

IMPAC MORTGAGE HOLDINGS INC
Form 10-K
March 14, 2007

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year-ended December 31, 2006 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 Number: 1-14100

IMPAC MORTGAGE HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

Maryland
(State or other jurisdiction of
incorporation or organization)

33-0675505
(I.R.S. Employer
Identification No.)

19500 Jamboree Road, Irvine, California 92612

(Address of principal executive offices)

(949) 475-3600

(Registrant's telephone number, including area code)

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

Title of each class	Name of each exchange on which registered
Common Stock, \$0.01 par value	New York Stock Exchange
Preferred Share Purchase Rights	New York Stock Exchange
9.375% Series B Cumulative Redeemable Preferred Stock	New York Stock Exchange
9.125% Series C Cumulative Redeemable Preferred Stock	New York Stock Exchange

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

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

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 ý No o

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

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer

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

As of June 30, 2006, the aggregate market value of the voting stock held by non-affiliates of the registrant was approximately \$842.7 million, based on the closing sales price of common stock on the New York Stock Exchange on that date. For purposes of the calculation only, all directors and executive officers of the registrant have been deemed affiliates. There were 76,083,865 shares of common stock outstanding as of March 9, 2007.

Portions of information required by Items 10, 11, 12, 13 and 14 of Part III, are incorporated by reference from the Proxy Statement for the Company's 2007 Annual Meeting of Stockholders. Except with respect to information specifically incorporated by reference in the Form 10-K, the Proxy Statement is not deemed to be filed as part hereof. The Company's Proxy Statement will be filed with the Commission within 120 days after the year-ended December 31, 2006.

IMPAC MORTGAGE HOLDINGS, INC.
2006 FORM 10-K ANNUAL REPORT
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PART I

ITEM 1. BUSINESS

Unless the context otherwise requires, the terms "Company," "we," "us," and "our" refer to Impac Mortgage Holdings, Inc. (the Company or IMH), a Maryland corporation incorporated in August 1995, and its subsidiaries, IMH Assets Corp. (IMH Assets), Impac Warehouse Lending Group, Inc. (IWLG), and Impac Funding Corporation (IFC), together with its wholly-owned subsidiaries Impac Secured Assets Corp. (ISAC), and Impac Commercial Capital Corporation (ICCC).

Forward-Looking Statements

This report on Form 10-K contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements, some of which are based on various assumptions and events that are beyond our control may be identified by reference to a future period or periods or by the use of forward-looking terminology, such as "may," "will," "believe," "expect," "likely," "should," "could," "anticipate," or similar terms or variations on those terms or the negative of those terms. The forward-looking statements are based on management expectations. Actual results may differ materially as a result of several factors, including, but not limited to, failure to achieve projected earnings levels; unexpected or greater than anticipated increases in credit and bond spreads; the ability to generate sufficient liquidity; the ability to access the equity markets; increased operating expenses and mortgage origination or purchase expenses that reduce current liquidity position more than anticipated; continued increase in price competition; risks of delays in raising, or the inability to raise on acceptable terms, additional capital, either through equity offerings, lines of credit or otherwise; the ability to generate taxable income and to pay dividends; interest rate fluctuations on our assets that unexpectedly differ from those on our liabilities; unanticipated interest rate fluctuations; changes in expectations of future interest rates; unexpected increase in prepayment rates on our mortgages; changes in assumptions regarding estimated loan losses or an increase in loan losses; continued ability to access the securitization markets or other funding sources, the availability of financing and, if available, the terms of any financing; changes in markets which the Company serves, such as mortgage refinancing activity and housing price appreciation; the adoption of new laws that affect our business or the business of people with whom we do business; changes in laws that affect our products and our business; and other general market and economic conditions.

For a discussion of these and other risks and uncertainties that could cause actual results to differ from those contained in the forward-looking statements, see Item 1A "Risk Factors" and Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" in this report. This document speaks only as of its date and we do not undertake, and specifically disclaim any obligation, to publicly release the results of any revisions that may be made to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

Available Information

Our Internet website address is www.impaccompanies.com. We make available our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and proxy statement for our annual stockholders' meetings, as well as any amendments to those reports, free of charge through our website as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission, or "SEC." You can learn more about us by reviewing our SEC filings on our website by clicking on "Stockholder Relations" located on our home page and proceeding to "Financial Reports." We also make available on our website, under "Corporate Governance," charters for the audit, compensation, and governance and nominating committees of our board of directors, our Code of Business Conduct and Ethics, our Corporate Governance Guidelines and other company information, including amendments to such documents and waivers, if any to our Code of Business Conduct and Ethics. These documents will also be furnished, free of charge, upon written request to Impac Mortgage Holdings, Inc., Attention: Stockholder Relations, 19500 Jamboree Road, Irvine, California 92612. The SEC also maintains a website at www.sec.gov that contains reports, proxy statements and other information regarding SEC registrants, including the Company.

General Overview

We are a mortgage real estate investment trust, or "REIT," that is a nationwide acquirer, originator, seller and investor of non-conforming Alt-A residential mortgages, or "Alt-A mortgages," and to a lesser extent, small-balance, commercial mortgages and multi-family, or "commercial mortgages." We also provide warehouse financing to originators of mortgages.

We operate four core businesses:

the Long-Term Investment Operations conducted by IMH and IMH Assets;

the Mortgage Operations conducted by IFC, and ISAC;

the Commercial Operations conducted by ICCG; and

the Warehouse Lending Operations conducted by IWLG.

The REIT (IMH) is comprised of the long-term investment operations and the warehouse lending operations. The Taxable REIT Subsidiaries (TRS) include the Mortgage Operations and Commercial Operations which are subsidiaries of the REIT.

The long-term investment operations primarily invest in adjustable rate and, to a lesser extent, fixed rate Alt-A mortgages and commercial mortgages that are acquired and originated by our mortgage and commercial operations. Alt-A mortgages are primarily first lien mortgages made to borrowers whose credit is generally within typical Fannie Mae and Freddie Mac guidelines, but have loan characteristics that make them non-conforming under those guidelines. Some of the principal differences between mortgages purchased by Fannie Mae and Freddie Mac and Alt-A mortgages are as follows:

credit and income histories of the mortgagor;

underwriting guidelines for debt and income ratios;

loan to value ratios accepted;

documentation required for approval of the mortgagor; and

loan balances in excess of maximum Fannie Mae and Freddie Mac lending limits.

For instance, Alt-A mortgages may not have certain documentation or verifications that are required by Fannie Mae and Freddie Mac and, therefore, in making our credit decisions, we are more reliant upon the borrower's credit score and the adequacy of the underlying collateral. We believe that Alt-A mortgages provide an attractive net earnings profile by producing higher yields without commensurately higher credit losses than other types of mortgages. We believe Alt-A mortgages are normally subject to lower rates of loss and delinquency than subprime mortgages acquired and originated by the mortgage operations. As a result, our subprime mortgages normally bear a higher rate of interest and are typically subject to higher fees than Alt-A mortgages. In general, greater emphasis is placed upon the value of the mortgaged property and, consequently, the quality of appraisals, and less upon the credit history of the borrower in underwriting subprime mortgages than in underwriting Alt-A mortgages. We generally do not acquire or retain subprime mortgages. During 2006 subprime mortgages represented 0.04 percent of retentions, and 0.44 percent of acquisitions and originations. At December 31, 2006 subprime mortgages were 0.2 percent of the ending securitized mortgage collateral.

In general, we define subprime mortgages as residential mortgages made to borrowers with credit ratings less than 620, or other characteristics, that increase the credit risk, including previous late payments, shorter credit history or other derogatory credit patterns that increase the credit risk of the mortgage.

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The long-term investment operations also invest in commercial mortgages that are primarily adjustable rate mortgages with initial fixed interest rate periods of two-, three-, five-, seven- and ten-years that subsequently convert to adjustable rate mortgages, or "hybrid ARMs." Commercial mortgages have interest rate floors, which are

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the initial start rate, in some circumstances lock out periods and prepayment penalty periods of three-, five- seven- and ten-years. Commercial mortgages provide greater asset diversification on our balance sheet as borrowers of commercial mortgages typically have higher credit scores and commercial mortgages typically have lower loan-to-value ratios, or "LTV ratios," and longer average life to payoff than Alt-A mortgages.

The long-term investment operations generate earnings primarily from net interest income (expense) earned on mortgages held as securitized mortgage collateral and mortgages held-for-investment (long-term mortgage portfolio) and associated derivative cash flows. The long-term mortgage portfolio as reported on our consolidated balance sheet consists of mortgages held as securitized mortgage collateral and mortgages held-for-investment. Investments in Alt-A mortgages and commercial mortgages are initially financed with short-term borrowings under reverse repurchase agreements that are subsequently converted to long-term financing in the form of securitized mortgage borrowings. Cash flows from the long-term mortgage portfolio, proceeds from the sale of capital stock and the issuance of trust preferred securities also finance the acquisitions of new Alt-A and commercial mortgages.

The mortgage operations acquire, originate, sell and securitize primarily Alt-A adjustable rate mortgages (ARMs) and fixed rate mortgages (FRMs) from correspondents, mortgage brokers and retail customers. Correspondents originate and close mortgages under their mortgage programs and then sell the closed mortgages to the mortgage operations on a flow (loan-by-loan basis) or through bulk sale commitments. Correspondents include; savings and loan associations, commercial banks and mortgage bankers. The mortgage operations generate income by securitizing and selling mortgages to permanent investors, including the long-term investment operations. This business also earns revenue from fees associated with mortgage servicing rights, master servicing agreements and interest income earned on mortgages held-for-sale. The mortgage operations use warehouse facilities provided by the warehouse lending operations to finance the acquisition and origination of mortgages.

The Company securitizes mortgages in the form of real estate mortgage investment conduits (REMICs). The typical REMIC securitizations are designed so that the transferee (securitization trust) is not a qualifying special purpose entity (QSPE) and we are not always the residual interest holder on REMICs, the Company consolidates such variable interest entities (VIEs). Amounts consolidated are classified as Securitized mortgage collateral and Securitized mortgage borrowings in the consolidated balance sheets. Occasionally, the Company's REMIC securitization qualifies for sale accounting treatment and the securitization trust is a QSPE and thus not consolidated by the Company. To the extent that our REMIC securitization trusts do not meet the QSPE criteria, consolidation is assessed pursuant to Financial Accounting Standards Board (FASB) Interpretation No. 46 (revised December 2003), "Consolidation of Variable Interest Entities" (FIN 46R).

The following table depicts the Company's loan sales and securitizations that were completed for the periods below (in thousands):

	As of December 31, 2006		
	Residential	Commercial	Total
Consolidated CMO/REMIC securitizations	\$ 5,363,559	\$ 672,413	\$ 6,035,972
REMIC securitizations (Sales for GAAP)	584,814	249,179	833,993
Whole loan sales	6,275,571	35,006	6,310,577
Total	\$ 12,223,944	\$ 956,598	\$ 13,180,542
	As of December 31, 2005		
	Residential	Commercial	Total
Consolidated CMO/REMIC securitizations	\$ 12,730,795	\$ 683,124	\$ 13,413,919
REMIC securitizations (Sales for GAAP)	633,912		633,912
Whole loan sales	8,052,080		8,052,080
Total	\$ 21,416,787	\$ 683,124	\$ 22,099,911

In determining whether or not to complete a REMIC transactions that is consolidated or un-consolidated under generally accepted accounting principles (GAAP), the Company primarily considers the economics of the deal. In 2005 and 2006, the mortgage and commercial operations completed ISAC REMIC 2005-2, ISAC REMIC

2006-1, ISAC REMIC 2006-3, ISAC REMIC 2006-4, and ISAC REMIC 2006-5 securitizations which were treated as sales for tax purposes but treated as secured borrowings under GAAP and consolidated in the financial statements. The associated collateral and borrowings are included in securitized mortgage collateral and borrowings, respectively, for reporting purposes. Hence, reference to "Securitized mortgage collateral" or "Securitized mortgage borrowings" includes the REMIC 2005-2, 2006-1, 2006-3, ISAC REMIC 2006-4, and ISAC REMIC 2006-5 securitized collateral and borrowings.

In the second quarter of 2006, the mortgage and commercial operations completed ISAC REMIC 2006-2 securitization in the amount of \$834.0 million which was treated as a sale for both tax and GAAP purposes. The retained interest, calculated as the present value of estimated future cash flows, was retained as a result of the ISAC REMIC 2006-2 securitization, and is recorded in other assets on the balance sheet as investment securities available for sale. Investments in residual interests and subordinated securities represent higher risk than investments in senior mortgage-backed securities because these subordinated securities bear all credit losses prior to the related senior securities. The risk associated with holding residual interest and subordinated securities is greater than holding the underlying mortgage loans directly due to the concentration of losses attributed to the subordinated securities. The fair value of residual interests represents the present value of future cash flows expected to be received by us from excess cash flows created in the securitization transaction. In general, future cash flows are estimated by taking the coupon rate of the mortgages underlying the transaction less the interest rate paid to the investors, less contractually specified servicing and trustee fees, and after giving effect to estimated prepayments and credit losses. The Company estimates future cash flows from these securities utilizing assumptions based in part on discount rates, projected delinquency rates, mortgage loan prepayment speeds and credit losses.

The commercial operations originate commercial mortgages, that are primarily adjustable rate mortgages with initial fixed interest rate periods of two-, three-, five-, seven- and ten-years that subsequently convert to adjustable rate mortgages, or "hybrid ARMs," with balances that generally range from \$500,000 to \$5.0 million and on exception up to \$10 million. Commercial mortgages have interest rate floors, which are the initial start rates; in some circumstances have lock out periods, and prepayment penalty periods of three-, five-, seven- and ten-years. These mortgages provide greater asset diversification on our balance sheet as commercial mortgage borrowers typically have higher credit scores and typically have lower loan-to-value ratios, or "LTV ratios," and the mortgages have longer average lives than residential mortgages.

The warehouse lending operations provide short-term financing to mortgage loan originators, including the mortgage and commercial operations, by funding mortgages from their closing date until sale to pre-approved investors. This business earns fees from warehouse transactions as well as net interest income from the difference between its cost of borrowings and the interest earned on warehouse advances, both of which are tied to the one-month London Inter-Bank Offered Rate (LIBOR) rate.

For financial information relating to the long-term investment operations, mortgage operations, commercial operations and warehouse lending operations, please refer to Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our consolidated financial statements beginning on page F-1.

The following is a diagram of the fiscal 2006 operational flow of loans. The diagram provides a visual complement to the Company's operations described below (in millions).

-
- (1) The purpose of this schedule is to provide a visual demonstration of the Company's operations during the year. REMICs sold for GAAP represent REMIC securitizations that meet the accounting requirements to be reflected as sales in the consolidated financial statements.
- (1) Dispositions include mortgages that were in the ending December 31, 2005 balances of mortgages held-for-sale.
- (2) IWLG had a \$44.0 million decrease in finance receivables. The number of borrowers with ending balances at December 31, 2006 increased to 46 as compared to 43 at December 31, 2005.

Long-Term Investment Operations

The long-term investment operations generate revenue primarily from net interest income (expense) on its long-term mortgage portfolio. Net interest income represents the difference between income received on mortgages and the corresponding cost of borrowings. Net interest income also includes (1) amortization of acquisition costs on mortgages acquired from the mortgage operations, (2) amortization of mortgage securitization expenses and, to a lesser extent, (3) amortization of securitized mortgage bond discounts. Net cash payments or receipts on derivative instruments which partially offset changes in the cost of borrowings, are included in realized gain (loss) from derivative instruments, which is a component of non-interest income on our financial statements. We show the effects of the net cash payments or receipts on derivative instruments in our calculation of adjusted net interest margin in the yield table presented in Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations Results of Operations and Financial Condition."

The mortgage and commercial operations support the investment objectives of the long-term investment operations by supplying mortgages at prices that are comparable to those available through mortgage bankers and brokers and other third parties. We believe that retaining mortgages acquired and originated by our mortgage operations give us a competitive advantage because of our historical understanding of the underlying credit of these mortgages and the extensive information on the performance and historical prepayment patterns of these types

of mortgages. We also believe that Alt-A mortgages provide an attractive net earnings profile by producing higher yields without commensurately higher credit risks than other types of mortgages.

Long-Term Mortgage Portfolio

Alt-A and commercial mortgages that we retain for long-term investment are primarily adjustable rate mortgages, or "ARMs," hybrid ARMs and fixed rate mortgages, or "FRMs." The interest rate on ARMs are typically tied to an index, such as the six-month London Interbank Offered Rate, or "LIBOR," plus a spread and adjust periodically, subject to lifetime interest rate caps and periodic interest rate and payment caps. The initial interest rates on ARMs are typically lower than average comparable FRMs but may be higher than average comparable FRMs over the life of the mortgage. Hybrid ARMs are mortgages with maturity periods ranging from 15 to 30 years with initial fixed interest rate periods generally ranging from two to ten years, which subsequently adjust to ARMs. The majority of mortgages retained by the long-term investment operations have prepayment penalty features with prepayment penalty periods ranging from six months to seven years. Prepayment penalties may be assessed to the borrower if the borrower refinances or, in some cases, sells the home.

During 2006, the long-term investment operations retained \$5.3 billion and \$526.6 million in principal balance of Alt-A and commercial mortgages respectively, originated during the current year for long-term investment. The long-term mortgage portfolio decreased \$3.6 billion during 2006, to \$21.1 billion at year-end.

The following tables present selected information on mortgages held as securitized mortgage collateral, which comprise a substantial portion of the long-term mortgage portfolio, for the periods indicated:

	Residential As of December 31,			Commercial As of December 31,		
	2006	2005	2004	2006	2005	2004
Percent of Alt-A mortgages	99%	99%	99%	N/A	N/A	N/A
Percent of option ARMs(1)	0%	0%	0%	N/A	N/A	N/A
Percent of non-hybrid ARMs	7%	14%	21%	2%	4%	8%
Percent of hybrid ARMs	73%	75%	69%	98%	96%	92%
Percent of FRMs	20%	10%	10%	0%	0%	0%
Percent of interest-only	72%	71%	62%	14%	11%	0%
Weighted average coupon	7%	6%	6%	6%	6%	5%
Weighted average margin	4%	4%	4%	3%	3%	3%
Weighted average original LTV	74	76	76	66	67	66
Weighted average original credit score	697	695	695	730	728	725
Percent with original prepayment penalty	68%	75%	75%	100%	100%	100%
Prior 3-month constant prepayment rate	39%	39%	30%	6%	9%	7%
Prior 12-month prepayment rate	38%	37%	30%	8%	9%	4%
Lifetime prepayment rate	29%	25%	27%	6%	5%	3%
Weighted average debt service coverage ratio	N/A	N/A	N/A	1.27	1.22	1.34
Percent of mortgages in California	51%	55%	61%	63%	71%	86%
Percent of purchase transactions	58%	60%	60%	51%	52%	49%
Percent of owner occupied	78%	81%	84%	N/A	N/A	N/A
Percent of first lien	99%	99%	99%	100%	100%	100%

* N/A = Not Applicable

- (1) The Company originates option ARMs which allow the borrower the ability to pay an amount less than the interest due. The Company has historically sold all option ARMs originated. There was \$244,000 of option-ARMs included in the mortgage portfolio at December 31, 2006 and 2005, and none at December 31, 2004. There was no capitalized interest included in the securitized mortgage collateral of any of the years presented above.

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Retained mortgages are mortgages that were transferred to the long-term mortgage portfolio during the current year from the mortgage and commercial operations. The following table presents mortgages retained by the long-term investment operations by loan characteristic for the periods indicated (dollars in thousands):

For the year ended December 31,

	2006		2005		2004	
	Principal Balance	%	Principal Balance	%	Principal Balance	%
Mortgages by Type:						
Fixed rate first trust deeds	\$ 1,677,429	29	\$ 1,087,092	8	\$ 1,195,200	7
Fixed rate second trust deeds	166,140	3	69,866	1	244,491	1
Adjustable rate first trust deeds:						
ARM's (1)	66,579	1	1,775,892	14	2,754,757	16
Hybrid ARM's (1)	3,900,060	67	10,096,987	77	13,173,928	76
Option ARM's (1)(2)	-	-	14,391	-	-	-
Total adjustable rate first trust deeds	3,966,639	68	11,887,270	91	15,928,685	92
Total mortgages retained	\$ 5,810,208	100	\$ 13,044,228	100	\$ 17,368,376	100
Mortgages by Credit Quality:						
Alt-A mortgages (3)	\$ 5,281,058	91	\$ 12,232,576	94	\$ 16,846,781	97
Commercial mortgages (4)	526,607	9	798,463	6	458,532	3
Subprime mortgages (5)	2,543	-	13,189	-	63,063	-
Total mortgages retained	\$ 5,810,208	100	\$ 13,044,228	100	\$ 17,368,376	100
Mortgages by Purpose:						
Purchase	\$ 3,247,170	56	\$ 8,045,595	62	\$ 10,516,622	61
Refinance	2,563,038	44	4,998,633	38	6,851,754	39
Total mortgages retained	\$ 5,810,208	100	\$ 13,044,228	100	\$ 17,368,376	100
Mortgages with Prepayment Penalty:						
With prepayment penalties	\$ 3,263,251	56	\$ 9,512,218	73	\$ 12,657,395	73
Without prepayment penalties	2,546,957	44	3,532,010	27	4,710,981	27
Total mortgages retained	\$ 5,810,208	100	\$ 13,044,228	100	\$ 17,368,376	100

(1) Primarily includes mortgages indexed to one-, three- and six-month LIBOR and one-year LIBOR. Also includes minimal amounts of mortgages indexed to the prime lending rate and constant maturity Treasury index.

(2) Option-ARMs provide borrowers the ability to pay an amount less than the interest due. As of December 31, 2006, 2005, and 2004, there were no additions to principal due to capitalized interest.

(3) Alt-A residential mortgages do not qualify as conforming loans as a result of various factors such as documentation, loan balances, and credit scores. All mortgages classified as Alt-A generally have credit scores greater than 620.

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- (4) Commercial mortgages were originated by the long-term investment operations during 2005 and 2004.
- (5) Subprime mortgages are defined as loans from borrowers whose credit score generally are less than 620 or include other qualitative factors such as, previous late payments, shorter credit history or other derogatory credit patterns that increase the credit risk of the mortgage.

For additional information regarding the long-term mortgage portfolio refer to Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations," "Note C Securitized Mortgage Collateral," and "Note D Mortgages Held-for-Investment" in the accompanying notes to the consolidated financial statements.

Financing

We primarily finance our mortgage portfolio as follows:

issuance of securitized mortgage borrowings;

short-term borrowings under reverse repurchase agreements, prior to securitization via CMOs or REMICs;

proceeds from the sale of common or preferred stock securities; and

As we accumulate mortgages we may issue securitized mortgages secured by such mortgages as a means of financing. The decision to issue securitized mortgages is based on our current and future investment needs, market conditions and other factors. Each issue of securitized mortgages is fully payable from the principal and interest payments on the underlying mortgages securing such debt and any cash or other collateral pledged as a condition of receiving the desired rating on the debt. We earn a net interest spread on interest income on mortgages held as securitized mortgage collateral less interest and other expenses associated with the acquisition or origination of the mortgages and with securitized mortgage financing. Net interest spreads may be directly impacted by levels of early prepayment of underlying mortgages and, to the extent each securitized mortgage class has variable rates of interest, may be affected by changes in short-term interest rates or long-term T-Bill rates. Our securitized mortgages typically are structured as adjustable rate securities that are indexed to one-month LIBOR and fixed rate securities with interest payable monthly.

When we issue securitized mortgages for financing purposes, we seek an investment grade rating for our securitized mortgages by nationally recognized rating agencies. To secure such ratings, it is often necessary to incorporate certain structural features that provide for credit enhancement. This can include the pledge of collateral in excess of the principal amount of the securities to be issued, generally referred to as over collateralization, a bond guaranty insurance policy for some or all of the issued securities, or additional forms of mortgage insurance. The need for additional collateral or other credit enhancements depends upon factors such as the type of collateral provided, the interest rates paid, the geographic concentration of the mortgaged property securing the collateral and other criteria established by the rating agencies. The pledge of additional collateral reduces our capacity to raise additional funds through short-term secured borrowings or additional securitized mortgages, and diminishes the potential expansion of our long-term mortgage portfolio. As a result, our objective is to pledge additional collateral for securitized mortgages only in the amount required to obtain an investment grade rating by nationally recognized rating agencies. Our total loss exposure is limited to total capital invested in the securitized mortgages at any point in time.

For additional information regarding securitized mortgages refer to Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources" and "Note J Securitized mortgage Borrowings" in the accompanying notes to the consolidated financial statements.

Prior to the issuance of securitized mortgages we use reverse repurchase agreements as short-term financing. A reverse repurchase agreement acts as a financing vehicle under which we effectively pledge our mortgages as collateral to secure a short-term loan. Generally, the other party to the agreement makes the loan in an amount equal to a percentage of the market value of the pledged collateral. At maturity of the reverse repurchase agreement, we are required to pay interest and repay the loan and in return, we receive our collateral. Our borrowing agreements require us to pledge cash, additional mortgages or additional investment securities backed by mortgages in the event the market value of existing collateral declines. We may be required to sell assets to reduce our borrowings to the extent that cash reserves are insufficient to cover such deficiencies in collateral.

For additional information regarding reverse repurchase agreements refer to Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources" and "Note I Reverse Repurchase Agreements" in the accompanying notes to the consolidated financial statements.

Interest Rate Risk Management

Our primary objective is to manage exposure to the variability in future cash flows attributable to the variability of one-month LIBOR, which is the underlying index of our adjustable rate securitized mortgage

borrowings. We also monitor on an ongoing basis the prepayment risks that arise in fluctuating interest rate environments. Our interest rate risk management program is formulated with the intent to mitigate the potential adverse effects of changing interest rates on cash flows on adjustable rate securitized mortgage borrowings.

To mitigate our exposure to the effect of changing interest rates on cash flows on our adjustable rate securitized mortgage borrowings, we acquire derivatives in the form of interest rate swaps, or "swaps," interest rate cap agreements, or "caps" and interest rate floor agreements, or "floors," collectively, "derivatives." For additional information regarding interest rate risk management activities refer to Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations," Item 7A. "Quantitative and Qualitative Disclosures About Market Risk" and "Note Q Derivative Instruments" in the accompanying notes to the consolidated financial statements.

Mortgage Operations

The mortgage operations acquire, originate, sell and securitize primarily adjustable rate and fixed rate Alt-A mortgages from correspondents, mortgage bankers and brokers, and retail customers.

Correspondent Acquisition Channel. The mortgage operations acquire adjustable rate and fixed rate Alt-A mortgages from its network of third party correspondents on a flow basis (loan-by-loan) or on a bulk basis (pools of multiple mortgages) from approved correspondent mortgage companies. Correspondents originate and close mortgages under the mortgage operations' mortgage programs. Correspondents include savings and loan associations, commercial banks and mortgage bankers. The mortgage operations act as intermediaries between the originators of mortgages that may not meet the guidelines for purchase by Fannie Mae and Freddie Mac and permanent investors in mortgage-backed securities secured by or representing an ownership interest in such mortgages. The mortgage operations also acquire Alt-A mortgages on a bulk basis from approved correspondent sellers that are underwritten to guidelines substantially similar to Alt-A loan programs, but not specific to those of the mortgage operations.

Wholesale and Retail Origination Channel. The mortgage operations market, underwrite, process and fund mortgages for wholesale and, to a lesser extent, retail customers. The wholesale origination channel works directly with mortgage bankers and brokers to originate, underwrite and fund their mortgages. Many wholesale customers cannot conduct business with the mortgage operations as correspondents because they do not have the necessary net worth or financing to close mortgages in their name. Through its retail channel, the mortgage operations markets mortgages directly to the public.

Subprime Origination Channel. The mortgage operations also originate subprime mortgages through a network of wholesale mortgage brokers and sell its mortgages to third party investors on a whole loan basis. In January 2006, the subprime Wholesale and Retail Origination channels were combined under Impac Lending Group, a division of IFC. As of March 2006, the Company no longer originates subprime residential mortgages through a retail channel.

Marketing Strategy

In order to accomplish our production objectives, we design and offer mortgage products that we believe are attractive to potential Alt-A borrowers and to end-investors in Alt-A mortgages and mortgage-backed securities. We have historically emphasized and continue to emphasize flexibility in our mortgage product mix as part of our strategy to attract and establish long-term relationships with our correspondents and mortgage bankers and brokers. We also maintain relationships with numerous investors so that we may develop mortgage products that may be of interest to them as market conditions change. In response to the needs of our correspondents, and as part of our strategy to facilitate the sale of our mortgages through the mortgage operations, our marketing strategy offers efficient response time in the purchase process, direct and frequent contact with our correspondents and mortgage bankers and brokers through a trained sales force and flexible commitment programs. Finally, due to the price sensitivity of most homebuyers, we are competitive in pricing our products in order to attract a sufficient numbers of mortgages.

As part of our strategy to offer our customers technological tools to enhance their businesses, Impac has also created a proprietary macro strategy application system. Launched in May of 2006, Impac Market Analysis,

(iMAP) is a risk-based target marketing tool that analyzes and ranks metropolitan statistical areas (MSA) based on macroeconomic data such as unemployment, home price appreciation and loan delinquencies. iMap ranks each MSA from 1 to 5 with higher scores indicating stronger macroeconomics and expected loan performance. The ranking can change as Impac refreshes the macro data every quarter with forward employment and price appreciation forecasts. iMap enables the Company's correspondent and brokers customers to enter a zip code and receive a comprehensive credit risk analysis for each particular mortgage. The Web-based platform is designed to help Impac's customers to make better marketing decisions, increase loan sales and earn a "master broker" rating from the Company, which in turn rewards them with better pricing on the loans they sell to us.

We believe that we can compete effectively with other Alt-A mortgage conduits through our efficient loan purchasing process, flexible purchase commitment options, competitive pricing and by designing Alt-A mortgages that suit the needs of our correspondents, mortgage bankers, brokers and their borrowers. Our principal strategy is to expand our market position as a low-cost nationwide acquirer and originator of Alt-A mortgages, while continuing to emphasize an efficient centralized operating structure. To help accomplish this, we have developed a second-generation web-based automated underwriting and pricing system called Impac Direct Access System for Lending, or "iDASLg2." iDASLg2 substantially increases efficiencies for our customers and our mortgage operations by significantly decreasing the processing time for a mortgage while improving employee productivity and maintaining superior customer service.

iDASLg2 is an interactive Internet-based system that allows our customers to automatically underwrite mortgages, enabling our customers to pre-qualify borrowers for various mortgage programs and receive automated approval decisions. We believe iDASLg2 improves employee production and maintains superior customer service, which together leads to higher closing ratios, improved profit margins and increased profitability at all levels of our business operations. Most importantly, iDASLg2 allows us to move closer to our correspondents and mortgage bankers and brokers with minimal future capital investment while maintaining centralization, a key factor in the success of our operating strategy. All of our correspondents submit mortgages via iDASLg2 and all wholesale mortgages delivered by mortgage bankers and brokers are directly underwritten through iDASLg2. However, mortgages purchased on a bulk basis from approved correspondent sellers that may not be underwritten specifically to our Alt-A mortgage guidelines are not underwritten through iDASLg2.

We also focus on expansion opportunities to attract correspondent originators, mortgage bankers, and brokers to our nationwide network in order to increase mortgage acquisitions and originations in a controlled manner. This allows us to shift the high fixed costs of interfacing with the homeowner to our correspondents, mortgage bankers and brokers. This marketing strategy is designed to accomplish the following three objectives:

attract a geographically diverse group of both large and small correspondent originators, mortgage bankers and brokers;

establish relationships with correspondents, mortgage bankers, and brokers that facilitate their ability to offer a variety of loan products designed by the mortgage operations; and

purchase mortgages, securitize and sell them in the secondary market, or to the long-term investment operations.

Underwriting

To facilitate better underwriting and investment decisions, in 2005 Impac created Enterprise Risk Management Group (ERM). The goal of ERM is to integrate analytical technology and statistical data to better evaluate credit and prepayment risk. The Company seeks to utilize its risk based target marketing tools including, iMAP its external proprietary analytical/marketing tool, iSMA its internal profit ranking tool along with the integration of third party products to better access layered risk, optimize pricing and selectively invest in loans. Third party vendors technology allows us to evaluate a property, broker and third party broker correspondent combined with key credit characteristics such as FICO, LTV, CLTV and loan purpose to create a comprehensive risk score. Scores range from 0 to 20, with a 10+ score signifying high risk. HistoryPro is a property based risk score that measures home prices, foreclosure rates and flip activity in a geographic area.

We have developed comprehensive purchase guidelines for the acquisition and origination of mortgages. Each mortgage underwritten assesses the borrower's credit score and ability to repay the mortgage obligation and the adequacy of the mortgaged property as collateral for the mortgage. Subject to certain exceptions and the type of mortgage product, each purchased mortgage generally conforms to the loan parameters and eligibility requirements specified in our seller/servicer guide with respect to, among other things, loan amount, type of property, compliance, LTV ratio, mortgage insurance, credit history, debt service-to-income ratio, appraisal and loan documentation.

All mortgages acquired or originated under our loan programs are underwritten either by our employees or by contracted mortgage services companies or delegated sellers. Under all of our underwriting methods, loan documentation requirements for verifying the borrower's income and assets vary according to LTV ratios and other factors. Generally, as the standards for required documentation are lowered, the borrowers' down payment requirements are increased and the required LTV ratios are decreased. The borrower is also required to have a stronger credit history, larger cash reserves and an appraisal of the property that may be validated by an enhanced desk or field review, depending on the loan program. Lending decisions are based on a risk analysis assessment after the review of the entire mortgage file. Each mortgage is individually underwritten with emphasis placed on the overall quality of the mortgage.

Seller Eligibility Requirements

Mortgages acquired by the mortgage operations are originated by various sellers, including mortgage bankers, savings and loan associations and commercial banks. Sellers are required to meet certain regulatory, financial, insurance and performance requirements established by us before they are eligible to participate in our mortgage purchase programs. Sellers must also submit to periodic reviews to ensure continued compliance with these requirements. Our current criteria for seller participation generally includes a minimum tangible net worth requirement of \$250,000, approval as a Fannie Mae or Freddie Mac seller/ servicer in good standing, a Housing and Urban Development, or "HUD," approved mortgagee in good standing or a financial institution that is insured by the Federal Deposit Insurance Corporation, or "FDIC," or comparable federal or state agency, or that the seller is examined by a federal or state authority.

In addition, sellers are required to have comprehensive mortgage origination quality control procedures. In connection with its qualification, each seller enters into an agreement that generally provides for recourse by us against the seller in the event of a breach of representations or warranties made by the seller with respect to mortgages sold to us, which includes but is not limited to any fraud or misrepresentation during the mortgage loan origination process or upon early payment default on mortgages.

Mortgage Acquisitions and Originations

Mortgages acquired and originated by the mortgage operations are adjustable rate and fixed rate Alt-A mortgages. A portion of Alt-A mortgages that are acquired and originated by the mortgage operations exceed the maximum principal balance for a conforming loan purchased by Fannie Mae or Freddie Mac, which was \$417,000 as of December 31, 2006, and are referred to as "jumbo loans." However, we do acquire some Alt-A mortgages with principal balances above \$2.0 million. Alt-A mortgages generally consist of mortgages that are acquired and originated in accordance with underwriting or product guidelines that differ from those applied by Fannie Mae and Freddie Mac. Alt-A mortgages may involve greater risk as a result of different underwriting and product guidelines. Additionally, an insignificant portion of mortgages acquired through the mortgage operations are subprime mortgages, which may entail greater credit risks than Alt-A mortgages. Essentially we are not in the subprime business which represented 0.44 percent and 3.8 percent of total acquisitions and originations during 2006 and 2005, respectively.

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Residential mortgages acquired or originated by the mortgage operations are generally secured by first liens and, to a lesser extent, second liens on single-family residential properties with either adjustable rate or fixed rates of interest. FRMs have a constant interest rate over the life of the loan, which is generally 15 or 30 years. The interest rates on ARMs are typically tied to an index, such as the six-month LIBOR, plus a spread and adjust periodically, subject to lifetime interest rate caps and periodic interest rate and payment caps. The initial interest rates on ARMs are typically lower than the average comparable FRM but may be higher than average comparable FRMs over the life of the loan. We acquire and originate mortgages with the following most common loan characteristics, although we may purchase mortgages with other interest rate, prepayment and maturity characteristics:

Fixed Rate Mortgages (FRMs) Have original terms to maturity ranging from 15 to 30 years;

Adjustable Rate Mortgages (ARMs or Non-hybrid ARMs) Adjust based on one-, three- and six-month LIBOR and one-year LIBOR with terms to maturity ranging from 15 to 30 years;

Hybrid ARMs Have two-, three-, five- and seven-year fixed terms with total maturity terms ranging from 15 to 30 years that subsequently adjust to one-, three- and six-month LIBOR and one-year LIBOR;

Option-ARMs ARMs that allow the borrower to pay less than the interest due. These mortgages are also referred to as negative amortization loans.

All of the loan types described above may have an interest only period of 5 to 10 years and terms to maturity of 30 years with a six-month to five-year prepayment penalty period.

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The following table presents the mortgage and commercial operation's acquisitions and originations by loan characteristic for the periods indicated (in thousands):

For the year ended December 31,

	2006		2005		2004	
	Principal Balance	%	Principal Balance	%	Principal Balance	%
Mortgages by Type:						
Fixed rate first trust deeds	\$ 2,457,205	20	\$ 2,914,055	13	\$ 1,968,502	9
Fixed rate second trust deeds	602,112	5	1,189,145	5	755,913	3
Adjustable rate first trust deeds:						
ARM's (1)	201,883	2	2,776,787	12	3,382,978	15
Hybrid ARM's (1)	6,087,157	48	14,437,507	65	16,105,711	73
Option ARM's (1)(2)	3,176,781	25	838,343	4	-	-
Total adjustable rate first trust deeds	9,465,821	75	18,052,637	81	19,488,689	88
Adjustable rate second trust deeds	35,025	-	154,766	1	-	-
Total adjustable rate first & second trust deeds	9,500,846	75	18,207,403	82	19,488,689	88
Total acquisitions and originations	\$ 12,560,163	100	\$ 22,310,603	100	\$ 22,213,104	100
Mortgages by Channel:						
Correspondent acquisitions:						
Flow acquisitions	\$ 4,660,717	37	\$ 8,386,911	37	\$ 10,996,260	50
Bulk acquisitions	3,890,116	31	10,659,756	48	8,537,504	38
Total correspondent acquisitions	8,550,833	68	19,046,667	85	19,533,764	88
Wholesale and retail originations	2,970,868	24	2,431,382	11	1,994,569	9
Sub-prime originations (3)	55,060	-	832,554	4	684,771	3
Total mortgage operations	11,576,761	92	22,310,603	100	22,213,104	100
Commercial mortgage operations	983,402	8	-	-	-	-
Total acquisitions and originations	\$ 12,560,163	100	\$ 22,310,603	100	\$ 22,213,104	100
Mortgage by Credit Quality:						
Alt-A mortgages (4)	\$ 11,565,512	92	\$ 21,460,424	96	\$ 21,453,383	97
Commercial mortgages (5)	983,402	8	-	-	-	-
Sub-prime mortgages (3)	11,249	-	850,179	4	759,721	3
Total acquisitions and originations	\$ 12,560,163	100	\$ 22,310,603	100	\$ 22,213,104	100
Mortgage by Purpose:						
Purchase	\$ 5,795,941	46	\$ 13,469,872	60	\$ 13,373,840	60
Refinance	6,764,222	54	8,840,731	40	8,839,264	40

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For the year ended December 31,

Total acquisitions and originations	\$	12,560,163	100	\$	22,310,603	100	\$	22,213,104	100
Mortgages with Prepayment Penalty:									
With prepayment penalties	\$	8,605,183	69	\$	16,071,802	72	\$	15,965,959	72
Without prepayment penalties		3,954,980	31		6,238,801	28		6,247,145	28
Total acquisitions and originations	\$	12,560,163	100	\$	22,310,603	100	\$	22,213,104	100

- (1) Primarily includes mortgages indexed to one-, three- and six-month LIBOR and one-year LIBOR. Also includes minimal amounts of mortgages indexed to the prime lending rate and constant maturity Treasury index.
- (2) Option-ARMs provide borrowers the ability to pay an amount less than the interest due. As of December 31, 2006, 2005 and 2004, there was \$231.3 million \$455.5 million, and none, respectively, recorded as option

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ARMs included in mortgages held-for-sale, which had capitalized interest of \$206 thousand, zero and zero, respectively. These mortgages were subsequently sold to third party investors on a whole loan basis.

- (3) Subprime mortgages are defined as loans from borrowers whose credit score generally are less than 620 or include other qualitative factors such as, previous late payments, shorter credit history or other derogatory credit patterns that increase the credit risk of the mortgage.
- (4) Alt-A residential mortgages do not qualify as conforming loans as a result of various factors such as documentation, loan balances, and credit scores. All mortgages classified as Alt-A have credit scores greater than or equal to 620.
- (5) On January 1, 2006, we elected to convert Impac Commercial Capital Corporation from a qualified REIT subsidiary to a taxable REIT subsidiary. Therefore, there is no corresponding year over year comparison.

The percentages below represent the credit scores of the originations during the periods presented below:

	Residential During the years ended			Commercial During the years ended		
	December 31, 2006	December 31, 2005	December 31, 2004	December 31, 2006	December 31, 2005 (1)	December 31, 2004 (1)
Percent of Credit Score < 620	2%	4%	6%	2%	0%	1%
Percent of Credit Score 620-650	19%	19%	16%	3%	3%	3%
Percent of Credit Score 651-680	22%	22%	21%	9%	9%	9%
Percent of Credit Score 681-700	15%	15%	15%	13%	14%	20%
Percent of Credit Score 701-720	13%	12%	12%	15%	12%	17%
Percent of Credit Score 721-750	14%	14%	15%	19%	23%	19%
Percent of Credit Score > 750	15%	15%	15%	39%	38%	31%

- (1) These amounts represent the credit scores for commercial loans originated at the REIT.

Our mortgage acquisition and origination activities focus on those regions of the country where higher volumes of Alt-A mortgages are originated including California, Florida, New York, Colorado, New Jersey, Maryland, Virginia, Illinois, Arizona and Nevada. During the years ended December 31, 2006 and 2005, 54 percent and 54 percent, respectively, of mortgage acquisitions and originations were secured by properties located in California, and 12 percent and 11 percent, respectively, were secured by properties located in Florida.

Of the \$12.6 billion in principal balance of mortgages acquired and originated in 2006, \$4.1 billion, or 32.8 percent, were acquired from our top ten correspondents. No individual correspondent, banker or broker accounted for more than 10 percent of the total mortgages acquired and originated by the mortgage operations in 2006.

Securitization and Sales

After acquiring mortgages from correspondents on a flow or bulk basis and originating mortgages through wholesale and retail channels, the mortgage operations securitize or sell mortgages to permanent investors. The mortgage operations sell much of its ARM and FRM acquisitions to the long-term investment operations at prices comparable to prices available from third party investors at the date of sale.

During 2006, the mortgage operations sold \$5.4 billion in principal balance of mortgages as on balance sheet REMICs to the long-term investment operations, sold \$6.3 billion in principal balance of mortgages as whole loan sales and sold \$584.8 million in principal balance of mortgages as GAAP sale REMICs to third parties, of which \$29.8 million was retained by the long-term investment operations. Additionally, the

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mortgage operations retained \$151.7 million as securitized mortgage collateral, related primarily to residential mortgages repurchased during 2006. Generally, the mortgage operations sell all of its mortgage acquisitions and originations to third party investors as servicing released, which means that it does not retain primary mortgage servicing rights. However, the mortgage operations retain rights as master servicer for its securitizations; see "Master Servicing" below.

The period of time between when we commit to purchase mortgages and the time we sell or securitize mortgages generally ranges from 15 to 90 days, depending on certain factors, including the length of the purchase commitment period, volume by product type and the securitization process. REMIC securities generally consist of one or more classes of "regular interests" and a single class of "residual interest." The regular interests are tailored to the needs of investors and may be issued in multiple classes with varying maturities, average lives and interest

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rates. REMICs created by us are structured so that one or more of the classes of securities are rated investment grade by at least one nationally recognized rating agency. The ratings for our REMICs are based upon the perceived credit risk by the applicable rating agency of the underlying mortgages, the structure of the securities and the associated level of credit enhancement. Credit enhancement is designed to provide protection to the security holders in the event of borrower defaults and other losses including those associated with fraud or reductions in the principal balances or interest rates on mortgages as required by law or a bankruptcy court.

In addition to the cash the mortgage operations receive from the sale of securitization interests, the long-term investment operations typically retain certain interests in the securitization trust. The Company retains the master servicing rights (MSRs) and the residual interest, which may include interest-only securities, subordinated classes of securities and residual securities. The residual securities are associated with prepayment charges on the underlying mortgage loans, cash reserve funds, or an over-collateralization account. Other than interest-only securities, the securities associated with prepayment charges on the underlying mortgage loans, the other residual interests are subordinated and serve as credit enhancement for the more senior securities issued by the securitization trust. We are entitled to receive payment on most of these retained interests only after the third party investors are repaid their investment plus interest and there is excess cash in the securitization trust. Our ability to obtain repayment of our residual interests depends solely on the performance of the underlying mortgage loans. Material adverse changes in performance of the mortgages, including actual credit losses and prepayment speeds which differ from our assumptions, may have a significant adverse effect on the value of these retained interests.

When we sell loans as whole-loan sales we are required to make customary representations and warranties about the loans to the purchaser. Our whole-loan sale agreements generally require us to repurchase loans if we breach a representation or warranty given to the loan purchaser. In addition, we may be required to repurchase loans as a result of borrower fraud or if a payment default occurs on a mortgage loan shortly after its sale.

Master Servicing

We retain master servicing rights on substantially all of our Alt-A and commercial mortgage acquisitions and originations that we retain or sell through REMIC securitizations. Our function as master servicer includes collecting loan payments from loan servicers and remitting loan payments, less master servicing fees receivable and other fees, to a trustee or other purchaser for each series of mortgage-backed securities or mortgages master serviced. In addition, as master servicer, we monitor compliance with our servicing guidelines and are required to perform, or to contract with a third party to perform, all obligations not adequately performed by any loan servicer. We may also be required to advance funds or we may cause our loan servicers to advance funds to cover principal and interest payments not received from borrowers depending on the status of their mortgages. We also earn income or incur expense on principal and interest payments we receive from our borrowers until those payments are remitted to the investors in those mortgages. Master servicing fees are generally 0.03 percent per annum on the declining principal balances of the mortgages serviced. At year-end 2006, we master serviced approximately 116,000 mortgages with a principal balance of approximately \$31.5 billion.

The following table presents the amount of delinquent mortgages, both those sold to third parties and those we own, in our master servicing portfolio for the periods indicated (dollars in thousands):

As of December 31,

	2006		2005		2004	
	Principal Balance of Mortgage	% of Master Servicing Portfolio	Principal Balance of Mortgage	% of Master Servicing Portfolio	Principal Balance of Mortgage	% of Master Servicing Portfolio
Loans delinquent for:						
60-89 days	\$ 530,706	1.68%	\$ 379,848	1.34%	\$ 205,486	0.72%
90 days and over	563,778	1.79%	265,085	0.93%	87,277	0.31%
Total 60 days and over	1,094,484	3.47%	644,933	2.27%	292,763	1.03%
Foreclosures pending	608,893	1.93%	308,965	1.09%	258,189	0.91%
Bankruptcies pending	80,183	0.25%	50,314	0.18%	23,807	0.08%
Total	\$ 1,783,560	5.66%	\$ 1,004,212	3.53%	\$ 574,759	2.02%

As of December 31,

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Included in our master servicing portfolio is \$1.4 billion of mortgage loan delinquencies that we own. A table that summarizes mortgages we own that are not performing is located under "Item 7. Management Discussion and Analysis and Results of Operations."

Servicing

We sell or subcontract all of our servicing obligations to independent third parties pursuant to sub-servicing agreements. We believe that the sale of servicing rights or the selection of third-party sub-servicers is more effective than establishing a servicing department within our mortgage operations. However, part of our responsibility is to continually monitor the performance of servicers or sub-servicers through performance reviews and regular site visits. Depending on our reviews, we may in the future rely on our internal default management group to take an ever more active role to assist servicers or sub-servicers in the servicing of our mortgages. Servicing includes collecting and remitting loan payments, making required advances, accounting for principal and interest, holding escrow or impound funds for payment of taxes and insurance, if applicable, making required inspections of the mortgaged property, contacting delinquent borrowers, and supervising foreclosures and property dispositions in the event of un-remedied defaults in accordance with our guidelines. Servicing fees are charged on the declining principal balances of mortgages serviced. Residential servicing generally ranges from 0.25 percent per annum for FRMs, 0.375 percent per annum for ARMs, 0.50 percent per annum for subprime mortgages and 0.75 percent per annum for services of delinquent loans for properties secured by second liens.

Commercial servicing generally ranges from 0.25 percent per annum to 0.75 percent for special servicing of delinquent loans. To the extent the mortgage operations finance the acquisition of mortgages with facilities provided by the warehouse lending operations, the mortgage operations pledges mortgages and the related servicing rights to the warehouse lending operations as collateral. As a result, the warehouse lending operations have an absolute right to control the servicing of such mortgages, including the right to collect payments on the underlying mortgages, and to foreclose upon the underlying real property in the case of default. Typically, the warehouse lending operations delegate its right to service the mortgages securing the facility to the mortgage operations.

The following table presents information regarding our mortgage-servicing portfolio which includes our mortgages held-for-sale and our mortgage portfolio for the periods shown (dollars in millions, except average loan size and number of mortgages serviced):

	For the year ended December 31,		
	2006	2005	2004
Beginning servicing portfolio	\$ 2,208.4	\$ 1,690.8	\$ 1,402.1
Add: Loan acquisitions and originations	12,560.2	22,310.6	22,213.1
Less: Servicing transferred and principal repayment (1)	(13,270.3)	(21,793.0)	(21,924.4)
Ending servicing portfolio	\$ 1,498.3	\$ 2,208.4	\$ 1,690.8
Number of loans serviced	5,435	10,892	9,256
Average loan size	\$ 276,000	\$ 203,000	\$ 183,000
Weighted average coupon rate	7.15%	6.39%	6.62%

- (1) Includes the sale of mortgages on a servicing released basis, the sale of servicing rights on mortgages owned and scheduled and unscheduled principal repayments.

Interest Rate Risk Management

The mortgage operations manage interest rate risk and price volatility on its pipeline of rate-locked mortgage loans, or "mortgage pipeline," during the time it commits to acquire or originate mortgages at a pre-determined rate and the time it sells the mortgage loans. To mitigate interest rate and price volatility risks, the mortgage operations may enter into derivatives. The nature and quantity of derivatives are determined based on various factors, including expected pull-through, price sensitivity, market conditions, and the expected volume of mortgage acquisitions and originations. For additional information regarding interest rate risk management activities refer to

Item 7A. "Quantitative and Qualitative Disclosures About Market Risk" and "Note Q Derivative Instruments" in the accompanying notes to the consolidated financial statements.

Commercial Operations

On January 1, 2006, the Company elected to convert Impac Commercial Capital Corporation "ICCC" from a qualified REIT subsidiary to a taxable REIT subsidiary. On June 30, 2006, the Company approved the transfer of ICCC to be a wholly-owned subsidiary of IFC effective January 1, 2006.

The commercial operations originate commercial mortgages and multi-family mortgages that are primarily hybrid adjustable rate mortgages with initial fixed interest rate periods of two-, three-, five-, seven- and ten-years that subsequently convert to adjustable rate mortgages, with balances that generally range from \$500,000 to \$5.0 million. Commercial mortgages have interest rate floors, which are the initial start rates; in some circumstances have lockouts and prepayment penalty periods of three-, five-, seven- and ten-years. These mortgages provide greater asset diversification on our balance sheet as commercial mortgage borrowers typically have higher credit scores and typically have lower loan-to-value ratios, or "LTV ratios," and the mortgages have longer average lives than residential mortgages.

Commercial mortgages include multifamily mortgages and commercial property mortgages ("commercial mortgages"). During 2006, the commercial operations originated \$983.4 million in commercial mortgages compared to \$798.5 million originated by the REIT in 2005.

Securitization and Sales

During 2006, the commercial operations sold \$526.6 million in principal balance of mortgages as consolidated REMICs to the long-term investment operations, sold \$35.0 million in principal balance of commercial mortgages as whole loan sales and sold \$240.6 million in principal balance of commercial mortgages as REMICs to third parties. Generally, the commercial operations sell all of its mortgage acquisitions and originations to third party investors as servicing released, which means that it does not retain primary mortgage servicing rights. However, the commercial operations retains rights as master servicer for its securitizations, see "Master Servicing" above.

Warehouse Lending Operations

The warehouse lending operations provide warehouse lines of credit to affiliated companies and reverse repurchase financing to approved, non-affiliated mortgage bankers, or "non-affiliated clients," some of which are correspondents of the mortgage operations, to finance mortgages during the time from the closing of the mortgages to sale or other settlement with pre-approved investors. The warehouse lending operations rely mainly on the sale or liquidation of the mortgages as a source of repayment. Any claim of the warehouse lending operations as a secured lender in a bankruptcy proceeding may be subject to adjustment and delay. Advances to customers under these facilities are presented on our balance sheet as finance receivables. Terms of non-affiliated clients' repurchase facilities, including the commitment amount, are determined based upon the financial strength, historical performance and other qualifications of the borrower. As of December 31, 2006, the warehouse lending operations had approved facilities to non-affiliated clients of \$724.0 million, of which \$306.3 million was outstanding, as compared to \$691.5 million and \$350.2 million, respectively, as of December 31, 2005.

Regulation

We establish underwriting guidelines that include provisions for inspections and appraisals, require credit reports on prospective borrowers and determine maximum loan amounts. Our mortgage acquisition and origination activities are subject to, among other laws, the Equal Credit Opportunity Act, Federal Truth-in-Lending Act, Fair Credit Reporting Act, Fair and Accurate Credit Transaction Act, Fair Housing Act, Gramm-Leach, Bliley Act, Telephone Consumer Protection Act, Can Spam Act, Real Estate Settlement Procedures Act and Home Mortgage Disclosure Act and the regulations promulgated there-under. These laws and regulations, among other things, prohibit discrimination and require the disclosure of certain basic information to mortgagors concerning credit terms and settlement costs, prohibit the payment of kickbacks for the referral of business incident to a real estate settlement service, limit payment for settlement services to the reasonable value of the services rendered and goods furnished, restrict the marketing practices we may use to find customers, require us to safeguard non-public

information about our customers and require the maintenance and disclosure of information regarding the disposition of mortgage applications based on race, gender, geographical distribution, price and income level. Our mortgage acquisition and origination activities are also subject to state and local laws and regulations, including state licensing laws, anti-predatory lending laws, and may also be subject to applicable state usury statutes. IFC is an approved Fannie Mae seller/servicer, an approved servicer of Freddie Mac, and an approved Housing and Urban Development "HUD" lender. In addition, IFC is required annually to submit to Fannie Mae, Freddie Mac, and HUD audited financial statements, or the equivalent, according to the financial reporting requirements of each regulatory entity for its sellers/ servicers. IFC's affairs are also subject to examination by Fannie Mae and Freddie Mac at any time to assure compliance with applicable regulations, policies and procedures. Also refer to "Regulatory Risks" under Item 1A. Risk Factors for a further discussion of regulations that may effect our Company.

Competition

In acquiring and originating Alt-A mortgages and issuing securities backed by such mortgages, we compete with other established mortgage conduit programs, investment banking firms, savings and loan associations, banks, thrift and loan associations, finance companies, mortgage bankers and brokers, insurance companies, other lenders and other entities purchasing mortgage assets. As loan originations diminish, the mortgage industry may experience a consolidation that may reduce the number of current correspondents and independent mortgage bankers and brokers available to the mortgage operations, reducing our potential customer base and resulting in the mortgage operations and commercial operations acquiring and originating a larger percentage of mortgages from a smaller number of customers. In addition, while consolidation continues to occur in the mortgage industry, price competition among competitors can affect the profitability on the sale of mortgage loans or the return on investments, as mortgage lenders are willing to cut their profitability margins to maintain current production levels. Changes of this nature could continue to negatively impact our businesses.

Mortgage-backed securities issued by the mortgage operations and the long-term investment operations face competition from other investment opportunities available to prospective investors. We face competition in our mortgage operations, commercial operations and warehouse lending operations from other financial institutions, including but not limited to banks and investment banks. Our main competitors include Countrywide Home Loans, IndyMac Bancorp, Inc., Greenpoint Financial Corporation, Residential Funding Corporation, Aurora Loan Services, Inc., Credit Suisse First Boston Corporation and Bear Stearns and Company, Inc.

Competition can take place on various levels, including convenience in obtaining a mortgage, service, marketing, origination channels and pricing. We depend primarily on correspondents and independent mortgage bankers and brokers for the acquisition and origination of mortgages. These independent mortgage bankers and brokers deal with multiple lenders for each prospective borrower. We compete with these lenders for the independent bankers and brokers' business on the basis of price, service, loan fees, costs and other factors. Our competitors also seek to establish relationships with such bankers and brokers, who are not obligated by contract or otherwise to do business with us. Many of the institutions with which we compete in our mortgage operations, commercial operations, and warehouse lending operations have significantly greater financial resources than we have. However, we can compete effectively with other Alt-A mortgage conduits through our efficient loan purchasing process, flexible purchase commitment options and competitive pricing and by designing Alt-A mortgage programs that suit the needs of our correspondents and their borrowers, which is intended to provide sufficient credit quality to our investors.

Risk factors, as outlined below, provide additional information related to risks associated with competition in the mortgage banking industry.

Employees

As of December 31, 2006, we had a total of 827 full-time and part-time employees. Management believes that relations with its employees are good. We are not a party to any collective bargaining agreements.

Revisions in Policies and Strategies

Our board of directors has approved our investment and operating policies and strategies. Our core operations involve the acquisition and origination of mortgages and their subsequent securitization and sale. We also act as a warehouse lender providing financing facilities to mortgage originators. These operations and their associated policies and strategies, are further described herein. Our board of directors has delegated asset/liability management to the Asset/Liability Committee, or "ALCO," which reports to the board of directors at least quarterly. See a further discussion of ALCO in Item 7. "Management's Discussion of Financial Condition and Results of Operations" and Item 7A. "Quantitative and Qualitative Disclosures About Market Risk." Any of our policies, strategies and activities may be modified or waived by our board of directors without stockholder consent. Developments in the market, which affect the policies and strategies mentioned herein or which change our assessment of the market, may cause our board of directors to revise our policies and financing strategies.

We have elected to qualify as a REIT for tax purposes. We have adopted certain compliance guidelines to ensure we maintain our REIT status which include limitations on the acquisition, holding and sale of certain assets.

The long-term investment operations primarily invest in Alt-A and commercial mortgages. The long-term investment operation does not limit the proportion of its assets that may be invested in each type of mortgage.

We closely monitor our acquisition and investment in mortgage assets and the sources of our income, including income or expense from interest rate risk management strategies, to ensure at all times that we maintain our qualifications as a REIT. We have developed certain accounting systems and testing procedures to facilitate our ongoing compliance with the REIT provisions of the Internal Revenue Code. No changes in our investment policies, including credit criteria for mortgage asset investments, may be made without the approval of our board of directors.

We may at times and on terms that our Board of Directors deem appropriate:

Issue senior securities In 2006 and 2005, we issued an aggregate of 72,800 shares and 71,200 shares, respectively, of our 9.125% Series C Cumulative Redeemable Preferred Stock, par value \$0.01 per share, liquidation preference \$25.00 per share;

Borrow money We finance our operations in large part through the issuance of securitized mortgages and short-term borrowings under reverse repurchase agreements;

Make loans to other persons The warehouse lending operations provide financing to affiliated companies and to approved non-affiliated clients, some of which are correspondents of the mortgage operations, to finance mortgages during the time from the closing of the mortgages to their sale or other settlement with pre-approved investors;

Engage in the purchase and sale of investment In connection with the issuance of mortgage-backed securities by our mortgage operations in the form of REMICs, our long-term investment operations may retain senior or subordinated securities on a short- or long-term basis;

Repurchase or otherwise reacquire our shares or other securities in the future During 2005, we adopted a repurchase plan to repurchase up to 5.0 million shares of our common stock in the open market. As of the date of the filing of this report, we have repurchased 104,300 shares of common stock; and

Issue common stock and other securities During 2006 we did not issue any equity securities other than the preferred Series C described above. During 2005 and 2004, we issued an aggregate of 363,700 shares and 18.4 million shares of common stock, respectively. During 2005, we formed four wholly-owned trust subsidiaries for the purposes of issuing an aggregate of \$96.3 million of trust preferred securities.

We may also offer securities in exchange of property, invest in securities of other issuers for the purpose of exercising control and underwrite the securities of other issuers, although we have not done so in the past three years and have no present intention to do so. Historically, we have and intend to continue to distribute annual reports to our stockholders, including financial statements audited by independent auditors, describing our current business and strategy.

During 2006, we tightened our underwriting guidelines, which we believe significantly decreased our loan production and resulted in a change in the product concentration of our acquisitions and originations to primarily longer duration and higher credit quality loans.

ITEM 1.A. RISK FACTORS

Some of the following risk factors relate to a discussion of our assets. For additional information on our asset categories refer to Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations," "Note B Mortgages Held-for-Sale," "Note C Securitized Mortgage Collateral," "Note D Mortgages Held-for-Investment," and "Note E Allowance for Loan Losses" in the accompanying notes to the consolidated financial statements.

Risks Related To Our Businesses

We face risks related to our recent accounting restatements.

On February 23, 2007, we reported that we had discovered accounting errors in previously reported Consolidated Statements of Operations and Comprehensive Earnings. These errors related to the presentation of deferred charge as a non-interest expense amount compared to the restated presentation as a component of income tax expense. We also reported restated amounts in the Consolidated Statements of Cash Flows to eliminate certain non-cash items related to intercompany transactions and the redesignation of loans from held-for-sale to held-for-investment. We present these corrections in the 2006 consolidated financial statements included in this report.

Furthermore, on July 22, 2004, we publicly announced that we had discovered accounting inaccuracies in previously reported financial statements. As a result, following consultation with our auditors, we decided to restate our financial statements for the three months ended March 31, 2004 and 2003, the three and six months ended June 30, 2003, the three and nine months ended September 30, 2003 and for each of the years ended December 31, 2003, 2002 and 2001. The restatements related to a correction to our revenue recognition policy with respect to the cash sales of mortgage servicing rights to unrelated third parties when the mortgage loans are retained, our accounting for derivatives and interest rate risk management activities, the accounting for loan purchase commitments as derivatives and selected elimination entries to consolidate IFC with that of IMH. We corrected a clerical error in the calculation of earnings per share for the six months ended June 30, 2004.

The restatement of our financial statements could lead to litigation claims and/or regulatory proceedings against us. The defense of any such claims or proceedings may cause the diversion of management's attention and resources, and we may be required to pay damages if any such claims or proceedings are not resolved in our favor. Any litigation or regulatory proceeding, even if resolved in our favor, could cause us to incur significant legal and other expenses. We also may have difficulty raising equity capital or obtaining other financing, such as lines of credit or otherwise. We may not be able to effectuate our current operating strategy, including the ability to originate, acquire or securitize mortgage loans for retention or sale at projected levels. The occurrence of any of the foregoing could harm our business and reputation and cause the price of our securities to decline.

If we fail to maintain effective systems of internal control over financial reporting and disclosure controls and procedures, we may not be able to accurately report our financial results or prevent fraud, which could cause current and potential shareholders to lose confidence in our financial reporting, adversely affect the trading price of our securities or harm our operating results.

Effective internal control over financial reporting and disclosure controls and procedures are necessary for us to provide reliable financial reports and effectively prevent fraud and operate successfully as a public company. Any failure to develop or maintain effective internal control over financial reporting and disclosure controls and procedures could harm our reputation or operating results, or cause us to fail to meet our reporting obligations. We cannot be certain that our efforts to improve our internal control over financial reporting and disclosure controls and procedures will be successful or that we will be able to maintain adequate controls over our financial processes and reporting in the future. Any failure to develop or maintain effective controls or difficulties encountered in their implementation or other effective improvement of our internal control over financial reporting and disclosure controls and procedures could harm our operating results, or cause us to fail to meet our reporting obligations. If we

are unable to adequately establish our internal control over financial reporting, our external auditors will not be able to issue an unqualified opinion on the effectiveness of our internal control over financial reporting. Due to the reported material weakness in management's assessment of our internal control over financial reporting and the conclusion that our internal control over financial reporting is not effective as of December 31, 2006, our external auditors issued an adverse opinion on the effectiveness of our internal control over financial reporting. In the past, we have reported, and may discover in the future, material weaknesses in our internal control over financial reporting.

Ineffective internal control over financial reporting and disclosure controls and procedures could cause investors to lose confidence in our reported financial information, which could have a negative effect on the trading price of our securities or affect our ability to access the capital markets and could result in regulatory proceedings against us by, among others, the SEC. In addition, a material weakness in internal control over financial reporting, which may lead to deficiencies in the preparation of financial statements, could lead to litigation claims against us. The defense of any such claims may cause the diversion of management's attention and resources, and we may be required to pay damages if any such claims or proceedings are not resolved in our favor. Any litigation, even if resolved in our favor, could cause us to incur significant legal and other expenses. Such events could harm our business, affect our ability to raise capital and adversely affect the trading price of our securities.

If we are unable to generate sufficient liquidity we may be unable to conduct our operations as planned.

If we cannot generate sufficient liquidity, we may be unable to continue to grow our operations, grow our asset base, maintain our current interest rate risk management policies and pay dividends. We have traditionally derived our liquidity from the following primary sources:

financing facilities provided to us by others to acquire or originate mortgage assets;

whole loan sales and securitizations of acquired or originated mortgages;

our issuance of equity and debt securities;

excess cash flow from our long-term mortgage portfolio; and

earnings from operations.

We cannot assure you that any of these alternatives will be available to us, or if available, that we will be able to negotiate favorable terms. Our ability to meet our long-term liquidity requirements is subject to the renewal of our credit and repurchase facilities and/or obtaining other sources of financing, including additional debt or equity from time to time. Any decision by our lenders and/or investors to make additional funds available to us in the future will depend upon a number of factors, such as our compliance with the terms of our existing credit arrangements, our financial performance, industry and market trends in our various businesses, the lenders' and/or investors' own resources and policies concerning loans and investments, and the relative attractiveness of alternative investment or lending opportunities. If we cannot raise cash by selling debt or equity securities, we may be forced to sell our assets at unfavorable prices or discontinue various business activities. Our inability to access the capital markets could have a negative impact on our growth of taxable income and also our ability to pay dividends.

Recently, the subprime sector of the mortgage industry has been experiencing difficulties with greater credit and mortgage losses resulting from a decline in real estate value and rising interest rates. As a result, certain subprime lenders have been unable to obtain further financing and may not be able to satisfy outstanding debt obligations. The decline in the subprime mortgage industry and the failure of subprime mortgage lenders may also effect the Alt-A mortgage industry with increased delinquencies and the inability to obtain further financing. This may result in a reduction of our mortgage originations and acquisitions and reduce or eliminate the liquidity currently available to us to fund our operations.

Representations and warranties made by us in our loan sales and securitizations may subject us to liability.

In connection with our loan sales to third parties and our securitizations, we transfer mortgages acquired and originated by us to the third parties or into a trust in exchange for cash and, in the case of a securitized mortgage, residual certificates issued by the trust. The trustee or purchaser will have recourse to us with respect to the breach of the standard representations and warranties made by us at the time such mortgages are transferred. While we may have recourse to our customers for any such breaches, there can be no assurance of our customers' abilities to honor their respective obligations. Also, we engage in bulk whole loan sales pursuant to agreements that generally provide for recourse by the purchaser against us in the event of a breach of one of our representations or warranties, any fraud or misrepresentation during the mortgage origination process, or upon early default on such mortgage. We attempt to limit the potential remedies of such purchasers to the potential remedies we receive from the customers from whom we acquired or originated the mortgages. However, in some cases, the remedies available to a purchaser of mortgages from us may be broader or extend longer than those available to us against the sellers of the mortgages and should a purchaser enforce its remedies against us, we are not always able to enforce whatever remedies we have against our customers. Furthermore, if we discover, prior to the sale or transfer of a loan, that there is any fraud or misrepresentation with respect to the mortgage and the originator fails to repurchase the mortgage, then we may not be able to sell the mortgage or we may have to sell the mortgage at a discount.

In the ordinary course of our business, we may be subject to claims made against us by borrowers, purchasers of our loans, and trustees in our securitizations arising from, among other things, losses that are claimed to have been incurred as a result of alleged breaches of fiduciary obligations, misrepresentations, errors and omissions of our employees, officers and agents (including appraisers), incomplete documentation and our failure to comply with various laws and regulations applicable to our business. Any claims asserted against us may result in legal expenses or liabilities that could have a material adverse effect on our results of operations or financial condition.

Our use of second mortgages exposes us to greater credit risks.

Our security interest in the property securing second mortgages is subordinated to the interest of the first mortgage holder and typically the second mortgages have a higher combined LTV ratio than do the first mortgages. If the borrower experiences difficulties in making senior lien payments or if the value of the property is equal to or less than the amount needed to repay the borrower's obligation to the first mortgage holder upon foreclosure, our second mortgage loan may not be repaid.

Competition for mortgages is intense and may adversely affect our operations.

We compete in acquiring and originating Alt-A and commercial mortgages and issuing mortgage-backed securities with other mortgage conduit programs, investment banking firms, savings and loan associations, banks, thrift and loan associations, finance companies, mortgage bankers and brokers, insurance companies, other lenders, and other entities purchasing mortgage assets.

We also face intense competition from Internet-based lending companies where entry barriers are relatively low. Some of our competitors are much larger than we are, have better name recognition than we do, and have far greater financial and other resources. Government-sponsored entities, in particular Fannie Mae and Freddie Mac, are also expanding their participation in the Alt-A mortgage industry. These government-sponsored entities have a size and cost-of-funds advantage over us that allows them to price mortgages at lower rates than we are able to offer. This phenomenon may seriously destabilize the Alt-A mortgage industry. In addition, if as a result of what may be less-conservative, risk-adjusted pricing, these government-sponsored entities experience significantly higher-than-expected losses, it would likely adversely affect overall investor perception of the Alt-A and subprime mortgage industry because the losses would be made public due to the reporting obligations of these entities.

The intense competition in the Alt-A, subprime and commercial mortgage industry has also led to rapid technological developments, evolving industry standards and frequent releases of new products and enhancements. As mortgage products are offered more widely through alternative distribution channels, such as the Internet, we may be required to make significant changes to our current retail and wholesale structure and

information systems to compete effectively. Our inability to continue enhancing our current Internet capabilities, or to adapt to other technological changes in the industry, could have a material adverse effect on our business, financial condition, liquidity and results of operations.

The need to maintain mortgage loan volume in this competitive environment creates a risk of price competition in the Alt-A, subprime and Commercial mortgage industry. Competition in the industry can take many forms, including interest rates and costs of a loan, less stringent underwriting standards, convenience in obtaining a loan, customer service, amount and term of a loan and marketing and distribution channels. Our failure to maintain our customer service levels may affect our ability to effectively compete in the mortgage industry. Price competition would lower the interest rates that we are able to charge borrowers, which would lower our interest income and/or our gain on sale of mortgage loans. Price-cutting or discounting reduces profits and will depress earnings if sustained for any length of time. If our competition uses less stringent underwriting standards we will be pressured to do so as well, resulting in greater loan risk without being able to price for that greater risk. Our competitors may lower their underwriting standards to increase their market share. If we do not relax underwriting standards in the face of competition, we may lose market share. Increased competition may also reduce the volume of our loan originations and acquisitions. Any increase in these pricing and credit pressures could have a material adverse effect on our business, financial condition, liquidity and results of operations.

Any significant margin calls under our financing facilities would adversely affect our liquidity and may adversely affect our financial results.

During periods of disruption in the financial markets, the mortgage industry may experience substantial turmoil as a result of a lack of liquidity in the secondary markets. At such times, investors may be unwilling to purchase interests in securitizations due, in part, to:

the lack of financing to acquire these securitization interests;

the narrowing of spread expected by institutional investors on securitization interests over the prevailing Treasury rate; and

market uncertainty.

As a result, during these periods, many mortgage originators, including us, may be unable to access the securitization market on favorable terms. This may result in some companies declaring bankruptcy. Some companies, like us, may be required to sell loans on a whole loan basis and liquidate holdings of mortgage-backed securities to repay short-term borrowings. However, the large amount of mortgages available for sale on a whole loan basis may create an oversupply and affect the pricing offered for these mortgages, which in turn may reduce the value of the collateral underlying the financing facilities. Therefore, many providers of financing facilities may initiate margin calls. Margin calls may result when our lenders evaluate the market value of the collateral securing our financing facilities and require us to provide them with additional equity or collateral to secure our borrowings.

Our financing facilities are short-term borrowings and in the event of a market disruption, many traditional providers of financing facilities may be unwilling to provide facilities on favorable terms, or at all. Our current financing facilities continue to be short-term borrowings and we expect this to continue. If we cannot renew or replace maturing borrowings, we may have to sell, on a whole loan basis, the mortgages securing these facilities, which, depending upon market conditions may result in substantial losses.

Some of our reverse repurchase agreements contain numerous representations, warranties and covenants, including requirements to maintain a certain minimum net worth, to maintain minimum equity ratios, to maintain our REIT status, and other customary debt covenants. Events of default under these facilities include material breaches of representations and warranties, failure to comply with covenants, material adverse effects upon or changes in our business, assets, or financial condition, and other customary matters. Events of default under certain of our facilities also include termination of our status as servicer with respect to certain securitized loan pools and failure to maintain profitability over consecutive quarters. If we were unable to make the necessary representations and warranties at the time we need financing or satisfy, or obtain waivers from, the continuing covenants, we would not have sufficient liquidity to fund our current operations.

Increased levels of early prepayments of mortgages may accelerate our amortization expenses and decrease our net interest income.

Mortgage prepayments generally increase on our ARMs when fixed mortgage interest rates fall below the then-current interest rates on outstanding ARMs or fully indexed ARMs. Prepayments on mortgages are also affected by the terms and credit grades of the mortgages, their interest rate reset date, conditions in the financial markets, housing appreciation and general economic conditions. If we acquire mortgages at a premium and they are subsequently prepaid, we must expense the unamortized premium at the time of the prepayment. We could possibly lose the opportunity to earn interest at a higher rate over the expected life of the mortgage. Also, if prepayments on mortgages increase when interest rates are declining, our net interest income may decrease if we cannot reinvest the prepayments in mortgage assets with comparable net interest margins. If prepayment rates differ from our projections, we may experience a change in net earnings due to a change in the ratio of derivatives to the related mortgages. This may result in a reduction of cash flows from our mortgage loans net of financing costs as we have a higher percentage of derivative costs related to these mortgages than originally projected.

We generally acquire mortgages on a servicing released basis, meaning we acquire both the mortgages and the rights to service them. This strategy requires us to pay a higher purchase price or premium for the mortgages. If the mortgages that we acquire at a premium prepay faster than originally projected GAAP requires us to write down the remaining capitalized premium amounts at a faster speed than was originally projected, which would decrease our current net interest income.

Interest rate fluctuations may adversely affect our operating results.

Our operations, as a mortgage loan acquirer and originator, an investor in mortgage loans or a warehouse lender, may be adversely affected by rising and falling interest rates. Interest rates have been historically low over the past few years; however increases in interest rates may discourage potential borrowers from refinancing mortgages, borrowing to purchase homes or seeking second mortgages. For example, during 2006, the Federal Reserve Bank increased short-term rates a total of 100 basis points. This has decreased the amount of mortgages available to be acquired or originated by our mortgage operations and has decreased the demand for repurchase financing provided by our warehouse lending operations, which adversely affects our operating results if we are not able to commensurately increase our market share. If short-term interest rates exceed long-term interest rates, there is a higher risk of increased loan prepayments, as borrowers may seek to refinance their fixed and adjustable rate mortgages at lower long-term fixed interest rates. Increased loan prepayments could lead to a reduction in the number of mortgages in our long-term mortgage portfolio and reduce our net interest income. Rising interest rates may also increase delinquencies, foreclosures and losses on our adjustable rate mortgages.

We are subject to the risk of rising mortgage interest rates between the time we commit to purchase mortgages at a fixed price through the issuance of individual, bulk or other rate-locks and the time we sell or securitize those mortgages. An increase in interest rates will generally result in a decrease in the market value of mortgages that we have committed to purchase at a fixed price, but have not been sold or securitized. As a result, we may record a smaller gain, or even a loss, upon the sale or securitization of those mortgages.

If we are unable to complete securitizations or if we experience delayed mortgage loan sales or securitization closings, we could face a liquidity shortage which would adversely affect our operating results.

We rely significantly upon securitizations to generate cash proceeds to repay borrowings and replenish our borrowing capacity. If there is a delay in a securitization closing or any reduction in our ability to complete securitizations we may be required to utilize other sources of financing, which, if available at all, may not be on similar terms. In addition, delays in closing mortgage sales or securitizations of our mortgages increase our risk by exposing us to credit and interest rate risks for this extended period of time. Furthermore, gains on sales from certain of our securitizations represent a significant portion of the taxable income dividend to the REIT from our taxable REIT subsidiary, IFC. Several factors could affect our ability to complete securitizations of our mortgages, including:

conditions in the securities and secondary markets;

credit quality of the mortgages acquired or originated through our mortgage operations;

volume of our mortgage loan acquisitions and originations;

our ability to obtain credit enhancements; and

lack of investors purchasing higher risk components of the securities.

If we are unable to sell a sufficient number of mortgages at a premium or profitably securitize a significant number of our mortgages in a particular financial reporting period, then we could experience lower net earnings or a loss for that period, which could have a material adverse affect on our operations. We cannot assure you that we will be able to continue to profitably securitize or sell our mortgages on a whole loan basis, or at all.

The market for first loss risk securities, which are securities that take the first loss when mortgages are not paid by the borrowers, is generally limited. In connection with our REMIC securitizations, we may not sell all securities subjecting us to a first loss risk. If we do not sell these securities, we may hold them for an extended period, subjecting us to a first loss risk.

A prolonged economic downturn or recession would likely result in a reduction of our mortgage origination activity which could adversely affect our financial results.

The United States economy has undergone in the past and may in the future, undergo, a period of economic slowdown, which some observers view as a recession. An economic downturn or a recession may have a significant adverse impact on our operations and our financial condition. For example, a reduction in new mortgages may adversely affect our ability to maintain or expand our long-term mortgage portfolio, our principal means of generating earnings. In addition, a decline align="left"> 75.4% 75.4% n/a

* Other sales primarily consist of sales to Advanced Medical Optics, Inc., or AMO, pursuant to a manufacturing and supply agreement entered into as part of the AMO spin-off that is scheduled to terminate in June 2005.

The \$6.7 million increase in net sales from the impact of foreign currency changes for the three month period ended March 25, 2005 was due primarily to the strengthening of the euro, Canadian dollar and Brazilian real compared to the U.S. dollar.

The \$54.8 million increase in net sales in the first quarter of 2005 compared to the first quarter of 2004 was primarily the result of increases in sales of our eye care pharmaceuticals, *Botox*® and skin care product lines, partially offset by a decrease in other non-pharmaceutical sales. Eye care pharmaceuticals sales increased in the first quarter of 2005 compared to the first quarter of 2004 primarily because of strong growth in sales of *Restasis*®, our drug for the treatment of chronic dry eye disease, an increase in sales of our glaucoma drug *Lumigan*®, growth in sales of eye drop products, primarily *Refresh*®, an increase in sales of *Zymar*®, a newer anti-infective, an increase in sales of *Elestat* , our topical antihistamine

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Allergan, Inc.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE QUARTER ENDED MARCH 25, 2005 (Continued)

RESULTS OF OPERATIONS (Continued)

used for the prevention of itching associated with allergic conjunctivitis that was launched in the United States in the first quarter of 2004 by our co-promotion partner, Inspire Pharmaceuticals, Inc., and an increase in sales of *Acular LS*, our newer non-steroidal anti-inflammatory. This increase in sales was partially offset by a decrease in sales of *Ocuflox*, our older generation anti-infective that is experiencing generic competition in the United States, and *Acular*, our older generation anti-inflammatory. Our *Alphagan* franchise sales also decreased in the first quarter of 2005 compared to the first quarter of 2004 due to a general decline in U.S. wholesaler demand for *Alphagan P* and the negative impact from generic *Alphagan* competition. We continue to believe that generic formulations of *Alphagan* will have a negative impact on future net sales of our *Alphagan* franchise. We estimate the majority of the change in our eye care pharmaceutical sales was due to mix and volume changes; however, we increased the published list prices for certain eye care pharmaceutical products in the United States, ranging from three and one-half percent to nine percent, effective February 5, 2005. We increased the published U.S. list price for *Lumigan* by seven percent, *Restasis* by three and one-half percent and *Alphagan P* by five percent. This increase in prices had a subsequent positive net effect on our U.S. sales, but the actual net effect is difficult to determine due to the various managed care sales rebate and other incentive programs in which we participate. Wholesaler buying patterns and the change in dollar value of prescription product mix also affected our reported net sales dollars. We have a policy to attempt to maintain average U.S. wholesaler inventory levels of our products at an amount between one to two months of our net sales. At March 25, 2005, based on available external and internal information, we believe the amount of average U.S. wholesaler inventories of our products was below our stated policy levels. We currently expect the wholesaler inventory levels of our products to return to our normal policy levels during the next six months of 2005, which may create above average U.S. wholesaler demand for our products during our second and third fiscal quarters of 2005 compared to demand experienced during the same periods in 2004.

Botox sales increased in the first quarter of 2005 compared to the first quarter of 2004 primarily as a result of strong growth in demand in international markets and in the United States for both therapeutic and cosmetic uses. Effective January 4, 2005, we increased the published price for *Botox* and *Botox* Cosmetic in the United States by approximately four percent, which we believe had a positive effect on our U.S. sales growth in 2005. International *Botox* sales also benefited from strong sales growth in Europe, especially in Germany, the U.K., Spain and Italy, as well as an increase in sales of *Botox* in smaller distribution markets serviced by our European export sales group. We believe our worldwide market share for neuromodulators, including *Botox*, is currently over 85%.

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Allergan, Inc.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE QUARTER ENDED MARCH 25, 2005 (Continued)

RESULTS OF OPERATIONS (Continued)

Skin care sales increased in the first quarter of 2005 compared to the first quarter of 2004 primarily due to higher sales of *Tazorac*®, *Zorac*®, *Avage*® and new product sales generated from *Prevage* antioxidant cream, which we launched in January 2005. Net sales of *Tazorac*®, *Zorac*® and *Avage*® increased \$1.8 million, or 9.9%, to \$19.8 million in the first quarter of 2005 compared to \$18.0 million in the first quarter of 2004. We increased the published U.S. list price for *Tazorac*® by nine percent effective February 5, 2005.

The decrease in the percentage of U.S. sales as a percentage of total product net sales during the first three months of 2005 compared to the same period in 2004 was primarily attributable to an increase in international eye care pharmaceuticals and *Botox*® sales, principally in Europe and Latin America, as a percentage of total product net sales.

Our gross margin percentage for the first quarter of 2005 was 82.2% of net sales, which represents a 0.7 percentage point increase from our gross margin percentage of 81.5% for the first quarter of 2004. Our gross margin percentage increased in the first quarter of 2005 compared to the first quarter of 2004 primarily as a result of an increase in gross margin percentage for the *Botox*® product line and contract manufacturing sales to AMO, partially offset by a decrease in gross margin percentage for eye care pharmaceuticals. Our gross margin percentage also increased due to an increase in the mix of *Botox*® sales, which generally have a higher gross margin percentage than our other pharmaceutical product lines. The gross margin percentage for eye care pharmaceuticals declined in the first quarter of 2005 compared to the first quarter of 2004 due to an increase in the mix of international sales, which generally have a lower gross margin percentage than U.S. sales, an increase in sales from products with higher royalty rates payable to third parties and a higher ratio of U.S. sales subject to rebates and other incentive programs. The gross margin percentage for our *Botox*® product line experienced an increase in the first quarter of 2005 compared to the first quarter of 2004 due primarily to a price increase for *Botox*® and *Botox*® Cosmetic in the United States, partially offset by an increase in the mix of international sales, which generally have a lower gross margin percentage than U.S. sales. The gross margin percentage for contract manufacturing sales improved primarily due to an increase in U.S. dollar denominated pricing allowed under the manufacturing and supply agreement with AMO at the beginning of our 2005 fiscal year. Gross margin in dollars increased in the first quarter of 2005 compared to the first quarter of 2004 by \$48.3 million, or 12.6%, as a result of the 11.6% increase in net sales and by the 0.7 percentage point increase in gross margin percentage.

Selling, general and administrative, or SG&A, expenses were \$210.3 million, or 39.9% of net sales, in the first quarter of 2005 compared to \$180.6 million, or 38.2% of net sales, in the first quarter of 2004. The increase in SG&A expense dollars in the first quarter of 2005 compared to the first

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Allergan, Inc.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE QUARTER ENDED MARCH 25, 2005 (Continued)

RESULTS OF OPERATIONS (Continued)

quarter of 2004 was primarily a result of an increase in promotion costs associated with direct-to-consumer advertising in the United States for *Botox*® Cosmetic and *Restasis*®, and an increase in selling expenses, principally personnel costs, and marketing expenses supporting the increase in consolidated sales, especially for *Restasis*®, *Lumigan*®, *Botox*® and *Botox*® Cosmetic. SG&A expenses also increased due to an increase in co-promotion costs related to sales of *Elestat*®, higher general and administrative expenses, principally headcount related costs and consulting fees, and the non-recurrence of a favorable settlement of a patent dispute amounting to \$2.4 million in the first quarter of 2004. SG&A expenses were also negatively impacted by an increase in the translated U.S. dollar value of foreign currency denominated expenses, especially in Europe and Latin America. As a percentage of net sales, SG&A expenses increased in the first quarter of 2005 compared to the first quarter of 2004, due primarily to higher promotion and marketing expenses as a percentage of net sales and lower miscellaneous royalty income earned in the first quarter of 2005 compared to the first quarter of 2004, partially offset by lower selling and general and administrative expenses as a percentage of net sales.

Research and development expenses were \$82.0 million, or 15.6% of net sales, in the first quarter of 2005 compared to \$86.1 million, or 18.2% of net sales, in the first quarter of 2004. Research and development spending decreased \$4.1 million in the first quarter of 2005 compared to the first quarter of 2004 primarily as a result of lower rates of investment in our skin care and *Botox*® product lines, partially offset by an increase in spending for eye care pharmaceuticals. Our expected spending for research and development activities in the first quarter of 2005 was also negatively impacted by the timing of patient enrollments in clinical trials. We expect research and development expenses to increase in fiscal year 2005 compared to 2004 as we continue to increase our investments in eye care pharmaceuticals and increase spending for our *Botox*® product lines and new technologies during the remainder of 2005.

Restructuring Charges and Transition/Duplicate Operating Expenses

Restructuring and Streamlining of European Operations

Effective January 2005, our Board of Directors approved the initiation and implementation of a restructuring of certain activities related to our European operations. The restructuring seeks to optimize operations, improve resource allocation and create a scalable, lower cost and more efficient operating model for our European research and development, or R&D, and commercial activities. Specifically, the restructuring anticipates moving key European R&D and select commercial functions from our Mougins, France and other European locations to our Irvine, California, High Wycombe, U.K. and Dublin, Ireland facilities and streamlining functions in our European management services group.

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Allergan, Inc.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE QUARTER ENDED MARCH 25, 2005 (Continued)

RESULTS OF OPERATIONS (Continued)

Under applicable law, the proposed restructuring requires consultations and, in certain cases, negotiations with European and national works councils, other management/labor organizations and local authorities. The restructuring steps to be implemented and their ultimate cost will depend in part on the outcome of such consultations and negotiations.

We anticipate incurring restructuring charges and charges relating to severance, relocation and one-time termination benefits, payments to public employment and training programs, implementation, transition, capital and other asset-related expenses, duplicate operating expenses and contract termination costs in connection with the restructuring. We currently estimate that the pre-tax charges resulting from the restructuring, including transition and duplicate operating expenses, will be between \$40 million and \$53 million and capital expenditures will be between \$5 million and \$7 million. We began to incur these amounts beginning in the first quarter of 2005 and expect to continue to incur them up through and including the second quarter of 2006. Of the total amount of pre-tax charges and capital expenditures, approximately \$45 million to \$58 million are expected to be cash expenditures.

The foregoing estimates are based on assumptions relating to, among other things, a reduction of approximately 160 positions, principally R&D and selling, general and administrative positions in the affected European locations. These workforce reduction activities began in the first quarter of 2005 and are expected to be substantially completed by the close of the second quarter of 2006. Charges associated with the workforce reduction, including severance, relocation and one-time termination benefits, and payments to public employment and training programs, are currently expected to total approximately \$28 million to \$33 million. We began to incur these charges in the first quarter of 2005 and expect to continue to incur them up through and including the second quarter of 2006. Certain severance costs included in the estimates totaling approximately \$3 million to \$4 million for a limited number of personnel are dependent upon the employees' future decision to continue employment after specific contractual work assignments end between 2006 and 2007. These contingent contractual severance costs will be recorded in the period when we determine that they become probable.

Estimated costs also include approximately \$2 million to \$7 million for contract and lease termination costs and asset write-offs (primarily for accelerated amortization related to leasehold improvements in facilities to be exited). These costs are currently expected to be recorded beginning in the second quarter of 2005 and to be completed by the close of the second quarter of 2006.

Estimated implementation and transition related expenses include, among other things, legal, consulting, recruiting, information system implementation costs and taxes. These costs are currently expected to total approximately \$9 million to \$11 million, began to be recorded in the

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Allergan, Inc.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE QUARTER ENDED MARCH 25, 2005 (Continued)**RESULTS OF OPERATIONS (Continued)**

first quarter of 2005 and are expected to continue up through and including the second quarter of 2006. We also expect to incur duplicate operating expenses during the transition period to ensure that job knowledge and skills are properly transferred to new employees. These duplicate operating expenses are currently expected to total between \$1 million and \$2 million, began to be recorded in the first quarter of 2005 and are expected to continue up through and including the first quarter of 2006.

We also expect to incur additional capital expenditures for leasehold improvements (primarily at our High Wycombe, U.K. facility or a new facility in the U.K. to accommodate increased headcount). These capital expenditures are currently estimated to be between approximately \$5 million and \$7 million, and are currently expected to be recorded beginning in the second quarter of 2005 and continuing up through and including the first quarter of 2006.

During the first quarter of 2005, we recorded pre-tax restructuring charges of \$20.7 million and transition/duplicate operating expenses of \$0.3 million related to the restructuring of our European operations. The restructuring charges primarily consist of employee severance, employee relocation and other costs. The following table presents the cumulative restructuring activities through March 25, 2005:

	Employee Severance	Other Costs	Total
Net charge during 2005	\$ 20.5	\$ 0.2	\$ 20.7
Spending	(0.8)	(0.2)	(1.0)
Balance at March 25, 2005	\$ 19.7	\$	\$ 19.7

Employee severance in the preceding table relates to 153 employees, of which five were severed as of March 25, 2005. Employee severance charges were based on social plans in France and Italy, and our severance practices for employees in the other affected European countries. Transition/duplicate operating expenses consisted primarily of salaries, travel, communications and consulting costs. Transition/duplicate operating expenses have been included in the normal operating expense classifications to which they relate on the unaudited condensed consolidated statements of earnings.

Termination of Manufacturing and Supply Agreement with Advanced Medical Optics

In October 2004, our board of directors approved certain restructuring activities related to the scheduled termination of our manufacturing and supply agreement with AMO. Under the manufacturing and supply agreement, which was entered into in connection with the AMO spin-off, we agreed to

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE QUARTER ENDED MARCH 25, 2005 (Continued)**RESULTS OF OPERATIONS (Continued)**

manufacture certain contact lens care products and VITRAX, a surgical viscoelastic, for AMO for a period of up to three years ending in June 2005. As part of the termination of the manufacturing and supply agreement, we plan to eliminate certain manufacturing positions at our Westport, Ireland; Waco, Texas; and Guarulhos, Brazil manufacturing facilities.

We currently anticipate that the pre-tax restructuring charges to be incurred in connection with the termination of the manufacturing and supply agreement will total between approximately \$24 million and \$28 million. We began recording these charges in the fourth quarter of 2004 and expect to continue recording them up through and including the fourth quarter of 2005. The pre-tax charges are net of expected tax credits available under qualifying government-sponsored employment programs. Approximately \$24 million of the restructuring charges are expected to be cash charges. The restructuring charges are expected to include approximately \$20 million to \$22 million associated with the reduction in our workforce of approximately 350 individuals. The workforce reduction will impact personnel in Europe, the United States and Latin America. The workforce reduction began in the fourth quarter of 2004 and is expected to be completed by the end of the second quarter of 2005. The restructuring costs are also expected to include approximately \$4 million to \$6 million of other costs associated with the termination of the manufacturing and supply agreement.

As of March 25, 2005, we recorded cumulative pre-tax restructuring charges of \$13.8 million related to the termination of the manufacturing and supply agreement. These charges primarily include accruals for net statutory severance costs and the ratable recognition of termination benefits to be earned by employees who are required to render service until they are terminated in order to receive the termination benefits.

The following table presents the cumulative restructuring activities through March 25, 2005 resulting from the scheduled termination of the manufacturing and supply agreement in June 2005:

	Charges for Employees Involuntarily and Voluntarily Terminated (in millions)
Net charge during 2004	\$ 7.1
Spending	(0.1)
Balance at December 31, 2004	7.0
Net charge during 2005	6.7
Spending	(1.2)
Balance at March 25, 2005	\$ 12.5

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Allergan, Inc.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE QUARTER ENDED MARCH 25, 2005 (Continued)

RESULTS OF OPERATIONS (Continued)

The remaining balance at March 25, 2005 is comprised of accrued statutory severance and one-time termination benefits of \$15.5 million, less expected employment program tax credits of \$3.0 million.

Operating income in the first quarter of 2005 was \$113.4 million compared to operating income of \$118.1 million for the first quarter of 2004. The \$4.7 million decrease in operating income was due primarily to the \$27.4 million restructuring charge and increase in SG&A expenses of \$29.7 million, partially offset by the \$48.3 million increase in gross margin and \$4.1 million decrease in research and development expenses.

Total net non-operating income in the first quarter of 2005 was \$5.6 million compared to net non-operating expenses of \$1.9 million in the first quarter of 2004. Interest income in the first quarter of 2005 was \$5.5 million compared to interest income of \$2.0 million in the first quarter of 2004. This increase in interest income in the first quarter of 2005 was primarily due to higher average cash equivalent balances earning interest of approximately \$354 million and an increase in average interest rates earned on all cash equivalent balances earning interest of approximately 1.18% in the first quarter of 2005 compared to the same period in 2004. Interest expense increased \$0.8 million to \$4.5 million in the first quarter of 2005 compared to \$3.7 million in the first quarter of 2004, primarily due to an increase in the amortization of deferred debt issuance costs related to our outstanding zero coupon convertible senior notes due 2022, or Senior Notes, and higher other statutory interest expense. During the third quarter of 2004, we accelerated our amortization of debt issuance costs to a more conservative view, electing to amortize such costs related to our Senior Notes over the five year period from date of issuance in November 2002 to the first note holder put date in November 2007 instead of over the 20 year life of the Senior Notes.

We recorded a net unrealized gain on derivative instruments of \$0.1 million in the first quarter of 2005 compared to a net unrealized loss of \$0.1 million in the first quarter of 2004. We record as Unrealized gain (loss) on derivative instruments, net the mark to market adjustments on our outstanding foreign currency options, which we enter into to reduce the volatility of expected earnings in currencies other than U.S. dollars. Other, net income was \$4.5 million in the first quarter of 2005 compared to net expenses of \$0.1 million in the first quarter of 2004. In the first quarter of 2005, Other, net includes a gain of \$3.5 million for the receipt of a technology transfer fee related to the assignment of a third party patent licensing arrangement covering the use of botulinum toxin type B for cervical dystonia, and net realized gains from foreign currency transactions of \$0.3 million. Other, net in the first quarter of 2004 includes net realized losses from foreign currency transactions of \$1.0 million and a gain of \$0.8 million realized from the settlement of a non-income tax dispute with AMO.

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE QUARTER ENDED MARCH 25, 2005 (Continued)

RESULTS OF OPERATIONS (Continued)

Our effective tax rate for the first quarter of 2005 was 32.9% compared to the effective tax rate of 30.2% for the first quarter of 2004, and our full year 2004 adjusted effective tax rate of 29.8%. Our full year 2004 adjusted effective tax rate excludes the impact of restructuring charges of \$7.0 million and related tax benefit of \$0.8 million and an estimated \$6.1 million income tax benefit for previously paid state income taxes, which became recoverable due to a favorable state court decision that became final during the second quarter of 2004. Included in our operating income in the first quarter of 2005 are pre-tax restructuring charges of \$27.4 million associated with the scheduled termination of our manufacturing and supply agreement with AMO and the restructuring of our European operations. We recorded an income tax benefit of \$2.9 million related to these pre-tax restructuring charges. Excluding the impact of the \$27.4 million pre-tax restructuring charges and related tax benefit of \$2.9 million, our adjusted effective tax rate for the first quarter of 2005 was 28.8%. The decrease in our adjusted effective tax rate in the first quarter of 2005 compared to our full year 2004 adjusted effective tax rate is primarily due to a reduction in the estimated amount of repatriation of current year foreign earnings and a tax rate benefit from expected changes in the mix of our earnings included in our estimated annual effective tax rate for fiscal year 2005 compared to 2004. Included in the provision for income taxes in the first quarter of 2005 is an additional amount for state income taxes paid related to the California income tax amnesty program.

Net earnings in the first quarter of 2005 were \$79.9 million compared to net earnings of \$80.8 million for the same period last year. The \$0.9 million decrease in earnings in the first quarter of 2005 compared to the first quarter of 2004 was primarily the result of the decrease in operating income of \$4.7 million and the increase in the provision for income taxes of \$4.1 million, partially offset by the increase in total net non-operating income of \$7.5 million.

Acceleration of Vesting of Premium Priced Stock Options

The Financial Accounting Standards Board recently published Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (FAS 123R). FAS 123R, which is effective for us beginning January 1, 2006, will require us to recognize in our financial statements the grant-date fair value of stock options and other equity-based compensation issued to employees. Currently, we account for our stock-based compensation using the intrinsic-value-based method allowed by Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation, which does not require the recognition of stock-based compensation cost in the income statement of the financial statements if stock options are granted to employees at market price at the date of grant.

On July 30, 2001, we granted non-qualified stock options to purchase up to 2,500,000 shares of our common stock to participants, including our executive officers under the Allergan, Inc. 2001 Premium Priced Stock Option Plan. Each option was issued with three tranches:

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE QUARTER ENDED MARCH 25, 2005 (Continued)

RESULTS OF OPERATIONS (Continued)

the first tranche has an exercise price equal to \$88.55;

the second tranche has an exercise price equal to \$106.26; and

the third tranche has an exercise price equal to \$127.51.

Each tranche of an option vests and becomes exercisable upon the earlier of the date on which the fair value of a share of our common stock equals or exceeds the applicable exercise price or five years from the grant date of the option (July 30, 2006). The options expire six years from the grant date of the option (July 30, 2007). The first tranche of the options vested and became exercisable on March 1, 2004 as a result of the fair value of our common stock exceeding \$88.55.

In response to FAS 123R, on April 25, 2005, the organization and compensation committee of our board of directors approved an acceleration of the vesting of the options issued under the Allergan, Inc. 2001 Premium Priced Stock Option Plan that are held by our current employees, including our executive officers, and certain former employees who received grants while employees prior to the June 2002 spin-off of Advanced Medical Optics (AMO). The former employees are current employees of AMO. As a result of the acceleration, the second tranche and third tranche of each such option will become immediately vested and exercisable effective as of May 10, 2005, subject to the consent of the option holder. Unlike typical stock options that vest over a predetermined period, the options automatically vest as soon as they are in the money. Consequently, as soon as the options have any value to the participant, they vest according to their terms. Therefore, early vesting does not provide any immediate benefit to participants, including our executive officers.

The acceleration of the options eliminates future compensation expense that we would otherwise recognize in our income statement with respect to the vesting of these options following the effectiveness of FAS 123R. Assuming that no holders of the options elect to decline the acceleration, the maximum future expense that is eliminated is approximately \$1.6 million (of which approximately \$0.2 million is attributable to options held by executive officers). This amount will instead be reflected in pro forma footnote disclosure to the 2005 financial statements. This footnote treatment is permitted under the transition guidance provided by FAS 123R.

LIQUIDITY AND CAPITAL RESOURCES

We assess our liquidity by our ability to generate cash to fund our operations. Significant factors in the management of liquidity are:

funds generated by operations; levels of accounts receivable, inventories, accounts payable and capital expenditures; the extent of our stock repurchase program; funds required for acquisitions; adequate credit facilities; and financial flexibility to attract long-term capital on satisfactory terms.

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE QUARTER ENDED MARCH 25, 2005 (Continued)

LIQUIDITY AND CAPITAL RESOURCES (Continued)

Historically, we have generated cash from operations in excess of working capital requirements. The net cash provided by operating activities for the three months ended March 25, 2005 was \$90.9 million compared to cash provided of \$47.9 million for the three months ended March 26, 2004. The increase in net cash provided by operating activities of \$43.0 million was primarily due to an increase in earnings, including the effect of non-cash items, a decrease in cash required to fund growth in trade receivables, an increase in accounts payable and a decrease in other non-current assets. These increases in operating cash flow were partially offset by a decrease in income taxes payable, principally due to an increase in income taxes paid, a decrease in accrued expenses, an increase in inventories, primarily for eye care pharmaceuticals and *Botox*®, and higher interest paid. In the first three months of 2005 and 2004, we paid pension contributions of \$1.5 million and \$2.0 million, respectively, to our U.S. defined benefit pension plan. In 2005, we currently expect to pay contributions of between \$14.3 million and \$16.3 million for our U.S. and non-U.S. pension plans.

At December 31, 2004, we disclosed consolidated unrecognized net actuarial losses of \$166.3 million, which were included in our reported net prepaid benefit cost. The unrecognized net actuarial losses resulted primarily from lower than expected investment returns on plan assets in 2002 and 2001 and decreases in the discount rates used to measure projected benefit obligations that occurred over the past four years. Unrecognized net actuarial gains or losses are evaluated annually by our actuaries for each of our pension and postretirement plans based on information at the plans annual measurement date. Assuming constant actuarial assumptions estimated as of our pension plans measurement date of September 30, 2004, we expect the amortization of these unrecognized net actuarial losses to increase our total pension costs by approximately \$3.0 million in 2005 compared to the amortization of approximately \$6.7 million of unrecognized net actuarial losses included in pension costs expensed in fiscal year 2004. The future amortization of the unrecognized net actuarial losses is not expected to materially affect future pension contribution requirements.

Net cash used in investing activities in the first three months of 2005 was \$13.9 million. Net cash used in investing activities in the first three months of 2004 was \$18.1 million. We invested \$11.5 million in new facilities and equipment during the three months ended March 25, 2005 compared to \$15.1 million during the same period in 2004. Net cash used in investing activities also includes \$3.3 million and \$3.0 million to acquire software during the three months ended March 25, 2005 and March 26, 2004, respectively. We currently expect to invest between \$55 million to \$60 million in expenditures for manufacturing and laboratory facilities and other property, plant and equipment during 2005. As discussed in Note 14, Subsequent Event, in our unaudited condensed consolidated financial statements, we expect to pay \$110.0 million in April 2005 in connection with a certain royalty buy-out agreement. We expect to fund this payment from existing cash and equivalents.

Net cash used in financing activities was \$108.1 million in the first three months of 2005 compared to net cash provided by financing activities of \$29.9 million in the first three months of 2004. Dividends paid to stockholders

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE QUARTER ENDED MARCH 25, 2005 (Continued)

LIQUIDITY AND CAPITAL RESOURCES (Continued)

were \$13.1 million in the first three months of 2005 compared to \$11.8 million for the same period in 2004. Effective April 26, 2005, our Board of Directors declared a quarterly cash dividend of \$0.10 per share, payable on June 8, 2005 to stockholders of record on May 13, 2005. Receipts from the sale of stock to employees were \$3.9 million in the first three months of 2005 compared to \$49.8 million in the same period last year. During the first three months of 2005, we repaid \$4.6 million in notes payable compared to net borrowings of \$4.0 million in the first three months of 2004. During the first three months of 2005, we repurchased \$94.3 million of treasury stock. During the first three months of 2004, we repurchased \$1.7 million of treasury stock and repaid \$10.4 million under our commercial paper arrangements. Under our stock repurchase program, we may maintain up to 9.2 million repurchased shares in our treasury account at any one time. As of March 25, 2005, we held approximately 3.8 million treasury shares under this program. We are uncertain as to the level of treasury stock repurchases to be made in the future.

As of March 25, 2005, we had a committed domestic long-term credit facility, a committed foreign line of credit in Japan, a commercial paper program, a medium term note program, an unused debt shelf registration statement that we may use for a new medium term note program and other issuances of debt securities, and various foreign bank facilities. The committed domestic credit facility allows for borrowings of up to \$400 million through May 2009. The committed foreign line of credit allows for borrowings of up to three billion yen (approximately \$28.2 million) through July 2006. The commercial paper program also provides for up to \$300 million in borrowings. We do not currently intend to have combined borrowings under our committed credit facilities and our commercial paper program that would exceed \$300 million in the aggregate. The current medium term note program allows us to issue up to an additional \$8.3 million in registered notes on a non-revolving basis. The debt shelf registration statement provides for up to \$350 million in additional debt securities. Borrowings under the domestic credit facility and medium term note program are subject to certain financial and operating covenants that include, among other provisions, maintaining minimum debt to capitalization ratios and a minimum consolidated net worth. Certain covenants also limit subsidiary debt and restrict dividend payments. We were in compliance with these covenants at March 25, 2005. As of March 25, 2005, we had no borrowings under our domestic committed credit facility or commercial paper program, \$4.1 million in borrowings outstanding under our committed foreign line of credit, \$4.0 million outstanding in borrowings under various foreign bank loans and \$56.8 million in borrowings outstanding under the medium term note program.

On November 6, 2002, we issued zero coupon convertible senior notes due 2022, or Senior Notes, in a private placement with an aggregate principal amount at maturity of \$641.5 million. The Senior Notes, which were issued at a discount of \$141.5 million, are unsecured, accrue interest at 1.25%

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE QUARTER ENDED MARCH 25, 2005 (Continued)

LIQUIDITY AND CAPITAL RESOURCES (Continued)

annually and mature on November 6, 2022. The Senior Notes are convertible into 11.41 shares of our common stock for each \$1,000 principal amount at maturity if the closing price of our common stock exceeds certain levels, the credit ratings assigned to the Senior Notes are reduced below specified levels, or we call the Senior Notes for redemption, make specified distributions to our stockholders or become a party to certain consolidation, merger or binding share exchange agreements. On July 28, 2004, we, together with Wells Fargo Bank, as trustee, executed a supplemental indenture to the indenture governing the Senior Notes. The supplemental indenture amends the indenture's redemption and conversion provisions to restrict our ability to issue common stock in lieu of cash to holders of the Senior Notes upon any redemption or conversion. Upon any redemption, we are now required to pay the entire redemption amount in cash. In addition, upon any conversion, we will pay cash up to the accreted value of the Senior Notes converted and will have the option to pay any amounts due in excess of the accreted value in either cash or common stock. The rights of the holders of the Senior Notes were not affected or limited by the supplemental indenture. As of March 25, 2005, the conversion criteria had not been met. As a sensitivity measure, the incremental dilutive effect to be used in the computation of diluted earnings per share from the assumed conversion of the Senior Notes would have been an increase of approximately 1.1 million shares of common stock to the total number of diluted shares used to compute diluted earnings per share for the three month period ended March 25, 2005, if the closing price of our common stock during the specified conversion periods averaged \$90.01 per share (the minimum price allowed for conversion during the periods) and any amounts above the accreted value were settled in common stock.

Holders of the Senior Notes may require us to purchase the Senior Notes on any one of the following dates at the following prices: \$829.51 per Senior Note on November 6, 2007; \$882.84 per Senior Note on November 6, 2012; and \$939.60 per Senior Note on November 6, 2017. Pursuant to the supplemental indenture, we are required to pay cash for any Senior Notes purchased by us on any of these three dates. We may not redeem the Senior Notes before November 6, 2005, and prior to November 6, 2007 we may redeem all or a portion of the Senior Notes for cash in an amount equal to their accreted value only if the price of our common stock reaches certain thresholds for a specified period of time. On or after November 6, 2007, we may redeem all or a portion of the Senior Notes for cash in an amount equal to their accreted value.

A substantial portion of our existing cash and equivalents are held by non-U.S. subsidiaries. We currently plan to use these funds in our operations outside the United States. Withholding and U.S. taxes have not been provided for unremitted earnings of certain non-U.S. subsidiaries because we have currently reinvested or expect to reinvest these earnings permanently in such operations. As of December 31, 2004, we had approximately \$1,011 million in unremitted earnings outside the United

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE QUARTER ENDED MARCH 25, 2005 (Continued)

LIQUIDITY AND CAPITAL RESOURCES (Continued)

States for which withholding and U.S. taxes have not been provided. Tax costs would be incurred if these funds were remitted to the United States.

On October 22, 2004, the American Jobs Creation Act of 2004, or the Act, was enacted in the United States. We are currently evaluating the impact of the Act on our operations and effective tax rate. In particular, we are evaluating the Act's provisions relating to incentives to reinvest foreign earnings in the United States, which require a domestic reinvestment plan to be created and approved by our board of directors before executing any repatriation activities. At this time, we have not completed our evaluation. We expect to complete our evaluation by the end of our third fiscal quarter of 2005. The range of reasonably possible amounts of unremitted foreign earnings that may be considered for repatriation under the provisions of the Act is currently between zero and \$674 million. The related range of estimated income tax effects on such repatriation is currently between zero and \$60 million.

Our manufacturing and supply agreement with AMO is scheduled to terminate in June 2005. We currently estimate that we will incur between \$24 million and \$28 million of total restructuring costs associated with the termination of that agreement and related exit activities. We expect approximately \$24 million of the restructuring charges to be cash charges. As of March 25, 2005, we recorded cumulative pre-tax restructuring charges of \$13.8 million beginning in the fourth quarter of 2004 up through and including the first quarter of 2005 and expect to complete the additional restructuring activities by the end of the fourth quarter of 2005.

Effective January 2005, our Board of Directors approved the initiation and implementation of a restructuring of certain activities related to our European operations. We currently estimate that the pre-tax charges resulting from the restructuring, including transition and duplicate operating expenses, will be between \$40 million and \$53 million and capital expenditures will be between \$5 million and \$7 million. These amounts are expected to be incurred beginning in the first quarter of 2005 and continuing up through and including the second quarter of 2006. Of the total amount of pre-tax charges and capital expenditures, approximately \$45 million to \$58 million are expected to be cash expenditures. During the first quarter of 2005, we recorded pre-tax restructuring charges of \$20.7 million and transition/duplicate operating expenses of \$0.3 million related to the implementation of this restructuring of our European operations. We expect to complete the additional restructuring activities by the end of the second quarter of 2006.

We believe that the net cash provided by operating activities, supplemented as necessary with borrowings available under our existing credit facilities and existing cash and equivalents, will provide us with sufficient resources to meet working capital requirements, debt service and other cash needs over the next year.

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ALLERGAN, INC.

Item 3. Quantitative and Qualitative Disclosures About Market Risk and Certain Factors and Trends Affecting Allergan and its Businesses

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

In the normal course of business, our operations are exposed to risks associated with fluctuations in foreign currency exchange rates. We address these risks through controlled risk management that includes the use of derivative financial instruments to economically hedge or reduce these exposures. We do not enter into financial instruments for trading or speculative purposes.

To ensure the adequacy and effectiveness of our foreign exchange hedge positions, we continually monitor our foreign exchange forward and option positions both on a stand-alone basis and in conjunction with our foreign currency exposures, from an accounting and economic perspective.

However, given the inherent limitations of forecasting and the anticipatory nature of the exposures intended to be hedged, we cannot assure you that such programs will offset more than a portion of the adverse financial impact resulting from unfavorable movements in foreign exchange rates. In addition, the timing of the accounting for recognition of gains and losses related to mark-to-market instruments for any given period may not coincide with the timing of gains and losses related to the underlying economic exposures and, therefore, may adversely affect our consolidated operating results and financial position.

We record current changes in the fair value of open foreign currency option contracts as Unrealized gain (loss) on derivative instruments, net and record the gains and losses realized from settled option contracts in Other, net in the accompanying unaudited condensed consolidated statements of earnings. The premium costs of purchased foreign exchange option contracts are recorded in Other current assets and are amortized to Other, net over the life of the options. We have recorded all unrealized and realized gains and losses from foreign currency forward contracts through Other, net in the accompanying unaudited condensed consolidated statements of earnings.

Interest Rate Risk

Our interest income and expense is more sensitive to fluctuations in the general level of U.S. interest rates than to changes in rates in other markets. Changes in U.S. interest rates affect the interest earned on our cash and equivalents, interest expense on our debt as well as costs associated with foreign currency contracts.

At March 25, 2005, we had approximately \$7.3 million of variable rate debt. If the interest rates on our variable rate debt were to increase or decrease by 1% for the year, annual interest expense would increase or decrease by approximately \$0.1 million.

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Allergan, Inc.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK (Continued)

The tables below present information about certain of our investment portfolio and our debt obligations at March 25, 2005 and December 31, 2004.

	MARCH 25, 2005						Fair Market Value	
	2005	2006	Maturing in		2009	Thereafter		Total
	(in millions, except interest rates)							
ASSETS								
Cash equivalents:								
Repurchase Agreements	\$ 50.0						\$ 50.0	\$ 50.0
Weighted Average Interest Rate	3.02%						3.02%	
Commercial Paper	695.4						695.4	695.4
Weighted Average Interest Rate	2.73%						2.73%	
Foreign Time Deposits	31.2						31.2	31.2
Weighted Average Interest Rate	3.13%						3.13%	
Other Cash Equivalents	73.2						73.2	73.2
Weighted Average Interest Rate	2.60%						2.60%	
Total Cash Equivalents	\$ 849.8						\$ 849.8	\$ 849.8
Weighted Average Interest Rate	2.75%						2.75%	
LIABILITIES								
Debt Obligations:								
Fixed Rate (US\$)		\$ 515.2	\$ 31.8		\$ 25.0		\$ 572.0	\$ 623.6
Weighted Average Interest Rate		1.25%	3.56%		7.47%		1.65%	
Other Fixed Rate (non-US\$)	\$ 0.8						0.8	0.8
Weighted Average Interest Rate	13.40%						13.40%	
Other Variable Rate (non-US\$)	7.3						7.3	7.3
Weighted Average Interest Rate	2.48%						2.48%	
Total Debt Obligations	\$ 8.1	\$ 515.2	\$ 31.8		\$ 25.0		\$ 580.1	\$ 631.7
Weighted Average Interest Rate	3.60%	1.25%	3.56%		7.47%		1.68%	

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Allergan, Inc.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK (Continued)

DECEMBER 31, 2004

	2005	2006	Maturing in		2009	Thereafter	Total	Fair Market Value
			2007	2008				
	(in millions, except interest rates)							
ASSETS								
Cash equivalents:								
Repurchase Agreements	\$ 100.0						\$ 100.0	\$ 100.0
Weighted Average Interest Rate	2.37%						2.37%	
Commercial Paper	648.9						648.9	648.9
Weighted Average Interest Rate	2.23%						2.23%	
Foreign Time Deposits	26.0						26.0	26.0
Weighted Average Interest Rate	2.47%						2.47%	
Other Cash Equivalents	54.9						54.9	54.9
Weighted Average Interest Rate	2.18%						2.18%	
Total Cash Equivalents	\$ 829.8						\$ 829.8	\$ 829.8
Weighted Average Interest Rate	2.25%						2.25%	
LIABILITIES								
Debt Obligations:								
Fixed Rate (US\$)		\$ 513.6	\$ 31.5		\$ 25.0		\$ 570.1	\$ 690.7
Weighted Average Interest Rate		1.25%	3.56%		7.47%		1.65%	
Other Fixed Rate (non-US\$)	\$ 1.4						1.4	1.4
Weighted Average Interest Rate	13.32%						13.32%	
Other Variable Rate (non-US\$)	11.7						11.7	11.7
Weighted Average Interest Rate	1.46%						1.46%	
Total Debt Obligations	\$ 13.1	\$ 513.6	\$ 31.5		\$ 25.0		\$ 583.2	\$ 703.8
Weighted Average Interest Rate	2.73%	1.25%	3.56%		7.47%		1.67%	

Foreign Currency Risk

Overall, we are a net recipient of currencies other than the U.S. dollar and, as such, benefit from a weaker dollar and are adversely affected by a stronger dollar relative to major currencies worldwide. Accordingly, changes in exchange rates, and in particular a strengthening of the U.S. dollar, may negatively affect our consolidated sales and gross

margins as expressed in U.S. dollars.

From time to time, we enter into foreign currency option and foreign currency forward contracts to reduce earnings and cash flow volatility associated with foreign exchange rate changes to allow our management to focus its attention on our core business issues and challenges. Accordingly, we enter into various contracts which change in value as foreign exchange rates change to economically offset the effect of changes in the value of foreign currency assets and liabilities, commitments and anticipated foreign currency denominated sales and operating expenses. We enter into foreign currency option and foreign currency forward contracts in amounts between minimum and maximum anticipated foreign exchange exposures, generally for periods not to exceed one year.

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Allergan, Inc.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK (Continued)

We use foreign currency option contracts, which provide for the sale of foreign currencies to offset foreign currency exposures expected to arise in the normal course of our business. While these instruments are subject to fluctuations in value, such fluctuations are anticipated to offset changes in the value of the underlying exposures. The principal currencies subject to this process are the Canadian dollar, Mexican peso, Australian dollar, Brazilian real, euro and the Japanese yen.

All of our outstanding foreign exchange forward contracts are entered into to protect the value of intercompany receivables denominated in currencies other than the lender's functional currency. The realized and unrealized gains and losses from foreign currency forward contracts and the revaluation of the foreign denominated intercompany receivables are recorded through Other, net in the accompanying unaudited condensed consolidated statements of earnings.

The following tables provide information about our foreign currency derivative financial instruments outstanding as of March 25, 2005 and December 31, 2004. The information is provided in U.S. dollar amounts, as presented in our consolidated financial statements.

	March 25, 2005		December 31, 2004	
	Notional Amount (in millions)	Average Contract Rate or Strike Amount	Notional Amount (in millions)	Average Contract Rate or Strike Amount
Foreign currency forward contracts: (Receive US\$/Pay Foreign Currency)				
Euros	\$3.1	1.34	\$13.2	1.32
U.K. Pound			3.4	1.90
Japanese Yen	3.4	103.32		
	\$6.5		\$16.6	
Estimated fair value	\$0.2		\$ (0.5)	

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Allergan, Inc.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK (Continued)

	March 25, 2005		December 31, 2004	
	Notional Amount (in millions)	Average Contract Rate or Strike Amount	Notional Amount (in millions)	Average Contract Rate or Strike Amount
Foreign currency purchased put options:				
Canadian Dollar	\$17.8	1.22	\$22.0	1.22
Mexican Peso	8.3	11.82	10.1	11.75
Australian Dollar	9.0	0.74	11.0	0.74
Brazilian Real	6.0	3.09	6.6	3.06
Euro	21.8	1.33	22.4	1.32
Japanese Yen	6.5	102.02	7.4	102.21
U.K. Pound	2.8	1.90	2.9	1.90
	\$72.2		\$82.4	
Estimated fair value	\$ 1.6		\$ 1.6	
Foreign currency sold call options:				
U.K. Pound	\$		\$ 1.0	1.92
Estimated fair value	\$		\$	

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ALLERGAN, INC.

CERTAIN FACTORS AND TRENDS AFFECTING ALLERGAN AND ITS BUSINESSES

Statements made by us in this report and in other reports and statements released by us that are not historical facts constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, Section 21 of the Securities Exchange Act of 1934 and the Private Securities Litigation Reform Act of 1995. These forward-looking statements are necessarily estimates reflecting the best judgment of senior management and include comments that express our opinions about trends and factors that may impact future operating results. Disclosures that use words such as we believe, anticipate, estimate, intend, could, plan, expect and similar expressions are intended to be forward-looking statements. Such statements rely on a number of assumptions concerning future events, many of which are outside of our control, and involve risks and uncertainties that could cause actual results to differ materially from opinions and expectations. Any such forward-looking statements, whether made in this report or elsewhere, should be considered in the context of the various disclosures made by us about our businesses including, without limitation, the risk factors discussed below. We do not plan to update any such forward-looking statements and expressly disclaim any duty to update the information contained in this filing except as required by law.

We operate in a rapidly changing environment that involves a number of risks. The following discussion highlights some of these risks and others are discussed elsewhere in this report. These and other risks could materially and adversely affect our business, financial condition, prospects, operating results or cash flows.

We operate in a highly competitive business.

The pharmaceutical industry is highly competitive. This competitive environment requires an ongoing, extensive search for technological innovation. It also requires, among other things, the ability to effectively develop, test, and obtain regulatory approvals for products, as well as the ability to effectively commercialize, market and promote approved products, including communicating the effectiveness, safety and value of products to actual and prospective customers and medical professionals. Many of our competitors have greater resources than we have. This enables them, among other things, to spread their research and development costs, as well as their marketing and promotion costs, over a broader revenue base. Our competitors may also have more experience and expertise in obtaining marketing approvals from the FDA and other regulatory authorities. In addition to product development, testing, approval and promotion, other competitive factors in the pharmaceutical industry include industry consolidation, product quality and price, reputation, customer service and access to technical information. It is possible that developments by our competitors could make our products or technologies less competitive or obsolete. In addition, competition from generic drug manufacturers is a major challenge in the United States and is growing internationally. For instance, Falcon Pharmaceuticals, Ltd., an affiliate of Alcon Laboratories, Inc., is currently attempting to obtain

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ALLERGAN, INC.

CERTAIN FACTORS AND TRENDS AFFECTING ALLERGAN AND ITS BUSINESSES (Continued)

FDA approval for and to launch a brimonidine product to compete with our *Alphagan® P* product.

Until December 2000, *Botox®* was the only neuromodulator approved by the FDA. At that time, the FDA approved *Myobloc®*, a neuromodulator formerly marketed by Elan Pharmaceuticals and now marketed by Solstice Neurosciences, Inc. We believe that Beaufour Ipsen Ltd. intends to seek FDA approval of its *Dysport®* neuromodulator for certain therapeutic indications, and that Beaufour Ipsen's marketing partner, Inamed Corporation, intends to seek FDA approval of *Dysport®/Reloxin®* for cosmetic indications. Beaufour Ipsen has marketed *Dysport®* in Europe since 1991, prior to our European commercialization of *Botox®* in 1992. Also, Mentor Corporation has announced its intention to develop and seek regulatory approval to market a competing neuromodulator in the United States. In addition, we are aware of competing neuromodulators currently being developed and commercialized in Asia, Europe, South America and other markets. A Chinese entity received approval to market a botulinum toxin in China in 1997, and we believe that it has launched or is planning to launch its botulinum toxin product in other lightly regulated markets in Asia, South America and Central America. These lightly regulated markets may not require adherence to the FDA's current Good Manufacturing Practices, or cGMPs, the European Medical Evaluation Agency or other regulatory agencies in countries that are members of the Organization for Economic Cooperation and Development, and companies operating in these markets may be able to produce products at a lower cost than we can. In addition, Merz Pharmaceuticals is seeking German regulatory approval for a botulinum toxin currently expected to be launched during the second half of 2005, and a Korean company is developing a botulinum toxin that received exportation approval from Korean authorities in early 2005 and that is expected to be launched in Korea during 2005. Our sales of *Botox®* could be materially and negatively impacted by this competition or competition from other companies that might obtain FDA approval or approval from other regulatory authorities to market a neuromodulator.

Botox® Cosmetic is a consumer product; trends may change and applicable laws may affect sales or product margins of Botox® or Botox® Cosmetic.

Botox® Cosmetic is a consumer product. If we fail to anticipate, identify or to react to competitive products or if consumer preferences in the cosmetic marketplace shift to other treatments for the temporary improvement in the appearance of moderate to severe glabellar lines, we may experience a decline in demand for Botox® Cosmetic. In addition, the popular media has at times in the past produced, and may continue in the future to produce, negative reports and entertainment regarding the efficacy, safety or side effects of Botox® Cosmetic. Consumer perceptions of Botox® Cosmetic may be negatively impacted by these reports and other reasons, including the use of unapproved botulinum toxins that result in injury, which may cause demand to decline.

Demand for *Botox® Cosmetic* may be materially adversely affected by changing economic conditions. Generally, the costs of cosmetic procedures are borne

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ALLERGAN, INC.

CERTAIN FACTORS AND TRENDS AFFECTING ALLERGAN AND ITS BUSINESSES (Continued)

by individuals without reimbursement from their medical insurance providers or government programs. Individuals may be less willing to incur the costs of these procedures in weak or uncertain economic environments, and demand for *Botox*® Cosmetic could be adversely affected.

Because *Botox*® and *Botox*® Cosmetic are pharmaceutical products, we generally do not collect or pay sales or other tax on sales of *Botox*® or *Botox*® Cosmetic. We could be required to collect and pay sales or other tax associated with prior, current or future years on sales of *Botox*® or *Botox*® Cosmetic. In addition to any retroactive taxes and corresponding interest and penalties that could be assessed, if we were required to collect or pay sales or other tax associated with current or future years on sales of *Botox*® or *Botox*® Cosmetic, our sales of, or our product margins on, *Botox*® or *Botox*® Cosmetic could be adversely affected due to the increased cost associated with those products.

We could experience difficulties creating the raw material needed to produce Botox®.

The manufacturing process to create the raw material necessary to produce *Botox*® is technically complex and requires significant lead-time. Any failure by us to forecast demand for, or to maintain an adequate supply of, the raw material and finished product could result in an interruption in the supply of *Botox*® and a resulting decrease in sales of the product.

Our future success depends upon our ability to develop new products, and new indications for existing products, that achieve market acceptance.

Our future performance will be affected by the market acceptance of products such as *Lumigan*®, *Alphagan*® P, *Restasis*®, *Zymar*® and *Botox*®, as well as FDA approval of new indications for *Botox*®, and new products such as *Combigan* , our *Lumigan*®/*Timolol* combination, *Posurdex*® and the oral formulation of tazarotene. We have allocated substantial resources to the development and introduction of new products and indications. For our business model to be successful, new products must be continually developed, tested and manufactured and, in addition, must meet regulatory standards and receive requisite regulatory approvals in a timely manner. For instance, to obtain approval of new indications or products in the United States, we must submit, among other information, the results of preclinical and clinical studies on the new indication or product candidate to the FDA. The number of preclinical and clinical studies that will be required for FDA approval varies depending on the new indication or product candidate, the disease or condition for which the new indication or product candidate is in development and the regulations applicable to that new indication or product candidate. For example, in July 2004 an FDA advisory panel voted against approval for the oral formulation of tazarotene, and in September 2004 we received a non-approvable letter from the FDA for that product. If the FDA delays or does not approve of new indications for our products or drug candidates, the price per share of our common stock may be impacted upon the announcement of such delays or non-approvals. We are also

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ALLERGAN, INC.

CERTAIN FACTORS AND TRENDS AFFECTING ALLERGAN AND ITS BUSINESSES (Continued)

required to pass pre-approval reviews and plant inspections of our and our suppliers' facilities to demonstrate our compliance with the FDA's cGMP regulations. Products that we are currently developing or other future product candidates may or may not receive the regulatory approvals necessary for marketing. Furthermore, the development, regulatory review and approval, and commercialization processes are time consuming, costly and subject to numerous factors that may delay or prevent the development and commercialization of new products, including legal actions brought by our competitors. The FDA can delay, limit or deny approval of a new indication or product candidate for many reasons, including:

a determination that the new indication or product candidate is not safe and effective;

the FDA may interpret our preclinical and clinical data in different ways than we do;

the FDA may not approve our manufacturing processes or facilities; or

the FDA may change its approval policies or adopt new regulations.

In connection with our 2003 acquisitions of Bardeen Sciences Company, LLC and Oculex Pharmaceuticals, Inc., we acquired the right to continue researching and developing certain compounds and products, respectively, for commercialization. We cannot assure you that these or any other compounds or products that we are developing for commercialization will be able to be commercialized on terms that will be profitable, or at all. If any of our products cannot be successfully or timely commercialized, our operating results could be materially adversely affected. Delays or unanticipated costs in any part of the process or our inability to obtain timely regulatory approval for our products, including those attributable to, among other things, our failure to maintain manufacturing facilities in compliance with all applicable regulatory requirements, could cause our operating results to suffer and our stock price to decrease. We cannot assure you that new products or indications will be successfully developed, will receive regulatory approval or will achieve market acceptance. Further, even if we receive FDA and other regulatory approvals for a new indication or product, the product may later exhibit adverse effects that limit or prevent its widespread use or that force us to withdraw the product from the market or to revise our labeling to limit the indications for which the product may be prescribed.

If we are unable to obtain and maintain adequate patent protection for the technologies incorporated into our products, our business and results of operations could suffer.

Patent protection is generally important in the pharmaceutical industry. Upon the expiration or loss of patent protection for a product, we can lose a significant portion of sales of that product in a very short period of time as other companies manufacture generic forms of our previously protected product at lower cost, without having had to incur significant research and development costs in formulating the product. Therefore, our future financial success may depend in part on obtaining patent protection for technologies incorporated into our products. We cannot assure you that

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CERTAIN FACTORS AND TRENDS AFFECTING ALLERGAN AND ITS BUSINESSES (Continued)

such patents will be issued, or that any existing or future patents will be of commercial benefit. In addition, it is impossible to anticipate the breadth or degree of protection that any such patents will afford, and we cannot assure you that any such patents will not be successfully challenged in the future. If we are unsuccessful in obtaining or preserving patent protection, or if any of our products rely on unpatented proprietary technology, we cannot assure you that others will not commercialize products substantially identical to those products. Generic drug manufacturers are currently challenging the patents covering certain of our products and we expect that they will continue to do so in the future. Our business also relies on trade secrets and proprietary know-how that we seek to protect, in part, through confidentiality agreements with third parties, including our partners, customers, employees and consultants. It is possible that these agreements will be breached or that they will not be enforceable in every instance, and that we will not have adequate remedies for any such breach. It is also possible that our trade secrets will become known or independently developed by our competitors.

Interruptions in the supply of raw materials could disrupt our manufacturing and cause our sales and profitability to decline.

We obtain the specialty chemicals that are the active pharmaceutical ingredients in certain of our products from single sources, who must maintain compliance with the FDA's cGMP regulations. If we experience difficulties acquiring sufficient quantities of these materials from our existing suppliers, or if our suppliers are found to be non-compliant with the cGMPs, obtaining the required regulatory approvals, including from the FDA, to use alternative suppliers may be a lengthy and uncertain process. A lengthy interruption of the supply of one or more of these materials could adversely affect our ability to manufacture and supply products, which could cause our sales and profitability to decline.

Importation of products from Canada and other countries into the United States may lower the prices we receive for our products.

In the United States, our products are subject to competition from lower priced versions of our products and competing products from Canada, Mexico, and other countries where government price controls or other market dynamics result in lower prices. Our products that require a prescription in the United States are often available to consumers in these markets without a prescription, which may cause consumers to further seek out our products in these lower priced markets. The ability of patients and other customers to obtain these lower priced imports has grown significantly as a result of the Internet, an expansion of pharmacies in Canada and elsewhere targeted to American purchasers, the increase in U.S.-based businesses affiliated with Canadian pharmacies marketing to American purchasers, and other factors. Most of these foreign imports are illegal under current U.S. law. However, the volume of imports continues to rise due to the limited enforcement resources of the FDA and the U.S. Customs Service, and there is

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CERTAIN FACTORS AND TRENDS AFFECTING ALLERGAN AND ITS BUSINESSES (Continued)

increased political pressure to permit the imports as a mechanism for expanding access to lower priced medicines.

In December 2003, Congress enacted the Medicare Prescription Drug, Improvement and Modernization Act of 2003. This law contains provisions that may change U.S. import laws and expand consumers' ability to import lower priced versions of our products and competing products from Canada, where there are government price controls. These changes to U.S. import laws will not take effect unless and until the Secretary of Health and Human Services certifies that the changes will lead to substantial savings for consumers and will not create a public health safety issue. The former Secretary of Health and Human Services did not make such a certification. However, it is possible that the current Secretary or a subsequent Secretary could make the certification in the future. As directed by Congress, a task force on drug importation recently conducted a comprehensive study regarding the circumstances under which drug importation could be safely conducted and the consequences of importation on the health, medical costs and development of new medicines for U.S. consumers. The task force issued its report in December 2004, finding that there are significant safety and economic issues that must be addressed before importation of prescription drugs is permitted, and the current Secretary has not yet announced any plans to make the required certification. In addition, federal legislative proposals have been made to implement the changes to the U.S. import laws without any certification, and to broaden permissible imports in other ways. Even if the changes to the U.S. import laws do not take effect, and other changes are not enacted, imports from Canada and elsewhere may continue to increase due to market and political forces, and the limited enforcement resources of the FDA, the U.S. Customs Service and other government agencies. For example, state and local governments have suggested that they may import drugs from Canada for employees covered by state health plans or others, and some already have implemented such plans.

The importation of foreign products adversely affects our profitability in the United States. This impact could become more significant in the future, and the impact could be even greater if there is a further change in the law or if state or local governments take further steps to import products from abroad.

Our business will continue to expose us to risks of environmental liabilities.

Our product development programs and manufacturing processes involve the controlled use of hazardous materials, chemicals and toxic compounds. These programs and processes expose us to risks that an accidental contamination could lead to noncompliance with environmental laws, regulatory enforcement actions and claims for personal injury and property damage. If an accident occurs, or if we discover contamination caused by prior operations, including by prior owners and operators of properties we acquire, we could be liable for cleanup obligations, damages and fines. The substantial

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ALLERGAN, INC.

CERTAIN FACTORS AND TRENDS AFFECTING ALLERGAN AND ITS BUSINESSES (Continued)

unexpected costs we may incur could have a significant and adverse effect on our business and results of operations.

We may experience losses due to product liability claims, product recalls or corrections.

The design, development, manufacture and sale of our products involve an inherent risk of product liability claims by consumers and other third parties. We have in the past been, and continue to be, subject to various product liability claims and lawsuits. In addition, we have in the past and may in the future recall or issue field corrections related to our products due to manufacturing deficiencies, labeling errors or other safety or regulatory reasons. We cannot assure you that we will not experience material losses due to product liability claims, lawsuits, product recalls or corrections.

Additionally, our products may cause, or may appear to cause, serious adverse side effects or potentially dangerous drug interactions if misused or improperly prescribed. These events, among others, could result in additional regulatory controls, such as the performance of costly post-approval clinical studies or revisions to our approved labeling, which could limit the indications or patient population for our products or could even lead to the withdrawal of a product from the market. Furthermore, any adverse publicity associated with such an event could cause consumers to seek alternatives to our products, which may cause our sales to decline, even if our products are ultimately determined not to have been the primary cause of the event.

Health care initiatives and other cost-containment pressures could cause us to sell our products at lower prices, resulting in less revenue to us.

Some of our products are purchased or reimbursed by state and federal government authorities, private health insurers and other organizations, such as health maintenance organizations, or HMOs, and managed care organizations, or MCOs. Third party payors increasingly challenge pharmaceutical product pricing. The trend toward managed healthcare in the United States, the growth of organizations such as HMOs and MCOs, and various legislative proposals and enactments to reform healthcare and government insurance programs, including the Medicare Prescription Drug, Improvement and Modernization Act of 2003, could significantly influence the manner in which pharmaceutical products are prescribed and purchased, which could result in lower prices and/or a reduction in demand for our products. Such cost containment measures and healthcare reforms could adversely affect our ability to sell our products. Furthermore, individual states have become increasingly aggressive in passing legislation and implementing regulations designed to control pharmaceutical product pricing, including price or patient reimbursement constraints, discounts, restrictions on certain product access, importation from other countries and bulk purchasing. Legally mandated price controls on payment amounts by

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ALLERGAN, INC.

CERTAIN FACTORS AND TRENDS AFFECTING ALLERGAN AND ITS BUSINESSES (Continued)

third party payors or other restrictions could negatively and materially impact our revenues and financial condition. We encounter similar regulatory and legislative issues in most countries outside the United States.

We are subject to risks arising from currency exchange rates, which could increase our costs and may cause our profitability to decline.

We collect and pay a substantial portion of our sales and expenditures in currencies other than the U.S. dollar. Therefore, fluctuations in foreign currency exchange rates affect our operating results. We cannot assure you that future exchange rate movements, inflation or other related factors will not have a material adverse effect on our sales, gross profit or operating expenses.

We are subject to risks associated with doing business internationally.

Our business is subject to certain risks inherent in international business, many of which are beyond our control. These risks include, among other things:

- adverse changes in tariff and trade protection measures;
- unexpected changes in foreign regulatory requirements;
- potentially negative consequences from changes in or interpretations of tax laws;
- differing labor regulations;
- changing economic conditions in countries where our products are sold or manufactured or in other countries;
- differing local product preferences and product requirements;
- exchange rate risks;
- restrictions on the repatriation of funds;
- political unrest and hostilities;
- differing degrees of protection for intellectual property; and
- difficulties in coordinating and managing foreign operations.

Any of these factors, or any other international factors, could have a material adverse effect on our business, financial condition and results of operations. We cannot assure you that we can successfully manage these risks or avoid their effects.

We may be subject to intellectual property litigation and infringement claims, which could cause us to incur significant expenses and losses or prevent us from selling our products.

Although we have a corporate policy not to infringe the valid and enforceable patents of others, we cannot assure you that our products will not infringe patents held by third parties. In the event we discover that we may be infringing third party patents, licenses from those third parties may not be available on commercially attractive terms or at all. We may have to defend, and have recently defended, against charges that we

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ALLERGAN, INC.

CERTAIN FACTORS AND TRENDS AFFECTING ALLERGAN AND ITS BUSINESSES (Continued)

violated patents or the proprietary rights of third parties. Litigation is costly and time-consuming, and diverts the attention of our management and technical personnel. In addition, if we infringe the intellectual property rights of others, we could lose our right to develop, manufacture or sell products or could be required to pay monetary damages or royalties to license proprietary rights from third parties. An adverse determination in a judicial or administrative proceeding or a failure to obtain necessary licenses could prevent us from manufacturing or selling our products, which could harm our business, financial condition, prospects, results of operations and cash flows. See Item 1 of Part II of this report, *Legal Proceedings* and Note 8, *Litigation*, in the notes to the unaudited condensed consolidated financial statements listed under Item 1(D) of Part I of this report for information concerning our current intellectual property litigation.

The consolidation of drug wholesalers and other wholesaler actions could increase competitive and pricing pressures on pharmaceutical manufacturers, including us.

We sell our pharmaceutical products primarily through wholesalers. These customers comprise a significant part of the distribution network for pharmaceutical products in the United States. This distribution network is continuing to undergo significant consolidation marked by mergers and acquisitions. As a result, a smaller number of large wholesale distributors control a significant share of the market. We expect that consolidation of drug wholesalers will increase competitive and pricing pressures on pharmaceutical manufacturers, including us. In addition, wholesalers may apply pricing pressure through the implementation of fee-for-service arrangements, and their purchases may exceed customer demand, resulting in reduced wholesaler purchases in later quarters. We cannot assure you that we can manage these pressures or that wholesaler purchases will not decrease as a result of this potential excess buying.

We may acquire companies in the future and these acquisitions could disrupt our business.

As part of our business strategy, we regularly consider and, as appropriate, make acquisitions of technologies, products and businesses that we believe are complementary to our business. Acquisitions typically entail many risks and could result in difficulties in integrating the operations, personnel, technologies and products of the companies acquired, some of which may result in significant charges to earnings. If we are unable to successfully integrate our acquisitions with our existing business, we may not obtain the advantages that the acquisitions were intended to create, which may materially adversely affect our business, results of operations, financial condition and cash flows, our ability to develop and introduce new products and the market price of our stock. In connection with acquisitions, we could experience disruption in our business or employee base, or key employees of companies that we acquire

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CERTAIN FACTORS AND TRENDS AFFECTING ALLERGAN AND ITS BUSINESSES (Continued)

may seek employment elsewhere, including with our competitors. Furthermore, the products of companies we acquire may overlap with our products or those of our customers, creating conflicts with existing relationships or with other commitments that are detrimental to the integrated businesses.

Compliance with the extensive government regulations to which we are subject is expensive and time consuming, and may result in the delay or cancellation of product sales, introductions or modifications.

Extensive industry regulation has had, and will continue to have, a significant impact on our business, especially our product development and manufacturing capabilities. All pharmaceutical companies, including Allergan, are subject to extensive, complex, costly and evolving regulation by federal governmental authorities, principally by the FDA and the U.S. Drug Enforcement Administration, or DEA, and similar foreign and state government agencies. Failure to comply with the regulatory requirements of the FDA, DEA and other U.S. and foreign regulatory requirements may subject a company to administrative or judicially imposed sanctions, including, among others, a refusal to approve a pending application to market a new product or a new indication for an existing product. The Federal Food, Drug, and Cosmetic Act, the Controlled Substances Act and other domestic and foreign statutes and regulations govern or influence the research, testing, manufacturing, packing, labeling, storing, record keeping, safety, effectiveness, approval, advertising, promotion, sale and distribution of our products. Under certain of these regulations, we are subject to periodic inspection of our facilities, production processes and control operations and/or the testing of our products by the FDA, the DEA and other authorities, to confirm that we are in compliance with all applicable regulations, including the FDA's cGMP regulations. The FDA conducts pre-approval and post-approval reviews and plant inspections of us and our suppliers to determine whether our record keeping, production processes and controls, personnel and quality control are in compliance with the cGMPs and other FDA regulations. We also need to perform extensive audits of our vendors, contract laboratories and suppliers to ensure that they are compliant with these requirements. In addition, in order to commercialize our products or new indications for an existing product, we must demonstrate that the product or new indication is safe and effective, and that our and our suppliers' manufacturing facilities are compliant with applicable regulations, to the satisfaction of the FDA and other regulatory agencies.

The process for obtaining governmental approval to manufacture pharmaceutical products is rigorous, typically takes many years and is costly, and we cannot predict the extent to which we may be affected by legislative and regulatory developments. We are dependent on receiving FDA and other governmental approvals prior to manufacturing, marketing and shipping our products. We may fail to obtain approval from FDA or other governmental authorities for our product candidates, or experience delays in obtaining such approvals, due to varying interpretations of data or failure to satisfy rigorous efficacy, safety and manufacturing quality standards. Consequently, there is always a risk that the FDA or other

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CERTAIN FACTORS AND TRENDS AFFECTING ALLERGAN AND ITS BUSINESSES (Continued)

applicable governmental authorities will not approve our products, or will take post-approval action limiting or revoking our ability to sell our products, or that the rate, timing and cost of such approvals will adversely affect our product introduction plans, results of operations and stock price. Despite the time and expense exerted, regulatory approval is never guaranteed.

Even after we obtain regulatory approval for a product candidate or new indication, we are subject to extensive regulation, including ongoing compliance with the FDA's cGMP regulations, post-marketing clinical studies mandated by the FDA, adverse event reporting, labeling, advertising, marketing and promotion. If we or any third party that we involve in the testing, packing, manufacture, labeling, marketing and distribution of our products fail to comply with any such regulations, we may be subject to, among other things, warning letters, product seizures, recalls, fines or other civil penalties, injunctions, suspension or revocation of approvals, operating restrictions and criminal prosecution. Physicians may prescribe pharmaceutical or biologic products for uses that are not described in a product's labeling or differ from those tested by us and approved by the FDA. While such off-label uses are common and the FDA does not regulate a physician's choice of treatment, the FDA does restrict a manufacturer's communications on the subject of off-label use. Companies cannot actively promote FDA-approved pharmaceutical or biologic products for off-label uses, but they may disseminate to physicians articles published in peer-reviewed journals. To the extent allowed by law, we disseminate peer-reviewed articles on our products to targeted physicians. If, however, our promotional activities fail to comply with the FDA's regulations or guidelines, we may be subject to warnings from, or enforcement action by, the FDA or another enforcement agency.

If we market products in a manner that violates health care fraud and abuse laws, we may be subject to civil or criminal penalties.

Federal health care program anti-kickback statutes prohibit, among other things, knowingly and willfully offering, paying, soliciting, or receiving remuneration to induce or in return for purchasing, leasing, ordering, or arranging for the purchase, lease or order of any health care item or service reimbursable under Medicare, Medicaid, or other federally financed health care programs. This statute has been interpreted to apply to arrangements between pharmaceutical manufacturers on one hand and prescribers, purchasers, and formulary managers on the other. Although there are a number of statutory exemptions and regulatory safe harbors protecting certain common activities from prosecution, the exemptions and safe harbors are drawn narrowly, and practices that involve remuneration intended to induce prescribing, purchases, or recommendations may be subject to scrutiny if they do not qualify for an exemption or safe harbor. Although we believe that we are in compliance, our practices may be determined to fail to meet all of the criteria for safe harbor protection from anti-kickback liability.

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CERTAIN FACTORS AND TRENDS AFFECTING ALLERGAN AND ITS BUSINESSES (Continued)

Federal false claims laws prohibit any person from knowingly presenting, or causing to be presented, a false claim for payment to the federal government, or knowingly making, or causing to be made, a false statement to get a false claim paid. Pharmaceutical companies have been prosecuted under these laws for a variety of alleged promotional and marketing activities, such as allegedly providing free product to customers with the expectation that the customers would bill federal programs for the product; reporting to pricing services inflated average wholesale prices that were then used by federal programs to set reimbursement rates; engaging in off-label promotion that caused claims to be submitted to Medicaid for non-covered off-label uses; and submitting inflated best price information to the Medicaid Rebate Program. The majority of states also have statutes or regulations similar to the federal anti-kickback law and false claims laws, which apply to items and services reimbursed under Medicaid and other state programs, or, in several states, apply regardless of the payor. Sanctions under these federal and state laws may include civil monetary penalties, exclusion of a manufacturer's products from reimbursement under government programs, criminal fines, and imprisonment. Because of the breadth of these laws and the narrowness of the safe harbors, it is possible that some of our business activities could be subject to challenge under one or more of such laws. For example, we and several other pharmaceutical companies are currently subject to suits by governmental entities in several jurisdictions, including Massachusetts, New York and Alabama alleging that we and these other companies, through promotional, discounting, and pricing practices reported false and inflated average wholesale prices or wholesale acquisition costs and failed to report best prices as required by federal and state rebate statutes, resulting in the plaintiffs overpaying for certain medications.

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ALLERGAN, INC.

ITEM 4. Controls and Procedures

CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our Principal Executive Officer and our Principal Financial Officer, as appropriate, to allow timely decisions regarding required disclosures. Our management, including our Principal Executive Officer and our Principal Financial Officer, does not expect that our disclosure controls or procedures will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within Allergan have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. Also, we have investments in certain unconsolidated entities. As we do not control or manage these entities, our disclosure controls and procedures with respect to such entities are necessarily substantially more limited than those we maintain with respect to our consolidated subsidiaries.

We carried out an evaluation, under the supervision and with the participation of our management, including our Principal Executive Officer and our Principal Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of March 25, 2005, the end of the quarterly period covered by this report. Based on the foregoing, our Principal Executive Officer and our Principal Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

There has been no change in the Company's internal controls over financial reporting during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

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Allergan, Inc.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

Litigation

The following supplements and amends the Company's discussion set forth under Part I, Item 3, Legal Proceedings in the Company's Annual Report on Form 10-K for the year ended December 31, 2004.

On June 6, 2001, after receiving paragraph 4 invalidity and noninfringement Hatch-Waxman Act certifications from Apotex indicating that Apotex had filed an Abbreviated New Drug Application with the FDA for a generic form of *Acular*®, we and Syntex, the holder of the *Acular*® patent, filed a lawsuit entitled *Syntex (U.S.A.) LLC and Allergan, Inc. v. Apotex, Inc., et al.* in the United States District Court for the Northern District of California. Following a trial, the court entered final judgment in our favor on January 27, 2004, holding that the patent at issue is valid, enforceable and infringed by Apotex's proposed generic drug. On February 17, 2004, Apotex filed a Notice of Appeal with the United States Court of Appeals for the Federal Circuit. Oral argument on the appeal took place on November 1, 2004 and we are currently awaiting the Court of Appeals' ruling. If the Court of Appeals reverses the prior judgment in our favor, *Acular*® could face immediate generic competition. On June 29, 2001, we filed a separate lawsuit in Canada against Apotex similarly relating to a generic version of *Acular*®. A mediation in the Canadian lawsuit was held on January 4, 2005 and a settlement conference previously scheduled for April 6, 2005 has been continued to summer 2005.

On January 23, 2003, a complaint entitled *Irena Medavoy and Morris Mike Medavoy v. Arnold W. Klein, M.D., et al. and Allergan, Inc.* was filed in the Superior Court of the State of California for the County of Los Angeles. The complaint contained, among other things, allegations against us of negligence, unfair business practices, product liability, intentional misconduct, fraud, negligent misrepresentation, strict liability in tort, improper off-label promotion and loss of consortium. The complaint also contained separate allegations against the other defendants. On April 10, 2003, Morris Mike Medavoy voluntarily served on us a Request for Dismissal Without Prejudice for the only two causes of action he asserted in the complaint. The causes of action asserted by Irena Medavoy against us were not affected by this Request for Dismissal. On July 8, 2003, Irena Medavoy filed a First Amended Complaint, adding allegations against us of false and/or misleading advertising and unjust enrichment, as well as false and/or misleading advertising and unfair competition. A jury trial in the matter began on August 31, 2004. On October 8, 2004, the jury ruled in favor of us and Dr. Klein. Also on October 8, 2004, the court dismissed the unfair business practices claims against us and Dr. Klein. On November 29, 2004, Irena Medavoy filed a Motion for New Trial. On December 16, 2004, the court denied Irena Medavoy's Motion for a New Trial. On January 13, 2005, Irena Medavoy filed a Notice of Appeal with the Clerk of Court of the Superior Court of the State of California for the County of Los Angeles and her opening appellate brief is due on May 31, 2005.

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Allergan, Inc.

Litigation (Continued)

On June 2, 2003, a complaint entitled *Klein-Becker usa, LLC v. Allergan, Inc.* was filed in the United States District Court for the District of Utah – Central Division. The complaint, as later amended, contained claims against us for declaratory relief, intentional interference with contractual and economic relations, unfair competition under federal and Utah law, and injunctive relief, based on allegations that we interfered with Klein-Becker’s contractual and economic relations by dissuading certain magazines from running Klein-Becker’s advertisements for its anti-wrinkle cream. On July 30, 2003, we filed a reply and counterclaims against Klein-Becker, asserting, as later amended, claims for false advertising, unfair competition under federal and Utah law, trade libel, declaratory relief, and trademark infringement and dilution, and alleging that Klein-Becker’s advertisements for its anti-wrinkle cream that use the heading “Better than BOTOX®?” are false and misleading. On July 31, 2003, the court denied Klein-Becker’s application for a temporary restraining order to restrain us from, among other things, contacting magazines regarding Klein-Becker’s advertisements. On October 7, 2003, the court granted in part and denied in part our motion to dismiss Klein-Becker’s complaint, dismissing Klein-Becker’s claims for unfair competition under federal and Utah law and injunctive relief. On August 14, 2004, the court denied in its entirety Klein-Becker’s motion to dismiss our claims. From July 2004 through December 2004, the case was voluntarily stayed while the parties explored settlement through mediation. The voluntary stay ended December 29, 2004, without the parties reaching settlement. On March 2, 2005, Klein-Becker filed a motion to amend the scheduling order and a motion for leave to amend the first amended complaint. The court has not set a hearing date for either motion. Trial is scheduled for August 1, 2005.

On July 13, 2004, we received a paragraph 4 Hatch-Waxman Act certification from Alcon, Inc. indicating that Alcon had filed a New Drug Application under section 505(b)(2) of the Federal Food, Drug, and Cosmetic Act for a drug containing brimonidine tartrate ophthalmic solution in a 0.15% concentration. In the certification, Alcon contends that U.S. Patent Nos. 5,424,078; 6,562,873; 6,627,210; 6,641,834; and 6,673,337, all of which are assigned to us or our wholly-owned subsidiary, Allergan Sales, LLC, and are listed in the Orange Book under *Alphagan® P*, are invalid and/or not infringed by the proposed Alcon product. On August 24, 2004, we filed a complaint, entitled *Allergan, Inc., Allergan Sales, LLC v. Alcon, Inc., Alcon Laboratories, Inc., and Alcon Research, Ltd.*, against Alcon for patent infringement in the United States District Court for the District of Delaware. On September 3, 2004, Alcon filed an answer to the complaint and a counterclaim against us. On September 23, 2004, we filed a reply to Alcon’s counterclaim. A claim construction hearing is scheduled for June 7, 2005. Trial is scheduled for March 6, 2006. Pursuant to the Hatch-Waxman Act, approval of Alcon’s generic New Drug Application is stayed until the earlier of (1) 30 months from the date of the paragraph 4 certification, or (2) a ruling in the patent infringement litigation in Alcon’s favor.

On August 26, 2004, a complaint entitled *Clayworth, et al. v. Allergan, Inc., et al.* was filed in the Superior Court of the State of California for the County of Alameda. The complaint, which names us and 12 other defendants, alleges unfair business practices based upon a price fixing

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Allergan, Inc.

Litigation (Continued)

conspiracy in connection with the reimportation of pharmaceuticals from Canada. On September 3, 2004, the plaintiffs filed a first amended complaint, making various modifications to the original complaint. On November 22, 2004, the pharmaceutical defendants jointly filed a demurrer to the first amended complaint. On February 4, 2005, the court issued an order sustaining the pharmaceutical defendants' demurrer and granting plaintiffs leave to further amend the first amended complaint. On February 22, 2005, the plaintiffs filed a second amended complaint to which the defendants again filed a demurrer. The hearing on the demurrer to the second amended complaint was held on April 8, 2005 and the court took the matter under submission.

We are involved in various other lawsuits and claims arising in the ordinary course of business. These other matters are, in the opinion of management, immaterial both individually and in the aggregate with respect to our consolidated financial position, liquidity or results of operations.

Because of the uncertainties related to the incurrence, amount and range of loss on any pending litigation, investigation or claim, management is currently unable to predict the ultimate outcome of any litigation, investigation or claim, determine whether a liability has been incurred or make an estimate of the reasonably possible liability that could result from an unfavorable outcome. We believe, however, that the liability, if any, resulting from the aggregate amount of uninsured damages for any outstanding litigation, investigation or claim will not have a material adverse effect on our consolidated financial position, liquidity or results of operations. However, an adverse ruling in a patent infringement lawsuit involving us could materially affect our ability to sell one or more of our products or could result in additional competition. In view of the unpredictable nature of such matters, we cannot provide any assurances regarding the outcome of any litigation, investigation or claim to which we are a party or the impact on us of an adverse ruling in such matters.

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Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

Issuer Purchases of Equity Securities

The following table discloses the purchases of our equity securities during the first fiscal quarter of 2005.

<u>Period</u>	Total Number of Shares Purchased(1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs(2)
January 1, 2005 to January 31, 2005	0	\$ N/A	0	6,373,362
February 1, 2005 to February 28, 2005	0	\$ N/A	0	6,550,367
March 1, 2005 to March 25, 2005	1,256,600	\$ 75.00	1,256,600	5,352,684
Total	1,256,600	\$ 75.00	1,256,600	N/A

(1) The Company maintains an evergreen stock repurchase program, which was first announced on September 28, 1993. Under the stock repurchase program, the Company may maintain up to 9.2 million repurchased shares in its treasury account at any one time. As of March 25, 2005, the Company held approximately 3.8 million treasury shares under this program.

(2) The following share numbers reflect the maximum number of shares that may be purchased under the Company's stock repurchase program and are as of the end of each of the respective periods.

Item 5. Other Information.

Other Information

None.

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Item 6. Exhibits

- Exhibits (numbered in accordance with Item 601 of Regulation S-K)

- 10.57 Acceleration of Vesting of Premium Priced Stock Options
- 31.1 Certification of Principal Executive Officer Required Under Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended
- 31.2 Certification of Principal Financial Officer Required Under Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended
- 32 Certification of Principal Executive Officer and Principal Financial Officer Required Under Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, and 18 U.S.C Section 1350

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: April 27, 2005

ALLERGAN, INC.

/s/ Eric K. Brandt
Eric K. Brandt
Executive Vice President, Finance and
Technical Operations, Chief Financial
Officer
(Principal Financial Officer)

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- 32 Certification of Principal Executive Officer and Principal Financial Officer Required Under Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, and 18 U.S.C Section 1350