PHH CORP
Form 10-Q
November 10, 2008

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2008

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to

Commission File No. 1-7797

PHH CORPORATION
(Exact name of registrant as specified in its charter)

MARYLAND	**52-0551284**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification Number)*
3000 LEADENHALL ROAD MT. LAUREL, NEW JERSEY	**08054**
(Address of principal executive offices)	*(Zip Code)*

856-917-1744
(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 þ No o

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

Non-accelerated filer o (Do not check if a smaller reporting company) Smaller reporting company o

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

As of October 16, 2008, 54,256,294 shares of common stock were outstanding.

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Except as expressly indicated or unless the context otherwise requires, the Company, PHH, we, our or us means Corporation, a Maryland corporation, and its subsidiaries.

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q for the quarter ended September 30, 2008 (the Form 10-Q) contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements are subject to known and unknown risks, uncertainties and other factors and were derived utilizing numerous important assumptions that may cause our actual results, performance or achievements to differ materially from any future results, performance or achievements expressed or implied by such forward-looking statements. Investors are cautioned not to place undue reliance on these forward-looking statements.

Statements preceded by, followed by or that otherwise include the words believes, expects, anticipates, intends, projects, estimates, plans, may increase, may fluctuate and similar expressions or future or conditional verbs suc will, should, would, may and could are generally forward-looking in nature and are not historical facts. Forward-looking statements in this Form 10-Q include, but are not limited to, the following: (i) our expectations regarding the impact of the adoption of recently issued accounting pronouncements on our financial statements; (ii) our belief that we would have various periods to cure an event of default if one or more notices of default were to be given by our lenders or trustees under certain of our financing agreements; (iii) our expectations regarding lower origination volumes, home sale volumes and increasing competition in the mortgage industry and our intention to take advantage of this environment by entering into new outsourcing arrangements and our belief that we will gain market share by entering into new outsourcing relationships; (iv) our belief that the amount of securities held in trust related to our potential obligations from our reinsurance agreements are significantly higher than claims expected to be paid and our expectation that any paid claims will have minimal impact on our liquidity; (v) our belief that the Housing and Economic Recovery Act of 2008, the conservatorship of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Association (Freddie Mac) and the Emergency Economic Stabilization Act of 2008 (the EESA) could improve the negative trends that the mortgage industry has experienced since the middle of 2007; (vi) our expected savings during the remainder of 2008 and during 2009 from cost-reducing initiatives; (vii) our belief that our sources of liquidity are adequate to fund our operations for the next 12 months; (viii) our expected capital expenditures for 2008; (ix) our intention not to replace our $275 million committed mortgage repurchase facility that was terminated on October 27, 2008 and our belief that we have adequate capacity under our other mortgage warehouse asset-backed debt facilities; (x) our belief that the reduced capacity under the committed secured line of credit maintained by PHH Home Loans, LLC will not have a material impact on our liquidity and that there is sufficient capacity under our committed repurchase facility; (xi) our expectation that the London Interbank Offered Rate and commercial paper, long-term United States (U.S.) Treasury and mortgage interest rates will remain our primary benchmark for market risk for the foreseeable future; (xii) our expectation that increased reliance on the natural business hedge could result in greater volatility in the results of our Mortgage Servicing segment; (xiii) our intention to utilize the available capacity under the Series 2006-1 notes, issued by our wholly owned subsidiary, Chesapeake Funding LLC (Chesapeake), to fund vehicle leases in the event that we choose to allow the Series 2006-2 notes issued by Chesapeake to amortize in accordance with their terms and (xiv) our intention to enter into negotiations with the lenders of the Series 2006-1 notes regarding whether to renew all or a portion of these notes.

The factors and assumptions discussed below and the risks and uncertainties described in Item 1A. Risk Factors in this Form 10-Q, Item 1A. Risk Factors included in our Annual Report on Form 10-K for the year ended December 31, 2007 and Item 1A. Risk Factors in our Quarterly Reports on Form 10-Q for the quarters ended March 31, 2008 and June 30, 2008, could cause actual results to differ materially from those expressed in such forward-looking statements:

- the effects of environmental, economic or political conditions on the international, national or regional economy, the outbreak or escalation of hostilities or terrorist attacks and the impact thereof on our businesses;

- the effects of continued credit market volatility on the availability and cost of our financing arrangements, the value of our assets and the price of our Common stock;

- the effects of a continued decline in the volume or value of U.S. home sales, due to adverse economic changes or otherwise, on our Mortgage Production and Mortgage Servicing segments;

- n the effects of changes in current interest rates on our Mortgage Production and Mortgage Servicing segments and on our financing costs;
- n the effects of changes in spreads between mortgage rates and swap rates, option volatility and the shape of the yield curve, particularly on the performance of our risk management activities;
- n our decision to close out substantially all of our derivatives related to MSRs and the resulting potential volatility of the results of operations of our Mortgage Servicing segment;
- n the effects of any significant adverse changes in the underwriting criteria of government-sponsored entities, including Fannie Mae and the Freddie Mac;
- n the effects of the insolvency or inability of any of the counterparties to our significant customer contracts or financing arrangements to perform its obligations under our contracts;
- n our ability to develop and implement operational, technological and financial systems to manage growing operations and to achieve enhanced earnings or effect cost savings;
- n the effects of competition in our existing and potential future lines of business, including the impact of consolidation within the industries in which we operate and competitors with greater financial resources and broader product lines;
- n the effects of the decline in the results of operations or financial condition of automobile manufacturers and/or their willingness or ability to make new vehicles available to us on commercially favorable terms, if at all;
- n our ability to quickly reduce overhead and infrastructure costs in response to a reduction in revenue;
- n our ability to implement fully integrated disaster recovery technology solutions in the event of a disaster;
- n our ability to obtain financing on acceptable terms, if at all, to finance our operations and growth strategy, to operate within the limitations imposed by financing arrangements, to maintain our credit ratings and to maintain the amount of cash required to service our indebtedness;
- n our ability to maintain our relationships with our existing clients;
- n a deterioration in the performance of assets held as collateral for secured borrowings;
- n a downgrade in our credit ratings below investment grade or any failure to comply with certain financial covenants under our financing agreements;
- n the effects of the declining health of the U.S. and global banking systems, the consolidation of financial institutions and the related impact on the availability of credit;
- n the impact of the EESA enacted by the U.S. government on the securities market and valuations of mortgage-backed securities and the impact of actions taken or to be taken by the U.S. Treasury and the Federal Reserve Bank on the credit markets and the U.S. economy and
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changes in laws and regulations, including changes in accounting standards, mortgage- and real estate-related regulations and state, federal and foreign tax laws.

Other factors and assumptions not identified above were also involved in the derivation of these forward-looking statements, and the failure of such other assumptions to be realized as well as other factors may also cause actual results to differ materially from those projected. Most of these factors are difficult to predict accurately and are generally beyond our control.

The factors and assumptions discussed above may have an impact on the continued accuracy of any forward-looking statements that we make. Except for our ongoing obligations to disclose material information under the federal securities laws, we undertake no obligation to release publicly any revisions to any forward-looking statements, to report events or to report the occurrence of unanticipated events unless required by law. For any forward-looking statements contained in any document, we claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995.

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PART I FINANCIAL INFORMATION

Item 1. ***Financial Statements***

PHH CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(In millions, except per share data)

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Revenues				
Mortgage fees	$ 50	$ 34	$ 172	$ 101
Fleet management fees	40	41	123	122
Net fee income	90	75	295	223
Fleet lease income	401	403	1,191	1,190
Gain (loss) on mortgage loans, net	49	(37)	177	76
Mortgage interest income	38	91	138	280
Mortgage interest expense	(44)	(69)	(128)	(212)
Mortgage net finance (expense) income	(6)	22	10	68
Loan servicing income	111	123	330	384
Change in fair value of mortgage servicing rights	(77)	(249)	(109)	(232)
Net derivative (loss) gain related to mortgage servicing rights	(62)	119	(179)	(93)
Valuation adjustments related to mortgage servicing rights	(139)	(130)	(288)	(325)
Net loan servicing (loss) income	(28)	(7)	42	59
Other income	27	28	123	74
Net revenues	533	484	1,838	1,690
Expenses				
Salaries and related expenses	108	81	341	249
Occupancy and other office expenses	19	19	55	55
Depreciation on operating leases	325	318	971	944
Fleet interest expense	37	55	119	159

Other depreciation and amortization		7		6		19		22
Other operating expenses		117		92		337		274
Goodwill impairment		61				61		
Total expenses		674		571		1,903		1,703
Loss before income taxes and minority interest		(141)		(87)		(65)		(13)
(Benefit from) provision for income taxes		(32)		(50)		(4)		7
Loss before minority interest		(109)		(37)		(61)		(20)
Minority interest in (loss) income of consolidated entities, net of income taxes of $3, $(1), $2 and $(3)		(25)		1		(23)		4
Net loss	$	(84)	$	(38)	$	(38)	$	(24)
Basic and diluted loss per share	$	(1.56)	$	(0.69)	$	(0.70)	$	(0.44)

See Notes to Condensed Consolidated Financial Statements.

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PHH CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)
(In millions, except share data)

	September 30, 2008	December 31, 2007
ASSETS		
Cash and cash equivalents	$ 105	$ 149
Restricted cash	658	579
Mortgage loans held for sale, net		1,564
Mortgage loans held for sale (at fair value)	1,195	
Accounts receivable, net	477	686
Net investment in fleet leases	4,228	4,224
Mortgage servicing rights	1,671	1,502
Investment securities	37	34
Property, plant and equipment, net	62	61
Goodwill	25	86
Other assets	408	472
Total assets	$ 8,866	$ 9,357
LIABILITIES AND STOCKHOLDERS EQUITY		
Accounts payable and accrued expenses	$ 455	$ 533
Debt	5,990	6,279
Deferred income taxes	707	697
Other liabilities	208	287
Total liabilities	7,360	7,796
Commitments and contingencies (Note 11)		
Minority interest	3	32
STOCKHOLDERS EQUITY		
Preferred stock, $0.01 par value; 1,090,000 shares authorized at September 30, 2008 and 10,000,000 shares authorized at December 31, 2007; none issued or outstanding at September 30, 2008 or December 31, 2007		
Common stock, $0.01 par value; 108,910,000 shares authorized at September 30, 2008 and 100,000,000 shares authorized at December 31, 2007; 54,256,294 shares issued and outstanding at September 30, 2008; 54,078,637 shares issued and outstanding at December 31, 2007	1	1
Additional paid-in capital	1,004	972
Retained earnings	478	527
Accumulated other comprehensive income	20	29
Total stockholders equity	1,503	1,529

Total liabilities and stockholders equity	$	8,866	$	9,357

See Notes to Condensed Consolidated Financial Statements.

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PHH CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY
Nine Months Ended September 30, 2008
(Unaudited)
(In millions, except share data)

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
Balance at December 31, 2007	54,078,637	$ 1	$ 972	$ 527	$ 29	$ 1,529
Adjustment to distributions of assets and liabilities to Cendant related to the Spin-Off				3		3
Effect of adoption of SFAS No. 157 and SFAS No. 159, net of income taxes of $(10)				(14)		(14)
Net loss				(38)		(38)
Other comprehensive loss, net of income taxes of $0					(9)	(9)
Proceeds on sale of Sold Warrants (Note 9)			24			24
Reclassification of Purchased Options and Conversion Option, net of income taxes of $(1) (Note 9)			(1)			(1)
Stock compensation expense			10			10
Stock options exercised, including excess tax benefit/(shortfall) of $0	28,765		1			1
Restricted stock award vesting, net of excess tax benefit/(shortfall) of $0	148,892		(2)			(2)
Balance at September 30, 2008	54,256,294	$ 1	$ 1,004	$ 478	$ 20	$ 1,503

See Notes to Condensed Consolidated Financial Statements.

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PHH CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(In millions)

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Cash flows from operating activities:		
Net loss	$ (38)	$ (24)
Adjustments to reconcile Net loss to net cash provided by operating activities:		
Goodwill impairment charge	61	
Capitalization of originated mortgage servicing rights	(272)	(348)
Net unrealized loss on mortgage servicing rights and related derivatives	288	325
Vehicle depreciation	971	944
Other depreciation and amortization	19	22
Origination of mortgage loans held for sale	(17,235)	(23,896)
Proceeds on sale of and payments from mortgage loans held for sale	17,706	24,921
Other adjustments and changes in other assets and liabilities, net	(152)	94
Net cash provided by operating activities	1,348	2,038
Cash flows from investing activities:		
Investment in vehicles	(1,463)	(1,699)
Proceeds on sale of investment vehicles	414	740
Purchase of mortgage servicing rights	(6)	(37)
Proceeds on sale of mortgage servicing rights	175	
Cash paid on derivatives related to mortgage servicing rights	(129)	(95)
Net settlement proceeds from (payments for) derivatives related to mortgage servicing rights	26	(11)
Purchases of property, plant and equipment	(16)	(16)
Increase in Restricted cash	(79)	(68)
Other, net	10	32
Net cash used in investing activities	(1,068)	(1,154)
Cash flows from financing activities:		
Net decrease in short-term borrowings	(73)	(913)
Proceeds from borrowings	24,601	17,739
Principal payments on borrowings	(24,777)	(17,715)
Issuances of Company Common stock	1	5
Proceeds from the sale of Sold Warrants (Note 9)	24	
Cash paid for Purchased Options (Note 9)	(51)	
Cash paid for debt issuance costs	(52)	(2)
Other, net	(5)	(4)
Net cash used in financing activities	(332)	(890)

Effect of changes in exchange rates on Cash and cash equivalents		8		1
Net decrease in Cash and cash equivalents		(44)		(5)
Cash and cash equivalents at beginning of period		149		123
Cash and cash equivalents at end of period	$	105	$	118

See Notes to Condensed Consolidated Financial Statements.

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PHH CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Summary of Significant Accounting Policies

Basis of Presentation

PHH Corporation and subsidiaries (collectively, PHH or the Company) is a leading outsource provider of mortgage and fleet management services operating in the following business segments:

Mortgage Production provides mortgage loan origination services and sells mortgage loans.

Mortgage Servicing provides servicing activities for originated and purchased loans.

Fleet Management Services provides commercial fleet management services.

The Condensed Consolidated Financial Statements include the accounts and transactions of PHH and its subsidiaries, as well as entities in which the Company directly or indirectly has a controlling interest and variable interest entities of which the Company is the primary beneficiary. PHH Home Loans, LLC and its subsidiaries (collectively, PHH Home Loans or the Mortgage Venture) are consolidated within PHH s Condensed Consolidated Financial Statements, and Realogy Corporation s ownership interest is presented as Minority interest in the Condensed Consolidated Balance Sheets and Minority interest in (loss) income of consolidated entities, net of income taxes in the Condensed Consolidated Statements of Operations.

The Condensed Consolidated Financial Statements have been prepared in conformity with accounting principles generally accepted in the United States (GAAP) for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC). Accordingly, they do not include all of the information and disclosures required by GAAP for complete financial statements. In management s opinion, the unaudited Condensed Consolidated Financial Statements contain all adjustments, which include normal and recurring adjustments necessary for a fair presentation of the financial position and results of operations for the interim periods presented. The results of operations reported for interim periods are not necessarily indicative of the results of operations for the entire year or any subsequent interim period. These unaudited Condensed Consolidated Financial Statements should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2007.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. These estimates and assumptions include, but are not limited to, those related to the valuation of mortgage servicing rights (MSRs), mortgage loans held for sale (MLHS), other financial instruments and goodwill and the determination of certain income tax assets and liabilities and associated valuation allowances. Actual results could differ from those estimates.

Changes in Accounting Policies

Fair Value Measurements. In September 2006, the Financial Accounting Standards Board (the FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements (SFAS No. 157). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in GAAP and expands disclosures about fair value measurements. SFAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. SFAS No. 157 also prioritizes the use of market-based assumptions, or observable inputs, over entity-specific assumptions or unobservable inputs when measuring fair value and establishes a three-level hierarchy based upon the relative reliability and availability of the inputs to market participants for the valuation of an asset or liability as of the measurement date. The fair value hierarchy designates quoted prices in active markets for identical assets or liabilities at the highest level and unobservable inputs at the lowest level. (See Note 14, Fair Value Measurements for additional information regarding the fair value hierarchy.) SFAS No. 157 also nullified the guidance in Emerging

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PHH CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

Issues Task Force (EITF) 02-3, Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities (EITF 02-3), which required the deferral of gains and losses at the inception of a transaction involving a derivative financial instrument in the absence of observable data supporting the valuation technique.

The Company adopted the provisions of SFAS No. 157 for assets and liabilities that are measured at fair value on a recurring basis effective January 1, 2008. In February 2008, the FASB issued FASB Staff Position (FSP) FAS 157-2, Effective Date of FASB Statement No. 157 (FSP FAS 157-2), which delays the effective date of SFAS No. 157 for one year for nonfinancial assets and nonfinancial liabilities, except for those that are recognized or disclosed at fair value on a recurring basis. The Company elected the deferral provided by FSP FAS 157-2 and will apply the provisions of SFAS No. 157 to its assessment of impairment of its Goodwill, indefinite-lived intangible assets and Property, plant and equipment for the year ended December 31, 2009. The Company is currently evaluating the impact of adopting FSP FAS 157-2 on its Consolidated Financial Statements. In October 2008, the FASB issued FSP FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active (FSP FAS 157-3), which clarifies the application of SFAS No. 157 in a market that is not active. FSP FAS 157-3 was effective upon issuance and was adopted by the Company on September 30, 2008. The adoption of FSP FAS 157-3 did not impact the Company s Consolidated Financial Statements as its application of measuring fair value under SFAS No. 157 was consistent with FSP FAS 157-3. As a result of the adoption of SFAS No. 157 for assets and liabilities that are measured at fair value on a recurring basis, the Company recorded a $9 million decrease in Retained earnings as of January 1, 2008. This amount represents the transition adjustment, net of income taxes, resulting from recognizing gains and losses related to the Company s interest rate lock commitments (IRLCs) that were previously deferred in accordance with EITF 02-3. The fair value of the Company s IRLCs, as determined for the January 1, 2008 transition adjustment, excluded the value attributable to servicing rights, in accordance with the transition provisions of Staff Accounting Bulletin (SAB) No. 109, Written Loan Commitments Recorded at Fair Value Through Earnings (SAB 109). The fair value associated with the servicing rights is included in the fair value measurement of all written loan commitments issued after January 1, 2008.

After the adoption of SFAS No. 157, all of the Company s derivative assets and liabilities existing at the effective date, including IRLCs, were included in Other assets and Other liabilities in the Condensed Consolidated Balance Sheet, which is consistent with the classification of these instruments prior to the adoption of SFAS No. 157.

The following table summarizes the transition adjustment at the date of adoption of SFAS No. 157:

	Balance January 1, 2008 Prior to Adoption	Transition Adjustment	Balance January 1, 2008 After Adoption
		(In millions)	
Derivative assets	$ 177	$ (3)	$ 174
Derivative liabilities	121	(12)	133
Income tax benefit		6	

Cumulative-effect adjustment, net of income taxes	$	(9)

Fair Value Option. In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159). SFAS No. 159 permits entities to choose, at specified election dates, to measure eligible items at fair value (the Fair Value Option). Unrealized gains and losses on items for which the Fair Value Option has been elected are reported in earnings. Additionally, fees and costs associated with instruments for which the Fair Value Option is elected are recognized as earned and expensed as incurred, rather than deferred. The Fair Value Option is applied instrument by instrument (with certain exceptions), is irrevocable (unless a new election date occurs) and is applied only to an entire instrument.

PHH CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

The Company adopted the provisions of SFAS No. 159 effective January 1, 2008. Upon adopting SFAS No. 159, the Company elected to measure certain eligible items at fair value, including all of its MLHS and Investment securities existing at the date of adoption. The Company also made an automatic election to record future MLHS and retained interests in securitizations at fair value. The Company s fair value election for MLHS is intended to better reflect the underlying economics of the Company as well as eliminate the operational complexities of the Company s risk management activities related to its MLHS and applying hedge accounting pursuant to SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS No. 133). The Company s fair value election for Investment securities enables it to record all gains and losses on these investments through the Consolidated Statement of Operations.

Upon the adoption of SFAS No. 159, fees and costs associated with the origination and acquisition of MLHS are no longer deferred pursuant to SFAS No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases (SFAS No. 91), which was the Company s policy prior to the adoption of SFAS No. 159. Prior to the adoption of SFAS No. 159, interest receivable related to the Company s MLHS was included in Accounts receivable, net in the Consolidated Balance Sheets; however, after the adoption of SFAS No. 159, interest receivable is recorded as a component of the fair value of the underlying MLHS and is included in Mortgage loans held for sale in the Condensed Consolidated Balance Sheet. Also, prior to the adoption of SFAS No. 159 the Company s investments were classified as either available-for-sale or trading securities pursuant to SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities (SFAS No. 115) or hybrid financial instruments pursuant to SFAS No. 155, Accounting for Certain Hybrid Financial Instruments (SFAS No. 155). The recognition of unrealized gains and losses in earnings related to the Company s investments classified as trading securities and hybrid financial instruments is consistent with the recognition prior to the adoption of SFAS No. 159. However, prior to the adoption of SFAS No. 159, available-for-sale securities were carried at fair value with unrealized gains and losses reported net of income taxes as a separate component of Stockholders equity. Unrealized gains or losses included in Stockholders equity as of January 1, 2008, prior to the adoption of SFAS No. 159, were not significant. As a result of the adoption of SFAS No. 159, the Company recorded a $5 million decrease in Retained earnings as of January 1, 2008. This amount represents the transition adjustment, net of income taxes, resulting from the recognition of fees and costs, net associated with the origination and acquisition of MLHS that were previously deferred in accordance with SFAS No. 91. (See Note 14, Fair Value Measurements for additional information.)

The following table summarizes the transition adjustment at the date of adoption of SFAS No. 159:

	Balance January 1, 2008 Prior to Adoption	Transition Adjustment	Balance January 1, 2008 After Adoption
		(In millions)	
Mortgage loans held for sale	$ 1,564	$ (4)	$ 1,560
Accounts receivable, net	686	(5)	681
Income tax benefit		4	

Cumulative-effect adjustment, net of income taxes	$	(5)

Offsetting of Amounts Related to Certain Contracts. In April 2007, the FASB issued FSP FASB Interpretation Number (FIN) 39-1, Amendment of FASB Interpretation No. 39 (FSP FIN 39-1). FSP FIN 39-1 modified FIN 39, Offsetting of Amounts Related to Certain Contracts by permitting companies to offset fair value amounts recognized for multiple derivative instruments executed with the same counterparty under a master netting arrangement against fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral arising from the same master netting arrangement as the derivative instruments. Retrospective application was required for all prior period financial statements presented. The Company adopted the provisions of FSP FIN 39-1 on January 1, 2008. The adoption of FSP FIN 39-1 did not impact the Company s Consolidated Financial Statements, as its practice of netting cash collateral against net derivative assets and liabilities under the

PHH CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

same master netting arrangements prior to the adoption of FSP FIN 39-1 was consistent with the provisions of FSP FIN 39-1.

Written Loan Commitments. In November 2007, the SEC issued SAB 109. SAB 109 supersedes SAB No. 105, Application of Accounting Principles to Loan Commitments and expresses the view of the SEC staff that, consistent with the guidance in SFAS No. 156, Accounting for Servicing of Financial Assets (SFAS No. 156) and SFAS No. 159, the expected net future cash flows related to the associated servicing of a loan should be included in the measurement of all written loan commitments that are accounted for at fair value through earnings. SAB 109 also retains the view of the SEC staff that internally developed intangible assets should not be recorded as part of the fair value of a derivative loan commitment and broadens its application to all written loan commitments that are accounted for at fair value through earnings. The Company adopted the provisions of SAB 109 effective January 1, 2008. SAB 109 requires prospective application to derivative loan commitments issued or modified after the date of adoption. Upon adoption of SAB 109 on January 1, 2008, the expected net future cash flows related to the servicing of mortgage loans associated with the Company s IRLCs issued from the adoption date forward are included in the fair value measurement of the IRLCs at the date of issuance. Prior to the adoption of SAB 109, the Company did not include the net future cash flows related to the servicing of mortgage loans associated with the IRLCs in their fair value. This change in accounting policy results in the recognition of earnings on the date the IRLCs are issued rather than when the mortgage loans are sold or securitized. Pursuant to the transition provisions of SAB 109, the Company recognized a benefit to Gain on mortgage loans, net in the Condensed Consolidated Statement of Operations for the nine months ended September 30, 2008 of approximately $30 million, as the value attributable to servicing rights related to IRLCs as of January 1, 2008 was excluded from the transition adjustment for the adoption of SFAS No. 157.

Expected Term for Employee Stock Options. In December 2007, the SEC issued SAB No. 110, Certain Assumptions Used in Valuation Methods (SAB 110). SAB 110 amends SAB No. 107, Share-Based Payment to allow the continued use, under certain circumstances, of the simplified method in developing the expected term for stock options. The Company adopted the provisions of SAB 110 effective January 1, 2008. The adoption of SAB 110 will impact the Company s Consolidated Financial Statements prospectively in the event circumstances provide for the application of the simplified method to future stock option grants made by the Company.

Recently Issued Accounting Pronouncements

Business Combinations. In December 2007, the FASB issued SFAS No. 141(R), Business Combinations (SFAS No. 141(R)), which replaces SFAS No. 141. SFAS No. 141(R) applies the acquisition method to all transactions and other events in which one entity obtains control over one or more other businesses and establishes principles and requirements for how the acquirer recognizes and measures identifiable assets acquired and liabilities assumed, including assets and liabilities arising from contingencies, any noncontrolling interest in the acquiree and goodwill acquired or gain realized from a bargain purchase. SFAS No. 141(R) is effective prospectively for business combinations for which the acquisition date is on or after the first annual reporting period beginning after December 15, 2008. The adoption of SFAS No. 141(R) will impact the Company s Consolidated Financial Statements prospectively in the event of any business combinations entered into by the Company after the effective date in which the Company is the acquirer.

Noncontrolling Interests. In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements (SFAS No. 160), which amends Accounting Research Bulletin No. 51, Consolidated Financial Statements. SFAS No. 160 establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. Specifically, SFAS No. 160 requires a noncontrolling interest in a subsidiary to be reported as equity, separate from the parent s equity, in the consolidated statement of financial position and the amount of net income or loss and comprehensive income or loss attributable to the parent and noncontrolling interest to be presented separately on the face of the consolidated financial statements. Changes in a parent s ownership interest in its subsidiary in which a controlling financial

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interest is retained are accounted for as equity transactions. If a controlling financial interest in the subsidiary is not retained, the subsidiary is deconsolidated and any retained noncontrolling equity interest is initially measured at fair value. SFAS No. 160 is effective for fiscal years beginning after December 15, 2008 and is to be applied prospectively, except that presentation and disclosure requirements are to be applied retrospectively for all periods presented. The Company is currently evaluating the impact of adopting SFAS No. 160 on its Consolidated Financial Statements. However, the Company does not expect the adoption of SFAS No. 160 to have a significant impact on its Consolidated Financial Statements.

Transfers of Financial Assets and Repurchase Financing Transactions. In February 2008, the FASB issued FSP FAS 140-3, Accounting for Transfers of Financial Assets and Repurchase Financing Transactions (FSP FAS 140-3). The objective of FSP FAS 140-3 is to provide guidance on accounting for the transfer of a financial asset and repurchase financing. An initial transfer of a financial asset and a repurchase financing are considered part of the same arrangement for purposes of evaluation under SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities (SFAS No. 140) unless the criteria of FSP FAS 140-3 are met at the inception of the transaction. If the criteria are met, the initial transfer of the financial asset and repurchase financing transaction shall be evaluated separately under SFAS No. 140. FSP FAS 140-3 is effective for financial statements issued for fiscal years beginning after November 15, 2008 and is to be applied prospectively. The Company is currently evaluating the impact of adopting FSP FAS 140-3 on its Consolidated Financial Statements.

Disclosures about Derivative Instruments and Hedging Activities. In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities (SFAS No. 161). SFAS No. 161 enhances disclosure requirements for derivative instruments and hedging activities regarding how and why derivative instruments are used, how derivative instruments and related hedged items are accounted for under SFAS No. 133 and its related interpretations and how they affect financial position, financial performance and cash flows. SFAS No. 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments and disclosures about credit-risk-related contingent features in derivative agreements. SFAS No. 161 is effective for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. SFAS No. 161 enhances disclosure requirements and will not impact the Company s financial condition, results of operations or cash flows.

Hierarchy of GAAP. In May 2008, the FASB issued SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles (SFAS No. 162). SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the accounting principles used in preparing financial statements of nongovernmental entities that are presented in conformity with GAAP (the GAAP Hierarchy). Currently, the GAAP Hierarchy is provided in the American Institute of Certified Public Accountants United States (U.S.) Auditing Standards Section 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles. SFAS No. 162 is effective November 15, 2008. The Company does not expect the adoption of SFAS No. 162 to have an impact on its Consolidated Financial Statements.

Financial Guarantee Insurance Contracts. In May 2008, the FASB issued SFAS No. 163, Accounting for Financial Guarantee Insurance Contracts (SFAS No. 163). SFAS No. 163 clarifies how SFAS No. 60, Accounting and Reporting by Insurance Enterprises applies to financial guarantee insurance and reinsurance contracts issued by insurance enterprises, including the recognition and measurement of premium revenue and claim liabilities.
SFAS No. 163 requires insurance enterprises to recognize a liability for the unearned premium revenue at inception of

the financial guarantee insurance contract and recognize revenue over the period of the contract in proportion to the amount of insurance protection provided. SFAS No. 163 also requires an insurance enterprise to recognize a claim liability prior to an event of default when there is evidence that credit deterioration has occurred in an insured financial obligation. Additional disclosures about financial guarantee contracts are also required. SFAS No. 163 is effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2008. Early adoption is not permitted, except for certain disclosures about risk management activities

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which are effective for the first period beginning after the issuance of SFAS No. 163. The Company is currently evaluating the impact of adopting SFAS No. 163 on its Consolidated Financial Statements. However, the Company does not expect the adoption of SFAS No. 163 to have a significant impact on its Consolidated Financial Statements as SFAS No. 163 does not apply to the Company s mortgage reinsurance agreements.

Intangible Assets. In April 2008, the FASB issued FSP FAS 142-3, Determination of the Useful Life of Intangible Assets (FSP FAS 142-3). FSP FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, Goodwill and Other Intangible Assets (SFAS No. 142) in order to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141(R) and other GAAP. FSP FAS 142-3 is effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2008 and is to be applied prospectively to intangible assets acquired after the effective date. Disclosure requirements are to be applied to all intangible assets recognized as of, and subsequent to, the effective date. Early adoption is not permitted.

Convertible Debt Instruments. In May 2008, the FASB issued FSP Accounting Principles Board Opinion (APB) 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (FSP APB 14-1). FSP APB 14-1 requires the issuer of certain convertible debt instruments that may be settled in cash or other assets upon conversion to separately account for the liability and equity components of the instrument in a manner that reflects the issuer s nonconvertible debt borrowing rate. FSP APB 14-1 is effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2008 and is to be applied retrospectively to all periods presented, with certain exceptions. Early adoption is not permitted. The Company is currently evaluating the impact of adopting FSP APB 14-1 on its Consolidated Financial Statements. However, the Company does not expect the adoption of FSP APB 14-1 to have any impact on its Consolidated Financial Statements for its 4.0% Convertible Senior Notes due 2012 (the Convertible Notes) as its application of EITF 06-7, Issuer s Accounting for a Previously Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation Criteria in FASB Statement No. 133 results in separate accounting for the liability and equity components of the Convertible Notes and continued amortization of the original issue discount. See Note 9, Debt and Borrowing Arrangements for additional information regarding the Convertible Notes.

Participating Securities. In June 2008, the FASB issued FSP EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities (FSP EITF 03-6-1). FSP EITF 03-6-1 addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing earnings per share under the two class method described in SFAS No. 128, Earnings per Share. FSP EITF 03-6-1 is effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2008 and prior period earnings per share data presented shall be adjusted retrospectively. The Company is currently evaluating the impact of adopting FSP EITF 03-6-1 on its Consolidated Financial Statements. However, the Company does not expect the adoption of FSP EITF 03-6-1 to impact the calculation of its earnings per share as its unvested stock-based compensation awards do not contain nonforfeitable rights to dividends or dividend equivalents.

Instruments Indexed to Stock. In June 2008, the FASB ratified the consensus reached by the EITF on three issues discussed at its June 12, 2008 meeting pertaining to EITF 07-5, Determining Whether an Instrument (or Embedded Feature) is Indexed to an Entity s Own Stock (EITF 07-5). The issues include how an entity should evaluate whether an instrument, or embedded feature, is indexed to its own stock, how the currency in which the strike price of an equity-linked financial instrument, or embedded equity-linked feature, is denominated affects the determination of whether the instrument is indexed to an entity s own stock and how the issuer should account for market-based employee stock option valuation instruments. EITF 07-5 is effective for financial instruments issued for fiscal years and interim periods beginning after December 15, 2008 and is applicable to outstanding instruments as of the beginning of the fiscal year it is initially applied. The cumulative effect, if any, of the change in accounting

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principle shall be recognized as an adjustment to the opening balance of Retained earnings. The Company is currently evaluating the impact of adopting EITF 07-5 on its Consolidated Financial Statements.

Conforming Changes to EITF 98-5. In June 2008, the FASB ratified the consensus reached on June 12, 2008 by the EITF on EITF 08-4, Transition Guidance for Conforming Changes to EITF Issue No. 98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios (EITF 08-4). The conforming changes to EITF 98-5 resulting from EITF 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments (EITF 00-27) and SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity are effective for financial statements issued for fiscal years and interim periods ending after December 15, 2008. The effect, if any, of applying the conforming changes shall be presented retrospectively and the cumulative effect of the change in accounting principle shall be recognized as an adjustment to the opening balance of Retained earnings of the first period presented. The Company is currently evaluating the impact of adopting EITF 08-4 on its Consolidated Financial Statements. However, the Company does not expect the adoption of EITF 08-4 to have any impact on its Consolidated Financial Statements for its existing Convertible Notes as the Company s application of EITF 00-27 is consistent with the guidance of this issue.

2. Terminated Merger Agreement

On March 15, 2007, the Company entered into a definitive agreement (the Merger Agreement) with General Electric Capital Corporation (GE) and its wholly owned subsidiary, Jade Merger Sub, Inc. to be acquired (the Merger). In conjunction with the Merger Agreement, GE entered into an agreement (the Mortgage Sale Agreement) to sell the mortgage operations of the Company (the Mortgage Sale) to Pearl Mortgage Acquisition 2 L.L.C. (Pearl Acquisition), an affiliate of The Blackstone Group (Blackstone), a global investment and advisory firm.

On January 1, 2008, the Company gave a notice of termination to GE pursuant to the Merger Agreement because the Merger was not completed by December 31, 2007. On January 2, 2008, the Company received a notice of termination from Pearl Acquisition pursuant to the Mortgage Sale Agreement and on January 4, 2008, a Settlement Agreement (the Settlement Agreement) between the Company, Pearl Acquisition and Blackstone Capital Partners V L.P. (BCP V) was executed. Pursuant to the Settlement Agreement, BCP V paid the Company a reverse termination fee of $50 million, which is included in Other income in the Condensed Consolidated Statement of Operations for the nine months ended September 30, 2008, and the Company paid BCP V $4.5 million for the reimbursement of certain fees for third-party consulting services incurred by BCP V and Pearl Acquisition in connection with the transactions contemplated by the Merger Agreement and the Mortgage Sale Agreement upon the Company s receipt of invoices reflecting such fees from BCP V. As part of the Settlement Agreement, the Company received work product that those consultants provided to BCP V and Pearl Acquisition.

3. Loss Per Share

Basic loss per share was computed by dividing net loss during the period by the weighted-average number of shares outstanding during the period. Diluted loss per share was computed by dividing net loss by the weighted-average number of shares outstanding, assuming all potentially dilutive common shares were issued. The weighted-average computation of the dilutive effect of potentially issuable shares of Common stock under the treasury stock method for both the three and nine months ended September 30, 2008 excludes approximately 4.3 million outstanding stock-based compensation awards, as well as the assumed conversion of the Company s outstanding Convertible

Notes, Purchased Options and Sold Warrants (as defined and further discussed in Note 9, Debt and Borrowing Arrangements), as their inclusion would be anti-dilutive. The weighted-average computation of the dilutive effect of potentially issuable shares of Common stock under the treasury stock method for both the three and nine months ended September 30, 2007 excludes approximately 3.3 million outstanding stock-based compensation awards as their inclusion would be anti-dilutive.

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The following table summarizes the basic and diluted loss per share calculations for the periods indicated:

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
	(In millions, except share and per share data)			
Net loss	$ (84)	$ (38)	$ (38)	$ (24)
Weighted-average common shares outstanding basic and diluted	54,331,664	54,019,721	54,265,271	53,864,639
Basic and diluted loss per share	$ (1.56)	$ (0.69)	$ (0.70)	$ (0.44)

4. Goodwill and Other Intangible Assets

Intangible assets consisted of:

	September 30, 2008			December 31, 2007		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
	(In millions)					
Amortized Intangible Assets:						
Customer lists	$ 40	$ 15	$ 25	$ 40	$ 14	$ 26
Other	13	12	1	12	11	1
	$ 53	$ 27	$ 26	$ 52	$ 25	$ 27