision for income taxes consists of the following for the years ended December 31, 2007, 2006 and 2005:

	2007	2006	2005
Federal	\$ 5,385	\$ (13,752)	\$ 17,438
State	\$ 18,083	\$ (1,759)	\$ 8,691
Foreign	\$ (536)	\$ 829	\$ 554
	<u>\$22,932</u>	<u>\$ (14,682)</u>	<u>\$26,683</u>
Current	\$23,779	\$ (12,945)	\$ 34,895
Deferred	\$ (847)	\$ (1,737)	\$ (8,212)
	<u>\$22,932</u>	<u>\$ (14,682)</u>	<u>\$26,683</u>

Deferred tax assets and liabilities consisted of the following as of December 31, 2007 and 2006:

	2007	2006
Unrealized investment gains, recorded in accumulated other comprehensive loss	\$ 755	\$ (528)
Unrealized investment gains and losses	27,305	(7,701)
Accrued compensation	16,293	10,734
Depreciation and amortization	872	(1,895)
Mark-to-market and other than temporary impairments	1,491	2,614
Loan loss and real estate owned reserve accounts	—	4,343
Accrued expenses	—	4,606
Deferred intercompany gain	—	4,034
Other, net	4,125	1,107
Net operating loss	18,256	7,824
Valuation allowance	(54,240)	(4,099)
Net deferred tax asset	<u>\$ 14,857</u>	<u>\$21,039</u>

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The provision (benefit) for income taxes results in effective tax rates that differ from the Federal statutory rates. The reconciliation of the Company and its taxable REIT subsidiaries income tax attributable to net income (loss) computed at Federal statutory rates to income tax expense (benefit) was:

<u>December 31,</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>
Federal income tax at statutory rate	\$(94,367)	\$ 25,788	\$19,631
State income taxes, net of Federal benefit	(6,269)	(2,103)	4,243
Gain on issuance of subsidiary stock	—	(42,499)	—
Effect of FAS 123R implementation-accounting for stock options	8,040	1,655	—
Book loss in excess of tax loss from subsidiary	26,168	—	—
Book gain in excess of tax gain on sale of subsidiary	18,182	—	—
Effect of regulatory settlements	—	—	2,494
Other, net	13,017	138	315
Valuation allowance	58,161	2,339	—
Effective income tax rate	<u>\$ 22,932</u>	<u>\$(14,682)</u>	<u>\$26,683</u>

The company adopted FASB Interpretation (FIN) No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109" (FIN 48) effective January 1, 2007. Adoption of FIN 48 did not have a material effect on the financial statements. The total unrecognized tax benefit as of January 1, 2007, that, if recognized would affect the Company's effective tax rate, was immaterial. The Company continues to record interest and penalties in other expenses/other income in the statement of operations. The total amount of accrued interest and penalties as of the date of adoption was immaterial.

As of December 31, 2007, the parent company REIT has a capital loss carryforward of \$268,708 that can be used to offset future capital gains. Capital losses of \$163,702 and \$105,006 will expire in 2011 and 2012, respectively. In addition, as of December 31, 2007, the parent company REIT has a net operating loss carryforward of \$372,158 that can be used to offset future taxable income. The net operating loss carryforward will expire in 2027. One of the taxable REIT subsidiaries has federal net operating loss carryforwards of \$38,300 that will expire in 2027. One of the taxable REIT subsidiaries has state and local net operating loss carryforwards of \$11,200 which will begin to expire in 2010. One of the taxable REIT subsidiaries has foreign net operating loss carryforwards of \$4,272 that can be carried forward indefinitely. The valuation allowance relates primarily to the ability to utilize losses in various tax jurisdictions.

As of January 1, 2008, tax years subsequent to March 31, 2003 remain open under the statute of limitations. The company is subject to examination by the U.S. Internal Revenue Service (IRS), and other taxing authorities in jurisdictions where the firm has significant business operations, such as New York. In November 2007, the company concluded as IRS examination of tax years 2003 to 2005. The results of this examination were not material. Tax years subsequent to 2005 remain open to IRS examination.

**Note 10. Regulatory Capital Requirements:**

FBR & Co. and FBRIS, are registered with the SEC and are members of the National Association of Securities Dealers, Inc. (now FINRA). Additionally, FBRIL is registered with the Financial Services Authority (FSA) of the United Kingdom. As such, they are subject to the minimum net capital requirements promulgated by the SEC and FSA. As of December 31, 2007 and 2006, FBR & Co. had net capital of \$102,421 and \$94,591, respectively that was \$97,433 and \$90,116, respectively, in excess of its required net capital of \$4,978 and \$4,475, respectively. As of December 31, 2007 and 2006, FBRIS and FBRIL had net capital in excess of required amounts.

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**Note 11. Commitments and Contingencies:**

***Contractual Obligations***

The Company has contractual obligations to make future payments in connection with long-term debt and non-cancelable lease agreements and other contractual commitments as well as uncalled capital commitments to various investment partnerships that may be called over the next ten years. The following table sets forth these contractual obligations by fiscal year:

	2008	2009	2010	2011	2012	Thereafter	Total
Long-term debt <sup>(1)</sup>	\$ 970	\$ 970	\$ 970	\$ 970	\$ —	\$ 319,695	\$ 323,575
Minimum rental and other contractual commitments <sup>(2)</sup>	24,508	24,611	21,042	23,039	20,235	41,992	155,427
Capital commitments <sup>(3)</sup>	—	—	—	—	—	—	—
	<u>\$ 25,478</u>	<u>\$ 25,581</u>	<u>\$ 22,012</u>	<u>\$ 24,009</u>	<u>\$ 20,235</u>	<u>\$ 361,687</u>	<u>\$ 479,002</u>

- (1) This table excludes interest payments to be made on the Company's long-term debt securities issued through TRS Holdings. Based on the 3-month LIBOR of 5.00% as of December 31, 2007, plus a weighted average margin of 2.63%, estimated annualized interest on the current outstanding principal of \$317,500 of long-term debt securities would be approximately \$24,214 for the year ending December 31, 2008. These long-term debt securities mature in thirty years beginning in March 2033 through October 2035. Note that interest on this long-term debt floats based on 3-month LIBOR, therefore, actual coupon interest will differ from this estimate.
- (2) Equipment and office rent expense for 2007, 2006 and 2005 were \$23,195, \$23,283 and \$18,355, respectively.
- (3) The table above excludes \$3,840 of uncalled capital commitments to various investment partnerships that may be called over the next ten years. This amount was excluded because the Company cannot currently determine when, if ever, the commitments will be called.

The Company also has short-term repurchase agreement liabilities of \$1,744,377, as of December 31, 2007. See Note 7 for further information.

***Clearing Broker***

FBR & Co. clears all of its securities transactions through a clearing broker on a fully disclosed basis. Pursuant to the terms of the agreements between FBR & Co. and the clearing broker, the clearing broker has the right to charge FBR & Co. for losses that result from a counterparty's failure to fulfill its contractual obligations.

As the right to charge FBR & Co. has no maximum amount and applies to all trades executed through the clearing broker, the Company believes there is no maximum amount assignable to this right. At December 31, 2007, the Company has recorded no liabilities and during 2007 incurred no significant costs with regard to this right.

***Repurchase and Premium Recapture Obligations***

The Company's sales of mortgage loans are subject to standard mortgage industry representations and warranties that may require the Company to repurchase the mortgage loans due to breaches of these representations and warranties or if a borrower fails to make one or more of the first loan payments due on the loan. In addition, the Company is generally obligated to repay all or a portion of the original premium received on the sale of loans in the event that the loans are repaid within a specified time period subsequent to sale. The Company maintains a liability reserve for its repurchase and premium recapture obligations that is included in accounts payable, accrued expenses and other liabilities in the consolidated balance sheets. The reserve is

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increased through charges to the gain (or loss) recorded at the time of sale. The reserve is reduced by charge-offs when loans are repurchased or premiums are repaid. Activity for the reserve was as follows for the period ended December 31, 2007 and 2006:

	December 31, 2007	December 31, 2006
Balance at beginning of period	\$ 23,527	\$ 12,457
Provision	47,254	40,830
Charge-offs	(61,147)	(29,760)
Balance at end of period	<u>\$ 9,634</u>	<u>\$ 23,527</u>

***First NLC Recapitalization***

On July 25, 2007, the Company entered into a recapitalization agreement with an affiliate of Sun Capital. The recapitalization agreement resulted in the investment by Sun Capital and the Company of \$60,000 and \$15,000, respectively, on a *pari passu* basis, subject to the terms and conditions set forth in the recapitalization agreement and other related agreements. Pursuant to the terms and conditions of the recapitalization agreement and the other related agreements, each of Sun Capital's and the Company's investment in First NLC was treated as convertible debt of First NLC. Prior to conversion of any of this debt to equity, First NLC continued to be a wholly-owned subsidiary of the Company, was governed by a board of directors controlled by the Company and operated under state mortgage licenses based on this governance structure. Accordingly, Sun Capital has been treated as a senior lender of First NLC and its convertible debt investment in First NLC is non-recourse to the Company. Upon satisfaction of various conditions, the convertible debt was expected to convert into equity interests in First NLC, which would have resulted in First NLC being owned 80% by Sun Capital and 20% by the Company. As of December 31, 2007, the Company has continued to consolidate First NLC for financial reporting purposes.

For information regarding First NLC and the voluntary petition for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code filed by First NLC on January 18, 2008, see Note 19.

***Litigation***

As of December 31, 2007, except as described below, the Company was not a defendant or plaintiff in any lawsuits or arbitrations, nor involved in any governmental or self-regulatory organization (SRO) matters that are expected to have a material adverse effect on the Company's financial condition or statements of operations. The Company is a defendant in a small number of civil lawsuits and arbitrations (together, litigation) relating to its various businesses. In addition, the Company is subject to various reviews, examinations, investigations and other inquiries by governmental agencies and SROs. There can be no assurance that these matters individually or in aggregate will not have a material adverse effect on the Company's financial condition or results of operations in a future period. However, based on management's review with counsel, resolution of these matters is not expected to have a material adverse effect on the Company's financial condition, results of operations or liquidity.

Many aspects of the Company's business involve substantial risks of liability and litigation. Underwriters, broker-dealers and investment advisers are exposed to liability under Federal and state securities laws, other Federal and state laws and court decisions, including decisions with respect to underwriters' liability and

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limitations on indemnification, as well as with respect to the handling of customer accounts. For example, underwriters may be held liable for material misstatements or omissions of fact in a prospectus used in connection with the securities being offered and broker-dealers may be held liable for statements made by their securities analysts or other personnel. In certain circumstances, broker-dealers and asset managers may also be held liable by customers and clients for losses sustained on investments. In recent years, there has been an increasing incidence of litigation and actions by government agencies and SROs involving the securities industry, including class actions that seek substantial damages. The Company is also subject to the risk of litigation, including litigation that may be without merit. As the Company intends to actively defend such litigation, significant legal expenses could be incurred. An adverse resolution of any future litigation against the Company could materially affect the Company's operating results and financial condition.

The Company's business (through its subsidiary First NLC and affiliated entities) includes the origination, acquisition, pooling, securitization and sale of non-conforming residential mortgage loans. Consequently, the Company is subject to additional federal and state laws in this area of operation, including laws relating to lending, consumer protection, privacy and unfair trade practices.

*Putative Class Action Securities Lawsuits*

The Company and certain current and former senior officers and directors have been named in a series of putative class action securities lawsuits filed in the second quarter of 2005, all of which are pending in the United States District Court for the Southern District of New York. These cases have been consolidated under the name *In re FBR Inc. Securities Litig.* A consolidated amended complaint has been filed asserting claims under the Securities Exchange Act of 1934 and alleging misstatements and omissions concerning (i) the SEC and NASD (now FINRA) investigations described below relating to FBR & Co.'s involvement in the private investment in public equity on behalf of CompuDyne, Inc. in October 2001 and (ii) the alleged conduct of FBR and certain FBR officers and employees in allegedly facilitating certain sales of CompuDyne shares. The Company is contesting these lawsuits vigorously, but the Company cannot predict the likely outcome of these lawsuits or their likely impact on the Company at this time.

*Shareholders' Derivative Action*

The Company has been named a nominal defendant, and certain current and former senior officers and directors have been named as defendants, in three shareholders' derivative actions. Two of these actions, brought by Lemon Bay Partners LLC and Walter Boyle, are pending in the United States District Court for the Southern District of New York and have been consolidated, for pre-trial purposes only, with the pending putative class action securities lawsuits under the name *In re FBR Inc. Securities and Derivative Litig.* The third, brought by Gary Walter and Harry Goodstadt, has been filed in the Circuit Court for Arlington County, Virginia. All three cases claim that certain of the Company's current and former officers and directors breached their duties to the Company based on allegations substantially similar to those in the *In re FBR Inc. Securities Litig.* et al. putative class action lawsuits described above. The Company has not responded to any of these complaints and no discovery has commenced. The Company cannot predict the likely outcome of this action or its likely impact on us at this time. The Board of Directors has established a special committee whose jurisdiction includes the Boyle and Walter/Goodstadt matters as well as consideration of shareholder demand letters which contain similar allegations, and the special committee has been authorized to make final decisions whether such litigation is in the Company's best interests.

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*Other Litigation*

Our subsidiary, First NLC, has been named in a putative class action in the U.S. District Court for the Northern District of Illinois ( *Cerda v. First NLC Financial Services, LLC* ), which alleges violations of the Fair Credit Reporting Act, 15 U.S.C. § 1681 et seq. First NLC is contesting this lawsuit vigorously, but we cannot predict the likely outcome of this lawsuit or the likely impact on First NLC or on us at this time.

Our subsidiary, First NLC has been named in a putative class action in the U.S. District Court for the Northern District of California ( *Stanfield, et al. v. First NLC Financial Services, LLC*, Case No. C 06-3892 SBA ). The complaint was brought on behalf of former and current First NLC employees who worked as loan officers, loan processors, and account managers, for alleged violations of the Fair Labor Standards Act. The complaint also alleges violations of California wage and hour laws, including claims for Unfair Competition, waiting-time penalties, and damages for missed meal and rest periods under California law. The court granted conditional class certification on November 1, 2006 for violations of the Fair Labor Standards Act and ordered circulation of a notice about the case on December 5, 2006. First NLC denies plaintiffs' allegations in their entirety and intends to vigorously defend itself. This litigation is in its preliminary stages and the outcome of these types of cases is highly fact specific. We therefore cannot predict the likely outcome of this lawsuit or the likely impact on First NLC or on us at this time. We are aware that the number of cases involving alleged violations of the FLSA and state wage and hour laws have recently increased in the financial services industry and that a certain number of judgments and settlements involving these claims have already occurred.

Alleging claims similar to those in *Stanfield*, a group of plaintiffs who work (or worked) for First NLC as "funders" filed suit in the U.S. District Court for the Central District of California on January 30, 2007 ( *Sparrow-Milrot, et al. v. First NLC Financial Services, LLC*, Case No. SA CV 07-0119 AHS RCX ). Plaintiffs have not obtained class or collective action certification and First NLC has not answered the complaint. First NLC denies plaintiffs' allegations in their entirety and intends to vigorously defend itself, but we cannot predict the likely outcome of this lawsuit or the likely impact on First NLC or on us at this time.

***Regulatory Charges and Related Matters***

On December 20, 2006, the SEC and the NASD (now FINRA) accepted settlement offers made by FBR & Co. with respect to alleged violations relating to FBR & Co.'s trading in a company account and the offering of a private investment in public equity on behalf of CompuDyne, Inc, in October 2001.

In the SEC settlement, FBR & Co., without admitting or denying any wrongdoing, proposed to pay disgorgement, civil penalties and interest totaling approximately \$3,700 and to consent to the entry of a permanent injunction with respect to violations of the antifraud provisions of the federal securities laws. FBR & Co. also agreed to consent to an administrative proceeding under Section 15(b) of the Exchange Act in which FBR & Co. would be subjected to a censure and agreed to certain additional undertakings, including review by an independent consultant of its Chinese Wall procedures and the implementation of any recommended improvements. In the parallel NASD (now FINRA) settlement, FBR & Co. agreed to the same undertakings provided for in the SEC settlement approved by the staff of the Division of Enforcement of the SEC, including agreeing to an independent consultant to review its Chinese Wall procedures and implementing any recommended improvements, and also agreed pay a fine of \$4,000 to NASD (now FINRA).

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***Other Legal and Regulatory Matters***

Except as described above, as of December 31, 2007, the Company was not a defendant or plaintiff in any lawsuits, arbitrations or regulatory actions that are expected to have a material adverse effect on the Company's financial condition or results of operations. The Company is a defendant in a small number of civil lawsuits and arbitrations relating to its various businesses, and is subject to various reviews, examinations, investigations and other inquiries by governmental agencies and SROs, none of which are expected to have a material adverse effect on the Company's financial condition, results of operations or liquidity.

***Incentive Fees***

The Company recognizes incentive income from the partnerships based on what would be due to the Company if the partnership terminated on the balance sheet date. Incentive allocations may be based on unrealized gains and losses, and could vary significantly based on the ultimate realization of the gains or losses. We may therefore reverse previously recorded incentive allocations in future periods relating to the Company's managed partnerships. As of December 31, 2007 and 2006, \$-0- and \$35, respectively, was subject to such potential future reversal.

**Note 12. First NLC Financial Services, LLC**

On February 16, 2005, the Company completed the acquisition of First NLC, a non-conforming residential mortgage loan originator located in Florida for a purchase price of \$100,803 paid in a combination of cash and stock. First NLC is part of the Company's mortgage banking segment and operates as a wholly-owned subsidiary.

The Company accounted for the acquisition of First NLC in accordance with SFAS No. 141, "Business Combinations" (SFAS 141) using the purchase method of accounting. Under the purchase method, net assets and results of operations of acquired companies are included in the consolidated financial statements from the date of acquisition. In addition, SFAS 141 provides that the cost of an acquired entity must be allocated to the assets acquired, including identifiable intangible assets and the liabilities assumed based on their estimated fair values at the date of acquisition. The excess of cost over the fair value of the net assets acquired must be recognized as goodwill.

The \$100,803 purchase price included cash of \$74,325, issuance of 1,297,746 shares of FBR Class A common stock at a price of \$18.82 per share for a total of \$24,420, and direct acquisition costs of \$2,058. A summary of the fair values of the net assets acquired is as follows:

Cash	\$ 11,471
Interest receivable	1,107
Loans held for sale, net	508,443
Intangible asset	16,500
Other assets	10,029
Warehouse finance facilities	(483,164)
Other liabilities	(18,335)
Goodwill	54,752
Total purchase price, including acquisition costs	<u>\$ 100,803</u>

Identified intangible assets represent the fair value of First NLC's broker relationships. Pursuant to SFAS 142 this intangible asset was being amortized over an estimated useful life of ten years based on the economic depletion of this asset. The total amount of goodwill represents the purchase price of First NLC in excess of the fair value of

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the net assets acquired. Under SFAS 142, goodwill is not amortized. Instead, this asset is required to be tested at least annually for impairment. Both the identified broker relationship intangible asset and the goodwill are deductible for tax purposes.

The following presents unaudited pro forma consolidated results for the year ended December 31, 2005, as though the acquisition had occurred as of January 1, 2005.

	2005
Gross revenues, as reported	\$ 995,306
Revenues, net of interest expense and provision for loan losses, as reported	434,702
Net (loss) income, as reported	(170,910)
Gross revenues, pro forma	1,008,064
Revenues, net of interest expense and provision for loan losses, pro forma	444,758
Net (loss) income, pro forma	(172,169)
(Loss) earnings per common share:	
Basic, as reported	\$ (1.01)
Diluted, as reported	\$ (1.01)
Basic, pro forma	\$ (1.02)
Diluted, pro forma	\$ (1.02)

In March 2007, the Company's non-prime mortgage origination subsidiary, First NLC, announced the closing of certain wholesale operations centers and the consolidation of this function into its facilities at Deerfield Beach, Florida and Anaheim, California and the planned closing in April 2007 of certain of its retail branches. These restructuring actions, which included employee terminations, were taken in response to reduced origination volumes across the industry and to align the Company's cost structure with the current operating environment. As a result of these actions and the decline in value of First NLC's origination platform during 2007, the Company recorded charges of \$101,737.

These 2007 restructuring charges include write-downs of \$65,001 related to the impairment of goodwill and purchased intangible assets, measured as the amount by which the carrying amount exceeded estimated fair value of these assets as of each reporting date, reflecting the continued deterioration of the non-prime mortgage origination industry during 2007. These impairments were based on the Company's assessment of the current operating losses being generated by First NLC and values implied by potential third party sales transactions. As a result of these write-downs, there is no remaining balance of goodwill attributed to First NLC. Additionally, the write-down of \$10,249 of intangible assets associated with broker relationships was due to operating losses and reduction in wholesale loan origination volumes.

The consolidation of the operations centers into the remaining two facilities required a reduction in workforce and the termination of certain leases. During the twelve months ended December 31, 2007, the Company recognized a charge of \$7,802, associated with severance payments and benefits of terminated employees. In addition, during the twelve months ended December 31, 2007, the Company recognized a charge of \$13,801 associated with the termination of certain facility and equipment lease agreements. During the twelve months ended December 31, 2007, the Company also recognized expenses of \$15,133 associated with the disposal of equipment at these leased facilities and professional fees associated with these restructuring activities.

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The following table summarizes the activity related to the liability, included in accounts payable, accrued expenses and other liabilities in the consolidated balance sheets, for restructuring costs and other special charges as of December 31, 2007:

	Workforce Reduction	Consolidation of Operations Center and Other Charges	Impairment of Goodwill and Purchased Intangible Assets	Total
Initial charge in 2007	\$ 7,802	\$ 28,934	\$ 65,001	\$ 101,737
Non-cash charges	(258)	(14,329)	(65,001)	(79,588)
Payments	(5,558)	(4,432)	—	(9,990)
Liability as of December 31, 2007	<u>\$ 1,986</u>	<u>\$ 10,173</u>	<u>\$ —</u>	<u>\$ 12,159</u>

For information regarding First NLC and the voluntary petition for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code filed by First NLC on January 18, 2008, see Note 19.

**Note 13. Shareholders' Equity**

The Company has authorized share capital of 450 million shares of Class A Common Stock, par value \$0.01 per share; 100 million shares of Class B Common Stock, par value \$0.01 per share; and 25 million shares of undesignated preferred stock. Holders of the Class A and Class B Common Stock are entitled to one vote and three votes per share, respectively, on all matters voted upon by the shareholders. Shares of Class B Common Stock convert to shares of Class A Common Stock at the option of the Company in certain circumstances including (i) upon sale or other transfer, (ii) at the time the holder of such shares of Class B Common Stock ceases to be affiliated with the Company and (iii) upon the sale of such shares in a registered public offering. The Company's Board of Directors has the authority, without further action by the shareholders, to issue preferred stock in one or more series and to fix the terms and rights of the preferred stock. Such actions by the Board of Directors could adversely affect the voting power and other rights of the holders of common stock. Preferred stock could thus be issued quickly with terms that could delay or prevent a change in control of the Company or make removal of management more difficult. At present, the Company has no plans to issue any of the preferred stock.

**Dividends**

The Company declared the following distributions during the years ended December 31, 2007 and 2006:

Declaration Date	Record Date	Payment Date	Dividends Per Share
<b>2007</b>			
September 17, 2007	September 28, 2007	October 31, 2007	\$ 0.05
June 19, 2007	June 29, 2007	July 31, 2007	\$ 0.05
March 21, 2007	March 30, 2007	April 30, 2007	\$ 0.05
<b>2006</b>			
December 13, 2006	December 29, 2006	January 31, 2007	\$ 0.05
September 13, 2006	September 29, 2006	October 31, 2006	\$ 0.05
June 8, 2006	June 30, 2006	July 28, 2006	\$ 0.20
March 15, 2006	March 31, 2006	April 28, 2006	\$ 0.20

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On December 21, 2007 the Company announced that the Board of Directors had decided not to pay a cash dividend to shareholders for the fourth quarter of 2007.

**Stock Compensation Plans**

*FBR Group Long-Term Incentive Plan (FBR Group Long-Term Incentive Plan)*

Under the FBR Group Long-Term Incentive Plan, the Company may grant options to purchase stock, stock appreciation rights, performance awards and restricted and unrestricted stock and other stock-based awards for up to 24,900,000 shares of Class A common stock to eligible participants in the Plan. Participants include employees, officers and directors of the Company and its subsidiaries. The FBR Group Long-Term Incentive Plan has a term of 10 years and options granted may have an exercise period of up to 10 years. Options may be incentive stock options, as defined by Section 422 of the Internal Revenue Code, or nonqualified stock options. The FBR Long-Term Incentive Plan replaced the FBR Group Stock and Annual Incentive Plan and the Non-Employee Director Stock Compensation Plan (the Prior Plans), and shares that remained available for issuance under the Prior Plans became available under the FBR Long-Term Incentive Plan.

Effective January 1, 2006, in accordance with SFAS No. 123R, the Company adopted a fair value based measurement method in accounting for all share based payment transactions with employees. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for options granted for the year ended December 31, 2006: dividend yield of 8.5%, expected volatility of 49%, risk-free interest rate of 4.7%, and an expected life of five years for all grants. The weighted average fair value of options granted during the year ended December 31, 2006 was \$2.25. No options were granted during the twelve month period ended December 31, 2007.

A summary of option activity under the FBR Long-Term Incentive Plan and the FBR Group Stock and Annual Incentive Plan (the Stock Plans) as of December 31, 2007, and changes during the three year then ended is presented below:

	Number of Shares	Weighted- average Exercise Prices	Weighted- average Contractual Life
Share Balance as of December 31, 2004	3,324,633	\$ 17.39	3.4
Granted in 2005	451,461	14.13	
Cancelled in 2005	(416,952)	17.62	
Exercised in 2005	(170,416)	6.42	
Share Balance as of December 31, 2005	3,188,726	\$ 17.47	2.7
Granted in 2006	227,500	9.75	
Cancelled in 2006	(414,727)	18.97	
Exercised in 2006	(77,456)	6.15	
Share Balance as of December 31, 2006	2,924,043	\$ 16.92	1.9
Granted in 2007	—	—	
Cancelled in 2007	(1,914,006)	18.25	
Exercised in 2007	(10,000)	6.50	
Share Balance as of December 31, 2007	1,000,037	\$ 14.48	1.9
Options Exercisable	749,391	15.95	1.5

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The total intrinsic value of options exercised during the years ended December 31, 2007, 2006 and 2005, was \$7, \$277 and \$991, respectively.

As of December 31, 2007, there was \$234 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Stock Plans relating to 250,646 nonvested options. The total unrecognized cost is expected to be recognized over a weighted-average period of 1.1 years.

Pursuant to SFAS 123R, compensation expense recognized in the statement of operations for stock options for the year ended December 31, 2007 was \$904 and a related tax benefit of \$67. In addition, in accordance with the provisions of SFAS 123R, the Company recognized compensation expense of \$148 relating to shares offered under the Employee Stock Purchase Plan for the year ended December 31, 2007. The following table illustrates the effect on net income and earnings per share for the years ended December 31, 2005 and 2004, if the Company had applied the fair value recognition provisions of SFAS 123R to options granted under the Stock Plans. For purposes of this pro forma disclosure, the value of options is estimated using the Black-Scholes option pricing model with share-based awards amortized over the vesting periods pursuant to SFAS 123.

	2005
Net (loss), as reported	\$(170,910)
Add: Stock-based employee compensation expense included in reported net income, net of tax effects	39
Deduct: Stock-based employee compensation, net of tax effects	2,329
Pro Forma net (loss) income	\$ (173,200)
Basic (loss) earnings per share—as reported	\$ (1.01)
Basic (loss) earnings per share—pro forma	\$ (1.02)
Diluted (loss) earnings per share—as reported	\$ (1.01)
Diluted (loss) earnings per share—pro forma	\$ (1.02)

*FBR Capital Markets Corporation 2007 Long-Term Incentive Plan (FBR Capital Markets Long-Term Incentive Plan)*

FBR Capital Markets, and the Company (through its wholly owned taxable REIT subsidiary, TRS Holdings), adopted and approved the FBR Capital Markets Long-Term Incentive Plan in July 2006. In the fourth quarter of 2007, FBR Capital Markets adopted, and the shareholders approved, an amendment to the FBR Capital Markets Long-term Incentive plan to increase it by 16,500,000 shares of common stock authorized to issuance under that plan. Under the FBR Capital Markets Long-Term Incentive Plan, as amended, FBR Capital Markets may grant options to purchase stock, stock appreciation rights, performance awards and restricted and unrestricted stock for up to an aggregate of 22,069,985 shares of common stock, subject to increase under certain provisions of the plan, to eligible Participants. Participants include employees, officers and directors of the Company and its subsidiaries. The FBR Capital Markets Long-Term Incentive Plan has a term of 10 years and options granted may have an exercise period of up to 10 years. Options may be incentive stock options, as defined by Section 422 of the Internal Revenue Code, or nonqualified stock options.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for options granted for the years ended December 31, 2007: dividend yield of zero, expected volatility of 30%, risk-free interest rate of 4.7%, and an expected life of 4.3 years for all grants. The weighted average fair value of options granted by FBR Capital

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Markets under this plan during the year ended December 31, 2007 was \$4.90. The following weighted average assumptions used for options granted by FBR Capital Markets under this plan for the years ended December 31, 2006: dividend yield of zero, expected volatility of 30%, risk-free interest rate of 4.8%, and an expected life of 4.5 years for all grants. The weighted average fair value of options granted by FBR Capital Markets under this plan during the year ended December 31, 2006 was \$5.00.

Compensation expense recognized by the Company for stock options granted by FBR Capital Markets under this plan for the years ended December 31, 2007 and 2006 was \$6,061 and \$1,701, respectively, and a related tax benefit of \$2,402 and \$672, respectively, related to FBR Capital Markets Long-Term Incentive Plan.

A summary of option activity under the FBR Capital Markets Long Term Incentive Plan as of December 31, 2007, and changes during the year then ended is presented below:

	Number of Shares	Weighted- average Exercise Prices	Weighted- average Contractual Life
Share Balance as of December 31, 2005	—	\$ —	
Granted in 2006	3,385,000	15.00	
Cancelled in 2006	(9,000)	15.00	
Share Balance as of December 31, 2006	3,376,000	\$ 15.00	5.6
Granted in 2007	1,501,586	15.12	
Cancelled in 2007	(444,832)	15.10	
Vested in 2007	(13,500)	15.00	
Share Balance as of December 31, 2007	4,419,254	\$ 15.03	5.0

As of December 31, 2007, no options granted under the FBR Capital Markets Long Term Incentive Plan were exercisable.

As of December 31, 2007 and 2006, there was \$13,186 and \$14,809, respectively, of total unrecognized compensation cost related to 4,419,254 and 3,376,000, respectively, non-vested options granted by FBR Capital Markets under the FBR Capital Markets Long Term Incentive Plan as described above. The total unrecognized cost is expected to be recognized over a weighted-average period of 1.6 and 2.6 years, respectively.

*FBR Group Restricted Stock*

The Company grants restricted common shares to employees that vest ratably over a three to four year period or cliff-vest after two to three years for various purposes based on continued employment over these specified periods. As of December 31, 2007 and December 31, 2006, a total of 1,207,421 and 1,819,431, respectively, shares of such FBR Group restricted Class A common stock was outstanding with unamortized deferred compensation of \$3,377 and \$9,878, respectively. As a result of adopting SFAS 123R, deferred compensation costs have been reclassified within the equity section of the balance sheet. This change in presentation had no net effect on the Company's total equity. A summary of these unvested restricted stock awards is presented below:

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	Number of Shares	Weighted- average Grant- date Fair Value	Weighted- average Remaining Vested Period
Share Balance as of December 31, 2004	1,253,756	\$ 19.90	2.0
Granted	1,349,263	17.05	
Shares transferred to Trust	(452,856)	26.62	
Forfeitures	(84,157)	18.30	
Vestitures	(27,666)	13.64	
Share Balance as of December 31, 2005	2,038,340	\$ 16.40	1.8
Granted	781,597	9.50	
Forfeitures	(169,278)	15.34	
Vestitures	(831,228)	14.05	
Share Balance as of December 31, 2006	1,819,431	\$ 14.69	1.6
Granted	114,929	5.81	
Forfeitures	(54,388)	12.59	
Vestitures	(672,551)	17.84	
Share Balance as of December 31, 2007	1,207,421	\$ 12.34	1.0

For the years ended December 31, 2007, 2006 and 2005, the Company recognized \$6,468, \$10,490 and \$13,864, respectively, of compensation expense related to this FBR Group restricted stock.

In addition, as part of the Company's satisfaction of incentive compensation earned for past service under the Company's variable compensation programs, employees may receive restricted Class A common stock in lieu of cash payments. These restricted Class A common stock shares are issued to an irrevocable trust and are not returnable to the Company. The Company issued 164,508 and 755,852 shares of FBR Group restricted common stock valued at \$787 and \$7,649 respectively, to the trust for the year ended December 31, 2007 and 2006, respectively, in settlement of such accrued incentive compensation. A summary of the undistributed restricted stock issued to the trust is presented below:

	Number of Shares	Weighted- average Grant- date Fair Value	Weighted-average Remaining Vesting Period
Share Balance as of December 31, 2004	—	\$ —	—
Shares transferred to Trust	452,856	26.62	
Shares issued to Trust	765,242	16.34	
Shares distributed from Trust	(19,784)	22.37	
Share Balance as of December 31, 2005	1,198,314	\$ 20.12	1.9
Shares issued to Trust	755,852	10.12	
Shares distributed from Trust	(352,581)	16.43	
Share Balance as of December 31, 2006	1,601,585	\$ 16.20	1.5
Shares issued to Trust	164,508	4.78	
Shares distributed from Trust	(849,896)	18.96	
Share Balance as of December 31, 2007	916,197	\$ 11.44	1.2

*FBR Capital Markets Restricted Stock*

FBR Capital Markets also grants restricted common stock to employees that vest ratably over a three to five year period or cliff-vest after three years for various purposes based on continued employment over these specified periods. For the year ended December 31, 2007, FBR Capital Markets granted 2,088,546 of FBR

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Capital Markets restricted common stock at a weighted average share price of \$16.26. For the year ended December 31 2007, FBR Capital Markets recognized \$5,049 of compensation expense related to this restricted common stock. FBR Capital Markets did not grant any restricted common stock prior to January 1, 2007.

A summary of these unvested restricted stock awards is presented below:

	Number of Shares	Weighted- average Grant- date Fair Value	Weighted- average Remaining Vested Period
Share Balance as of December 31, 2006	—	\$ —	—
Granted	2,088,546	16.26	
Forfeitures	(144,683)	15.90	
Share Balance as of December 31, 2007	<u>1,943,863</u>	<u>\$ 16.29</u>	<u>3.9</u>

As of December 31, 2007, a total of 1,943,863 shares of such restricted common stock were outstanding with total unrecognized compensation cost related to unvested shares of \$26,482.

In addition, as part of FBR Capital Markets satisfaction of incentive compensation earned for past service under its variable compensation programs, employees may receive restricted common stock in lieu of cash payments. These shares of restricted common stock are issued to an irrevocable trust and are not returnable to FBR Capital Markets. During the year ended December 31, 2007, FBR Capital Markets issued 729,107 shares of restricted common stock valued at \$9,737 to the trust in settlement of such accrued incentive compensation. FBR Capital Markets did not grant any restricted common stock to the trust prior to January 1, 2007.

A summary of these irrevocable trust awards is presented below:

	Number of Shares	Weighted- average Grant- date Fair Value	Weighted- average Remaining Vested Period
Share Balance as of December 31, 2006	—	\$ —	—
Granted	729,107	13.35	
Vestitures	(1,143)	15.15	
Share Balance as of December 31, 2007	<u>727,964</u>	<u>\$ 13.35</u>	<u>2.6</u>

***Employee Stock Purchase Plans***

***FBR Group Employee Stock Purchase Plan***

The Company initiated the 1997 Employee Stock Purchase Plan (Purchase Plan) on September 1, 1998. Under the Purchase Plan, eligible employees may purchase Class A common stock through payroll deductions at a price that is 85% of the lower of the market value of the common stock on the first day of the offering period or the last day of the offering period. As discussed above, in accordance with the provisions of SFAS 123R, effective January 1, 2006 the Company is required to recognize compensation expense relating to shares offered under the Purchase Plan. For the year ended December 31, 2007 and December 31, 2006, the Company recognized such compensation expense of \$148 and \$1,319, respectively.

***FBR Capital Markets Corporation Employee Stock Purchase Plan***

FBR Capital Markets initiated the Employee Stock Purchase Plan (FBR Capital Markets Purchase Plan) on January 1, 2007. Under the 2007 FBR Capital Markets Purchase Plan, eligible employees may purchase common

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stock through payroll deductions at a price that is 85% of the lower of the market value of the common stock on the first day of the offering period or the last day of the offering period. In accordance with the provisions of SFAS 123R, the Company is required to recognize compensation expense relating to shares offered under the FBR Capital Markets Purchase Plan. For the year ended December 31, 2007, FBR Capital Markets recognized compensation expense of \$508.

***Director Stock Compensation Plan***

Under the Non-Employee Director Stock Compensation Plan and the FBR Long-Term Incentive Plan, the Company may grant options, stock or restricted stock units (RSUs) in lieu of or in addition to annual director fees to non-employee directors. Prior to the merger, the Company had awarded stock options to directors, all of which vested upon the merger. Following the merger, the Board determined to make awards of RSUs instead of options, and approved annual awards of RSUs equal in value to \$50 to each director to be made in conjunction with the annual shareholders meeting and, in the fourth quarter of 2004, increased such annual award value to \$80. In addition, each of the Chairmen of the Board's Committees receives one half of his quarterly fees for service as Chairmen in RSUs. These RSUs vest the day before the next annual meeting of shareholders, and are convertible to Class A Common Stock one year following completion of the director's service on the Board. All options, stock and RSUs awarded to non-employee directors are non-transferable other than by will or the laws of descent and distribution. During 2007, 2006, and 2005, the Company granted 92,820 RSUs, 66,146 RSUs and 43,695 RSUs, respectively. For the year ended December 31, 2007, 2006, and 2005, the Company recognized \$634, \$646, and \$483, respectively, of director fees related to these RSUs.

***Share Repurchases***

***FBR Group Share Repurchases***

In April 2003, the Company's Board of Directors authorized a share repurchase program in which the Company may repurchase up to 14 million shares of the Company's Class A common stock from time to time. In July 2007, the Company's Board of Directors authorized an increase in the number of shares the Company is authorized to repurchase in accordance with this repurchase program from 14 million to 50 million shares of the Company's Class A common stock. In December 2007, the Company's Board of Directors authorized a further increase in the number of shares of the Company's Class A common stock that the Company is authorized to repurchase in accordance with this repurchase program from 50 million shares to an aggregate of 100 million shares. In accordance with this repurchase program, a portion of the stock acquired may be used for the FBR Group stock-based compensation plans described previously. During the year ended December 31, 2007, the Company, in accordance with the Company's share repurchase program, repurchased 23,643,428 at a cost of \$109,777. There were no shares repurchased during the year ended December 31, 2006 and 2005.

***FBR Capital Markets Share Repurchases***

In July 2007, in order to offset dilution resulting from employee restricted stock and employee stock options granted under the FBR Capital Markets Long-Term Incentive Plan, the FBR Capital Market's Board of Directors authorized a share repurchase program under which the FBR Capital Markets could repurchase up to 1 million shares of the FBR Capital Market's outstanding shares of common stock. During the third quarter of 2007, the FBR Capital Markets, in accordance with the FBR Capital Market's share repurchase program, repurchased 1 million shares at a total cost of \$13,017. In October 2007, our Board of Directors authorized the repurchase of up to an additional 5 million shares of common stock. There were no additional shares repurchased during 2007. There were no shares repurchased during the year ended December 31, 2006.

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**Note 14. Financial Instruments with Off-Balance-Sheet Risk and Credit Risk:**

***Financial Instruments***

The Company's asset management entities trade and invest in public and non-public securities. As of December 31, 2007 and 2006, as discussed above, the Company had not entered into any transactions involving financial instruments that would expose the Company to significant related off-balance-sheet risk.

In addition, in certain circumstances, the Company sells securities it does not currently own (securities sold, not yet purchased—see Note 4). When the Company sells a security short and borrows the security to make a delivery, a gain, limited to the price at which the Company sold the security short, or a loss, unlimited in size, will be realized upon the termination of the short sale.

***Market Risk***

Market risk is primarily caused by movements in market prices of the Company's trading and investment account securities and changes in value of the underlying securities of the investment partnerships in which the Company invests. The Company's trading securities and investments are also subject to interest rate volatility and possible illiquidity in markets in which the Company trades or invests. The Company seeks to manage market risk through monitoring procedures. The Company's principal transactions are primarily long and short equity and debt transactions.

Positions taken and commitments made by the Company, including those made in connection with venture capital and investment banking activities, have resulted in substantial amounts of exposure to individual issuers and businesses, including non-investment grade issuers, securities with low trading volumes and those not readily marketable. These issuers and securities expose the Company to a higher degree of risk than associated with investment grade instruments.

***Credit Risk***

The Company's broker-dealer subsidiaries function as introducing brokers that place and execute customer orders. The orders are then settled by an unrelated clearing organization that maintains custody of customers' securities and provides financing to customers.

Through indemnification provisions in agreements with clearing organizations, customer activities may expose the Company to off-balance-sheet credit risk. Financial instruments may have to be purchased or sold at prevailing market prices in the event a customer fails to settle a trade on its original terms or in the event cash and securities in customer margin accounts are not sufficient to fully cover customer obligations. The Company seeks to manage the risks associated with customer activities through customer screening and selection procedures as well as through requirements on customers to maintain margin collateral in compliance with various regulations and clearing organization policies.

The Company's equity and debt investments include non-investment grade securities of privately held issuers with no ready markets. The concentration and illiquidity of these investments expose the Company to a higher degree of risk than associated with readily marketable securities.

***General Partnership and Managing Member Interests***

As general partner of investment partnerships (or managing member of limited liability companies), certain of the Company's subsidiaries may be exposed to liabilities that exceed the balance sheet value of the

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Company's investment in the relevant vehicles. To limit the Company's exposure to such excess liabilities the Company has formed limited liability companies, which are wholly owned by the relevant subsidiary, to hold the respective general partner or managing member interest. The hedge funds and other partnerships that the Company manages through subsidiaries as a general partner or managing member had \$2,605 and \$2,729 of liabilities as of December 31, 2007 and 2006, respectively, primarily margin debt, not reflected on our balance sheet.

**Note 15. Fair Value of Financial Instruments:**

The estimated fair value amounts of the Company's financial instruments have been determined using available market information and valuation methods that the Company believes are appropriate under the circumstances. These estimates are inherently subjective in nature and involve matters of significant uncertainty and judgment to interpret relevant market and other data. The use of different market assumptions and/or estimation methods may have a material effect on the estimated fair value amounts. The fair values reported reflect estimates and may not necessarily be indicative of the amounts the Company could realize in a current market transaction. The following describes the methods and assumptions used in estimating fair values:

*Securities and Principal Investments in Debt and Equity securities, including Trading Account Securities Sold But Not Yet Purchased*—Substantially all financial instruments used in the Company's trading and investing activities are carried at fair value or amounts that approximate fair value. Fair value is based generally on listed market prices or broker-dealer price quotations. The fair value of the Company's mortgage-backed securities are based on market prices provided by certain independent dealers who make markets in these financial instruments. To the extent that prices are not readily available, fair value is based on internal valuation models and estimates made by management. For example, investments in private securities and restricted securities have by their nature limited or no price transparency. Such investments are initially carried at cost as an approximation of fair value. Adjustments to carrying value may be made if there are third-party transactions evidencing a change in value. Downward adjustments also may be made, in the absence of third-party transactions, if the Company determines based on valuation models and estimates that the expected realizable value of the investment is less than the carrying value. In reaching that determination, the Company may consider factors such as, but not limited to, the financial performance of the companies relative to projections, trends within sectors, underlying business models and expected exit timing and strategy.

*Mortgage Loans Held for Sale*—For the mortgage loans held for sale, the Company determines fair value based on third party pricing quotes when available, current investor commitments and/or requirements for loans of similar terms and credit quality or is estimated based on the same pricing models used by the Company to bid on whole loans in the open market. Such models incorporate aggregated characteristics of groups of loans including, collateral type, index, interest rate, margin, length of fixed interest rate period, life cap, periodic cap, underwriting standards, age and credit.

*Derivatives*—The carrying amounts represent fair value determined based on quoted market prices.

*Temporary Subordinated Loan Payable*—The carrying amount is a reasonable estimate of fair value because of the short-term nature of the borrowing.

*Securitization Financing*—Fair value is based on market values provided by certain independent dealers who make markets in these financial instruments.

*Long-term Debt*—The interest rates on these borrowings adjust quarterly to market rates, as such the carrying amount is a reasonable estimate of fair value.

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*Other*—Cash and cash equivalents, restricted cash, interest receivable, reverse repurchase agreements, repurchase agreements, commercial paper, accounts payable, accrued expenses and other liabilities are reflected in the consolidated balance sheets at their amortized cost, which approximates fair value because of the short term nature of these instruments.

The estimated fair values of the Company's financial instruments are as follows:

	December 31, 2007		December 31, 2006	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
<b>Financial assets</b>				
Cash and cash equivalents	\$ 692,360	\$ 692,360	\$ 189,956	\$ 189,956
Restricted cash	14,166	14,166	132	132
Non-interest bearing receivables	68,297	68,297	148,268	148,268
Mortgage-backed securities	1,791,480	1,791,480	6,870,661	6,870,661
Mortgage loans held for sale, net	65,074	65,074	5,367,934	5,367,934
Long-term investments	169,274	169,274	185,458	185,458
Trading securities	19,057	19,057	18,180	18,180
Derivative assets	3,514	3,514	36,875	36,875
<b>Financial liabilities</b>				
Trading account securities sold short but not yet purchased	\$ 206	\$ 206	\$ 202	\$ 202
Commercial paper	—	—	3,971,389	3,971,389
Repurchase agreements	1,744,377	1,744,377	3,059,330	3,059,330
Derivative liabilities	3,558	3,558	44,582	44,582
Securitization financing, net	—	—	4,486,046	4,486,046
Long-term debt	323,575	323,575	324,453	324,453

**Note 16. Supplemental Cash Flow Information—Non-cash Transactions:**

The Company may receive shares and warrants in connection with certain capital raising activities. In 2007, 2006 and 2005, securities received in exchange for services provided were \$-0- \$-0- and \$1,524, respectively.

In connection with its acquisition of First NLC (see Note 12), the Company issued 1,297,746 shares of its Class A common stock valued at \$24,420.

The Company retained a residual interest and servicing rights valued at \$14,577 and \$6,177, respectively, related to the issuance of First NLC Trust 2005-4 Mortgage-Backed Certificates, Series 2005-4, in a non-cash transaction during the year ended December 31, 2005.

**Note 17. Segment Information:**

The Company considers its capital markets, asset management, principal investing, and mortgage banking operations to be four separately reportable segments.

The capital markets segment includes the Company's investment banking and institutional brokerage areas. These businesses operate as a single integrated unit to deliver capital raising, advisory and sales and trading services to corporate and institutional clients. Asset management includes the Company's fee based asset

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management operations. The Company's principal investing segment includes mortgage related investment activities, and substantially all of the Company's equity security investing activities. The Company's mortgage banking segment which was initiated subsequent to the acquisition of First NLC includes the origination and sale of non-conforming residential mortgage loans.

The accounting policies of these segments are the same as those described in Note 2. The Company has developed systems and methodologies to allocate overhead costs to its business units and, accordingly, presents segment information consistent with internal management reporting. Revenue generating transactions between the individual segments have been included in the net revenue and pre-tax income of each segment. These transactions include investment banking activities provided by the capital markets segment to other segments and the sale of mortgage loans between the mortgage banking and principal investing segments. The Company's net revenues from foreign operations totaled \$27,046, \$22,197, and \$20,174 for the years ended December 31, 2007, 2006 and 2005, respectively. The following tables illustrate the financial information for the Company's segments for the years indicated.

	Capital Markets	Asset Management	Principal Investing	Mortgage Banking	Intersegment Eliminations(1)	Consolidated Totals
<b>2007</b>						
Net revenues	\$ 446,882	\$ 31,052	\$ (155,501)	\$ (209,953)	\$ (6,973)	\$ 105,507
Compensation and benefits	271,749	14,915	20,816	53,875	—	361,355
Total expenses	418,166	38,068	174,910	216,421	(1,449)	846,116
Operating income (loss)	28,716	(7,016)	(330,411)	(426,374)	(5,524)	(740,609)
Total assets	494,678	39,467	2,309,597	101,213	—	2,944,955
Total net assets	205,270	17,711	243,091	(72,381)	—	393,691
<b>2006</b>						
Net revenues	\$ 330,865	\$ 27,313	\$ (90,488)	\$ 112,674	\$ —	\$ 380,364
Compensation and benefits	215,607	14,393	5,052	74,013	—	309,065
Total expenses	365,241	38,393	52,106	130,843	—	586,583
Operating loss	(34,376)	(11,080)	(142,594)	(18,169)	—	(206,219)
Total assets	288,115	46,395	11,946,976	1,071,032	—	13,352,518
Total net assets	142,430	30,603	913,039	84,973	—	1,171,045
<b>2005</b>						
Net revenues	\$ 504,602	\$ 36,335	\$ (149,558)	\$ 52,658	\$ (9,335)	\$ 434,702
Compensation and benefits	249,504	18,403	16,521	47,064	—	331,492
Total expenses	424,926	37,727	30,350	85,926	—	578,929
Operating income (loss)	79,676	(1,392)	(179,908)	(33,268)	(9,335)	(144,227)
Total assets	1,498,409	52,119	15,636,598	1,248,664	—	18,435,790
Total net assets	227,657	37,431	904,938	134,144	—	1,304,170

(1) Intersegment Eliminations represent the elimination of intersegment transactions noted above.

**FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**(Dollars in thousands, except per share amounts)**

**Note 18. Quarterly Data (Unaudited):**

The following tables set forth selected information for each of the fiscal quarters during the years ended December 31, 2007 and 2006. The selected quarterly data is derived from unaudited financial statements of the Company and has been prepared on the same basis as the annual, audited financial statements to include, in the opinion of management, all adjustments (consisting of only normal recurring adjustments) necessary for fair statement of the results for such periods.

Note: The sum of quarterly earnings per share amounts may not equal full year earnings per share amounts due to differing average outstanding shares amounts for the respective periods.

	Total Revenues	Net (Loss) Income Before Income Taxes and Minority Interest	Net (Loss) Income	Basic (Loss) Earnings Per Share	Diluted (Loss) Earnings Per Share
<b>2007</b>					
First Quarter	\$ 181,898	\$ (214,349)	\$ (185,878)	\$ (1.08)	\$ (1.08)
Second Quarter	319,658	75,253	10,704	0.06	0.06
Third Quarter	62,315	(199,264)	(214,717)	(1.28)	(1.28)
Fourth Quarter	19,073	(298,187)	(270,362)	(1.77)	(1.77)
Total Year	<u>\$ 582,944</u>	<u>\$ (636,547)</u>	<u>\$ (660,253)</u>	<u>\$ (3.95)</u>	<u>\$ (3.95)</u>
<b>2006</b>					
First Quarter	\$ 338,699	\$ 24,835	\$ 26,554	\$ 0.16	\$ 0.16
Second Quarter	246,111	(29,007)	(30,247)	(0.18)	(0.18)
Third Quarter	82,442	(98,162)	(67,392)	(0.39)	(0.39)
Fourth Quarter	340,652	17,626	3,810	0.02	0.02
Total Year	<u>\$1,007,904</u>	<u>\$ (84,708)</u>	<u>\$ (67,275)</u>	<u>\$ (0.39)</u>	<u>\$ (0.39)</u>

**Note 19. Subsequent Events:**

On January 18, 2008, First NLC, the Company's non-conforming residential mortgage loan origination subsidiary, filed a voluntary petition for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code in order to effectuate an orderly liquidation of First NLC's assets. The filing was made in the United States Bankruptcy Court for the Southern District of Florida, West Palm Beach Division.

In connection with the voluntary petition for bankruptcy protection under Chapter 11 of the U.S. Bankruptcy Code filed by First NLC, beginning in the first quarter of 2008, the Company will deconsolidate First NLC for financial reporting purposes and use the cost method to account for its investment.

As a result of the First NLC bankruptcy proceedings pending in the United States Bankruptcy Court for the Southern District of Florida, West Palm Beach Division, the recapitalization of First NLC discussed above in Note 11, "Commitments and Contingencies: First NLC Recapitalization," will not close. Pursuant to the terms of a loan agreement entered into in connection with the recapitalization agreement, any recovery from First NLC or its assets in respect of the convertible debt investments in First NLC made by Sun Capital or the Company in the third quarter of 2007 will be shared 80% by Sun Capital and 20% by the Company, notwithstanding whether Sun Capital's or the Company's convertible debt investment has been converted into equity of First NLC.

## AMENDMENT NO. 1 TO CORPORATE AGREEMENT

THIS AMENDMENT NO. 1 TO CORPORATE AGREEMENT (this “Amendment”) is entered into as of April 5, 2007, by and between FBR CAPITAL MARKETS CORPORATION, a Virginia corporation (“FBR Capital Markets”), and FRIEDMAN, BILLINGS, RAMSEY GROUP, INC., a Virginia corporation (“FBR Group”).

WHEREAS, FBR Capital Markets and FBR Group are parties to that certain Corporate Agreement, dated as of July 20, 2006, as the same is amended hereby and may be further amended, modified or supplemented from time to time (the “Corporate Agreement”);

WHEREAS, pursuant to Section 7.3 of the Corporate Agreement, the parties desire to amend the Corporate Agreement as provided in this Amendment; and

WHEREAS, capitalized terms not otherwise defined herein shall have the meaning set forth in the Corporate Agreement.

NOW THEREFORE, in consideration of the foregoing and the mutual covenants and agreements herein contained, and intending to be legally bound hereby, FBR Capital Markets and FBR Group hereby agree as follows:

1. Defined Terms. Capitalized terms used but not defined in this Amendment are as defined in the Corporate Agreement.
2. Amendments to the Corporate Agreement.

(a) Section 1.1 of the Corporate Agreement shall be amended by inserting after the defined term “Finally Determined” a new defined term, which reads as follows:

““Fully-Diluted Ownership Percentage” means, at any time, the fraction, expressed as a percentage and rounded to the next highest thousandth of a percent, whose numerator is the number of shares of the Applicable Stock and whose denominator is the number of outstanding shares of Common Stock of FBR Capital Markets on a fully-diluted basis; *provided, however*, that any shares of Common Stock issued by FBR Capital Markets in violation of its obligations under Article V of this Agreement shall not be deemed outstanding for the purpose of determining the Ownership Percentage.”

(b) Section 5.1(b) of the Corporate Agreement is hereby amended and restated in its entirety to read as follows:

“The provisions of Section 5.1(a) hereof notwithstanding, the Option granted pursuant to Section 5.1(a) shall not apply and shall not be exercisable in connection with the issuance by FBR Capital Markets of any shares of Common Stock pursuant to any stock option or other director, executive or employee benefit or compensation plan maintained by FBR Capital Markets unless such issuance would cause the Fully-Diluted Ownership Percentage to decrease to 50% or less.”

(c) Section 7.8 of the Corporate Agreement is hereby amended and restated in its entirety to read as follows:

**"Governing Law. ALL QUESTIONS CONCERNING THE CONSTRUCTION, VALIDITY AND INTERPRETATION OF THIS AGREEMENT SHALL BE GOVERNED BY AND CONSTRUED IN ACCORDANCE WITH THE DOMESTIC LAWS OF THE COMMONWEALTH OF VIRGINIA, WITHOUT GIVING EFFECT TO ANY CHOICE OF LAW OR CONFLICT OF LAW PROVISION OR RULE (WHETHER OF THE COMMONWEALTH OF VIRGINIA OR ANY OTHER JURISDICTION) THAT WOULD CAUSE THE APPLICATION OF THE LAWS OF ANY JURISDICTION OTHER THAN THE COMMONWEALTH OF VIRGINIA.**

3. Representations and Warranties.

(a) FBR Capital Markets represents and warrants to FBR Group that: (i) FBR Capital Markets has taken all action necessary to permit it to execute and deliver this Amendment and to carry out the terms hereof; (ii) this Amendment, when duly executed and delivered by FBR Capital Markets, will constitute a valid and binding obligation of FBR Capital Markets, enforceable against FBR Capital Markets in accordance with its terms; and (iii) FBR Capital Markets is not required to obtain any order, consent, approval or authorization of, or to make any declaration or filing with, any third party or governmental authority in connection with the execution and delivery of this Amendment or the consummation of the transactions contemplated hereby, except for such order, consent, approval, authorization, declaration or filing as which has been obtained or made.

(b) FBR Group represents and warrants to FBR Capital Markets that: (i) FBR Group has taken all action necessary to permit it to execute and deliver this Amendment and to carry out the terms hereof; (ii) this Amendment, when duly executed and delivered by FBR Group, will constitute a valid and binding obligation of FBR Group, enforceable against FBR Group in accordance with its terms; and (iii) FBR Group is not required to obtain any order, consent, approval or authorization of, or to make any declaration or filing with, any third party or governmental authority in connection with the execution and delivery of this Amendment or the consummation of the transactions contemplated hereby, except for such order, consent, approval, authorization, declaration or filing as which has been obtained or made.

4. No Other Change. Except as otherwise provided herein, all of the terms, covenants and other provisions of the Corporate Agreement shall continue to be in full force and effect in accordance with their respective terms. After the date hereof, all references to the Corporate Agreement shall refer to the Corporate Agreement, as amended by this Amendment.

5. No Waiver or Consent. Except as specifically set forth herein, the execution and delivery hereof by the parties hereto shall not constitute a consent or waiver of any provisions of the Corporate Agreement. No waiver by any party of any breach or violation or, default under or inaccuracy in any representation, warranty or covenant hereunder or under the Corporate Agreement, whether intentional or not, will be deemed to extend to any prior or subsequent breach, violation, default of, or inaccuracy in, any such representation, warranty or covenant

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hereunder or thereunder or affect in any way any rights arising by virtue of any prior or subsequent such occurrence. No delay or omission on the part of any party in exercising any right, power or remedy under this Amendment or the Corporate Agreement will operate as a waiver hereof or thereof.

6. Counterparts. For the convenience of the parties, any number of counterparts of this Amendment may be executed by any two or more parties hereto, and each such executed counterpart shall be, and shall be deemed to be, an original, but all of which shall constitute, and shall be deemed to constitute, in the aggregate but one and the same instrument.

7. Governing Law. **ALL QUESTIONS CONCERNING THE CONSTRUCTION, VALIDITY AND INTERPRETATION OF THIS AMENDMENT SHALL BE GOVERNED BY AND CONSTRUED IN ACCORDANCE WITH THE DOMESTIC LAWS OF THE COMMONWEALTH OF VIRGINIA, WITHOUT GIVING EFFECT TO ANY CHOICE OF LAW OR CONFLICT OF LAW PROVISION OR RULE (WHETHER OF THE COMMONWEALTH OF VIRGINIA OR ANY OTHER JURISDICTION) THAT WOULD CAUSE THE APPLICATION OF THE LAWS OF ANY JURISDICTION OTHER THAN THE COMMONWEALTH OF VIRGINIA.**

*[Signature Page Follows]*

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**IN WITNESS WHEREOF**, the parties hereto have executed this Amendment No. 1 to Corporate Agreement as of the day and year first above written.

**FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**

By: /s/ J. Rock Tonkel, Jr.

Name: J. Rock Tonkel, Jr.

Title: President and Chief Operating Officer

**FBR CAPITAL MARKETS CORPORATION**

By: /s/ Richard J. Hendrix

Name: Richard J. Hendrix

Title: President and Chief Operating Officer

*[Signature Page to Amendment No. 1 to Corporate Agreement]*

**AMENDMENT NO. 1 TO  
MANAGEMENT SERVICES AGREEMENT**

THIS AMENDMENT NO. 1 TO MANAGEMENT SERVICES AGREEMENT (this “Amendment”) is made as of April 5, 2007, by and between FRIEDMAN, BILLINGS, RAMSEY GROUP, INC., a Virginia Corporation (“FBR Group”), and FBR CAPITAL MARKETS CORPORATION, a Virginia corporation (“FBR Capital Markets”).

WHEREAS, FBR Group and FBR Capital Markets are parties to that certain Management Services Agreement, dated as of July 20, 2006, as the same is amended hereby and may be further amended, modified or supplemented from time to time (the “Management Services Agreement”);

WHEREAS, pursuant to Section 2(a) of the Management Services Agreement, the parties desire to amend the Management Services Agreement as provided in this Amendment; and

WHEREAS, capitalized terms not otherwise defined herein shall have the meaning set forth in the Management Services Agreement.

NOW THEREFORE, in consideration of the foregoing and the mutual covenants and agreements herein contained, and intending to be legally bound hereby, FBR Group and FBR Capital Markets hereby agree as follows:

1. Amendment to the Management Services Agreement.

(a) Section 3 of the Management Services Agreement is hereby amended and restated in its entirety to read as follows:

“Payment of Allocable Share of Executive Bonus Pool and Adjusted Flat Fee. In consideration for the provision of the Executive Management Team pursuant to the terms of this Agreement, FBR Capital Markets shall pay FBR Group its share of the amount that will be allocated to the Executive Bonus Pool established under The FBR Group Key Employee Incentive Plan (or any successor plan), which shall be an annual amount equal to 8.0% of the pre-tax net income of FBR Capital Markets (the “Allocable Share”), before deducting the Allocable Share. In addition, FBR Capital Markets shall pay FBR Group an annual cash fee in an amount equal to the Adjusted Flat Fee (as defined below). The Allocable Share and the Adjusted Base Fee shall be paid in equal quarterly installments within 45 days after the end of each calendar quarter of each year during the term of this Agreement. The term “Adjusted Flat Fee” means the amount equal to the sum of (i) \$1,500,000 and (ii) the Gross-Up Amount. The term “Gross-Up Amount” means the amount that FBR Group, in its discretion after consultation with the Company, determines is necessary to pay a portion of the cost of employee benefits for the Executive Management Team, including, without limitation, group health insurance and life insurance benefit programs that are provided on the same terms as other employees of FBR Group, plus federal, state and local employment and payroll taxes payable by FBR Group on account of the Executive Management Team’s employment by FBR Group.”

(b) Schedule 1 to the Management Services Agreement is hereby amended and restated in its entirety to read as follows:

### **SCHEDULE 1**

#### *Executive Management Team*

<u>Name</u>	<u>Title at FBR Capital Markets Corporation</u>
Eric F. Billings	Chairman of the Board and Chief Executive Officer
Richard J. Hendrix	President and Chief Operating Officer
J. Rock Tonkel, Jr.	Member of the Office of Chief Executive
Kurt R. Harrington	Executive Vice President, Chief Financial Officer and Treasurer
William J. Ginivan	Executive Vice President and General Counsel

#### **2. Representations and Warranties.**

(a) FBR Capital Markets represents and warrants to FBR Group that: (i) FBR Capital Markets has taken all action necessary to permit it to execute and deliver this Amendment and to carry out the terms hereof; (ii) this Amendment, when duly executed and delivered by FBR Capital Markets, will constitute a valid and binding obligation of FBR Capital Markets, enforceable against FBR Capital Markets in accordance with its terms; and (iii) FBR Capital Markets is not required to obtain any order, consent, approval or authorization of, or to make any declaration or filing with, any third party or governmental authority in connection with the execution and delivery of this Amendment or the consummation of the transactions contemplated hereby, except for such order, consent, approval, authorization, declaration or filing as which has been obtained or made.

(b) FBR Group represents and warrants to FBR Capital Markets that: (i) FBR Group has taken all action necessary to permit it to execute and deliver this Amendment and to carry out the terms hereof; (ii) this Amendment, when duly executed and delivered by FBR Group, will constitute a valid and binding obligation of FBR Group, enforceable against FBR Group in accordance with its terms; and (iii) FBR Group is not required to obtain any order, consent, approval or authorization of, or to make any declaration or filing with, any third party or governmental authority in connection with the execution and delivery of this Amendment or the consummation of the transactions contemplated hereby, except for such order, consent, approval, authorization, declaration or filing as which has been obtained or made.

3. No Other Change. Except as otherwise provided herein, all of the terms, covenants and other provisions of the Management Services Agreement shall continue to be in full force and effect in accordance with their respective terms. After the date hereof, all references to the Management Services Agreement shall refer to the Management Services Agreement (including the schedules thereto), as amended by this Amendment.

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4. No Waiver or Consent. Except as specifically set forth herein, the execution and delivery hereof by the parties hereto shall not constitute a consent or waiver of any provisions of the Management Services Agreement. No waiver by any party of any breach or violation or, default under or inaccuracy in any representation, warranty or covenant hereunder or under the Management Services Agreement, whether intentional or not, will be deemed to extend to any prior or subsequent breach, violation, default of, or inaccuracy in, any such representation, warranty or covenant hereunder or thereunder or affect in any way any rights arising by virtue of any prior or subsequent such occurrence. No delay or omission on the part of any party in exercising any right, power or remedy under this Amendment or the Management Services Agreement will operate as a waiver hereof or thereof.

5. Counterparts. For the convenience of the parties, any number of counterparts of this Amendment may be executed by any two or more parties hereto, and each such executed counterpart shall be, and shall be deemed to be, an original, but all of which shall constitute, and shall be deemed to constitute, in the aggregate but one and the same instrument.

6. Governing Law. **ALL QUESTIONS CONCERNING THE CONSTRUCTION, VALIDITY AND INTERPRETATION OF THIS AMENDMENT SHALL BE GOVERNED BY AND CONSTRUED IN ACCORDANCE WITH THE DOMESTIC LAWS OF THE COMMONWEALTH OF VIRGINIA, WITHOUT GIVING EFFECT TO ANY CHOICE OF LAW OR CONFLICT OF LAW PROVISION OR RULE (WHETHER OF THE COMMONWEALTH OF VIRGINIA OR ANY OTHER JURISDICTION) THAT WOULD CAUSE THE APPLICATION OF THE LAWS OF ANY JURISDICTION OTHER THAN THE COMMONWEALTH OF VIRGINIA.**

*[Signature Page Follows]*

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**IN WITNESS WHEREOF**, the parties hereto have executed this Amendment No. 1 to Management Services Agreement on the date first written above.

**FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**

By: /s/ J. Rock Tonkel, Jr.

Name: J. Rock Tonkel, Jr.

Title: President and Chief Operating Officer

**FBR CAPITAL MARKETS CORPORATION**

By: /s/ Richard J. Hendrix

Name: Richard J. Hendrix

Title: President and Chief Operating Officer

*[Signature Page to Amendment No. 1 to Management Services Agreement]*

**FBR CAPITAL MARKETS CORPORATION**  
**2007 EMPLOYEE STOCK PURCHASE PLAN**  
**(AMENDED AS OF APRIL 23, 2007)**

**1. ESTABLISHMENT OF PLAN.**

FBR Capital Markets Corporation, a Virginia corporation (the “Company”), proposes to grant options (“Options”) for purchase of the Company’s common stock, \$0.001 par value (“Common Stock”), to eligible employees of the Company and its Designated Affiliates (as hereinafter defined) pursuant to this 2007 Employee Stock Purchase Plan (this “Plan”). For purposes of this Plan, the term “Affiliate” means a “parent corporation” or “subsidiary corporation” as “parent corporation” and “subsidiary corporation” as defined in Sections 424(e) and 424(f), respectively, of the Internal Revenue Code of 1986, as amended (the “Code”). The Company intends this Plan to qualify as an “employee stock purchase plan” under Section 423 of the Code (including any amendments or successor provisions to such Section), and this Plan shall be so construed. Any term not expressly defined in this Plan but defined for purposes of Section 423 of the Code shall have the same definition therein.

**2. STOCK SUBJECT TO PLAN.**

The total number of shares of the Common Stock available for issuance under this Plan shall be 1,000,000 shares plus up to 1,400,000 shares reallocated to this Plan from the shares authorized for issuance under the Company’s 2006 Long-Term Incentive Plan. Such number shall be subject to adjustments effected in accordance with Section 16 of this Plan. Any shares of Common Stock that have been made subject to an Option that cease to be subject to the Option (other than by means of exercise of the Option), including, without limitation, in connection with the cancellation or termination of an Option, shall again be available for issuance in connection with future grants of Options under this Plan.

**3. PURPOSE.**

The purpose of this Plan is to provide employees of the Company and its Designated Affiliates, as that term is defined in Section 5 of this Plan, with a convenient means of acquiring an equity interest in the Company through payroll deductions, to enhance such employees’ sense of participation in the affairs of the Company and its Affiliates, and to provide an incentive for continued employment.

**4. ADMINISTRATION.**

This Plan shall be administered by a committee (the “Committee”) appointed by the Company’s Board of Directors (the “Board”) consisting of at least two members, who need not be members of the Board and who may be eligible to participate in the Plan. Subject to the provisions of this Plan and the limitations of Section 423 of the Code or any successor provision in the Code, the Committee shall have exclusive authority, in its discretion, to determine all

matters relating to Options granted under this Plan, including all terms, conditions, restrictions, and limitations of Options; provided, however, that all participants granted Options under an offering pursuant to this Plan shall have the same rights and privileges within the meaning of Code Section 423(b)(5) except as required by applicable law. The Committee shall also have exclusive authority to interpret this Plan and may from time to time adopt rules and regulations of general application for this Plan's administration. The Committee's exercise of discretion and interpretation of this Plan, its rules and regulations, and all actions taken and determinations made by the Committee pursuant to this Plan shall be conclusive and binding on all parties involved or affected. The Committee may delegate administrative duties to employees of the Company or to independent contractors, as it deems advisable. All expenses incurred in connection with the administration of this Plan shall be paid by the Company and the Designated Affiliates; provided, however, that the Committee may require a participant to pay any costs or fees in connection with the sale by the participant of shares of Common Stock acquired under this Plan or in connection with the participant's request for the issuance of a certificate for shares of Common Stock held in the participant's account under the Plan.

## **5. ELIGIBILITY.**

Any employee of the Company or a Designated Affiliate is eligible to participate in the Plan for any Offering Period (as hereinafter defined) under this Plan except the following:

- (a) employees who are customarily employed for less than 20 hours per week;
- (b) employees who are customarily employed for not more than five months in a calendar year;
- (c) employees who, together with any other person whose stock would be attributed to such employee pursuant to Section 424( d) of the Code, own stock or hold options to purchase stock possessing five percent or more of the total combined voting power or value of all classes of stock of the Company or any of its Affiliates or who, as a result of being granted Options under this Plan would own stock or hold options to purchase stock possessing five percent or more of the total combined voting power or value of all classes of stock of the Company or any of its Affiliates;
- (d) employees whose employment terms are covered by a collective bargaining agreement in situations where the applicable union or other collective bargaining unit has either refused to bargain with respect to this Plan as an employee benefit or has considered this Plan as a potential employee benefit and has rejected this Plan or has otherwise determined that employees which such union or other bargaining unit represents may not participate in this Plan; and
- (e) employees who are citizens of a foreign country, which prohibits foreign corporations from granting, stock options to any of its citizens.

Notwithstanding the foregoing, an employee of the Company or a Designated Affiliate shall not be eligible to participate in the Plan for any Offering Period (as hereinafter defined) during which the employee has elected to participate in an employee stock purchase plan of an Affiliate that is intended to meet the requirements of Code section 423 (an "Affiliate Plan").

For all purposes of this Plan, the term “Designated Affiliate” shall mean an Affiliate listed on Annex A to this Plan or any Affiliate which may hereafter be determined by the Committee or the Board to be a Designated Affiliate. A Designated Affiliate will cease to be a Designated Affiliate on the earlier of (i) the date the Committee or the Board determines that such Affiliate is no longer a Designated Affiliate or (ii) the date such Designated Affiliate ceases for any reason to be a “parent corporation” or “subsidiary corporation” as defined in Sections 424(e) and 424(f), respectively, of the Code.

## **6. OFFERING PERIODS.**

The offering periods of this Plan (individually, an “Offering Period”) shall be of periods not to exceed the maximum period permitted by Section 423 of the Code. Until determined otherwise by the Committee or the Board, (a) Offering Periods shall commence on January 1 and July 1 of each calendar year; provided, however, that the first Offering Period may begin on any date as shall be determined by the Committee or the Board, and (b) each Offering Period (with the exception of the first Offering Period if commenced on a date other than January 1 or July 1) shall consist of one six-month purchase period during which payroll deductions of the participants are accumulated under this Plan. The first day of each Offering Period is referred to as the “Offering Date.” The last day of each Offering Period is referred to as the “Purchase Date.” Subject to the requirements of Section 423 of the Code, the Committee or the Board shall have the power to change the duration of Offering Periods with respect to future offerings if such change is announced at least 15 days prior to the Offering Date of the first Offering Period to be affected by such change.

## **7. PARTICIPATION IN THIS PLAN.**

Eligible employees may become participants in an Offering Period under this Plan on any Offering Date by delivering an enrollment form provided by the Company to the administrator for this Plan (“Plan Administrator”) not later than the 15th day of the month (or if such day is not a business day for the Company or the applicable Affiliate, on the immediately preceding business day) before such Offering Date unless a later time for filing the enrollment form authorizing payroll deductions is set by the Committee for all eligible employees with respect to a given Offering Period. Once an employee becomes a participant in the Plan with respect to an Offering Period, such employee will automatically participate in the Offering Period commencing immediately following the last day of the prior Offering Period unless the employee withdraws from this Plan or terminates further participation in the Offering Period as set forth in Sections 13 and 14 below. Such participant is not required to file any additional enrollment form in order to continue participation in this Plan, except that the Committee may require the filing of new enrollment forms by participants who transfer to another division of the Company or a Designated Affiliate.

## **8. GRANT OF OPTION ON ENROLLMENT.**

Enrollment by an eligible employee in this Plan with respect to an Offering Period will constitute the grant by the Company to such employee of an Option to purchase on the Purchase Date up to that number of whole shares of Common Stock of the Company determined by dividing (a) the amount accumulated in such employee’s Employee Account (as defined in

Section 10(c)) during the Offering Period ending on such Purchase Date, by (b) the Purchase Price (as defined in Section 9); provided, however, that the number of shares which may be purchased pursuant to an Option may in no event exceed the number of shares determined in the manner set forth in Section 11(b) of the Plan or such other maximum number of shares as may be specified in the future by the Committee in lieu of the limitation set forth in Section 11(b).

## **9. PURCHASE PRICE.**

The purchase price per share (the "Purchase Price") at which a share of Common Stock will be sold in any Offering Period shall initially be the lower of (a) 85 percent of the fair market value of such share on the Offering Date or (b) 85 percent of the fair market value of such share on the Purchase Date; provided, however, that in no event may the purchase price per share of Common Stock be below the par value per share of Common Stock.

For purposes of this Plan, the "fair market value" of a share of Common Stock on a particular date shall be deemed to be the closing price of a share of Common Stock as reported on the principal stock exchange on which the shares are listed for trading for the immediately preceding day or, if no closing price was recorded on such day, then on the next preceding day on which such a closing price was recorded. If the Common Stock is not listed on an exchange, fair market value shall be determined by the Committee using any reasonable method and in good faith. The Committee may change the manner in which the Purchase Price is determined with respect to future offerings (provided such determination does not have the effect of lowering the Purchase Price to an amount less than that which would be computed utilizing the method for determining the Purchase Price set forth in the first paragraph of this Section 9) if such changed manner of computation is announced at least 15 days prior to the Offering Date of the first Offering Period to be affected by such change.

## **10. PURCHASE OF SHARES; CHANGES IN PAYROLL DEDUCTIONS; ISSUANCE OF SHARES.**

(a) Funds contributed by each participant for the purchase of shares under this Plan shall be accumulated by regular payroll deductions made during each Offering Period. The deductions shall be made as a percentage of the participant's Compensation in 1 percent increments comprising not less than 1 percent and not more than 15 percent of the participant's Compensation. As used herein, "Compensation" shall mean all base salary, cash bonuses, wages, commissions, and overtime; provided, however, that, for purposes of determining a participant's Compensation, any election by such participant to reduce his or her regular cash remuneration under Sections 125 or 401(k) of the Code shall be treated as if the participant did not make such election. "Compensation" does not include severance pay, hiring and relocation allowances, pay in lieu of vacation, automobile allowances, imputed income arising under any Company group insurance or benefit program, income received in connection with stock options, or any other special items of remuneration. Payroll deductions shall commence on the first payday following the Offering Date and shall continue through the last payday of the Offering Period unless sooner altered or terminated as provided in this Plan.

(b) A participant may increase or decrease the rate of payroll deductions during an Offering Period by filing with the Plan Administrator a new authorization for payroll deductions

on a form provided by the Company, in which case the new rate shall become effective for the next payroll period commencing more than 15 days after the Plan Administrator's receipt of the authorization and shall continue for the remainder of the Offering Period unless changed pursuant to this Section 10(b). Such change in the rate of payroll deductions may be made at any time during an Offering Period, but not more than two increases and two decreases may be made effective during any Offering Period. Notwithstanding the foregoing, a participant may lower the rate of payroll deductions to zero for the remainder of the Offering Period. A participant may increase or decrease the rate of payroll deductions for any subsequent Offering Period by filing with the Plan Administrator a new authorization for payroll deductions not later than the 15th day of the month (or if such date is not a business day, the immediately preceding business day) before the beginning of such Offering Period. A participant who has decreased the rate of withholding to zero will be deemed to continue as a participant in the Plan until the participant withdraws from the Plan in accordance with the provisions of Section 13 or his or her participation is terminated in accordance with the provisions of Section 14. A participant shall have the right to withdraw from this Plan in the manner set forth in Section 13 regardless of whether the participant has exercised his or her right to lower the rate at which payroll deductions are made during the applicable Offering Period.

(c) All payroll deductions made for a participant will be credited to an unfunded and unsecured bookkeeping account maintained on behalf of the participant (the "Employee Account") and deposited with the general funds of the Company. No interest will accrue on payroll deductions. All payroll deductions received or held by the Company may be used by the Company for any corporate purpose, and the Company shall not be obligated to segregate such payroll deductions. Contributions to an Employee Account other than by payroll deduction are not permitted.

(d) On each Purchase Date, provided that the participant has not withdrawn from the Plan pursuant to Section 13 or terminated employment pursuant to Section 14, in either case on or before the 15th day (or if such date is not a business day, on the immediately preceding business day) of the last month of the Offering Period in accordance with Section 13 or 14 of this Plan, or the Plan has not been terminated prior to the date referred to in the foregoing clause, the Company shall apply the funds then in the participant's Employee Account to the purchase at the Purchase Price of whole shares of Common Stock issuable under the Option granted to such participant with respect to the Offering Period to the extent that such Option is exercisable on the Purchase Date. Shares may be purchased in the public equity markets, directly from the Company or in privately negotiated transactions.

(e) During a participant's lifetime, such participant's Option to purchase shares hereunder is exercisable only by him or her or, in the event of the participant's disability, the participant's legal representatives. The participant will have no interest or voting right in shares covered by his or her Option until such Option has been exercised.

(f) Unless the Committee shall in the future determine otherwise, the maximum amount which may be deducted from any participant's Compensation for the purpose of purchasing Common Stock under this Plan shall not exceed \$21,250 in any single calendar year.

(g) No fractional shares of Common Stock shall be purchased by or issued to a participant. Any portion of the payroll deductions credited to an Employee Account which is not utilized to purchase Common Stock because it is insufficient to purchase an additional whole share of Common Stock shall be retained in the participant's Employee Account and applied to the purchase of Common Stock in the succeeding Offering Period. No interest will accrue on any amounts retained in an Employee Account.

#### **11. LIMITATIONS ON RIGHTS TO PURCHASE.**

(a) No employee shall be granted an Option to purchase Common Stock under this Plan at a rate which, when aggregated with his or her rights to purchase stock under all Affiliate Plans, exceeds \$25,000 in fair market value, determined as of the applicable date of the grant of the Option, for each calendar year in which the employee participates in this Plan (or any other employee stock purchase plan described in this Section 11 (a)).

(b) The number of shares which may be purchased by any employee on the first Purchase Date to occur in any calendar year may not exceed the number of shares determined by dividing \$25,000 by the fair market value (as defined in Section 9) of a share of Common Stock on the Offering Date of the Offering Period in which such Purchase Date occurs. The number of shares which may be purchased by any employee on any subsequent Purchase Date which occurs in the same calendar year (as that referred to in the preceding sentence) shall not exceed the number of shares determined by performing the calculation described below, with all computations to be made to the nearest ten thousandth of a whole share of Common Stock or one hundredth of one cent, as the case may be.

Step One: The number of shares purchased by the employee during any previous Offering Period which occurred in the same calendar year shall be multiplied by the fair market value (as defined in Section 9) of a share of Common Stock on the first day of such previous Offering Period in which such shares were purchased or the number of shares purchased by the employee under an Affiliate Plan during any previous offering period under such plan which occurred in the same calendar year shall be multiplied by the fair market value of such shares on the first day of such previous offering period.

Step Two: The amount determined in Step One shall be subtracted from \$25,000.

Step Three: The amount determined in Step Two shall be divided by the fair market value (as defined in Section 9) of a share of Common Stock on the Offering Date of the Offering Period in which the subsequent Purchase Date (for which the maximum number of shares which may be purchased is being determined by this calculation) occurs. The quotient so obtained shall be the maximum number of shares that may be purchased by any employee on such subsequent Purchase Date.

Subject to the limitations of Section 423 of the Code, the Committee may from time to time determine that a different maximum number of shares may be purchased on any given Purchase Date in lieu of the maximum amounts described above in this Section 11(b), in which case the number of shares which may be purchased by any employee on such Purchase Date may not exceed such different limitation.

(c) If the number of shares to be purchased on a Purchase Date by all employees participating in this Plan exceeds the number of shares then available for issuance under this Plan, then the Company will make a pro rata allocation of the remaining shares in as uniform a manner as shall be reasonably practicable and as the Committee shall determine to be equitable. In such event, the Company shall give written notice of such reduction of the number of shares to be purchased under a participant's Option to each participant affected thereby.

(d) Any payroll deductions accumulated in an Employee Account which are not used to purchase stock due to the limitations in this Section 11 shall be returned to the participant as soon as practicable after the end of the applicable Offering Period without interest.

## **12. EVIDENCE OF STOCK OWNERSHIP.**

(a) As soon as administratively practicable following the Purchase Date, the shares of Common Stock purchased on behalf of a participant pursuant to the exercise of his or her Option will be credited to an account at the Company's transfer agent or with a securities brokerage firm, as determined by the Company (the "Plan Financial Agent"), in the name of the participant. By electing to participate in the Plan, a participant will be deemed to authorize the establishment of an account (the "Stock Account") in his or her name with the Plan Financial Agent selected by the Company. A participant may request that the Plan Financial Agent arrange, subject to any applicable fee, for the delivery to the participant or an account designated by the participant of some or all of the Common Stock held in the participant's Stock Account. If the participant desires to sell some or all of his or her shares of Common Stock held in his or her Stock Account, he or she may do so either (i) by disposing of the shares of Common Stock through the Plan Financial Agent subject to any applicable fee, or (ii) through such other means as the Company may permit.

(b) Following termination of a participant's employment with the Company and its Affiliates for any reason, the participant shall have a period of 30 days to notify the Plan Financial Agent whether such participant desires (i) to receive a certificate representing all shares then in the participant's Stock Account with the Plan Financial Agent, (ii) to transfer the shares in the participant's Stock Account to a securities account designated by the participant, or (iii) to sell the shares in the participant's Stock Account through the Plan Financial Agent. If the terminated participant fails to file such notice with the Plan Financial Agent within 30 days after termination, he or she shall be deemed to have elected the alternative set forth in clause (i) above.

(c) Dividends credited to a participant's Stock Account shall be paid periodically to a participant at such times as the Board or the Committee shall designate. Copies of annual reports, proxy statements and any other materials issued to shareholders of the Company generally will be mailed to a participant provided the balance in his or her Stock Account is one share of Common Stock or more. In the absence of timely instructions from a participant with respect to tenders or exchanges of shares of Common Stock, the Company and the Plan Financial Agent will be deemed authorized to tender or exchange the participant's shares of Common Stock held in his or her Stock Account whenever the Company deems it to be in the best interest of the participant to do so.

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### **13. WITHDRAWAL.**

Each participant may withdraw from participation in the Plan by signing and delivering to the Plan Administrator a written notice to that effect on a form provided by the Company for such purpose. Upon withdrawal from this Plan, the participant's participation in this Plan shall terminate, subject to Section 15. In the event a participant elects to withdraw from the Plan pursuant to this Section 13, he or she may not resume his or her participation in this Plan during the same Offering Period, but he or she may participate in any subsequent Offering Period by filing a new enrollment form in the same manner as set forth above for initial participation in this Plan.

### **14. TERMINATION OF EMPLOYMENT; LEAVE OF ABSENCE.**

Termination of a participant's employment with the Company and its Affiliates for any reason, including resignation, retirement termination or death, or the failure of a participant to remain an eligible employee, immediately terminates his or her participation in this Plan, subject to Section 15. For purposes of this Section 14, an employee will not be deemed to have terminated employment or failed to remain in the continuous employ of the Company in the case of any leave of absence approved by the Committee.

### **15. RETURN OF PAYROLL DEDUCTIONS.**

In the event a participant's participation in this Plan is terminated by withdrawal pursuant to Section 13 or termination of employment pursuant to Section 14, or in the event this Plan is terminated by the Board, the Company shall promptly deliver to the participant, or in the case of the participant's death to his or her beneficiaries or heirs, all payroll deductions of the participant which have not yet been applied to the purchase of stock; provided, however, that if such withdrawal or termination of employment occurs later than the 15th day of the last month of an Offering Period (or if such date is not a business day, on the preceding business day), then such payroll deductions will be utilized to purchase Common Stock for the participant on the Purchase Date at the end of such Offering Period; provided, further, that upon termination of the Plan the Board may accelerate the Purchase Date. No interest shall accrue on the payroll deductions of a participant in this Plan.

### **16. CAPITAL CHANGES.**

In the event of any change in corporate capitalization, such as a stock split or a corporate transaction, such as any merger, consolidation, separation, including a spin-off, or other distribution of stock or property of the Company, any reorganization (whether or not such reorganization comes within the definition of such term in Section 368 of the Code) or any partial or complete liquidation of the Company or sale of all or substantially all of the Company's assets or stock then the Committee, in its sole discretion, shall make such equitable adjustments as it shall deem appropriate in the circumstances in the maximum number and kind of shares of stock subject to this Plan as set forth in Sections 1 and 2, the number and kind of shares subject to outstanding Options, and/or the Purchase Price. The determination by the Committee as to the terms of any of the foregoing adjustments shall be conclusive and binding.

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**17. NONASSIGNABILITY.**

Neither payroll deductions credited to an Employee Account nor any rights with regard to the exercise of an Option or to receive shares under this Plan may be assigned, transferred, pledged, or otherwise disposed of in any way (other than by will, the laws of descent and distribution, or as provided in Section 23 hereof) by the participant. Any such attempt at assignment, transfer, pledge, or other disposition shall be void and without effect.

**18. REPORTS AND STATUS OF ACCOUNTS.**

Individual account records will be maintained for each participant's Employee Account and Stock Account. The Plan Financial Agent shall send to each participant promptly after the end of each Offering Period a report of his or her account setting forth with respect to such Offering Period the number of shares purchased and the price per share thereof, and also setting forth the total number of shares then held in his or her Stock Account. Neither the Company nor any Designated Affiliate shall have any liability for any error or discrepancy in any such report.

**19. NO RIGHTS TO CONTINUED EMPLOYMENT; NO IMPLIED RIGHTS.**

Neither this Plan nor the grant of any Option hereunder shall confer any right on any employee to remain in the employ of the Company or any Affiliate or restrict the right of the Company or any Affiliate to terminate such employee's employment. The grant of any Option hereunder during any Offering Period shall not give a participant any right to similar grants thereafter.

**20. EQUAL RIGHTS AND PRIVILEGES.**

All eligible employees shall have equal rights and privileges with respect to this Plan except as required by applicable law so that this Plan qualifies as an "employee stock purchase plan" within the meaning of Section 423 or any successor provision of the Code and the related regulations. Any provision of this Plan which is inconsistent with Section 423 or any successor provision of the Code shall, without further act or amendment by the Company, the Board, or the Committee, be reformed to comply with the requirements of Section 423. This Section 20 shall take precedence over all other provisions in this Plan.

**21. AMENDMENT OF PLAN.**

The Board may amend this Plan in such respects as it shall deem advisable; provided, however, that stockholder approval will be required for any amendment that will increase the total number of shares as to which Options may be granted under this Plan or, but for such shareholder approval, cause this Plan to fail to continue to qualify as an "employee stock purchase plan" under Section 423 of the Code.

**22. TERMINATION OF THE PLAN.**

The Board may suspend or terminate this Plan at any time. Unless this Plan shall have been terminated by the Board, this Plan shall terminate on, and no Options shall be granted after, December 14, 2016. No Options shall be granted during any period of suspension of this Plan.

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**23. DESIGNATION OF BENEFICIARY.**

(a) A participant may file a written designation on a form provided by the Company of a beneficiary who is to receive any cash and shares, if any, from the participant's Employee Account and Stock Account under this Plan in the event of such participant's death.

(b) Such designation of beneficiary may be changed by the participant at any time on a form provided by the Company for such purpose. In the event of the death of a participant and in the absence of a beneficiary validly designated under this Plan who is living at the time of such participant's death, the Company shall deliver such cash or shares to the executor or administrator of the estate of the participant, or if no such executor or administrator has been appointed (to the knowledge of the Company), the Company, in its discretion, may deliver such cash or shares to the spouse or to any one or more dependents or relatives of the participant or, if no spouse, dependent, or relative is known to the Company, to such other person as the Company may in good faith determine to be an appropriate designee.

**24. CONDITIONS UPON ISSUANCE OF SHARES; LIMITATION ON SALE OF SHARES.**

Shares shall not be issued with respect to an Option unless the exercise of such Option and the issuance and delivery of such shares pursuant thereto shall comply with all applicable provisions of law, domestic or foreign, including, without limitation, the Securities Act of 1933, as amended, the Securities Exchange Act of 1934, as amended, the rules and regulations promulgated thereunder, and the requirements of any stock exchange or automated quotation system upon which the shares may then be listed, and shall be further subject to the approval of counsel for the Company with respect to such compliance.

**25. PLAN DATES.**

The effective date of the Plan is January 1, 2007. The first Offering Period under the Plan shall commence on January 1, 2007.

**AMENDMENT NO. 1  
TO  
FBR CAPITAL MARKETS CORPORATION  
2006 LONG-TERM INCENTIVE PLAN**

**WHEREAS**, by resolution duly adopted at a meeting of the Board of Directors (the “Board”) of FBR Capital Markets Corporation (the “Company”) on November 8, 2007, the Board approved adoption of this amendment (the “Amendment”) to the FBR Capital Markets Corporation 2006 Long-Term Incentive Plan (the “Plan”), subject to shareholder approval, for the purpose of increasing the total number of shares authorized for issuance under the Plan by 16,500,000 shares;

**WHEREAS**, this Amendment was approved by the Company’s shareholders at the special meeting of the Company’s shareholders held on December 12, 2007; and

**WHEREAS**, capitalized terms used in this Amendment but not otherwise defined shall have the meaning given to such terms in the Plan.

**NOW, THEREFORE**, the Plan is hereby amended as follows:

1. Section 3.1(a) of the Plan is hereby deleted in its entirety and replaced with the following new Section 3.1(a) in order to increase by 16,500,000 Shares the total number of Shares authorized for grant under the Plan from 5,569,985 Shares to 22,069,985 Shares:

“**3.1 Number of Shares.** (a) Subject to adjustment as provided in Section 12.2, a total of 22,069,985 Shares shall be authorized for grant under the Plan.”

2. Except to the extent hereby amended, the Plan remains unchanged and shall continue in full force and effect.

3. The effective date of this Amendment is December 12, 2007.

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**FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**  
**COMPUTATION OF RATIO OF EARNINGS TO FIXED CHARGES**  
(dollars in thousands)

	Years Ended December 31,				
	2007	2006	2005	2004	2003
Pre-tax income (loss) from continuing operations adjusted to exclude income or loss from equity investees	<u>\$ (639,336)</u>	<u>\$ (87,952)</u>	<u>\$ (144,289)</u>	<u>\$ 399,536</u>	<u>\$ 225,165</u>
Distributed income of equity investees	<u>2,701</u>	<u>5,097</u>	<u>32,334</u>	<u>2,141</u>	<u>553</u>
Fixed charges:					
Interest expense and amortization of debt discount and premium on all indebtedness	477,437	611,800	546,313	164,156	68,995
Rentals: 33.33% of Equipment and office rent expense	<u>7,178</u>	<u>7,301</u>	<u>6,057</u>	<u>2,798</u>	<u>1,719</u>
Total fixed charges	<u>\$ 484,615</u>	<u>\$ 619,101</u>	<u>\$ 552,370</u>	<u>\$ 166,954</u>	<u>\$ 70,714</u>
Pre-tax income (loss) from continuing operations before adjustments for income or loss from equity investees plus fixed charges and distributed income of equity investees	<u>\$ (152,020)</u>	<u>\$ 536,246</u>	<u>\$ 440,415</u>	<u>\$ 568,631</u>	<u>\$ 296,432</u>
Ratio of earnings to fixed charges	(A)	(A)	(A)	3.4	4.2

(A) Due to the company's losses in 2007, 2006, and 2005 the ratio coverage in these years was less than 1:1. The company would have had to generate additional earnings of \$636,635, \$82,855 and \$111,955, respectively, to achieve coverage of 1:1 in those years.

**List of Subsidiaries of the Registrant**

1. FBR TRS Holdings, Inc.—Virginia
2. FBR Capital Markets Corporation—Virginia
3. FBR Asset Management Holdings, Inc.—Virginia
4. FBR Capital Markets Holdings, Inc.—Delaware
5. Friedman, Billings, Ramsey & Co., Inc.—Delaware
6. Friedman, Billings, Ramsey International, Ltd.—England
7. FBR Investment Services, Inc.—Delaware
8. FBR Investment Management, Inc.—Delaware
9. FBR Fund Advisers, Inc.—Delaware
10. FBR Securitization, Inc.—Delaware
11. MHC I, Inc.—Delaware
12. FNLC Financial Services, Inc.—Delaware
13. First NLC Securitization, Inc.—Delaware
14. First NLC Financial Services, Inc.—Delaware
15. First NLC Financial Services, LLC—Florida
16. First NLC, Inc.—Minnesota
17. NLC, Inc.—Tennessee
18. FNLC Trust Investments, LLC—Delaware
19. FBR Trust Investments, LLC—Delaware
20. FBR NIM Investments, LLC—Delaware

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We hereby consent to the incorporation by reference in the Registration Statements on Form S-3 (Registration No. 333-107731 and Registration No. 333-113661) and Form S-8 (Registration No. 333-104475) of Friedman, Billings, Ramsey Group, Inc. of our report dated February 29, 2008 relating to the financial statements and the effectiveness of internal control over financial reporting, which appears in this Annual Report on Form 10-K.

/s/ PricewaterhouseCoopers LLP

McLean, Virginia

February 29, 2008

## CERTIFICATION

I, Eric F. Billings, certify that:

1. I have reviewed this annual report on Form 10-K of Friedman, Billings, Ramsey Group, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions);
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting, which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 29, 2008

/s/ ERIC F. BILLINGS

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ERIC F. BILLINGS  
Chief Executive Officer

# CERTIFICATION

I, Kurt R. Harrington, certify that:

1. I have reviewed this annual report on Form 10-K of Friedman, Billings, Ramsey Group, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have;
  - (a) Designed such disclosure controls and procedures or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions);
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting, which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 29, 2008

/s/ KURT R. HARRINGTON

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KURT R. HARRINGTON  
Chief Financial Officer

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report on Form 10-K of Friedman, Billings, Ramsey Group, Inc. (the "Company") for the year ended December 31, 2007, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Eric F. Billings, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

February 29, 2008

/s/ ERIC F. BILLINGS

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ERIC F. BILLINGS  
Chief Executive Officer

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report on Form 10-K of Friedman, Billings, Ramsey Group, Inc. (the "Company") for the year ended December 31, 2007, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Kurt R. Harrington, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

February 29, 2008

/s/ KURT R. HARRINGTON

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KURT R. HARRINGTON  
Chief Financial Officer

**FBR CAPITAL MARKETS CORPORATION**

WHEREAS, pursuant to resolutions of the Board duly adopted by unanimous written consent in lieu of a meeting on January 26, 2007 (the “Prior Board Resolutions”), the Board appointed Andrew M. Alper, Thomas J. Hynes, Jr., Richard A. Kraemer and Arthur J. Reimers to the Board (the “Additional Directors,” as defined in the Prior Board Resolutions) and,

\* \* \*

**Subscription of Shares Pursuant to Director Stock Purchase Plan**

WHEREAS, pursuant to the Prior Board Resolutions, the Board approved the opportunity for of each of the Additional Directors to subscribe from the Company for up to \$1 million of shares of the Company’s common stock, without payment of any broker’s commission or fee, at a purchase price equal to the fair market value of the Company’s common stock at the time of the appointment of the Additional Directors to the Board, and

WHEREAS, pursuant to the Prior Board Resolutions, the Board approved the issuance and sale of up to an aggregate of 266,668 shares of the Company’s common stock to the Additional Directors at a price of \$15.00 per share, subject to the terms and conditions set forth in the Prior Board Resolutions and the subscription letters between each of the Additional Directors and the Company (collectively, the “Subscription Letters”), and pursuant to the Prior Board Resolutions and the Subscription Letters, the issuance and sale of an aggregate of 163,334 shares of the Company’s common stock at a purchase price of \$15.00 per share were made to the Additional Directors (in the following specific amounts: Mr. Alper, 66,667 shares; Mr. Hynes, 10,000 shares; Mr. Kramer, 20,000 shares; and Mr. Reimers, 66,667 shares) (collectively, the “Additional Director Subscriptions”);

WHEREAS, the Board wishes to approve the opportunity for John T. Wall, and for any outside director who is elected or appointed to the Board in the future, to subscribe for up to \$1 million of shares of the Company’s common stock, without payment of any broker’s commission or fee, at a purchase price equal to the fair market value of the Company’s common stock at the time of his or her election or appointment to the Board of Directors,

WHEREAS, the Board wishes to confirm that the Additional Director Subscriptions, the subscription by John T. Wall of up to 65,573 shares of Common Stock at a purchase price of \$15.25 per share, and any similar subscription by outside directors who are appointed or elected in the future, were, are or will be made pursuant to a director stock purchase plan established for the purpose of better aligning the interests of each such director with the interests of the Company’s shareholders;

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RESOLVED, that the Designated Officers are, and each of them hereby is, authorized and directed to cause the Company to issue and sell: up to 65,573 shares of the Company's common stock, \$0.001 par value per share to John T. Wall at a price of \$15.25 per share pursuant to a subscription letter in the form of Exhibit A attached hereto (the "Subscription Letter");

RESOLVED, that the Board of Directors has determined in good faith that the consideration to be received for the shares of Common Stock to be issued and sold to Mr. Wall pursuant to the foregoing resolution represents adequate consideration for such shares; and that, an aggregate of 65,573 shares of Common Stock is hereby reserved for issuance in accordance with the foregoing resolutions, and that, upon the issuance of such shares in exchange for payment therefor in accordance with the terms of the Subscription Letter, such shares shall be validly issued, fully paid and non-assessable, and no personal liability shall attach to the ownership of such shares.

RESOLVED, that the Additional Director Subscriptions subject to the terms and conditions of the Prior Board Resolutions and the Subscription Letters, the issuance and sale of up to 65,573 shares of the Company's common stock at a purchase price of \$15.25 per share subject to the terms of these resolutions and the Subscription Letter, and any similar subscription by an outside director appointed or elected in the future, were, are or will be made pursuant to an approved director stock purchase plan (the "plan") established to enable each of the Company's newly elected or appointed outside directors and any outside director that is elected or appointed in the future to purchase directly from the Company up to \$1 million of shares of the Company's Common Stock, without payment of any broker's commission or fee, at a purchase price equal to the fair market value of the Company's common stock at the time of his or her election or appointment to the Board of Directors, in order to better align the interests of each of the Company's outside directors and any outside director that is elected or appointed to the Board of Directors in the future with the interests of the Company's shareholders.

#### General and Enabling

RESOLVED, that the Designated Officers are, and each of them hereby is, authorized in the name and on behalf of the Company to do and perform, or cause to be done and performed, all such acts, deeds and things to make, or cause to be made, all such payments and to make, execute and deliver, or cause to be made, executed and delivered, all such agreements, undertakings, documents, instruments or certificates in the name and on behalf of the Company or otherwise as each such officer may deem necessary or appropriate to effectuate or carry out fully the purpose and intent of the foregoing resolutions and the transactions contemplated thereby.

#### Effective Date

RESOLVED, that the effective date of these resolutions shall be April 30, 2007.

Form of Subscription Agreement

[\_\_\_\_], 200[\_\_]

Board of Directors  
 FBR Capital Markets Corporation  
 1001 North Nineteenth Street  
 Arlington, VA 22209

Re: Offer to Subscribe to Shares of Common Stock

Gentlemen:

The undersigned hereby offers to subscribe to [\_\_\_\_\_] shares of common stock, \$0.001 par value per share (the “Common Stock”), of FBR Capital Markets Corporation and agrees to pay \$[\_\_\_\_\_] per share in cash therefor.

The undersigned agrees that any certificate representing the shares of Common Stock will bear the following legend and that the undersigned will hold the shares of Common Stock subject to the restrictions referenced thereby:

**THE SHARES REPRESENTED BY THIS CERTIFICATE HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE “1933 ACT”), OR THE SECURITIES LAWS OF ANY STATE. SUCH SHARES MAY NOT BE TRANSFERRED WITHOUT PRIOR REGISTRATION UNDER THE 1933 ACT AND APPLICABLE STATE LAW OR UNLESS AN EXEMPTION FROM REGISTRATION IS AVAILABLE AND SUCH TRANSFER, IN THE OPINION OF COUNSEL FOR THE TRANSFEROR OF SUCH SHARES, WILL NOT CONSTITUTE OR RESULT IN A VIOLATION OF THE 1933 ACT OR ANY APPLICABLE STATE LAW.**

Very truly yours,

\_\_\_\_\_  
 [Director]

Agreed to as of [\_\_\_\_], 200[\_\_]:

**FBR CAPITAL MARKETS CORPORATION**

By: \_\_\_\_\_

\_\_\_\_\_  
 Name:

Title: