

MUNICIPAL MORTGAGE & EQUITY LLC

Form 10-Q

August 06, 2004

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

FORM 10-Q

**Quarterly Report Pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934**

For the quarterly period ended June 30, 2004

Commission File Number: 001-11981

MUNICIPAL MORTGAGE & EQUITY, LLC
(Exact Name of Registrant as Specified in Its Charter)

Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

52-1449733
(I.R.S. Employer Identification No.)

621 E. Pratt Street, Suite 300
Baltimore, Maryland
(Address of Principal Executive Offices)

21202-3140
(Zip Code)

(443) 263-2900
(Registrant's Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes No

The Registrant had 34,853,634 common shares outstanding as of July 30, 2004.

MUNICIPAL MORTGAGE & EQUITY, LLC
INDEX TO FORM 10-Q

Part I FINANCIAL INFORMATION

Item 1.	Financial Statements	3
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	33
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	47
Item 4.	Controls and Procedures	47

Part II OTHER INFORMATION

Item 2.	Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities	47
Item 4.	Submission of Matters to a Vote of Security Holders	47
Item 6.	Exhibits and Reports on Form 8-K	48
	Signatures	49

Forward-Looking Information

This Quarterly Report on Form 10-Q contains forward-looking statements, which involve certain risks and uncertainties. Assumptions contained in various portions of this Quarterly Report on Form 10-Q involve judgments with respect to, among other things, future economic market conditions and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond the control of Municipal Mortgage & Equity, LLC (**MuniMae** and, together with its subsidiaries, the **Company**). Although the Company believes that the assumptions underlying the forward-looking information included herein are reasonable, any of the assumptions could be inaccurate. Therefore, there can be no assurance that such forward-looking information will prove to be accurate. In light of the significant uncertainties inherent in forward-looking information, the inclusion of such information should not be regarded as a representation by the Company or any other person that the objectives and plans of the Company will be achieved.

PART I.
FINANCIAL INFORMATION

2

Item 1. Financial Statements.

MUNICIPAL MORTGAGE & EQUITY, LLC
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)
(unaudited)

	June 30, 2004	December 31, 2003
ASSETS		
Investment in tax-exempt bonds, net (Note 2)	\$ 1,180,237	\$ 1,043,973
Loans receivable, net (Note 3)	574,956	497,884
Loans receivable held for sale (Note 3)	39,740	54,492
Investment in partnerships (Note 4)	1,587,008	282,492
Investments in derivative financial instruments (Note 5)	3,320	2,563
Cash and cash equivalents	99,962	50,826
Interest receivable	18,205	16,843
Restricted assets (Note 6)	194,843	75,525
Other assets	66,786	73,961
Land, building and equipment	177,284	5,429
Mortgage servicing rights, net	11,622	10,967
Goodwill	108,578	107,505
Other intangibles	24,801	27,159
	<hr/>	<hr/>
Total assets	\$4,087,342	\$ 2,249,619
	<hr style="border-top: 3px double black;"/>	<hr style="border-top: 3px double black;"/>
LIABILITIES AND SHAREHOLDERS EQUITY		
Notes payable (Note 7)	\$ 1,010,878	\$ 646,096
Mortgage notes payable (Note 7)	122,578	
Debentures (Note 8)	60,000	
Short-term debt (Note 7)	409,493	371,881
Long-term debt (Note 7)	179,988	190,090
Preferred shares subject to mandatory redemption	168,000	168,000
Tax credit equity guarantee liability (Note 9)	150,475	151,326
Investments in derivative financial instruments (Note 5)	10,545	15,287
Accounts payable and accrued expenses	16,989	17,506
Interest payable	13,533	9,581
Unearned revenue and other liabilities	79,074	37,986
	<hr/>	<hr/>
Total liabilities	2,221,553	1,607,753
	<hr style="border-top: 3px double black;"/>	<hr style="border-top: 3px double black;"/>
Commitments and contingencies (Note 10)		

Minority interest in subsidiary companies (Note 1)	1,192,038	31
Shareholders equity:		
Common shares, par value \$0 (38,071,099 shares authorized, including 34,905,251 shares issued and outstanding, and 43,933 deferred shares at June 30, 2004 and 35,926,099 shares authorized, including 32,592,093 shares issued and outstanding, and 39,701 deferred shares at December 31, 2003)	692,034	654,700
Less common shares held in treasury at cost (124,715 at June 30, 2004 and December 31, 2003)	(2,615)	(2,615)
Less unearned compensation (deferred shares) (Note 1)	(3,799)	(3,992)
Accumulated other comprehensive loss	(11,869)	(6,258)
	<u>673,751</u>	<u>641,835</u>
Total shareholders equity	<u>673,751</u>	<u>641,835</u>
Total liabilities and shareholders equity	<u>\$4,087,342</u>	<u>\$ 2,249,619</u>

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

MUNICIPAL MORTGAGE & EQUITY, LLC
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except share and per share data)
(unaudited)

	For the three months ended June 30,		For the six months ended June 30,	
	2004	2003	2004	2003
INCOME:				
Interest income				
Interest on bonds and residual interests in bond securitizations	\$ 21,340	\$14,366	\$ 40,842	\$30,721
Interest on loans	11,388	7,894	22,109	17,804
Interest on short-term investments	1,859	332	2,666	524
	<hr/>	<hr/>	<hr/>	<hr/>
Total interest income	34,587	22,592	65,617	49,049
	<hr/>	<hr/>	<hr/>	<hr/>
Fee income				
Syndication fees	4,190	1,825	7,941	3,236
Origination and brokerage fees	2,848	2,219	3,765	2,917
Loan servicing fees	1,139	1,070	2,258	2,202
Asset management and advisory fees	1,967	1,198	8,133	2,274
Guarantee fees	1,506	112	3,359	223
Other income	1,705	3,197	3,542	5,283
	<hr/>	<hr/>	<hr/>	<hr/>
Total fee income	13,355	9,621	28,998	16,135
	<hr/>	<hr/>	<hr/>	<hr/>
Net rental income	5,496		5,496	
	<hr/>	<hr/>	<hr/>	<hr/>
Total income	53,438	32,213	100,111	65,184
	<hr/>	<hr/>	<hr/>	<hr/>
EXPENSES:				
Interest expense	21,279	8,724	36,743	19,092
Interest expense on preferred shares	3,035		6,081	
Salaries and benefits	20,421	8,671	33,480	14,637
General and administrative	6,992	1,972	11,017	3,628
Professional fees	2,731	877	4,225	1,866
Depreciation and amortization	3,597	414	5,209	803
	<hr/>	<hr/>	<hr/>	<hr/>
Total expenses	58,055	20,658	96,755	40,026

Edgar Filing: MUNICIPAL MORTGAGE & EQUITY LLC - Form 10-Q

Net gain on sale of loans	1,730	540	2,410	1,720
Net gain (loss) on sale of tax-exempt investments	1,013	(6)	1,205	(6)
Net gain on sale of investments in tax credit equity partnerships	379	178	2,814	276
Net gain on termination of derivatives		741		741
Net holding gains (losses) on derivatives	7,853	(2,449)	5,498	424
Impairments and valuation allowances related to investments	(430)	(1,144)	(730)	(1,144)
Net losses from equity investments in partnerships	(71,224)	(1,606)	(81,735)	(2,353)
Net income (loss) before income taxes, income allocable to minority interest, discontinued operations and cumulative effect of accounting change	(65,296)	7,809	(67,182)	24,816
Income tax benefit (expense)	(173)	540	2,337	472
Net income (loss) before income allocable to minority interest, discontinued operations and cumulative effect of accounting change	(65,469)	8,349	(64,845)	25,288
Net income (expense) allocable to minority interests	76,659	(2,995)	76,764	(5,989)
Net income before discontinued operations and cumulative effect of accounting change	11,190	5,354	11,919	19,299
Discontinued operations		25,748		25,748
Net income before cumulative effect of accounting change	11,190	31,102	11,919	45,047
Cumulative effect of a change in accounting principle			520	
Net income	\$ 11,190	\$ 31,102	\$ 12,439	\$ 45,047

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

MUNICIPAL MORTGAGE & EQUITY, LLC
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except share and per share data)
(unaudited)

	For the three months ended June 30,		For the six months ended June 30,	
	2004	2003	2004	2003
Basic earnings per common share:				
Earnings before discontinued operations and cumulative effect of accounting change	\$ 0.32	\$ 0.19	\$ 0.35	\$ 0.69
Discontinued operations		0.89		0.91
Cumulative effect of a change in accounting principle			0.02	
	<hr/>	<hr/>	<hr/>	<hr/>
Basic earnings per common share	\$ 0.32	\$ 1.08	\$ 0.37	\$ 1.60
	<hr/>	<hr/>	<hr/>	<hr/>
Weighted average common shares outstanding	34,800,580	28,857,305	34,047,243	28,104,281
Diluted earnings per common share:				
Earnings before discontinued operations and cumulative effect of accounting change	\$ 0.32	\$ 0.18	\$ 0.35	\$ 0.68
Discontinued operations		0.88		0.90
Cumulative effect of a change in accounting principle			0.02	
	<hr/>	<hr/>	<hr/>	<hr/>
Diluted earnings per common share	\$ 0.32	\$ 1.06	\$ 0.37	\$ 1.58
	<hr/>	<hr/>	<hr/>	<hr/>
Weighted average common shares outstanding	35,140,968	29,213,062	34,406,363	28,451,480

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

MUNICIPAL MORTGAGE & EQUITY, LLC
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands)
(unaudited)

	For the three months ended		For the six months ended	
	June 30,		June 30,	
	2004	2003	2004	2003
Net income	\$11,190	\$ 31,102	\$12,439	\$ 45,047
Other comprehensive loss:				
Unrealized gains (losses) on investments:				
Unrealized holding gains (losses) arising during the period	(202)	16,540	(4,406)	21,116
Reclassification adjustment for gains included in net income	(1,013)	(24,726)	(1,205)	(24,726)
Other comprehensive loss	(1,215)	(8,186)	(5,611)	(3,610)
Comprehensive income	\$ 9,975	\$ 22,916	\$ 6,828	\$ 41,437

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

MUNICIPAL MORTGAGE & EQUITY, LLC
CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY
(in thousands, except share data)
(unaudited)

	Common Shares	Treasury Shares	Unearned Compensation	Accumulated Other Comprehensive Loss	Total
Balance, January 1, 2004	\$654,700	\$(2,615)	\$(3,992)	\$ (6,258)	\$641,835
Net income	12,439				12,439
Unrealized gains on investments, net of reclassifications				(5,611)	(5,611)
Distributions	(30,689)				(30,689)
Options exercised	1,410				1,410
Issuance of common shares	52,482				52,482
Deferred shares issued under the Non-Employee Directors Share Plans	104				104
Deferred share grants	1,588		(1,588)		
Amortization of deferred compensation			1,781		1,781
	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Balance, June 30, 2004	\$692,034	\$(2,615)	\$(3,799)	\$(11,869)	\$673,751

	Common Shares	Treasury Shares
SHARE ACTIVITY:		
Balance, January 1, 2004	32,507,079	124,715
Options exercised	76,050	
Issuance of common shares	2,145,669	
Issuance of common shares under employee share incentive plans	91,440	
Deferred shares issued under the Non-Employee Directors Share Plans	4,231	
	<u> </u>	<u> </u>
Balance, June 30, 2004	34,824,469	124,715

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

MUNICIPAL MORTGAGE & EQUITY, LLC
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	For the six months ended	
	June 30,	
	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 12,439	\$ 45,047
Adjustments to reconcile net income to net cash provided by operating activities:		
Income allocated to preferred shareholders		5,679
Cumulative effect of a change in accounting principle	(520)	
Net holding gains on trading securities	(5,498)	(424)
Impairments and valuation allowances related to investments	730	1,144
Amortization of guarantee liability	(2,149)	
Net gain on sales	(6,429)	(2,731)
Loss from investments in partnerships	81,735	2,353
Minority interest income	(76,764)	
Distributions received from investments in partnerships	3,694	5,224
Net amortization of premiums, discounts and fees on investments	978	(185)
Depreciation, accretion and amortization	8,376	1,048
Discontinued operations		(25,748)
Deferred income taxes	2,527	1,283
Tax benefit from deferred share compensation		330
Deferred share compensation expense	1,781	883
Common and deferred shares issued under the Non-Employee Directors Share Plans	104	135
Net change in assets and liabilities:		
Increase in interest receivable	(1,362)	(1,095)
(Increase) decrease in other assets and goodwill	(14,202)	11,306
Increase in accounts payable, accrued expenses and other liabilities	11,399	10,353
Decrease in on loans held for sale	15,361	31,730
	<hr/>	<hr/>
Net cash provided by operating activities	27,146	54,602
	<hr/>	<hr/>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of tax-exempt bonds and residual interests in bond securitizations	(182,928)	(73,769)
Loan originations	(164,956)	(123,427)
Purchases of property and equipment	(8,076)	(394)
Net investment in restricted assets	10,484	(29,211)
Principal payments received	89,930	134,661
Termination of derivative financial instruments		(10,809)

Edgar Filing: MUNICIPAL MORTGAGE & EQUITY LLC - Form 10-Q

Proceeds from the sale of investments	38,479	44,558
Net investment in partnerships	(132,383)	(5,574)
	<u> </u>	<u> </u>
Net cash used in invested activities	(349,450)	(63,965)
	<u> </u>	<u> </u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Borrowings from credit facilities	630,521	350,710
Repayment of credit facilities	(477,502)	(364,685)
Proceeds from tax credit syndication investors	107,708	
Proceeds from short-term debt	38,200	27,250
Repayment of short-term debt	(588)	(35,525)
Proceeds from long-term debt	61,140	
Repayment of long-term debt	(11,242)	(5,351)
Issuance of common shares	52,482	71,871
Redemption of preferred shares		
Proceeds from stock options exercised	1,410	1,122
Distributions to common shares	(30,689)	(24,181)
Distributions to preferred shareholders in a subsidiary company		(5,988)
	<u> </u>	<u> </u>
Net cash provided by financing activities	371,440	15,223
	<u> </u>	<u> </u>
Net increase in cash and cash equivalents	49,136	37,590
Cash and cash equivalents at beginning of period	50,826	43,745
	<u> </u>	<u> </u>
Cash and cash equivalents at end of period	\$ 99,962	\$ 81,335
	<u> </u>	<u> </u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Interest paid	\$ 38,871	\$ 15,624
	<u> </u>	<u> </u>
Income taxes paid	\$ 3	\$ 143
	<u> </u>	<u> </u>
Non-cash activity resulting from consolidation of VIEs under FIN 46 (Note 1):		
Investment in partnership	\$ 1,271,457	\$
Restricted assets	134,228	
Other assets	21,150	
Land, building and equipment, net	166,360	
Notes payable	208,655	
Mortgage notes payable	123,900	
Accounts payable, accrued expenses and other liabilities	35,277	
Minority interest in subsidiary companies	1,182,482	
Accumulated other comprehensive income	61	

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

MUNICIPAL MORTGAGE & EQUITY, LLC
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

NOTE 1 BASIS OF PRESENTATION

Municipal Mortgage & Equity, LLC (**MuniMae** and, together with its subsidiaries, the **Company**) provides debt and equity financing to developers of multifamily housing and other real estate investments. The Company invests in tax-exempt bonds, or interests in bonds, issued by state and local governments or their agencies or authorities to finance multifamily housing developments. These tax-exempt bonds are not general obligations of state and local governments, or the agencies or authorities that issue the bonds. The multifamily housing developments, as well as the rents paid by the tenants, typically secure these investments. The Company also invests in other housing-related debt and equity investments, including equity investments in real estate operating partnerships; tax-exempt bonds, or interests in bonds, secured by student housing or assisted living developments; and tax-exempt bonds issued by community development districts to finance the development of community infrastructure supporting single-family housing or commercial developments and secured by specific payments or assessments pledged by the local improvement district that issues the bonds (**CDD bonds**). Interest income derived from the majority of the Company's bond investments is exempt income for Federal income tax purposes.

The Company is also a tax credit syndicator and a mortgage banker. As a syndicator, the Company acquires and sells to investors interests in partnerships that receive and distribute to investors low-income housing tax credits. The Company earns syndication fees on the placement of these interests with investors. The Company also earns fees for providing guarantees on certain tax credit funds and for managing the low-income housing tax credit funds it has syndicated. Mortgage banking activities include the origination of, investment in and servicing of investments in multifamily housing, both for its own account and on behalf of third parties. These investments generate taxable income.

MuniMae was organized in 1996 as a Delaware limited liability company. As a limited liability company, the Company combines many of the limited liability, governance and management characteristics of a corporation with the pass-through income features of a partnership. Since MuniMae is classified as a partnership for Federal income tax purposes, MuniMae is not itself subject to Federal and, in most cases, state and local income taxes. Instead, each shareholder must include his or her distributive share of MuniMae's income, deductions and credits on the shareholder's income tax return. Most of the Company's mortgage banking and tax credit syndication activities are conducted through subsidiaries classified as corporations for Federal income tax purposes, which do not have the pass-through income features of a partnership.

The condensed consolidated financial statements include the accounts of MuniMae, its wholly owned subsidiaries, its majority owned subsidiaries and variable interest entities (**VIEs**) where the Company was determined to be the primary beneficiary of the VIE. All significant intercompany balances and transactions have been eliminated.

In 1999, the Company placed a substantial portion of its tax-exempt bonds and residual interests in bond securitizations in an indirect subsidiary of the Company, MuniMae TE Bond Subsidiary, LLC (**TE Bond Sub**). TE Bond Sub sold Series A, Series B and Series A-1 and Series B-1 Cumulative Preferred Shares (collectively, the **TE Bond Sub Preferred Shares**) to institutional investors in May 1999, June 2000 and October 2001, respectively. The TE Bond Sub Preferred Shares have a senior claim to the income derived from the investments owned by TE Bond Sub. Any income from TE Bond Sub available after payment of the cumulative distributions of the TE Bond Sub Preferred Shares is allocated to the Company, which holds all of the common equity interests. As a result, the assets of TE Bond Sub and its subsidiaries, while indirectly controlled by MuniMae and thus included in the consolidated financial statements of the Company, are legally owned by TE Bond Sub and are not available to the creditors of the Company. The Company's common equity interest in TE Bond Sub was \$286.1 million and \$267.0 million at June 30, 2004 and December 31, 2003, respectively.

The Company's common equity interest in TE Bond Sub was pledged as collateral to secure the Company's total return swap associated with a term loan. The balance outstanding on the term loan was \$10.0 million and \$38.0 million at June 30, 2004 and December 31, 2003, respectively. The common equity interest in TE Bond Sub held by MuniMae is subject to the claims of the creditors of MuniMae and in certain circumstances could be foreclosed.

On July 1, 2003, the Company acquired the Housing and Community Investing (**HCI**) business of Lend Lease Corporation Limited (**Lend Lease**) for \$102.0 million in cash. HCI is a syndicator of low-income housing tax credit equity investments. The acquisition of this affordable housing tax credit syndication operation has enhanced the Company's competitive position, and as a result the Company is one of the nation's leaders in the affordable housing industry. The HCI business is owned by MMA Financial TC Corp. (**TC Corp**), a wholly owned subsidiary of the Company. The Company's results for June 30, 2004 reflect a full six months of activity from TC Corp.

Of the total purchase price, approximately \$75 million was allocated to goodwill. The factors contributing to a purchase price including this goodwill included: (a) the Company's valuation, which focused on HCI's historical and projected cash flows as well as its business prospects and strategic value, supported the purchase price; (b) the purchase included very few tangible or intangible assets (other than certain asset management contracts) to which significant value could be assigned; and (c) the Company did not assign value to HCI's customer relationships beyond the asset management contracts acquired.

Of the total purchase price, approximately \$32.0 million was allocated to asset management contracts. The amortizable intangible assets represent existing contracts that relate primarily to monitoring properties underlying the real estate investment vehicles sponsored or structured by HCI to insure these properties are producing expected returns with appropriate risk controls. The fair value assigned to the asset management contracts is based on a valuation model prepared internally using estimates and assumptions provided by management. The Company is amortizing the fair value of each contract on a straight-line basis over the contract's estimated useful life. The Company amortizes the contract intangible assets at the individual contract level because the fair value of the group of contract intangible assets was allocated to each individual contract intangible asset at the date of acquisition. The weighted average useful life of all these assets is 7.7 years. The Company evaluates its intangible assets subject to amortization for possible impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the intangible asset are less than the carrying amount at the date of the evaluation, an impairment loss is recognized. The impairment loss is measured as the amount by which the carrying amount exceeds the fair value of the intangible asset.

Uncertainties regarding several litigation matters and an Internal Revenue Service (**IRS**) audit of a partnership included in one of the tax credit equity funds sponsored by HCI precluded the Company from finalizing the purchase price allocation as of the closing date of July 1, 2003. These uncertainties included, among other things, judicial determinations on requests for class action certification, potential changes to the scope of the IRS audit, and similar factors. In June 2004, based on evaluation of these matters by the Company's inside counsel, the Company finalized its allocations to these contingent liabilities and recorded an increase in goodwill of \$1.0 million.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (the **SEC**) and in the opinion of management contain all adjustments (consisting of only normal recurring accruals) necessary to present a fair statement of the results for the periods presented. These results have been determined on the basis of accounting principles and policies discussed in Note 1 to the Company's Annual Report on Form 10-K for the year ended December 31, 2003 (the **Company's 2003 Form 10-K**). Certain information and footnote disclosures normally included in financial statements presented in accordance with generally accepted accounting principles (**GAAP**) have been condensed or omitted. The accompanying financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's 2003 Form 10-K. Certain 2003 amounts have been reclassified to conform to the 2004 presentation.

Loan Servicing, Origination and Construction Administration Fees

The Company earns fees in connection with the servicing of loans for its own account. The Company earns construction administration fees in connection with the servicing of its construction loans. The Company earns origination fees on the origination of tax-exempt bonds. The Company may also earn origination fees on supplemental loans. These fees on bonds and loans, which are carried on the Company's balance sheet, are deferred and amortized into interest income to approximate a level yield over the estimated life of the related bond or loan.

The Company earns fees in connection with the servicing of loans for third parties. These fees are recognized as income over the period in which the Company performs the associated services.

Brokerage Fees

The Company's brokerage fees are earned through its relationship with the Midland Affordable Housing Group Trust (the **Group Trust**) (see Note 1 under *Mortgage Banking Activities* in the Company's 2003 Form 10-K). The Group Trust commits to make permanent loans to borrowers through arrangements that were originated by the Company. The Company does not provide permanent loan financing to the borrower. The Company earns brokerage fees for establishing the meeting of the borrower and the Group Trust and recognizes revenue when all significant services have been performed, which typically coincides with when the Group Trust commits to extend permanent financing.

Other-than-Temporary Impairments and Valuation Allowances on Investments

The Company evaluates its investments on an ongoing basis to determine whether other-than-temporary impairments exist or a valuation allowance is needed. The Company considers the credit risk exposure of the investment, the Company's ability and intent to hold the investment for a period of time to allow for anticipated recoveries in market value, the length of time and extent to which the market value has been less than carrying value, the financial condition of the underlying collateral including the payment status of the investment and general economic and other more specific conditions applicable to the investment, other collateral available to support the investment and whether the Company expects to recover all amounts due under its mortgage obligations on a net present value basis. Third party quotes of securities with similar characteristics or discounted cash flow valuations are used to assist in determining if an impairment exists on investments. If the fair value of the investment is less than its amortized cost, and after assessing the above-mentioned factors it is determined that an other-than-temporary impairment exists, the impairment is recorded currently in earnings and the cost basis of the security is adjusted accordingly. When the Company believes that it is probable that it will not collect all amounts due, including principal and interest, under the terms of an investment, it records a valuation allowance. The Company also evaluates other receivables and advances for collectibility on an ongoing basis. When the Company believes it is probable that it will not collect all amounts due, the balance is written down to its realizable value.

Long-Lived Assets

The Company evaluates its long-lived assets for possible impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the long-lived asset are less than the carrying amount at the date of the evaluation, an impairment loss is recognized. The impairment loss is measured as the amount by which the carrying amount exceeds

the fair value of the long-lived asset.

Syndication of Low-Income Housing Tax Credits

The Company acquires and sells interests in partnerships (or **tax credit funds**) that provide low-income housing tax credits for investors. The Company earns syndication fees on the placement of these interests with investors. In conjunction with the sale of these partnership interests, the Company may provide performance guarantees on the underlying properties owned by the tax credit funds or guarantees to the fund investors. The Company earns fees for providing these guarantees. The Company also earns asset management fees for managing the low-income housing tax credit funds syndicated. The Company also acts as general partner of the tax credit funds and receives a pro rata share of cash distributions that may be distributed to the tax credit funds partners pursuant to a sale of the Project Partnerships or its assets. The Company's general partner interests range from 0.1% to 1%. The above-mentioned fees and the Company's pro rata share of income and losses from the Company's general partnership interests constitute all sources of income or gain and losses from tax credit syndication transactions. All fees represent normal market rates.

The Company, through a subsidiary, acquires limited partner interests in underlying project partnerships that the tax credit funds invest in (**Project Partnerships**). As investor capital is raised and investors are admitted as limited partners in, or subsequently contribute additional capital to, the tax credit funds, the tax credit funds acquire those Project Partnership limited partner interests from the subsidiary. The Company evaluates these transfers as real estate transactions, notwithstanding the fact that it is acquiring and transferring limited partner interests and not the underlying real property itself. The Company does not transfer options or contracts to buy properties in its tax credit syndication business.

The Company's significant accounting policies that directly relate to the syndication of low-income housing tax credits are described below.

Syndication and Guarantee Fees

Syndication fees are earned when third party investors are admitted as limited partners into the tax credit fund sponsored by the Company. Guarantee fees are earned when the Company provides certain performance guarantees to the limited partners of the tax credit fund or indemnifies third party guarantors of the tax credit fund with respect to the projected yield of the limited partnership interests. Guarantees are only provided to some of the tax credit funds. Syndication fees are recognized when the earnings process is complete and collectibility is reasonably assured. Guarantee fees are recognized ratably over the life of the guarantee. As an additional stipulation, syndication fees are considered earned and are recognized as income upon receipt of the initial cash payment from investors into the syndicated low-income housing tax credit funds, provided all of the following have occurred: (1) the investor has made a significant down payment; (2) the properties

for funds have been identified; (3) a firm contract exists that requires an investor to fund capital contribution installments; (4) all services required to earn the fee have been performed to contract specifications; and (5) all appropriate documents have been executed. The Company does not receive ownership interests in lieu of syndication or guarantee fees. Since March 31, 2004, as a result of the consolidation of certain tax credit funds pursuant to Financial Interpretation No. 46 (Revised), Consolidation of Variable Interest Entities (**FIN 46R**) (see *New Accounting Pronouncements* below), syndication fees previously recognized as income have been reclassified as intercompany transactions and have, accordingly, been eliminated in consolidation.

Asset Management Fees

Asset management fees are earned by the Company for managing the assets of the tax credit equity funds, including monitoring the compliance of the property with tax credit regulations. The amount of asset management fees due to the Company is outlined in the tax credit equity syndication fund documents. The Company earns asset management fees from the tax credit equity funds on an annual basis calculated based on a percentage of each tax credit equity fund's invested capital. The asset management fees are paid from available cash from the tax credit equity funds. The Company records asset management fees into income when the amount that the Company will receive is determinable and collection is reasonably assured. These fees are typically paid to the Company annually in arrears. Upon the adoption of FIN 46R, the Company was required to eliminate intercompany asset management fees earned through services provided to tax credit funds consolidated by the Company.

New Accounting Pronouncements

In January 2003, the Financial Accounting Standards Board (**FASB**) approved Financial Interpretation No. 46, Consolidation of Variable Interest Entities (**FIN 46**). FIN 46 requires the consolidation of a company's equity investment in a VIE if the company is the primary beneficiary of the VIE and if risks are not effectively dispersed among the owners of the VIE. The company is considered to be the primary beneficiary of the VIE if the company absorbs the majority of the losses of the VIE. FIN 46 is effective for VIEs created after January 31, 2003. For any VIE in which the Company held an interest that it acquired before February 1, 2003, FIN 46 was effective for the first interim reporting period beginning after June 15, 2003. In December 2003, FASB approved various amendments to FIN 46 and released FIN 46R. In addition, FASB extended the effective date of FIN 46 until the first reporting period ending after March 15, 2004 for VIEs which are not special purpose entities, and the Company elected to defer adoption of that portion of FIN 46 until that time.

The Company's residual interests in bond securitizations represent equity interests in VIEs, and the Company is the primary beneficiary of those VIEs. The Company determined that its bond securitization trusts were special purpose entities (**SPEs**) and did not qualify for the deferral. Therefore, these securitization trusts were consolidated at December 31, 2003. The Company examined each of its SPEs to determine if it meets the definition of a qualified SPE. Certain of the Company's SPEs are qualified SPEs and are not consolidated accordingly.

The Company initially measured the assets and liabilities of the securitization trusts at the carrying amounts.

The Company has general partnership interests in low-income housing tax credit equity funds where the respective funds have one or more limited partners. The determination of whether the Company is the primary beneficiary of (and must consequently consolidate) a given tax credit equity fund depends on a number of factors, including the number of limited partners and the rights and obligations of the general and limited partners in that fund. Upon adoption of FIN 46 in March 2004, the Company determined that it was the primary beneficiary in certain of the funds it originated where there are multiple limited partners. As a result, the Company consolidated these equity investments at March 31, 2004. The Company's general partner interests typically represent a one percent or less interest in each fund. For those funds which it consolidates, the Company reports the net assets of the funds, consisting primarily of restricted cash, investments in partnerships and notes payable, in the Company's consolidated balance sheet. In addition, the limited partnership interests in the funds, owned by third party investors, are reported as a minority interest. The net income (loss) from these tax credit equity funds is reported in the appropriate line items of the

Company's consolidated statement of income. An adjustment for the income (loss) allocable to the limited partners (investors) in the funds is recorded through minority interest expense (income) in the Company's consolidated statement of income. At March 31, 2004, the Company recorded net assets of these tax credit equity funds of \$1.2 billion, consisting primarily of \$1.4 billion in investment in partnerships, \$129.5 million in restricted assets and \$208.7 million in notes payable, which are non-recourse to the Company. The Company recorded \$1.2 billion in minority interest in subsidiary companies. As of March 31, 2004, the Company also recorded a \$0.5 million cumulative effect of a change in accounting principle as a result of recording the net equity allocable to the Company's general partner interest in the funds.

At times, the Company takes ownership of the general partnership interest in the underlying Project Partnerships in which the tax credit funds hold investments. For those property-level general partnership interests (a) owned by the Company and (b) relating to Project Partnerships included in tax credit funds consolidated pursuant to FIN 46, the Company has discontinued the equity method of accounting and consolidated the underlying Project Partnership. Such consolidation was recorded in the second quarter and resulted in an increase in assets of \$172.0 million, an increase in liabilities of \$172.0 million and net income of zero. The Company also has a general partnership interest in certain other low-income housing tax credit equity funds where it has concluded that it is not the primary beneficiary. Accordingly, funds with assets of \$970.3 million and liabilities of \$90.8 million as of March 31, 2004 have not been consolidated and continue to be accounted for using the equity method.

The Company initially measured the assets and liabilities of the tax credit equity funds at fair value as of July 1, 2003, the acquisition date of HCI, which was the point in time that the Company first met the criteria to be the primary beneficiary of the VIE. For funds consolidated pursuant to FIN 46 as of March 31, 2004, the fair value was used to record the net assets of the tax credit equity funds when the fair value was less than the carrying amount. For funds where the Company took ownership of the general partnership interest in the underlying Project Partnership in which the fund held an investment, the underlying Project Partnership was recorded at cost in consolidation.

Stock Based Employee Compensation

The Company accounts for both the non-employee director share plans and the employee share incentive plans (see Note 1 and Note 17 to the Company's 2003 Form 10-K) under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees. No options were issued pursuant to the plans and, accordingly, no compensation expense was recognized for options issued under the plans for the six months ended June 30, 2004. The Company issued 7,000 and 30,000 options, respectively, in the first and second quarters of 2003. The Company estimated the fair value of each option awarded using the Black Scholes option-pricing model with the following assumptions:

	For the three months ended June 30, 2003	For the six months ended June 30, 2003
Risk-free interest rate	3%	3%
Dividend yield	7.1%	7.0%
Volatility	14%	14%
Expected option life	7.5 years	7.5 years
Weighted average fair value of options	\$0.78	\$0.87

The following table illustrates the effect on net income and earnings per share if the compensation expense had been determined based on the fair value recognition provisions of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (**FAS 123**), as amended by Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure. There would be no effect on net income from the fair value method of accounting under FAS 123 for the three and six months ended June 30, 2004.

<i>(in thousands, except per share amounts)</i>	For the three months ended June 30, 2003	For the six months ended June 30, 2003
Net income allocated to common shares, as reported	\$ 31,102	\$ 45,047
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(23)	(32)
Net income allocated to common shares, pro forma	<u>\$ 31,079</u>	<u>\$ 45,015</u>
Earnings per common share:		
Basic as reported	<u>\$ 1.08</u>	<u>\$ 1.60</u>
Basic pro forma	<u>\$ 1.08</u>	<u>\$ 1.60</u>
Diluted as reported	<u>\$ 1.06</u>	<u>\$ 1.58</u>
Diluted pro forma	<u>\$ 1.06</u>	<u>\$ 1.58</u>

NOTE 2 INVESTMENT IN TAX-EXEMPT BONDS

The Company originates for its own account investments in tax-exempt bonds. Tax-exempt bonds are issued by state and local government authorities to finance multifamily housing developments and other types of real estate. The bonds are typically secured by nonrecourse mortgage loans on the underlying properties.

The Company invests in other housing-related securities, including tax-exempt bonds issued by community development districts, to finance the development of infrastructure supporting single-family housing or commercial developments and secured by specific payments or assessments

pledged by the local improvement district that issues the bonds. The Company also invests in tax-exempt bonds, or interests in bonds, secured by student housing or assisted living developments.

The Company's sources of capital to fund these lending activities include proceeds from equity and debt offerings, securitizations, loans from warehousing facilities with various pension funds and commercial banks, and draws on lines of credit. The Company earns interest income from its investment in tax-exempt bonds and taxable loans. The Company also earns origination and construction administration fees, through subsidiaries classified as corporations for Federal income tax purposes, for originating and servicing the bonds during the construction period.

For a further discussion of the general terms of tax-exempt bonds, see Note 1 to the Company's 2003 Form 10-K.

As of June 30, 2004 and December 31, 2003, the Company held \$1,180.2 million and \$1,044.0 million of tax-exempt bonds, respectively. The following tables summarize the tax-exempt bonds by type.

<i>(in thousands)</i>	June 30, 2004			
	Face Amount	Amortized Cost	Unrealized Gain (Loss)	Fair Value
Non-participating bonds	\$1,067,420	\$1,044,123	\$(26,456)	\$1,017,667
Participating bonds	101,434	100,537	(267)	100,270
Subordinate non-participating bonds	13,649	11,671	(626)	11,045
Subordinate participating bonds	58,890	35,799	15,456	51,255
	<hr/>	<hr/>	<hr/>	<hr/>
Total	\$1,241,393	\$1,192,130	\$(11,893)	\$1,180,237
	<hr/>	<hr/>	<hr/>	<hr/>

<i>(in thousands)</i>	December 31, 2003			
	Face Amount	Amortized Cost	Unrealized Gain (Loss)	Fair Value
Non-participating bonds	\$ 922,544	\$ 897,322	\$(22,719)	\$ 874,603
Participating bonds	101,589	100,693	1,666	102,359
Subordinate non-participating bonds	17,642	16,417	58	16,475
Subordinate participating bonds	58,890	35,799	14,737	50,536
	<hr/>	<hr/>	<hr/>	<hr/>
Total	\$1,100,665	\$1,050,231	\$ (6,258)	\$1,043,973
	<hr/>	<hr/>	<hr/>	<hr/>

Note: Of the tax-exempt bonds shown in the table above, TE Bond Sub owned bonds with aggregate fair value of \$846.0 million and \$840.1 million as of June 30, 2004 and December 31, 2003, respectively.

During the six months ended June 30, 2004, the Company invested in tax-exempt bonds with a face amount of \$185.1 million for \$182.9 million. Of the total face amount of \$185.1 million, \$148.2 million represents the Company's new primary investments (bonds which the Company originated), \$29.6 million reflects new secondary market investments (previously issued bonds purchased from third parties) and \$7.3 million reflects the refunding of a non-performing bond that the Company had purchased in 2003.

The Company structures tax-exempt bonds that allow the borrower to make draws on the bonds throughout the construction period (**draw down bonds**). In the year these bonds are originated, the total draws for the year are reported as new primary investments. The Company originated a face amount of \$29.6 million in new draw down bonds during the six months ended June 30, 2004. The Company also funded an additional \$20.8 million of existing tax-exempt draw down bonds with a face amount of \$20.8 million for the six months ended June 30, 2004.

Six tax-exempt bonds with an amortized cost of \$37.7 million were repaid during the six

months ended June 30, 2004. One of the bonds was repaid as a result of a refunding of the bond. The Company continues to hold the refunded bond. The Company recognized a gain of \$1.2 million on the repayment of the nonrefunded bonds.

In order to facilitate the securitization of certain assets at higher leverage ratios than otherwise available to the Company without the posting of additional collateral, the Company has pledged additional bonds to various pools that act as collateral for senior interests in certain securitization trusts. From time to time, the Company also pledges bonds as collateral for letters of credit, lines of credit, warehouse lending arrangements and other investments and derivative agreements. At June 30, 2004 and December 31, 2003, the total carrying amount of the tax-exempt bonds pledged as collateral was \$488.1 million and \$452.3 million, respectively.

NOTE 3 LOANS RECEIVABLE

The Company's loans receivable consist primarily of construction loans, permanent loans, supplemental loans and other taxable loans. For a further discussion of the general terms of loans held by the Company and the allowance for loan losses, see the description of mortgage banking activities in Note 1 to the Company's 2003 Form 10-K. The following table summarizes loans receivable by loan type at June 30, 2004 and December 31, 2003.

<i>(in thousands)</i>	June 30, 2004	December 31, 2003
Loan Type:		
Construction loans	\$472,886	\$396,817
Taxable permanent loans	39,740	54,492
Supplemental loans	71,457	72,966
Other taxable loans	32,355	29,780
	<u>616,438</u>	<u>554,055</u>
Allowance for loan losses	(1,742)	(1,679)
	<u>614,696</u>	<u>552,376</u>
Total	<u>\$614,696</u>	<u>\$552,376</u>

Note: Supplemental loans include working capital loans, bridge loans and preconstruction loans.

The Company had loans receivable held for sale of \$39.7 million and \$54.5 million at June 30, 2004 and December 31, 2003, respectively. These loans committed for sale are sold to Federal National Mortgage Association (**Fannie Mae**) and third party conduit lenders. Due to the short time the Company holds these loans, carrying value approximates fair value.

The Company pledges loans as collateral for the Company's notes payable, warehouse lending arrangements and line of credit borrowings. In addition, in order to facilitate the securitization of certain assets at higher leverage ratios than otherwise available to the Company without the posting of additional collateral, the Company has pledged additional taxable loans to a pool that acts as collateral for senior interests in certain securitization trusts and credit enhancement facilities. At June 30, 2004 and December 31, 2003, the total carrying amount of the loans receivable

pledged as collateral was \$578.3 million and \$480.1 million, respectively.

NOTE 4 INVESTMENT IN PARTNERSHIPS

The Company's investments in partnerships consist of equity interests in real estate operating partnerships. The Company's investments in partnerships are accounted for using the equity method. The Company ceases recording losses on an investment in partnership when the cumulative losses and distributions from the partnership exceed the carrying amount of the investment and any advances made by the Company. After the Company's investment in such partnership reaches \$0, cash distributions received from these investments are recorded as income. For partnerships in which the Company is a general partner (for example, the Company's interests in the tax credit equity syndication funds which it originates), the Company recognizes losses to the extent of its partnership liability, regardless of the Company's basis in its partnership interest. The following table summarizes investment in partnerships by major category at June 30, 2004 and December 31, 2003:

<i>(in thousands)</i>	June 30, 2004	December 31, 2003
Non-guaranteed tax credit equity funds:		
Investment in real estate operating partnerships (1)	\$1,325,462	\$
Guaranteed tax credit equity funds:		
Investment in real estate operating partnerships (2)	110,453	110,593
Investment in real estate operating partnerships warehousing (3)	86,097	108,677
Investment in CAPREIT (4)	64,335	62,561
Other investments in partnerships	661	661
	<u> </u>	<u> </u>
	\$1,587,008	\$ 282,492
	<u> </u>	<u> </u>

(1) As a result of FIN 46, the Company must include on its balance sheet investments by certain non-guaranteed tax credit equity funds. These funds invest in limited partnership interests in real estate operating partnerships and have been consolidated as of March 31, 2004. See Note 1 for a further discussion.

(2) These investments are limited partnership interests in real estate operating partnerships owned by tax credit funds where the Company provides a guarantee or otherwise has continuing involvement in the underlying assets of the fund. As a result of the guarantee, the Company includes the assets of the funds in its consolidated balance sheets until such time as the Company's guarantee expires.

(3) The Company acquires, through limited partnership interests, equity interests that typically represent a 99% interest in properties expected to earn tax credits. When the Company has a sufficient number of such limited partnership interests and has identified tax credit investors, it transfers those interests to a tax credit fund for the investors' benefit. The Company typically owns

these partnership interests for three to nine months before they are transferred to a fund.

(4) The Company makes equity investments in income-producing real estate partnerships in joint ventures with CAPREIT, Inc. and its affiliates (**CAPREIT**). In one such venture, the Company owns a 35% interest in general partnerships owning 12 property partnerships (the **CAPREIT Tera** investment) and in a second such venture the Company owns a 30% general partnership interest in 23 property partnerships and four related swap partnerships (the **CAPREIT 3M** investment). In each case, CAPREIT holds the remaining general partnership interest.

NOTE 5 INVESTMENT IN DERIVATIVE FINANCIAL INSTRUMENTS

At June 30, 2004 and December 31, 2003, the Company's investments in derivative financial instruments consisted of interest rate swaps, put option contracts and total return swaps. For a further discussion of the Company's investment in derivative financial instruments, see Note 7 to the Company's 2003 Form 10-K. The following table provides certain information with respect to the derivative financial instruments held by the Company at June 30, 2004 and December 31, 2003:

	June 30, 2004			December 31, 2003		
	Notional Amount	Fair Value (4) Assets	Liabilities (5)	Notional Amount	Fair Value (4) Assets	Liabilities (5)
<i>(in thousands)</i>						
Interest rate swap agreements (1)	\$310,975	\$3,320	\$(10,498)	\$310,975	\$2,559	\$(15,244)
Total return swaps (2)	10,000			38,000		
Put option agreements (3)	120,403		(47)	122,524	4	(43)
		_____	_____		_____	_____
Total investment in derivative financial instruments		\$3,320	\$(10,545)		\$2,563	\$(15,287)
		_____	_____		_____	_____

(1) For the interest rate swap agreements, notional amount represents the total amount of the Company's interest rate swap contracts (\$345,935 as of June 30, 2004 and December 31, 2003) less the total amount of the Company's reverse interest rate swap contracts (\$34,960 as of June 30, 2004 and December 31, 2003).

(2) For the total return swaps, the notional amount represents the total amount of the Company's total return swap contracts.

(3) For put option agreements, the notional amount represents the Company's aggregate obligation under the put option agreements.

(4) The amounts disclosed represent the net fair values of all the Company's derivatives at the reporting date.

(5) The aggregate negative fair value of the investments is included in liabilities for financial reporting purposes. The negative fair value of these investments is considered temporary and is not indicative of the future earnings on these investments.

NOTE 6 RESTRICTED ASSETS

The table below summarizes restricted assets by major category at June 30, 2004 and December 31, 2003:

	June 30, 2004	December 31, 2003
<i>(in thousands)</i>		
Tax credit equity fund cash (1)	\$ 162,037	\$ 44,192
Margin call deposits (2)	153	9,122
Cash deposit for guarantee on sale of certain taxable loans (3)	1,278	1,278
CAPREIT total return swaps collateral (4)	11,600	19,670
Other cash collateral (5)	19,775	1,263
	<u>\$ 194,843</u>	<u>\$ 75,525</u>

- (1) Under the financing method of accounting for guaranteed tax credit funds and due to the consolidation of certain other funds in accordance with FIN 46, the Company reports the restricted cash of the funds in the Company's consolidated balance sheet. The cash is to be used primarily for investments in partnerships and other approved uses as set out in the funds' partnership agreements.
- (2) Under the terms of the Company's interest rate swap agreements with counterparties, the Company is required to maintain cash deposits (**margin call deposits**). The margin call deposit requirements are specific to each counterparty. The Company must make margin call deposits when the total fair value of the Company's outstanding swap obligations to any one counterparty is, in most cases, greater than \$1.0 million. In certain cases, the Company is also required to post up-front collateral on the swap contracts.
- (3) In conjunction with a guarantee provided by the Company related to the sale of certain taxable notes, the Company deposited \$1.3 million in cash in an account with a counterparty. This money serves as collateral for the Company's obligation under the guarantee; however, the Company's obligation under the guarantee is not limited to this deposit. In the event that any of the properties cannot fund their payments on the loan, the money in this account can be used to fund any shortfalls. The Company does not believe that any loss is likely. These funds will not be released to the Company until the interest and principal obligations on all the loans are fulfilled. The Company does not believe it will have to perform under the guarantee.
- (4) Under the terms of the Company's investment with CAPREIT, the Company is required to post either bond or cash collateral for the CAPREIT total return swaps. From time to time, the Company may elect to post short-term floating-rate marketable securities in lieu of cash.
- (5) From time to time, the Company may elect to pledge cash collateral for the Company's account or on behalf of its customers in order to facilitate letters of credit, secured lines of credit and other collateral requirements. These transactions are considered temporary and the Company expects to be fully reimbursed.

NOTE 7 NOTES PAYABLE AND DEBT

The Company's notes payable consist primarily of notes payable and advances under line of credit arrangements that are used to: (1) finance construction lending needs; (2) finance working capital needs; (3) warehouse real estate operating partnerships before they are placed into tax credit equity funds; and (4) warehouse permanent loans before they are purchased by third parties. As of

Edgar Filing: MUNICIPAL MORTGAGE & EQUITY LLC - Form 10-Q

June 30, 2004, notes payable also includes factored and mortgage notes payable reflected on the Company's balance sheet as a result of consolidating certain tax credit equity funds upon adoption of FIN 46 (discussed in Note 1). The factored notes payable are obligations of the limited partners (investors) of the tax-credit funds and collateralized by the investors' subscription receivables. The factored notes payable are non-recourse and not guaranteed by the Company. The mortgage notes payable are obligations of Project Partnerships, in which the Company is the general partner, and are non-recourse and not guaranteed by the Company. The Company's short- and long-term debt relates to securitization transactions and other financing transactions that the Company has recorded as borrowings. The following table summarizes notes payable and debt at June 30, 2004 and December 31, 2003:

<i>(in thousands)</i>	Total of Facilities	June 30, 2004	December 31, 2003
Short-term notes payable	N/A	\$ 190,714	\$ 198,342
Lines of credit - unaffiliated entities	\$ 555,000	393,571	304,153
Lines of credit - affiliated entities	\$ 195,000		20,662
Short-term debt	N/A	409,493	371,881
		<u>993,778</u>	<u>895,038</u>
Total short-term notes payable and debt			
Long-term notes payable	N/A	167,063	122,939
Long-term debt	N/A	179,988	190,090
		<u>347,051</u>	<u>313,029</u>
Total long-term notes payable and debt			
Factored notes payable		259,530	
Mortgage notes payable		122,578	
		<u>382,108</u>	<u>382,108</u>
Total notes payable and debt		<u>\$ 1,722,937</u>	<u>\$ 1,208,067</u>

Covenant Compliance

As a result of the consolidation of certain assets and liabilities relating to the Company's tax credit equity syndication business pursuant to FIN 46 as of March 31, 2004, and the reclassification, pursuant to Financial Accounting Standards No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity as of September 30, 2003, as liabilities of the Company's outstanding preferred shares in a subsidiary company, during the second quarter of 2004 the Company, in the absence of a waiver or amendment, would have been in default of a financial covenant under a \$200.0 million short-term line of credit. Consequently, the Company and the lender executed a waiver of this default through June 30, 2004. While under the waiver of default, the Company

successfully negotiated an amendment to the line of credit to revise the covenant and cure the default. As of June 30, 2004, \$154.6 million of debt was outstanding under this line of credit and the Company was in compliance with all covenants applicable to its credit facilities.

NOTE 8 DEBENTURES

A consolidated indirect wholly owned subsidiary of the Company, Midland Financial Holdings, Inc. (**MFH**), formed MFH Financial Trust I (**MFH Trust**) in 2003 as a special purpose financing vehicle. On May 3, 2004, MFH Trust sold to institutional investors \$60.0 million in 9.5% Trust

Preferred Securities (the **Trust Preferred Securities**) having a liquidation amount of \$100 per Trust Preferred Security. The Trust Preferred Securities were sold with an initial purchasers' discount of \$3.15 per Trust Preferred Security, or \$1.9 million in the aggregate. MFH paid the entire initial purchasers' discount as well as offering expenses on behalf of MFH Trust. MFH Trust used the proceeds from the offering to purchase Junior Subordinated Debentures (the **Debentures**) issued by MFH. The Debentures have substantially the same economic terms as the Trust Preferred Securities. MFH Trust can make distributions to the Trust Preferred Securities only if MFH makes payments on the Debentures. The Debentures are unsecured obligations and are subordinate to all of MFH's existing and future senior debt.

The Trust Preferred Securities are guaranteed by MuniMae and MFH. The Trust Preferred Securities bear interest at an annual rate of 9.5% until May 5, 2014, to be increased thereafter to a rate which is equal to the greater of (a) 9.5% per annum or (b) the rate per annum which is equal to 6.0% plus the U.S. Treasury Note with a maturity nearest to May 5, 2024. The Trust Preferred Securities may be redeemed in whole or in part on May 5, 2014. Cash distributions on the Trust Preferred Securities are paid quarterly. MFH contributed the net proceeds from the offering to one of its subsidiaries, which in turn used the proceeds to pay off intercompany indebtedness to MuniMae. MuniMae used these amounts to repay a portion of its indebtedness.

MFH Trust must redeem the Trust Preferred Securities when and to the extent the Debentures are paid at maturity or earlier redeemed. The Company has recorded the Trust Preferred Securities in the accompanying condensed consolidated balance sheet as a long-term liability at the liquidation preference value of \$60.0 million. In addition, net offering costs of \$2.2 million related to the Trust Preferred Securities are recorded as debt issuance costs and included in other assets in the accompanying condensed consolidated balance sheet. The offering costs paid by MFH are amortized to interest expense in the accompanying condensed consolidated income statement over a 10-year period based on the call option of the preferred shares.

NOTE 9 TAX CREDIT EQUITY GUARANTEE LIABILITY

As part of the acquisition of HCI (see Note 1), the Company is providing guarantees to Lend Lease related to certain tax credit equity syndication funds where Lend Lease is providing a guarantee to investors or a third party. Subsequent to the acquisition of HCI, the Company established a new guaranteed tax credit fund whereby the Company provides a guarantee to a third party.

When the Company provides a guarantee in connection with the syndication of a tax credit fund, the Company is considered to have continuing involvement with the assets of that fund and to have effective control over the assets in the fund. Therefore, the Company accounts for its involvement in these funds under the financing method. Under the financing method, no profit is recognized from Project Partnership sales to tax credit funds. The sales value of the Project Partnership is equal to the Company's original cost basis of the investment. There are no fees charged by the Company to the Project Partnership as part of the syndication transaction. The Company reports the net assets of the tax credit funds, consisting primarily of restricted cash and investments in Project Partnerships, in the Company's consolidated balance sheet. In addition, the investor capital contributions to the tax credit funds are reported as a tax credit guarantee liability on the Company's consolidated balance sheet. The net income (loss) from the tax credit funds is reported in the appropriate line items of the Company's consolidated statement of income.

The Company's guarantee liability may expire based on the achievement of certain targets by the underlying Project Partnership in the fund or may be outstanding for the life of the tax credit fund. When the Company's liability is relieved by the achievement of certain targets, the tax credit guarantee liability is relieved as the guarantees expire and the related underlying investment in the Project Partnership is de-recognized. Any difference between the carrying value of the de-recognized investment in the Project Partnership and the guarantee liability is reflected as a gain or loss on sale and reported in the Company's consolidated statement of income. For tax credit funds in which the Company's guarantee obligation remains outstanding for the life of the fund, the guarantee liability is amortized straight line over the life of the fund, which is estimated to be 15 years, and the related amortization is reported in guarantee fees in the Company's consolidated statement of income.

When a guarantee is provided in connection with a syndication, the Company reduces syndication fee and asset management fee recognition by the amount of estimated losses. Typically, the Company estimates that no losses will be incurred and the Company has not incurred any losses to date through its guarantees on limited partnership interests.

The following table shows the changes in the tax credit equity guarantee liability:

(in thousands)

Balance at January 1, 2004	\$ 151,326
Amortization	(2,149)
Expiration of guarantees	(23,132)
Limited partner's capital contributions	25,700
Offering costs	(1,270)
	<hr/>
Balance at June 30, 2004	\$ 150,475
	<hr/>

NOTE 10 GUARANTEES, COMMITMENTS AND CONTINGENCIES

For a discussion of the Company's commitments and contingencies, see Note 14 to the Company's 2003 Form 10-K.

The following table summarizes the Company's guarantees by type at June 30, 2004. The Company's maximum exposure under its guarantee obligations is not indicative of the likelihood of the expected loss under the guarantees.

<i>(in millions)</i>		June 30, 2004		
Guarantee	Note	Maximum Exposure	Carrying Amount	Supporting Collateral
Loss-sharing agreements with Fannie Mae, GNMA and HUD	(1)	\$ 186.4	\$	\$5.4 million Letter of Credit pledged
	(2)	268.2	268.2	Investment in partnership and loans totaling \$283.1 million
Bank line of credit guarantees				
Tax credit related guarantees	(3)	364.4	160.8	\$0.9 million of cash
Other financial/payment guarantees	(4)	180.7	14.6	\$14.8 million of cash, tax exempt bonds and common equity
Put options	(5)	65.9	1.2	\$75.8 million of loans and tax exempt bonds
Letter of credit guarantees	(6)	56.4	44.7	\$0.6 million of cash
Indemnification contracts	(7)	77.4	58.9	None
Trust preferred guaranteed	(8)	60.1	60.1	None
		<hr/>	<hr/>	
		\$1,259.5	\$ 608.5	
		<hr/>	<hr/>	

Notes:

- (1) As a Fannie Mae and Government National Mortgage Association (**GNMA**) loan servicer, the Company may share in losses relating to underperforming real estate mortgage loans delivered to Fannie Mae and GNMA. More specifically, if the borrower fails to make a payment on a loan originated by the Company and sold to Fannie Mae, of principal, interest, taxes or insurance premiums, the Company may be required to make servicing advances to Fannie Mae. Also, the Company may participate in a deficiency after foreclosure on FNMA and GNMA loans. The term of the loss sharing agreement is based on the contractual requirements of the underlying loans delivered to Fannie Mae and GNMA, which varies to a maximum of 40 years.
- (2) The Company provides payment or performance guarantees for certain borrowings under line of credit facilities. The amount outstanding under these lines of credit was \$267.6 million at June 30, 2004. This amount is included in notes payable in the Company's consolidated balance sheet.
- (3) The Company acquires and sells interests in partnerships that provide low-income housing tax credits for investors. In conjunction with the sale of these partnership interests, the Company may provide performance guarantees on the underlying properties owned by the partnerships or guarantees to the fund investors. These guarantees have various expirations to a maximum term of 18 years.
- (4) The Company has entered into arrangements that require the Company to make payments in the event a specified third party fails to perform on its financial obligation. The Company typically provides these guarantees in conjunction with the sale of an asset to a third party or the Company's investment in equity ventures. The term of the guarantee varies based on loan payoff schedules or Company divestitures.
- (5) The Company has entered into put option agreements with counterparties whereby the counterparty has the right to sell to the Company, and the Company has the obligation to buy, an underlying investment at a specified price. These put option agreements expire at various dates through April 1, 2007.
- (6)

The Company provides a guarantee of the repayment on losses incurred under letters of credit issued by third parties or to provide substitute letters of credit at a predetermined future date. In addition, the Company may provide a payment guarantee for certain assets in securitization programs. These guarantees expire at various dates through September 1, 2007.

- (7) The Company has entered into indemnification contracts, which require the guarantor to make payments to the guaranteed party based on changes in an underlying investment that is related to an asset or liability of the guaranteed party. These agreements typically require the Company to reimburse the guaranteed party for legal and other costs in the event of an adverse judgment in a lawsuit or the imposition of additional taxes due to a change in the tax law or an adverse interpretation of the tax law. The term of the indemnification varies based on the underlying program life, loan payoffs or Company divestitures. Based on the terms of the underlying contracts, the maximum exposure amount only includes amounts that can be reasonably estimated at this time. The actual exposure amount could vary significantly.
- (8) The Company provides a payment guarantee of the underlying securities pursuant to the May 3, 2004 Trust Preferred Securities offering. The guarantee obligation is unsecured and subordinated to the Company's existing and future debt

and liabilities except for debt and liabilities which by their terms are specifically subordinated to the guarantee obligations and the rights of the holders of various classes of existing and future preferred shares of the Company.

NOTE 11 SHAREHOLDERS EQUITY

Equity Offering

In March 2004, the Company sold to the public 2.0 million common shares at a price of \$25.55 per share and granted the underwriters an option to purchase up to an aggregate of 195,000 common shares to cover overallotments at the same price. Net proceeds on the 2.0 million shares approximated \$47.7 million. On March 8, 2004, the underwriters exercised their option to purchase 195,000 common shares, generating additional net proceeds of approximately \$4.8 million. The net proceeds from this offering have been used for general corporate purposes, including funding of new investments, paying down debt and working capital.

Distributions

On April 22, 2004, the Board of Directors declared a distribution of \$0.4575 for the three months ended March 31, 2004 to common shareholders of record on May 3, 2004. The payment date was May 14, 2004.

Earnings per Share

The following tables reconcile the numerators and denominators in the basic and diluted earnings per share (**EPS**) calculations for common shares for the three and six months ended June 30, 2004 and 2003. The effect of all potentially dilutive securities was included in the calculation.

Municipal Mortgage & Equity, LLC
Reconciliation of Basic and Dilluted EPS
(unaudited)

	For the three months ended June 30, 2004			For the three months ended June 30, 2003		
	Income (Numerator)	Shares (Denominator)	Per	Income (Numerator)	Shares (Denominator)	Per
			Share Amount			Share Amount
<i>(in thousands, except share and per share data)</i>						
Basic EPS						
Net income from continuing operations	\$ 11,190		\$ 0.32	\$ 5,354		\$ 0.19
Discontinued operations				25,748		0.89
	<u>11,190</u>			<u>5,354</u>		<u>0.19</u>
Income allocable to common shares	\$ 11,190	34,800,580	\$ 0.32	\$ 31,102	28,857,305	\$ 1.08
	<u>11,190</u>		<u>0.32</u>	<u>31,102</u>		<u>1.08</u>
Effect of Dilutive Securities						
Options and deferred shares		340,388			355,757	
		<u>340,388</u>			<u>355,757</u>	
Diluted EPS						
Net income from continuing operations	\$ 11,190		\$ 0.32	\$ 5,354		\$ 0.18
Discontinued operations				25,748		0.88
	<u>11,190</u>		<u>0.32</u>	<u>5,354</u>		<u>0.18</u>
Income allocable to common shares plus assumed conversions	\$ 11,190	35,140,968	\$ 0.32	\$ 31,102	29,213,062	\$ 1.06
	<u>11,190</u>	<u>35,140,968</u>	<u>0.32</u>	<u>31,102</u>	<u>29,213,062</u>	<u>1.06</u>

	For the six months ended June 30, 2004			For the six months ended June 30, 2003		
	Income (Numerator)	Shares (Denominator)	Per	Income (Numerator)	Shares (Denominator)	Per
			Share Amount			Share Amount
<i>(in thousands, except share and per share data)</i>						
Basic EPS						
Net income from continuing operations	\$ 11,919		\$ 0.35	\$ 19,299		\$ 0.69
Discontinued operations				25,748		0.91
Cumulative effect of a change in accounting principle	520		0.02			
	<u>12,439</u>		<u>0.37</u>	<u>19,299</u>		<u>0.69</u>
Income allocable to common shares	\$ 12,439	34,047,243	\$ 0.37	\$ 45,047	28,104,281	\$ 1.60
	<u>12,439</u>		<u>0.37</u>	<u>45,047</u>		<u>1.60</u>

Effect of Dilutive Securities

Options and deferred shares	<u>359,120</u>	<u>347,199</u>
-----------------------------	----------------	----------------

Diluted EPS

Net income from continuing operations	\$ 11,919	\$ 0.35	\$ 19,299	\$ 0.68
Discontinued operations			25,748	0.90
Cumulative effect of a change in accounting principle	<u>520</u>	<u>0.02</u>	<u> </u>	<u> </u>
Income allocable to common shares plus assumed conversions	<u>\$ 12,439</u>	<u>34,406,363</u>	<u>\$ 0.37</u>	<u>\$ 45,047</u>
			<u>28,451,480</u>	<u>\$ 1.58</u>

NOTE 12 BUSINESS SEGMENT REPORTING

Subsequent to the acquisition of HCI, the Company has three reportable business segments: (1) a mortgage banking segment consisting of subsidiaries that primarily generate taxable fee income by providing loan servicing, loan origination and other related services; (2) a tax credit segment consisting of subsidiaries that primarily generate fees by providing tax credit equity syndication and asset management fees; and (3) an investing segment consisting primarily of subsidiaries holding investments producing tax-exempt interest income. Prior to the acquisition of HCI, the tax credit equity and mortgage banking segments were combined and reported as one segment called the

operating segment. The accounting policies of the segments are the same as those described in the summary of significant accounting policies in Note 1 to the Company's 2003 Form 10-K.

The following tables reflect the results of the Company's business segments for the three and six months ended June 30, 2004 and 2003.

Municipal Mortgage & Equity, LLC
 Segment Reporting for the three months ended June 30, 2004 and 2003
 (in thousands)

	Investing	Mortgage Banking	2004 Tax Credit	Adjustments	Total Consolidated	Investing	Mortgage Banking	2003 Tax Credit	Adjustments	Total Consolidated
Interest	\$ 26,646	\$ 9,743	\$ 2,565	\$(4,367) (1)	\$ 34,587	\$ 16,513	\$ 7,006	\$ 233	\$(1,160) (1)	\$ 15,586
Expense	786	6,229	7,678	(1,338) (2)	13,355	1,877	5,453	2,783	(492) (2)	8,143
Net			5,496		5,496					
Operating	27,432	15,972	15,739	(5,705)	53,438	18,390	12,459	3,016	(1,652)	29,213
Income	20,541	153	(8,166)	(1,338)	11,190	32,804	(566)	(644)	(492)	31,102
Provision		463	3,134		3,597		414			414
Income from										
Changes in	(223)	744	(71,745)		(71,224)		(1,222)	(384)		(1,606)
Relationships										
Continued						25,748				25,748
Operations										
Income										
Before										
Taxes										
Income										
Statement										
of										
Financial										
Position										
at										
June 30,										
2004	\$1,593,511	\$633,541	\$1,860,290	\$	\$4,087,342	\$1,086,577	\$449,907	\$62,886	\$	\$1,599,370
2003	\$1,593,511	\$633,541	\$1,860,290	\$	\$4,087,342	\$1,086,577	\$449,907	\$62,886	\$	\$1,599,370

(1) Adjustments represent intercompany interest and expense that are eliminated in consolidation.

(2) Adjustments represent origination fees on purchased investments which are deferred and amortized into income over the life of the investment.

Municipal Mortgage & Equity, LLC
 Segment Reporting for the six months ended June 30, 2004 and 2003
 (in thousands)

	2004					2003				
	Investing	Mortgage Banking	Tax Credit	Adjustments	Total Consolidated	Investing	Mortgage Banking	Tax Credit	Adjustments	Total Consolidated
INTEREST										
Interest	\$ 53,848	\$ 19,467	\$ 3,393	\$(11,091)	(1) \$ 65,617	\$ 34,935	\$ 15,920	\$ 421	\$(2,227)	(1) \$ 44,129
Expense	1,548	10,108	19,691	(2,349)	(2) 28,998	3,183	8,787	5,118	(953)	(2) 16,125
Net			5,496		5,496					
Income	55,396	29,575	28,580	(13,440)	100,111	38,118	24,707	5,539	(3,180)	65,284
Provision	31,256	(745)	(15,723)	(2,349)	12,439	47,351	(238)	(1,113)	(953)	45,007
Income from		866	4,343		5,209		803			6,012
Losses in	(491)	650	(81,895)		(81,736)		(1,500)	(853)		(85,089)
Income						25,748				25,748
NET INCOME										
Assets	\$ 1,593,511	\$ 633,541	\$ 1,860,290	\$	\$ 4,087,342	\$ 1,086,577	\$ 449,907	\$ 62,886	\$	\$ 1,599,370

(1) Adjustments represent intercompany interest and expense that are eliminated in consolidation.

(2) Adjustments represent origination fees on purchased investments which are deferred and amortized into income over the life of the investment.

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

General Business

The Company provides debt and equity financing to developers of multifamily housing and other real estate investments. The Company invests in tax-exempt bonds, or interests in bonds, issued by state and local governments or their agencies or authorities to finance multifamily housing developments. These tax-exempt bonds are not general obligations of state and local governments, or the agencies or authorities that issue the bonds. The multifamily housing developments, as well as the rents paid by the tenants, typically secure these investments. The Company also invests in other housing-related debt and equity investments, including equity investments in real estate operating partnerships; tax-exempt bonds, or interests in bonds, secured by student housing or assisted living developments; and tax-exempt bonds issued by community development districts to finance the development of community infrastructure supporting single-family housing or commercial developments and secured by specific payments or assessments pledged by the local improvement district that issues the bonds. Interest income derived from the majority of these bond investments is exempt income for Federal income tax purposes.

The Company is also a tax credit syndicator and a mortgage banker. As a syndicator, the Company acquires and sells to investors interests in partnerships that receive low-income housing tax credits. The Company earns syndication fees on the placement of these interests with investors. The Company also earns fees for providing guarantees on certain tax credit funds and for managing the low-income housing tax credit funds it has syndicated. Mortgage banking activities include the origination, investment in and servicing of investments in multifamily housing, both for its own account and on behalf of third parties. These investments generate taxable income.

The Company posts all reports filed with the SEC on its website at <http://www.mmafin.com>. The Company also makes available free of charge its Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those Reports filed pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after the Company electronically files such material with the SEC. These reports are also available free of charge by contacting Angela Richardson in Investor Relations at 621 E. Pratt Street, Suite 300, Baltimore, Maryland, 21202 or info@mmafin.com and by calling 888-788-3863.

Liquidity and Capital Resources

As discussed more fully in the Company's 2003 Form 10-K, the Company relies on the regular availability of capital from equity and debt offerings, securitization transactions, bank lines of credit, pension funds and government sponsored enterprises (GSEs) to finance its growth. The Company expects to meet its cash needs in the short-term, which consist primarily of funding of new investments, payment of distributions to shareholders, funding the warehousing of operating

partnerships for syndication activities and funding of mortgage banking activities, from equity and debt offering proceeds, cash on hand and bank lines of credit. To continue to grow these activities, the Company will need to increase its access to capital in 2004 and future years. The Company expects it will need \$400 million to \$650 million in new capital to meet its 2004 production targets for its lending and tax credit equity businesses. The Company expects to continue to generate capital through the issuance of privately placed preferred and trust preferred securities and listed common shares. The Company has entered into discussions with its existing capital providers to increase their financing commitments. In addition, the Company is seeking to establish relationships with additional pension funds and to expand its relationships with GSEs.

Activity for the three and six months ended June 30, 2004 related to liquidity and capital resources is discussed below. For a complete discussion of liquidity and capital resources, see the Company's 2003 Form 10-K.

The following table summarizes the transactions structured by the Company for the three months ended June 30, 2004:

<i>(in millions)</i>	
Transaction type:	
Taxable Construction/Permanent Lending	\$263.1
Tax-Exempt	211.6
Supplemental Loans	9.1
Equity Financings	204.4
	<hr/>
Total	\$688.2
	<hr/>

The Company also raised \$244.4 million for investment in syndicated tax credit equity funds during the three months ended June 30, 2004.

In January 2004, the Company obtained a \$70.0 million secured line of credit. This facility is being used to warehouse construction loans. As of June 30, 2004, borrowings under this facility totaled \$44.0 million.

In March 2004, the Company sold to the public 2.0 million common shares at a price of \$25.55 per share and granted the underwriters an option to purchase up to an aggregate of 195,000 common shares to cover overallotments. Net proceeds on the 2.0 million shares approximated \$47.7 million. On March 8, 2004, the underwriters exercised their option to purchase 195,000 common shares, generating additional net proceeds of approximately \$4.8 million. The net proceeds from this offering have been used for general corporate purposes, including funding of new investments, paying down debt and working capital.

An indirect wholly owned subsidiary of the Company, MFH, previously formed MFH Trust as its subsidiary. In May 2004, MFH Trust sold to institutional investors \$60.0 million in 9.5% Trust Preferred Securities. MFH Trust used the net proceeds from the offering to purchase Debentures issued by MFH. MFH contributed the net proceeds to one of its subsidiaries, which in turn used the

proceeds to pay off inter-company indebtedness to MuniMae. MuniMae in turn used these amounts to repay a portion of its indebtedness.

Covenant Compliance

As a result of the consolidation of certain assets and liabilities relating to the Company's tax credit equity syndication business pursuant to FIN 46 as of March 31, 2004, and the reclassification, pursuant to Financial Accounting Standards No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity as of September 30, 2003, as liabilities of the Company's outstanding preferred shares in a subsidiary company, during the second quarter of 2004 the Company would have, in the absence of a waiver or amendment, been in default of a financial covenant under a \$200.0 million short-term line of credit. Consequently, the Company and the lender executed a waiver of this default through June 30, 2004. While under the waiver of default, the Company successfully negotiated an amendment to the line of credit to revise the covenant and cure the default. As of June 30, 2004, \$154.6 million of debt was outstanding under this line of credit. As of June 30, 2004, the Company was in compliance with all covenants applicable to its credit facilities.

Factors that Could Affect Future Results

The Company's 2003 Form 10-K contains a detailed description of various factors that could affect the Company's future results. There has been no material change since December 31, 2003 to the information related to factors that could affect future results.

Contractual Obligations

The Company's 2003 Form 10-K contains a detailed description of the Company's contractual obligations. There has been no material change since December 31, 2003 to the information related to the Company's contractual obligations.

Guarantees

The Company's maximum exposure under its guarantee obligations is not indicative of the Company's expected loss under the guarantees. The following table summarizes the Company's guarantees by major group at June 30, 2004:

(in millions)

		June 30, 2004		
Guarantee	Note	Maximum Exposure	Carrying Amount	Supporting Collateral
Loss-sharing agreements with Fannie Mae, GNMA and HUD	(1)	\$ 186.4	\$	\$5.4 million Letter of Credit pledged
Bank line of credit guarantees	(2)	268.2	268.2	Investment in partnership and loans totaling \$283.1 million
Tax credit related guarantees	(3)	364.4	160.8	\$0.9 million of cash
Other financial/payment guarantees	(4)	180.7	14.6	\$14.8 million of cash, tax exempt bonds and common equity
Put options	(5)	65.9	1.2	\$75.8 million of loans and tax exempt bonds
Letter of credit guarantees	(6)	56.4	44.7	\$0.6 million of cash
Indemnification contracts	(7)	77.4	58.9	None
Trust preferred guaranteed	(8)	60.1	60.1	None
		<u>\$1,259.5</u>	<u>\$ 608.5</u>	

Notes:

- (1) As a Fannie Mae and Government National Mortgage Association loan servicer, the Company may share in losses relating to underperforming real estate mortgage loans delivered to Fannie Mae and GNMA. More specifically, if the borrower fails to make a payment on a loan originated by the Company and sold to Fannie Mae, of principal, interest, taxes or insurance premiums, the Company may be required to make servicing advances to Fannie Mae. Also, the Company may participate in a deficiency after foreclosure on FNMA and GNMA loans. The term of the loss sharing agreement is based on the contractual requirements of the underlying loans delivered to Fannie Mae and GNMA, which varies to a maximum of 40 years.
- (2) The Company provides payment or performance guarantees for certain borrowings under line of credit facilities. The amount outstanding under these lines of credit was \$267.6 million at June 30, 2004. This amount is included in notes payable in the Company's consolidated balance sheet.
- (3) The Company acquires and sells interests in partnerships that provide low-income housing tax credits for investors. In conjunction with the sale of these partnership interests, the Company may provide performance guarantees on the underlying properties owned by the partnerships or guarantees to the fund investors. These guarantees have various expirations to a maximum term of 18 years.
- (4) The Company has entered into arrangements that require the Company to make payment in the event a specified third party fails to perform on its financial obligation. The Company typically provides these guarantees in conjunction with the sale of an asset to a third party or the Company's investment in equity ventures. The term of the guarantee varies based on loan payoff schedules or Company divestitures.
- (5) The Company has entered into put option agreements with counterparties whereby the counterparty has the right to sell to the Company, and the Company has the obligation to buy, an underlying investment at a specified price. These put option agreements expire at various dates through April 1, 2007.
- (6)

The Company provides a guarantee of the repayment on losses incurred under letters of credit issued by third parties or to provide substitute letters of credit at a predetermined future date. In addition, the Company may provide a payment guarantee for certain assets in securitization programs. These guarantees expire at various dates through September 1, 2007.

- (7) The Company has entered into indemnification contracts, which require the guarantor to make payments to the guaranteed party based on changes in an underlying investment that is related to an asset or liability of the guaranteed party. These agreements typically require the Company to reimburse the guaranteed party for legal and other costs in the event of an adverse judgment in a lawsuit or the imposition of additional taxes due to a change in the tax law or an adverse interpretation of the tax law. The term of the indemnification varies based on the underlying program life, loan payoffs, or Company divestitures. Based on the terms of the underlying contracts, the maximum exposure amount only includes amounts that can be reasonably estimated at this time. The actual exposure amount could vary significantly.
- (8) The Company provides a payment guarantee of the underlying securities pursuant to the May 3, 2004, Trust Preferred Securities offering. The guarantee obligation is unsecured and subordinated to the Company's existing and future debt and liabilities except for debt and liabilities which by their terms are specifically subordinated to the guarantee obligations and the rights of the holders of various classes of existing and future preferred shares of the Company.

\

Off-Balance-Sheet Arrangements

The Company securitizes bonds and other assets in order to enhance its overall return on its investments and to generate proceeds that facilitate the acquisition of additional investments. The Company uses various programs to facilitate the securitization and credit enhancement of its bond investments. (For a description of a typical bond securitization structure, see further discussion under "Liquidity and Capital Resources" in the Company's 2003 Form 10-K.) The great majority of the Company's securitizations are reflected as indebtedness on its balance sheet, and off-balance sheet securitizations are not material to the Company's liquidity and capital needs. At June 30, 2004 and December 31, 2003, the Company's total off-balance-sheet debt relating to securitizations totaled \$83.3 million and \$83.4 million, respectively.

Distribution Policy

The Company's current policy is to maximize shareholder value through increases in cash distributions to shareholders. The Company's Board of Directors declares quarterly dividends based on management's recommendation, which itself is based on evaluation of a number of factors, including the Company's retained earnings, business prospects and current earnings, as measured by the Company's cash available for distribution (CAD). See *Other Key Measures of Performance* for a description of the differences between CAD and GAAP net income.

The Company's dividend per common share for the three months ended June 30, 2004 and 2003 was \$0.4625 and \$0.4475, respectively. The Company's dividend per common share for the six months ended June 30, 2004 and 2003 was \$0.92 and \$0.8925, respectively.

Cash Flow

Cash flow from operating activities was \$27.1 million and \$86.3 million for the six months ended June 30, 2004 and 2003, respectively. The decrease in operating cash flow is primarily due to a decrease in net income before discontinued operations of \$6.9 million, a decrease in distributions from investments in partnerships of \$1.5 million, a decrease in non-cash items and tax benefits of \$9.7 million and a decrease in net changes in assets and liabilities of \$41.1 million.

Results of Operations and Critical Accounting Estimates

Critical Accounting Policies and Estimates

The Company's 2003 Form 10-K contains a detailed description of the Company's critical accounting policies and estimates. There has been no material change to the information related to critical accounting policies and estimates since December 31, 2003, except as noted under the new accounting pronouncements section of this report.

New Accounting Pronouncements

In January 2003, the Financial Accounting Standards Board (**FASB**) approved Financial Interpretation No. 46, Consolidation of Variable Interest Entities (**FIN 46**). FIN 46 requires the consolidation of a company's equity investment in VIE if the company is the primary beneficiary of the VIE and if risks are not effectively dispersed among the owners of the VIE. The company is considered to be the primary beneficiary of the VIE if the company absorbs the majority of the losses of the VIE. FIN 46 is effective for VIEs created after January 31, 2003. For any VIE in which the Company held an interest that it acquired before February 1, 2003, FIN 46 was effective for the first interim reporting period beginning after June 15, 2003. In December 2003, FASB approved various amendments to FIN 46 and released a revised version of FIN 46 (**FIN 46R**). In addition, FASB extended the effective date of FIN 46 until the first reporting period ending after March 15, 2004 for VIEs which are not special purpose entities, and the Company elected to defer adoption of

that portion of FIN 46 until that time.

The Company's residual interests in bond securitizations represent equity interests in VIEs, and the Company is the primary beneficiary of those VIEs. The Company determined that its bond securitization trusts were special purpose entities (SPEs) and did not qualify for the deferral. Therefore, these securitization trusts were consolidated at December 31, 2003. The Company examined each of its SPEs to determine if it meets the definition of a qualified SPE. Certain of the Company's SPEs are qualified SPEs and are not consolidated accordingly.

The Company initially measured the assets and liabilities of the securitization trusts at the carrying amounts.

The Company has general partnership interests in low-income housing tax credit equity funds where the respective funds have one or more limited partners. The determination of whether the Company is the primary beneficiary of (and must consequently consolidate) a given tax credit equity fund depends on a number of factors, including the number of limited partners and the rights and obligations of the general and limited partners in that fund. Upon adoption of FIN 46 in March 2004, the Company determined that it was the primary beneficiary in certain of the funds it originated where there are multiple limited partners. As a result, the Company consolidated these equity investments at March 31, 2004. The Company's general partner interests typically represent a one percent or less interest in each fund. For those funds which it consolidates, the Company reports the net assets of the funds, consisting primarily of restricted cash, investments in partnerships and notes payable, in the Company's consolidated balance sheet. In addition, the limited partnership interests in the funds, owned by third party investors, are reported as a minority interest. The net income (loss) from these tax credit equity funds is reported in the appropriate line items of the Company's consolidated statement of income. An adjustment for the income (loss) allocable to the limited partners (investors) in the funds is recorded through minority interest expense (income) in the Company's consolidated statement of income. At March 31, 2004, the Company recorded net assets of these tax credit equity funds of \$1.2 billion, consisting primarily of \$1.4 billion in investment in partnerships, \$129.5 million in restricted assets and \$208.7 million in notes payable, which are non-recourse to the Company. The Company recorded \$1.2 billion in minority interest in subsidiary companies. As of March 31, 2004, the Company also recorded a \$0.5 million cumulative effect of a change in accounting principle as a result of recording the net equity allocable to the Company's general partner interest in the funds.

At times, the Company takes ownership of the general partnership interest in the underlying Project Partnerships in which the tax credit funds hold investments. For those property-level general partnership interests (a) owned by the Company and (b) relating to Project Partnerships included in tax credit funds consolidated pursuant to FIN 46, the Company has discontinued the equity method of accounting and consolidated the underlying Project Partnership. Such consolidation was recorded in the second quarter and resulted in an increase in assets of \$172.0 million, an increase in liabilities of \$172.0 million and net income of zero. The Company also has a general partnership interest in certain other low-income housing tax credit equity funds where it has concluded that it is not the primary beneficiary. Accordingly, funds with

assets of \$970.3 million and liabilities of \$90.8 million as of March 31, 2004 have not been consolidated and continue to be accounted for using the equity method.

The Company initially measured the assets and liabilities of the tax credit equity funds at fair value as of July 1, 2003 (the acquisition date of HCI), which was the point in time that the Company first met the criteria to be the primary beneficiary of the VIE. For funds consolidated pursuant to FIN 46 as of March 31, 2004, the fair value was used to record the net assets of the tax credit equity funds when the fair value was less than the carrying amount. For funds where the Company took ownership of the general partnership interest in the underlying Project Partnership in which the fund held an investment, the underlying Project Partnership was recorded at cost in consolidation.

Results of Operations

Net Interest Income

<i>(in thousands)</i>	For the three months ended		For the six months ended June	
	June 30, 2004	2003	2004	30, 2003
Interest on bonds and residual interests in bond securitizations	\$ 21,340	\$ 14,366	\$ 40,842	\$ 30,721
Interest on loans	11,388	7,894	22,109	17,804
Interest on short-term investments	1,859	332	2,666	524
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Total interest income	34,587	22,592	65,617	49,049
Interest expense	(21,279)	(8,724)	(36,743)	(19,092)
Interest expense on preferred shares	(3,035)		(6,081)	
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Net interest income	<u>\$ 10,273</u>	<u>\$ 13,868</u>	<u>\$ 22,793</u>	<u>\$ 29,957</u>

Net interest income for the three months ended June 30, 2004 decreased by \$3.6 million compared to the same period last year due primarily to: (1) a \$4.7 million increase in interest expense; (2) a \$3.0 million increase in interest expense related to the reclassification of the income allocable to preferred shares from minority interest to interest expense beginning on July 1, 2003; offset in part by (3) a \$3.6 million increase in net interest income on bonds and loans; and (4) a \$0.4 million increase in interest income resulting from including interest expense on Project Partnerships consolidated under FIN 46.

Net interest income for the six months ended June 30, 2004 decreased by \$7.2 million compared to the same period last year due primarily to (1) a \$6.1 million increase in interest expense related to the reclassification of the income allocable to preferred shares from minority interest to interest expense beginning on July 1, 2003; (2) a \$4.7 million increase in interest expense resulting from including interest expense on Project Partnerships consolidated under FIN 46; offset in part by (3) a \$3.1 million increase in net interest income on bonds and loans; and (4) a \$0.4 million increase in interest income resulting from including interest expense on Project Partnerships consolidated under FIN 46.

The majority of the increase in interest income on bonds is offset by an increase in interest expense related to these bond investments. These increases are due to a change in the method of accounting for certain securitization entities in accordance with FIN 46 beginning December 31, 2003. For the three and six months ended June 30, 2004, the Company is reporting the interest

income related to the securitization trust assets (tax-exempt bonds) and interest expense related to the senior interest in the trusts (short-term debt) due to the consolidation of the securitization trust. In 2003, the net interest income earned on the securitization trusts was reported as interest on bonds.

Fee Income