
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2005

or

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

For the transition period from _____ to _____

Commission File Number: 1-9819

DYNEX CAPITAL, INC.

(Exact name of registrant as specified in its charter)

Virginia

(State or other jurisdiction of incorporation or organization)

52-1549373

(I.R.S. Employer Identification No.)

4551 Cox Road, Suite 300, Glen Allen, Virginia

(Address of principal executive offices)

23060-6740

(Zip Code)

(804) 217-5800

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

☒ Yes ☐ No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

☐ Yes ☒ No

On July 31, 2005, the registrant had 12,163,391 shares of common stock outstanding with a par value of \$.01 per share, which is the registrant's only class of common stock.

DYNEX CAPITAL, INC.
FORM 10-Q

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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements
DYNEX CAPITAL, INC.
CONDENSED CONSOLIDATED
BALANCE SHEETS (UNAUDITED)

(amounts in thousands except share data)

	June 30, 2005	December 31, 2004
ASSETS		
Cash and cash equivalents	\$ 23,789	\$ 52,522
Other assets	6,058	4,964
	<u>29,847</u>	<u>57,486</u>
Investments:		
Securitized finance receivables:		
Loans, net	800,914	1,036,123
Debt securities	2,352	206,434
	<u>803,266</u>	<u>1,242,557</u>
Securities	89,556	87,706
Other investments	5,157	7,596
Other loans	3,442	5,589
	<u>901,421</u>	<u>1,343,448</u>
	<u>\$ 931,268</u>	<u>\$ 1,400,934</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES		
Securitization financing:		
Non-recourse bonds	\$ 559,070	\$ 1,177,280
Repurchase agreements	165,743	-
	<u>724,813</u>	<u>1,177,280</u>
Repurchase agreements	47,191	70,468
	<u>772,004</u>	<u>1,247,748</u>
Accrued expenses and other liabilities	6,399	4,420
	<u>778,403</u>	<u>1,252,168</u>
Commitments and contingencies (Note 10)	-	-
SHAREHOLDERS' EQUITY		
9.75% Cumulative Convertible Series D Preferred stock, par value \$.01 per share, 50,000,000 shares authorized, 5,628,737 shares issued and outstanding (\$57,624 and \$58,040 aggregate liquidation preference, respectively)	55,666	55,666
Common stock, par value \$.01 per share, 100,000,000 shares authorized, 12,163,391 and 12,162,391 shares issued and outstanding, respectively	122	122
Additional paid-in capital	366,903	366,896
Accumulated other comprehensive income	54	3,817
Accumulated deficit	(269,880)	(277,735)
	<u>152,865</u>	<u>148,766</u>
	<u>\$ 931,268</u>	<u>\$ 1,400,934</u>

See notes to unaudited condensed consolidated financial statements.

DYNEX CAPITAL, INC.
CONDENSED CONSOLIDATED STATEMENTS
OF OPERATIONS AND COMPREHENSIVE INCOME (UNAUDITED)
(amounts in thousands except share and per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Interest income:				
Securitized finance receivables	\$ 16,927	\$ 32,469	\$ 38,924	\$ 65,355
Securities	938	555	2,064	1,114
Other loans	209	163	467	333
Other investments	459	30	1,131	46
	<u>18,533</u>	<u>33,217</u>	<u>42,586</u>	<u>66,848</u>
Interest and related expense:				
Securitization financing	15,410	27,555	33,515	54,427
Repurchase agreements and senior notes	436	83	1,886	325
Other	(45)	60	(4)	142
	<u>15,801</u>	<u>27,698</u>	<u>35,397</u>	<u>54,894</u>
Net interest income	2,732	5,519	7,189	11,954
Provision for loan losses	(664)	(8,947)	(2,925)	(16,147)
Net interest income (loss) after provision for loan losses	2,068	(3,428)	4,264	(4,193)
Impairment charges	(1,786)	(7,746)	(2,052)	(9,407)
Gain on sale of investments, net	9,552	20	9,850	4
Other income (expense)	1,158	216	1,357	(261)
General and administrative expenses	(1,398)	(2,015)	(2,890)	(4,483)
Net income (loss)	<u>9,594</u>	<u>(12,953)</u>	<u>10,529</u>	<u>(18,340)</u>
Preferred stock (charge) benefit	(1,337)	2,045	(2,674)	854
Net income (loss) to common shareholders	<u>\$ 8,257</u>	<u>\$ (10,908)</u>	<u>\$ 7,855</u>	<u>\$ (17,486)</u>
Change in net unrealized (loss) gain on:				
Investments classified as available-for-sale	(465)	3,056	(4,348)	3,315
Hedge instruments	201	1,924	584	2,005
Comprehensive (loss) income	<u>\$ 9,330</u>	<u>\$ (7,973)</u>	<u>\$ 6,765</u>	<u>\$ (13,020)</u>
Net income (loss) per common share:				
Basic	<u>\$ 0.68</u>	<u>\$ (0.95)</u>	<u>\$ 0.65</u>	<u>\$ (1.59)</u>
Diluted	<u>\$ 0.54</u>	<u>\$ (0.95)</u>	<u>\$ 0.59</u>	<u>\$ (1.59)</u>
Weighted average number of common shares outstanding:				
Basic	<u>12,163,061</u>	<u>11,468,635</u>	<u>12,162,728</u>	<u>10,972,844</u>
Diluted	<u>17,791,798</u>	<u>11,468,635</u>	<u>17,791,594</u>	<u>10,972,844</u>

See notes to unaudited condensed consolidated financial statements.

DYNEX CAPITAL, INC.
CONDENSED CONSOLIDATED STATEMENTS
OF CASH FLOWS (UNAUDITED)
(amounts in thousands)

	Six Months Ended June 30,	
	2005	2004
Operating activities:		
Net income (loss)	\$ 10,529	\$ (18,340)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Provision for loan losses	2,925	16,147
Impairment charges	2,052	9,407
Gain on sale of investments	(9,850)	(4)
Amortization and depreciation	1,106	3,886
Net change in other assets, accrued expenses and other liabilities	(81)	2,096
Net cash and cash equivalents provided by operating activities	6,681	13,192
Investing activities:		
Principal payments received on securitized finance receivables	66,740	100,881
Payments received on other investments, securities and other loans	29,580	13,956
Proceeds from sales of securities and other investments	18,374	461
Purchase of, or advances on, investments	(34,770)	(1,308)
Other	179	(243)
Net cash and cash equivalents provided by investing activities	80,103	113,747
Financing activities:		
Principal payments on non-recourse securitization financing	(59,656)	(101,552)
Net borrowings under securitization financing repurchase agreement	165,743	-
Proceeds from issuance of bonds	-	7,377
Redemption of securitization financing bonds	(195,653)	-
Net repayments on repurchase agreement borrowings	(23,277)	(5,731)
Repayment of senior notes	-	(10,049)
Retirement of preferred stock	-	(1,465)
Dividends paid	(2,674)	-
Net cash and cash equivalents used for financing activities	(115,517)	(111,420)
Net (decrease) increase in cash and cash equivalents	(28,733)	15,519
Cash and cash equivalents at beginning of period	52,522	7,386
Cash and cash equivalents at end of period	\$ 23,789	\$ 22,905
Supplement disclosures of cash flow information:		
Cash paid for interest	\$ 20,193	\$ 50,531

See notes to unaudited condensed consolidated financial statements.

DYNEX CAPITAL, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

June 30, 2005

(amounts in thousands except share and per share data)

NOTE 1 - BASIS OF PRESENTATION

The accompanying condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and notes required by accounting principles generally accepted in the United States of America, hereinafter referred to as "generally accepted accounting principles," for complete financial statements. The condensed consolidated financial statements include the accounts of Dynex Capital, Inc. and its qualified real estate investment trust ("REIT") subsidiaries and taxable REIT subsidiary (collectively, "Dynex" or the "Company"). All inter-company balances and transactions have been eliminated in consolidation.

The Company consolidates entities in which it owns more than 50% of the voting equity and control does not rest with others. The Company follows the equity method of accounting for investments with greater than 20% and less than a 50% interest in partnerships and corporate joint ventures or when it is able to influence the financial and operating policies of the investee but owns less than 20% of the voting equity. For all other investments, the cost method is applied.

The Company has elected to follow the intrinsic value method in accounting for its stock based compensation issued to employees and non-employee directors. Accordingly, the Company did not recognize compensation expense upon the issuance of its stock appreciation rights and stock options.

The Company believes it has complied with the requirements for qualification as a REIT under the Internal Revenue Code of 1986, as amended (the "Code"). To the extent the Company qualifies as a REIT for federal income tax purposes, it generally will not be subject to federal income tax on the amount of its income or gain that is distributed as dividends to shareholders.

In the opinion of management, all significant adjustments, consisting of normal recurring accruals considered necessary for a fair presentation of the condensed consolidated financial statements have been included. The financial statements presented are unaudited. Operating results for the three and six months ended June 30, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005. Certain information and footnote disclosures normally included in the consolidated financial statements prepared in accordance with generally accepted accounting principles have been omitted. The unaudited financial statements included herein should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2004 (the "2004 Form 10-K"), filed with the Securities and Exchange Commission.

The preparation of financial statements, in conformity with generally accepted accounting principles, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. The primary estimates inherent in the accompanying condensed consolidated financial statements are discussed below and in the Notes to Consolidated Financial Statements in the Company's 2004 Form 10-K.

The Company uses estimates in establishing fair value for its financial instruments. Securities classified as available-for-sale are carried in the accompanying financial statements at estimated fair value. Securities are both fixed-rate and adjustable-rate. Estimates of fair value for securities are based on market prices provided by certain dealers, when available. Estimates of fair value for certain other securities are determined by calculating the present value of the projected cash flows of the instruments using market-based assumptions such as estimated future interest rates and estimated market spreads to applicable indices for comparable securities, and using collateral based assumptions such as prepayment rates and credit loss assumptions based on the most recent performance and anticipated performance of the underlying collateral.

The Company also has credit risk on loans in its portfolio as discussed in Note 4. An allowance for loan losses has been estimated and established for currently existing losses in the loan portfolio, which are deemed to be probable as to their occurrence. The allowance for loan losses is evaluated and adjusted periodically by management based on the actual and estimated timing and amount of credit losses. Provisions made to increase the allowance for loan losses are presented as provision for loan losses in the accompanying condensed consolidated statements of operations. The Company's actual credit losses may differ from those estimates used to establish the allowance.

Certain amounts for 2004 have been reclassified to conform to the presentation adopted in 2005.

NOTE 2 - NET INCOME (LOSS) PER COMMON SHARE

Net income (loss) per common share is presented on both a basic and diluted per common share basis. Diluted net income (loss) per common share assumes the conversion of the convertible preferred stock into common stock, using the if-converted method, and stock appreciation rights and options to the extent that they are outstanding, using the treasury stock method, but only if these items are dilutive. Each share of Series D preferred stock is convertible into one share of common stock. The following table reconciles the numerator and denominator for both basic and diluted net loss per common share for the three and six months ended June 30, 2005 and 2004.

	Three Months Ended June 30,				Six Months Ended June 30,			
	2005		2004		2005		2004	
	Income	Weighted-Average Number Of Shares	Loss	Weighted-Average Number Of Shares	Income	Weighted-Average Number Of Shares	Loss	Weighted-Average Number Of Shares
Net income (loss)	\$ 9,594		\$ (12,953)		\$ 10,529		\$ (18,340)	
Preferred stock (charge) benefit	(1,337)		2,045		(2,674)		854	
Net income (loss) to common shareholders	<u>\$ 8,257</u>	<u>12,163,061</u>	<u>\$ (10,908)</u>	<u>11,468,635</u>	<u>\$ 7,855</u>	<u>12,162,728</u>	<u>\$ (17,486)</u>	<u>10,972,844</u>
Net income (loss) per share:								
Basic		<u>\$ 0.68</u>		<u>\$ (0.95)</u>		<u>\$ 0.65</u>		<u>\$ (1.59)</u>
Diluted		<u>\$ 0.54</u>		<u>\$ (0.95)</u>		<u>\$ 0.59</u>		<u>\$ (1.59)</u>
Reconciliation of shares included in calculation of earnings per share due to dilutive effect								
Series D preferred stock	\$ (1,337)	5,628,737	-	-	(2,674)	5,628,737	-	-
Expense and incremental shares of stock appreciation rights	-	-	-	-	-	129	-	-
	<u>\$ (1,337)</u>	<u>5,628,737</u>	<u>\$ -</u>	<u>-</u>	<u>\$ (2,674)</u>	<u>5,628,866</u>	<u>\$ -</u>	<u>-</u>
Reconciliation of shares not included in calculation of earnings per share due to anti-dilutive effect								
Series A preferred stock	\$ -	-	\$ (48)	132,891	\$ -	-	\$ (337)	189,844
Series B preferred stock	-	-	(134)	185,282	-	-	(537)	264,688
Series C preferred stock	-	-	(167)	184,394	-	-	(666)	263,420
Series D preferred stock	-	-	(1,263)	2,659,733	-	-	(1,263)	1,329,866
Expense and incremental shares of stock appreciation rights	-	-	-	21,119	-	-	-	21,067
	<u>\$ -</u>	<u>-</u>	<u>\$ (1,612)</u>	<u>3,183,419</u>	<u>\$ -</u>	<u>-</u>	<u>\$ (2,803)</u>	<u>2,068,885</u>

NOTE 3 - SECURITIZED FINANCE RECEIVABLES

The following table summarizes the types of securitized finance receivables at June 30, 2005 and December 31, 2004:

	June 30, 2005	December 31, 2004
Loans, at amortized cost	\$ 817,450	\$ 1,064,137
Allowance for loan losses	(16,536)	(28,014)
Loans, net	800,914	1,036,123
Debt securities	2,352	206,434
	\$ 803,266	\$ 1,242,557

The following table summarizes the amortized cost basis, gross unrealized gains and losses and estimated fair value of debt securities pledged as securitized finance receivables at June 30, 2005 and December 31, 2004:

	June 30, 2005	December 31, 2004
Debt securities, at amortized cost	\$ 2,315	\$ 205,370
Gross unrealized gains	37	1,064
	\$ 2,352	\$ 206,434

The components of securitized finance receivables at June 30, 2005 and December 31, 2004 are as follows:

	June 30, 2005			December 31, 2004		
	Loans, net	Debt Securities	Total	Loans, net	Debt Securities	Total
Collateral:						
Commercial	\$ 617,281	\$ -	\$ 617,281	\$ 640,090	\$ -	\$ 640,090
Manufactured housing	-	-	-	198,246	149,420	347,666
Single-family	195,942	2,250	198,192	225,055	52,753	277,808
	813,223	2,250	815,473	1,063,391	202,173	1,265,564
Allowance for loan losses	(16,536)	-	(16,536)	(28,014)	-	(28,014)
Funds held by trustees	131	39	170	130	43	173
Accrued interest receivable	5,664	18	5,682	6,548	202	6,750
Unamortized discounts and premiums, net	(1,568)	8	(1,560)	(5,932)	2,952	(2,980)
Unrealized gain, net	-	37	37	-	1,064	1,064
	\$ 800,914	\$ 2,352	\$ 803,266	\$ 1,036,123	\$ 206,434	\$ 1,242,557

During the quarter ended June 30, 2005, the Company redeemed, at par, \$195,653 of non-recourse securitization financing bonds collateralized by the single-family loans pursuant to its redemption rights within the respective indenture. The redemption was partially financed with \$170,655 of repurchase agreements, of which \$165,743 remained outstanding at June 30, 2005. The redeemed bonds, which collateralize the related repurchase agreement financing, have been removed from the Company's financial statements. The repurchase agreement borrowings have been presented as securitization financing in the financial statements. The redeemed non-recourse securitization financing bonds have not been retired by the Company, because of its plans to reissue the bonds before the end of the year.

During the second quarter, the Company sold its interests in approximately \$367,154 in securitization finance receivables and the associated securitization trust, resulting in the derecognition of these receivables and the extinguishment of \$363,871 in related securitization financing bonds. The Company received proceeds of \$8,000 for the sale of these interests, recorded mortgage servicing assets of \$3,176 for the retained servicing on the loans, and recognized a gain of \$8,228. As part of this transaction, the Company also sold all of the outstanding stock of one of its subsidiaries on which it recorded a gain of \$1,000, which was recorded in other income.

The fair value of the mortgage servicing assets of \$3,176 recorded in connection with the derecognition of the securitization trusts discussed above was estimated using a discount rate of 16%. The cash flows were modeled using a CPR of 8% and loss rates of approximately 4.2% and 3.6%. The mortgage servicing cash flows are calculated on the outstanding principal balance of the underlying loans, which is projected based on the scheduled principal payments and expected prepayment speeds.

NOTE 4 - ALLOWANCE FOR LOAN LOSSES

The Company reserves for estimated currently existing credit losses on loans in its investment portfolio. The following tables summarize the aggregate activity for the allowance for loan losses for the three-month and six-month periods ended June 30, 2005 and 2004, respectively:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Balance, beginning of period	\$ 27,681	\$ 45,988	\$ 28,014	\$ 43,364
Provision for loan losses	664	8,947	2,925	16,147
Charge-offs	(499)	(5,467)	(3,093)	(10,043)
Portfolio sold	(11,310)	-	(11,310)	-
Balance, end of period	\$ 16,536	\$ 49,468	\$ 16,536	\$ 49,468

The portfolio sold of \$11,310 represent the amount of allowance that was removed from the balance sheet in connection with the derecognition as a result of the sale of the related securitized finance receivables described above in Note 3.

The Company identified \$55,659 and \$72,431 of impaired commercial mortgage loans at June 30, 2005 and December 31, 2004, respectively. The decline is primarily due to the repayment of approximately \$8,350 of loans, which were identified as impaired at December 31, 2004, during 2005 as well as improvement in the performance of the underlying real estate collateral value of certain other previously impaired loans. At June 30, 2005 and December 31, 2004, the Company had approximately \$36,896 and \$50,941 respectively, in sixty-plus day delinquent commercial mortgage loans outstanding. At June 30, 2005, the Company had reserves or other credit enhancement of \$19,181 against commercial mortgage loans.

NOTE 5 - OTHER INVESTMENTS

The following table summarizes the Company's other investments at June 30, 2005 and December 31, 2004:

	June 30, 2005	December 31, 2004
Delinquent property tax receivables and security	\$ 3,847	\$ 6,000
Real estate owned	1,310	1,596
	\$ 5,157	\$ 7,596

On June 30, 2005, the Company recorded an impairment of \$1,586 on its tax lien security to adjust the recorded value of the tax liens to its estimated fair value. The fair value was estimated by discounting the cash flows the Company projects to collect on this investment based on a probability weighted analysis. Effective June 1, 2005, the Company placed this investment on non-accrual due to the difficulty in reliably estimating the monthly cash flows from the security.

At June 30, 2005 and December 31, 2004, the Company had real estate owned with a current carrying value of \$1,310 and \$1,596, respectively, resulting from foreclosures on the properties collateralizing the delinquent property tax receivables and securities. During the six months ended June 30, 2005 and 2004, the Company collected an aggregate of \$1,582 and \$3,892, respectively, on delinquent property tax receivables and securities, including net sales proceeds from related real estate owned.

NOTE 6 - SECURITIES

The following table summarizes the Company's securities and their effective interest rate at June 30, 2005 and December 31, 2004:

	June 30, 2005		December 31, 2004	
	Fair Value	Effective Interest Rate	Fair Value	Effective Interest Rate
Securities, available-for-sale:				
Fixed-rate mortgage securities	\$ 54,103	4.75%	\$ 79,462	4.54%
Mortgage-related securities	22	0.33%	28	0.33%
U.S. Treasury bills and commercial paper	34,611	3.16%	-	-
Equity securities	778		7,438	
	89,514		86,928	
Gross unrealized gains	200		852	
Gross unrealized losses	(158)		(74)	
	\$ 89,556		\$ 87,706	

NOTE 7 -DEBT

The Company entered into a securitization financing repurchase agreement, which is recourse to the Company, to partially finance the redemption of certain non-recourse securitization financing bonds as described in Note 3. The securitization financing repurchase agreement of \$165,743 is collateralized by \$188,079 of the related redeemed bonds, which are eliminated in consolidation.

The Company utilizes other recourse repurchase agreements to finance certain of its investments. The Company had \$47,191 and \$70,468 of repurchase agreements outstanding at June 30, 2005 and December 31, 2004, respectively. The repurchase agreements were collateralized by securities with a fair value of \$53,018 and \$78,491 at June 30, 2005 and December 31, 2004, respectively.

NOTE 8 - PREFERRED STOCK

At June 30, 2005 and December 31, 2004, the total liquidation preference on the Preferred Stock was \$57,624 and \$58,040, respectively. There was \$1,337 (\$0.2375 per share) of dividends accrued and payable on the Series D Preferred Stock at both June 30, 2005 and December 31, 2004.

NOTE 9 - DERIVATIVE FINANCIAL INSTRUMENTS

At June 30, 2005, the Company had no outstanding derivative financial instruments. The derivative financial instruments outstanding at December 31, 2004 matured during the quarter. During the six-month period ended June 30, 2005, the Company recognized \$585 of other comprehensive loss outstanding at December 31, 2004 on these contracts. At June 30, 2005, there was \$24 of accumulated other comprehensive income remaining related to previous fair value adjustments, which will be amortized over the next six months.

NOTE 10 - COMMITMENTS AND CONTINGENCIES

GLS Capital, Inc. ("GLS"), a subsidiary of the Company, and the County of Allegheny, Pennsylvania ("Allegheny County"), were defendants in a lawsuit in the Commonwealth Court of Pennsylvania (the "Commonwealth Court"), the appellate court of the state of Pennsylvania. Plaintiffs were two local businesses seeking status to represent as a class delinquent taxpayers in Allegheny County whose delinquent tax liens had been assigned to GLS. Plaintiffs challenged the right of Allegheny County and GLS to collect certain interest, costs and expenses related to delinquent property tax receivables in Allegheny County, and whether the County had the right to assign the delinquent property tax receivables to GLS and therefore employ procedures for collection enjoyed by Allegheny County under state statute. This lawsuit was related to the purchase by GLS of delinquent property tax receivables from Allegheny County in 1997, 1998, and 1999. In July 2001, the Commonwealth Court issued a ruling that addressed, among other things, (i) the right of GLS to charge to the delinquent taxpayer a rate of interest of 12% per annum versus 10% per annum on the collection of its delinquent property tax receivables, (ii) the charging of a full month's interest on a partial month's delinquency; (iii) the charging of attorney's fees to the delinquent taxpayer for the collection of such tax receivables, and (iv) the charging to the delinquent taxpayer of certain other fees and costs. The Commonwealth Court in its opinion remanded for further consideration to the lower trial court items (i), (ii) and (iv) above, and ruled that neither Allegheny County nor GLS had the right to charge attorney's fees to the delinquent taxpayer related to the collection of such tax receivables. The Commonwealth Court further ruled that Allegheny County could assign its rights in the delinquent property tax receivables to GLS, and that plaintiffs could maintain equitable class in the action. In October 2001, GLS, along with Allegheny County, filed an Application for Extraordinary Jurisdiction with the Supreme Court of Pennsylvania, Western District appealing certain aspects of the Commonwealth Court's ruling. In March 2003, the Supreme Court issued its opinion as follows: (i) the Supreme Court determined that GLS can charge delinquent taxpayers a rate of 12% per annum; (ii) the Supreme Court remanded back to the lower trial court the charging of a full month's interest on a partial month's delinquency; (iii) the Supreme Court revised the Commonwealth Court's ruling regarding recouping attorney fees for collection of the receivables indicating that the recoupment of fees requires a judicial review of collection procedures used in each case; and (iv) the Supreme Court upheld the Commonwealth Court's ruling that GLS can charge certain fees and costs, while remanding back to the lower trial court for consideration the facts of each individual case. Finally, the Supreme Court, in March 2003, remanded to the lower trial court to determine if the remaining claims can be resolved as a class action. In August 2003, the Pennsylvania legislature enacted a law amending and clarifying certain provisions of the Pennsylvania statute governing GLS' right to the collection of certain interest, costs and expenses. The law is retroactive to 1996, and amends and clarifies that as to items (ii), (iii) and (iv) noted above by the Supreme Court, that GLS can charge a full month's interest on a partial month's delinquency, that GLS can charge the taxpayer for legal fees, and that GLS can charge certain fees and costs to the taxpayer at redemption. Subsequent to the enactment of the law, challenges to the retroactivity provisions of the law were filed in separate cases, which did not include GLS as a defendant. In September 2004, the Trial Court in that litigation upheld the retroactive provisions enacted in 2003. Plaintiffs have appealed in that case. The lower trial court had reset the hearing on the class-action status for June 2005, but the hearing was delayed until no earlier than September 2005. We believe that the ultimate outcome of this litigation will not have a material impact on our financial condition, but may have a material impact on reported results for the particular period presented.

The Company and Dynex Commercial, Inc. ("DCI"), formerly an affiliate of the Company and now known as DCI Commercial, Inc., were defendants in state court in Dallas County, Texas in the matter of Basic Capital Management et al (collectively, "BCM" or "the Plaintiffs") versus Dynex Commercial, Inc. et al. The suit was filed in April 1999 originally against DCI, and in March 2000, BCM amended the complaint and added the Company as a defendant. The complaint, which was further amended during pretrial proceedings, alleged that, among other things, DCI and the Company failed to fund tenant improvement or other advances allegedly required on various loans made by DCI to BCM, which loans were subsequently acquired by the Company; that DCI breached an alleged \$160,000 "master" loan commitment entered into in February 1998; and that DCI breached another alleged loan commitment of approximately \$9,000. The trial commenced in January 2004 and in February 2004, the jury in the case rendered a verdict in favor of one of the plaintiffs and against the Company on the alleged breach of the loan agreements for tenant improvements and awarded that plaintiff damages in the amount of \$253. The jury also awarded the Plaintiffs' attorneys fees in the amount of \$2,100. The jury entered a separate verdict against DCI in favor of BCM under two mutually exclusive damage models, for \$2,200 and \$25,600, respectively. The jury found in favor of DCI on the alleged \$9,000 loan commitment, but did not find in favor of DCI for counterclaims made against BCM. After considering post-trial motions, the presiding judge entered judgment in favor of the Company and DCI, effectively overturning the verdicts of the jury and dismissing damages awarded by the jury. Plaintiffs have filed an appeal with the Court of Appeals for the Fifth Judicial District of Texas at Dallas. DCI is a former affiliate of the Company, and the Company believes that it will have no obligation for amounts, if any, awarded to the plaintiffs as a result of the actions of DCI. Various briefs have been filed in the litigation, and the Company expects the appeal will be heard by the end of 2005.

On February 11, 2005, a putative class action complaint alleging violations of the federal securities laws and various state common law claims was filed against the Company, our subsidiary MERIT Securities Corporation, Stephen J. Benedetti, the Company's Executive Vice President, and Thomas H. Potts, the Company's former President and a former Director, in United States District Court for the Southern District of New York ("District Court") by the Teamsters Local 445 Freight Division Pension Fund ("Teamsters"). The lawsuit purported to be a class action on behalf of purchasers of MERIT Series 13 securitization financing bonds, which are collateralized by manufactured housing loans. On May 31, 2005, the Teamsters filed an amended class action complaint. The amended complaint dropped all state common law claims but added federal securities claims related to the MERIT Series 12 securitization financing bonds. The Company filed a motion to dismiss the amended complaint on July 15, 2005 to which Teamsters filed a response with the District Court on August 15, 2005. The Company has evaluated the allegations and believes them to be without merit and intends to vigorously defend itself against them.

Although no assurance can be given with respect to the ultimate outcome of the above litigation, the Company believes the resolution of these lawsuits will not have a material effect on our consolidated balance sheet but could materially affect our consolidated results of operations in a given year.

NOTE 11 - STOCK BASED COMPENSATION

On January 2, 2005, the Company granted 126,297 stock appreciation rights (SAR) to certain of its employees and officers under the Dynex Capital, Inc. 2004 Stock Incentive Plan. The SARs vest over the next four years in equal annual installments, expire on December 31, 2011 and have an exercise price of \$7.81 per share, which was the market price of the stock on the grant date.

On June 17, 2005, the Company granted options to acquire an aggregate of 40,000 shares of common stock to the members of its Board of Directors under the Dynex Capital, Inc. 2004 Stock Incentive Plan. The options have an exercise price of \$8.46 per share, which represents 110% of the closing stock price on the grant date, expire on June 17, 2010 and were fully vested when granted.

The following table presents the effect on net income and earnings per share if the Company had applied the fair value method to the SARs and options granted to employees and Directors using the Black-Scholes option pricing model.

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net income to common shareholders	\$ 8,257	\$ 7,855
Fair value method stock based compensation expense	(84)	(100)
Pro forma net income to common shareholders	\$ 8,173	\$ 7,755
Net income per common share:		
Basic - as reported	\$ 0.68	\$ 0.65
Basic - pro forma	\$ 0.67	\$ 0.64
Diluted - as reported	\$ 0.54	\$ 0.59
Diluted - pro forma	\$ 0.53	\$ 0.59

NOTE 12 - RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123 (Revised 2004), Share-Based Payment (FAS 123R). This statement supersedes APB Opinion No. 25 and its related implementation guidance. The statement establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods and services. This statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. The most significant change resulting from this statement is the requirement for public companies to expense employee share-based payments under fair value as originally introduced in SFAS No. 123. This statement is effective for public companies as of the beginning of the first annual reporting period that begins after June 15, 2005, or December 15, 2005 for small business issuers. The Company will adopt this statement effective January 1, 2006. The Company presented the amount that would have been recorded in general and administrative expense for the quarter and six month period ended June 30, 2005 if the Company had adopted the provisions of FAS 123R in Note 11 above.

In June 2004, the FASB issued Emerging Issues Task Force Abstract 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" ("EITF 03-1"). EITF 03-1 provides authoritative guidance regarding determining when an investment is considered impaired and the impairment is other-than-temporary. EITF 03-1 requires that the Company evaluate whether an impairment is other-than-temporary, and, if the impairment is other-than-temporary, recognize an impairment loss equal to the excess of the amortized cost over the estimated fair value of the investment. In September 2004 the FASB delayed the effective date of paragraphs 10-20 of this issue. These paragraphs give guidance on how to evaluate and recognize an impairment loss that is other-than-temporary. The delay does not suspend the requirement to recognize other than temporary impairments as required by existing authoritative literature. On July 5, 2005, the FASB decided not to provide additional guidance on the meaning of other-than-temporary impairment and stated that the proposed FASB Staff Position ("FSP") EITF Issue No. 03-1-a, "Implementation Guidance for the Application of Paragraph 16 of EITF Issue No. 03-1," will be issued as final. The final FSP will supersede EITF 03-1. The Company does not expect the adoption of the FSP, as contained in its current draft form, to have a material effect on our consolidated financial condition, consolidated results of operations, or liquidity.

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

The following discussion and analysis of the financial condition and results of operations of the Company as of and for the three-month and six-month periods ended June 30, 2005 should be read in conjunction with the Company's Unaudited Condensed Consolidated Financial Statements and the accompanying Notes to Unaudited Condensed Consolidated Financial Statements included in this report.

The Company is a financial services company organized as a real estate investment trust (REIT), which currently invests in loans and securities principally consisting of, or secured by, single family mortgage loans and commercial mortgage loans. The loans and securities in which the Company invests have generally been pooled and pledged to a securitization trust (i.e. securitized) as collateral for non-recourse bonds ("non-recourse securitization financing"), which provides long-term financing for such loans while limiting credit, interest rate and liquidity risk. The Company earns the net interest spread between the interest income on the loans and securities in its investment portfolio and the interest and other expenses associated with the non-recourse securitization financing. The Company also collects payments from property owners on its investment in delinquent property tax receivables. The predominant risk to the Company's investment portfolio is credit risk as discussed further in *Results of Operations*.

In recent years, the Company elected to sell certain non-core assets, improving its financial flexibility by converting investments into cash, and, in 2004, the Company completed a restructuring of its equity capital while simultaneously eliminating \$18.5 million in preferred dividends in arrears. The Company's total investment portfolio assets over the last four quarters have declined approximately \$817 million to \$901 million at June 30, 2005. During that time, the Company improved its liquidity and financial position, and cash and cash equivalents and liquid securities at June 30, 2005 were approximately \$63 million, with an additional \$18 million expected from the reissuance of securitization financing bonds redeemed during the quarter.

During the second quarter, the Company sold its interests in approximately \$367.2 million in securitization finance receivables and the associated securitization trust, resulting in the derecognition of these receivables and \$363.9 million in related securitization financing bonds. The Company received proceeds of \$8.0 million for the sale of these interests, and recorded a gain of \$8.2 million. As part of this transaction, the Company also sold one of its subsidiaries on which it recorded a gain of \$1.0 million, which was recorded in other income.

During the quarter ended June 30, 2005, the Company redeemed, at par, \$195.7 million of non-recourse securitization financing bonds collateralized by the single-family loans pursuant to its redemption rights within the respective indenture. The redemption was partially financed with \$170.7 million of repurchase agreements, of which \$165.7 million remained outstanding at June 30, 2005. The redeemed bonds, which collateralize the related repurchase agreement financing, have been removed from the Company's financial statements. This repurchase agreement has been presented as securitization financing in the financial statements. The redeemed non-recourse securitization financing bonds have not been retired by the Company, because of its plans to reissue the bonds before the end of the year.

At June 30, 2005, the Company had significant amounts of investable capital, which is currently invested in cash and cash equivalents and highly-liquid short-term securities. Given the low interest rate environment and the flat yield curve, the Company has not found compelling longer-term investment opportunities where the risk-adjusted return on those opportunities is acceptable to the Company. Further, given the challenging reinvestment environment in traditional mortgage REIT opportunities, the Company is considering investments in assets that are outside those of a traditional mortgage REIT, and at some point may forego its REIT status. For the near-term, the Company will continue its efforts on managing its current investment portfolio to maximize its cash flow, while evaluating longer-term opportunities for redeployment of its capital. The Company has an estimated \$149 million in net operating loss (NOL) carryforwards which can be used to offset future taxable income through approximately 2019, and the Company is retaining its investable capital currently in order to maximize its chances of utilizing the NOL carryforwards for the benefit of its shareholders. Because of the desire to retain its capital currently, other than dividends on its preferred stock, the Company will not make distributions on its equity capital unless they are necessary for the Company to maintain its REIT status. If the lack of compelling investment opportunities continues for an extended period of time, the Company will consider the repurchase of at least a portion of its outstanding Series D Preferred Stock.

CRITICAL ACCOUNTING POLICIES

The discussion and analysis of the Company's financial condition and results of operations are based in large part upon its consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States of America. The preparation of the financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reported period. Actual results could differ from those estimates.

Critical accounting policies are defined as those that are reflective of significant judgments or uncertainties, and which may result in materially different results under different assumptions and conditions, or the application of which may have a material impact on the Company's financial statements. The following are the Company's critical accounting policies.

Consolidation of Subsidiaries. The consolidated financial statements represent the Company's accounts after the elimination of inter-company transactions. The Company consolidates entities in which it owns more than 50% of the voting equity and control of the entity does not rest with others. The Company follows the equity method of accounting for investments with greater than 20% and less than a 50% interest in partnerships and corporate joint ventures or when it is able to influence the financial and operating policies of the investee but owns less than 20% of the voting equity. For all other investments, the cost method is applied.

Impairments. The Company evaluates all securities in its investment portfolio for other-than-temporary impairments. A security is generally defined to be other-than-temporarily impaired if, for a maximum period of three consecutive quarters, the carrying value of such security exceeds its estimated fair value and the Company estimates, based on projected future cash flows or other fair value determinants, that the fair value will remain below the carrying value for the foreseeable future. If an other-than-temporary impairment is deemed to exist, the Company records an impairment charge to adjust the carrying value of the security down to its estimated fair value. In certain instances, as a result of the other-than-temporary impairment analysis, the recognition or accrual of interest will be discontinued and the security will be placed on non-accrual status.

Allowance for Loan Losses. The Company has credit risk on loans pledged in securitization financing transactions and classified as securitized finance receivables in its investment portfolio. An allowance for loan losses has been estimated and established for currently existing probable losses on those assets. Factors considered in establishing an allowance include current loan delinquencies, historical cure rates of delinquent loans, and historical and anticipated loss severity of the loans as they are liquidated. The allowance for loan losses is evaluated and adjusted periodically by management based on the actual and estimated timing and amount of probable credit losses, using the above factors, as well as industry loss experience. Where loans are considered homogeneous, the allowance for loan losses is established and evaluated on a pool basis. Otherwise, the allowance for loan losses is established and evaluated on a loan-specific basis. Provisions made to increase the allowance are a current period expense to operations.

Generally, single-family loans are considered impaired when they are sixty-days past due. Commercial mortgage loans are evaluated on an individual basis for impairment. Generally, a commercial loan with a debt service coverage ratio of less than one is considered impaired. However, based on information specific to a commercial loan, commercial loans with a debt service coverage ratio less than one may not be considered impaired; conversely, commercial loans with a debt service coverage ratio greater than one may be considered impaired. This information may include whether the loan is delinquent, the current and expected performance of the underlying collateral, and information and analyses provided by the loan servicer. Certain of the commercial mortgage loans are covered by loan guarantees that limit the Company's exposure on these loans. The level of allowance for loan losses required for these loans is reduced by the amount of applicable loan guarantees. The Company's actual credit losses may differ from the estimates used to establish the allowance.

FINANCIAL CONDITION

The following table presents information on the Company's financial condition and is followed by a discussion of those items.

<i>(amounts in thousands except per share data)</i>	June 30, 2005	December 31, 2004
Investments:		
Securitized finance receivables:		
Loans, net	\$ 800,914	\$ 1,036,123
Debt securities	2,352	206,434
Securities	89,556	87,706
Other investments	5,157	7,596
Other loans	3,442	5,589
Securitization financing:		
Non-recourse bonds	559,070	1,177,280
Repurchase agreements	165,743	-
Repurchase agreements	47,191	70,468
Shareholders' equity	152,865	148,766
Book value per common share	\$ 7.94	\$ 7.60

Securitized finance receivables. Loans, net decreased to \$0.8 billion at June 30, 2005 compared to \$1.0 billion at December 31, 2004. This decrease of \$235.2 million is primarily the result of the derecognition of \$177.7 million of manufactured housing loans associated with the sale of the Company's interests in the related securitization trust, \$55.3 million in principal paydowns on the securitized finance receivables, \$3.2 million of additions to the allowance for loan losses, and decreases in accrued interest receivable of \$0.5 million and net premium amortization of \$0.5 million.

Debt securities decreased to \$2.4 million at June 30, 2005 compared to \$206.4 million at December 31, 2004. This decrease of \$204.1 million is primarily the result of the derecognition of \$189.5 million of a security supported by manufactured housing loans associated with the sale of the Company's interests in the related securitization trust, \$11.5 million in principal paydowns on the securitized finance receivables, and \$1.0 million related to realized market valuation adjustments resulting from the sale of the security.

Securities. Securities increased by \$1.9 million, to \$89.6 million at June 30, 2005 from \$87.7 million at December 31, 2004 due primarily to the purchase of \$34.6 million of commercial paper and treasury bills with original maturities ranging from 91-180 days, which was partially offset by principal payments of \$25.3 million, the sale of \$6.7 million of common stock of another mortgage REIT and \$0.7 million of market value adjustments.

Other investments. Other investments at June 30, 2005 consist of delinquent property tax receivables and a delinquent property tax security. Other investments decreased from \$7.6 million at December 31, 2004, to \$5.2 million at June 30, 2005. This decrease is primarily the result of market value adjustments of \$1.6 million, pay-downs of delinquent property tax receivables, which totaled \$1.2 million, and sales of real estate owned properties of \$0.4 million. These decreases were partially offset by additional advances for collections of \$0.3 million and interest accretion of \$0.6 million.

Other loans. Other loans decreased by \$2.1 million from \$5.6 million at December 31, 2004, to \$3.4 million at June 30, 2005, principally as the result of the sale of \$1.7 million of mezzanine loans and principal payments of \$0.6 million during the six month period.

Securitization financing. Non-recourse securitization financing decreased \$618.2 million, from \$1.2 billion at December 31, 2004 to \$0.6 billion at June 30, 2005. This decrease was primarily a result of derecognition of \$363.9 million of securitization financing resulting from the sale of the Company's interests in two securitizations, the redemption by the Company of the \$195.7 million of outstanding bonds, which were replaced by \$170.7 million of repurchase agreement financing, principal payments received of \$59.7 million on the associated securitized finance receivables pledged which were used to pay down the non-recourse securitization financing in accordance with the respective indentures and \$0.2 million of losses on loans passed through to the bondholders. Additionally, for certain securitizations, surplus cash in the amount of \$2.1 million was retained within the security structure and used to cover losses, as certain performance triggers were not met in such securitizations. These decreases were partially offset by \$1.4 million of amortization of net bond discount during the six months ended June 30, 2005.

The repurchase agreement securitization financing increased from zero at December 31, 2004 to \$165.7 million at June 30, 2005. This increase resulted from the partial financing of the redemption of \$195.7 million of non-recourse securitization financing bonds with \$170.7 million of repurchase agreements. This increase was partially offset by payments on these repurchase agreements of \$4.9 million.

Repurchase Agreements. Repurchase agreements decreased from \$70.5 million at December 31, 2004 to \$47.2 million at June 30, 2005. This decrease related to payments on the repurchase agreements of \$23.3 million.

Shareholders' equity. Shareholders' equity increased to \$152.9 million at June 30, 2005, from \$148.8 million at December 31, 2004. This increase was primarily the result of net income of \$10.5 million and a net decrease of \$3.8 million of accumulated other comprehensive income during the period. The decrease in accumulated other comprehensive income is comprised of the realization of previously unrealized gain on investments available-for-sale of \$4.3 million resulting from the sale of the security during the period. Unrealized losses of \$0.6 million on hedging instruments were recognized in income during the period.

RESULTS OF OPERATIONS

(amounts in thousands except per share information)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Net interest income	\$ 2,732	\$ 5,519	\$ 7,189	\$ 11,954
Net interest income (loss) after provision for losses	2,068	(3,428)	4,264	(4,193)
Impairment charges	(1,786)	(7,746)	(2,052)	(9,407)
Gain on sale of investments, net	9,552	20	9,850	4
General and administrative expenses	(1,398)	(2,015)	(2,890)	(4,483)
Net income (loss)	9,594	(12,953)	10,529	(18,340)
Preferred stock (charge) benefit	(1,337)	2,045	(2,674)	854
Net income (loss) to common shareholders	8,257	(10,908)	7,855	(17,486)
Net income (loss) per common share:				
Basic	\$ 0.68	\$ (0.95)	\$ 0.65	\$ (1.59)
Diluted	\$ 0.54	\$ (0.95)	\$ 0.59	\$ (1.59)

Three Months Ended June 30, 2005 Compared to Three Months Ended June 30, 2004. Net income and net income per common share increased during the three months ended June 30, 2005 as compared to the same period in 2004. The increase in net income is primarily the result of a \$8.3 million decrease in provision for loan losses and a \$6.0 million decrease of impairment charges, coupled with a \$9.5 million increase in gain on sale of investments as discussed above. These increases were offset by a decrease in net interest income of \$2.8 million, as discussed below.

Net interest income for the three months ended June 30, 2005 decreased to \$2.7 million from \$5.5 million for the same period in 2004 primarily due to the reduction in interest earning assets from sales of securitized finance receivables, and the decline in the net interest spread on interest earning assets. The decline in net interest spread is discussed further in connection with the *Average Balances and Effective Interest Rates* table below.

Impairment charges decreased by \$6.0 million for the three months ended June 30, 2005 from the same period last year due primarily to the sale of a security in 2005 supported by manufactured housing and single-family loans which experienced a \$7.6 million impairment charge in the three months ended June 30, 2004. The impairment charges for the three months ended June 30, 2005 primarily relate to a \$1.6 million impairment charge on the Company's investment in delinquent property tax receivables during the period.

Gain on sale of investments increased by \$9.5 million during the three months ended June 30, 2005 compared to the same period last year. A gain of \$8.2 million on the sale of securitized finance receivables and a gain of \$1.4 million on the sale of four healthcare mezzanine loans were realized during the period.

General and administrative expenses decreased by \$0.6 million to \$1.4 million for the three months ended June 30, 2005 compared to the same period in 2004 due principally to lower general and administrative expenses on the Company's delinquent property tax receivable servicing operation.

Six Months Ended June 30, 2005 Compared to Six Months Ended June 30, 2004. Net income and net income per common share increased during the six months ended June 30, 2005 as compared to the same period in 2004. The increase in net income is primarily the result of a decrease of provision for loan losses of \$13.2 million, a decrease in impairment charges of \$7.4 million, an increase in gain on sale of investments of \$9.8 million, and a decrease in net interest income of \$4.8 million. Net income to common shareholders increased from a \$17.5 million loss, or \$1.59 per share, for the six months ended June 30, 2004 to \$7.9 million of income, or \$0.65 per share basic earnings and \$0.59 per share fully diluted earnings, for the six months ended June 30, 2005. Net loss to common shareholders in 2005 includes \$2.7 million of dividends paid on preferred stock during the six months ended June 30, 2005.

Net interest income decreased by \$4.8 million during the six months ended June 30, 2005 compared to the same period in 2004 due a decline in interest earning assets from the sale of securitized finance receivables, and a decline in the overall net interest spread on interest earning assets compared to the six months ended June 30, 2004. The decline in net interest spread is discussed further in connection with the *Average Balances and Effective Interest Rates* table below. Net interest income after provision for loan losses for the six months ended June 30, 2005 increased to income of \$4.3 million from a loss of \$4.2 million for the same period in 2004. This increase was primarily the result of a \$13.2 million decrease in provision for loan losses as a result of the sale of the Company's investment in its manufactured housing loan finance receivables.

Impairment charges decreased by \$7.4 million for the six months ended June 30, 2005 from the same period last year. This decrease was primarily a result of losses experienced in 2004 on debt securities pledged as securitized finance receivables and comprised largely of manufactured housing loans. This security was sold during the second quarter of 2005 as part of the transaction discussed earlier in Management's Discussion and Analysis. The impairment charges for the six months ended June 30, 2005 primarily relate to a \$1.7 million impairment charge on the Company's investment in delinquent property tax receivables during the period.

Gain on sales of investments increased by \$9.8 million due to the sale of securitized finance receivables at a gain of \$8.2 million, and a gain of \$1.4 million on the sale of four healthcare mezzanine loans was realized during the period.

General and administrative expense decreased by \$1.6 million for the six months ended June 30, 2005 compared to the same period in 2004. The decline in general and administrative expenses during the period is due to the reduction in expenses at the Company's tax lien servicing operation and a decline in litigation related expenses.

The following table summarizes the average balances of interest-earning assets and their average effective yields, along with the average interest-bearing liabilities and the related average effective interest rates, for each of the periods presented.

Average Balances and Effective Interest Rates

	Three Months Ended June 30,				Six Months Ended June 30,			
	2005		2004		2005		2004	
	Average Balance	Effective Rate	Average Balance	Effective Rate	Average Balance	Effective Rate	Average Balance	Effective Rate
<i>(amounts in thousands)</i>								
Interest-earning assets ⁽¹⁾ :								
Securitized finance receivables ^{(2) (3)}	\$ 945,090	7.16%	\$ 1,707,230	7.61%	\$ 1,085,971	7.17%	\$ 1,737,618	7.52%
Securities	71,854	5.02%	24,211	7.87%	72,614	5.33%	26,310	7.87%
Cash	35,841	2.56%	15,545	0.77%	44,489	2.38%	12,092	0.76%
Other loans	6,486	12.90%	6,757	9.68%	6,789	13.75%	7,492	8.90%
Other investments ⁽⁴⁾	4,756	19.35%	-	-%	6,075	19.83%	-	-%
Total interest-earning assets	<u>\$ 1,064,027</u>	<u>6.95%</u>	<u>\$ 1,753,743</u>	<u>7.56%</u>	<u>\$ 1,215,938</u>	<u>6.98%</u>	<u>\$ 1,783,512</u>	<u>7.49%</u>
Interest-bearing liabilities:								
Non-recourse securitization financing ⁽³⁾	\$ 731,625	7.73%	\$ 1,602,163	6.71%	\$ 939,569	6.97%	\$ 1,627,252	6.54%
Recourse debt secured by securitized finance receivables	123,581	3.12%	-	-%	61,790	3.20%	-	-%
Repurchase agreements	57,177	3.02%	20,103	1.40%	63,197	2.80%	21,438	1.42%
Senior notes	-	-%	549	9.50%	-	-%	3,624	9.50%
Total interest-bearing liabilities	<u>\$ 912,383</u>	<u>6.81%</u>	<u>\$ 1,622,815</u>	<u>6.64%</u>	<u>\$ 1,064,556</u>	<u>6.50%</u>	<u>\$ 1,652,314</u>	<u>6.48%</u>
Net interest spread on all investments ⁽³⁾		<u>0.14%</u>		<u>0.92%</u>		<u>0.48%</u>		<u>1.01%</u>
Net yield on average interest-earning assets ⁽³⁾		<u>1.10%</u>		<u>1.41%</u>		<u>1.29%</u>		<u>1.49%</u>

⁽¹⁾ Average balances exclude adjustments made in accordance with Statement of Financial Accounting Standards No. 115, "Accounting for Certain Investments in Debt and Equity Securities," to record available-for-sale securities at fair value.

⁽²⁾ Average balances exclude funds held by trustees of \$251 and \$509 for the three months ended June 30, 2005 and 2004, respectively, and \$242 and \$422 for the six months ended June 30, 2005 and 2004, respectively.

⁽³⁾ Effective rates are calculated excluding non-interest related collateralized bond expenses. If included, the effective rate on interest-bearing liabilities would be 6.93% and 6.83% for the three months ended June 30, 2005 and 2004, respectively, and 6.65% and 6.64% for the six months ended June 30, 2005 and 2004, respectively.

⁽⁴⁾ Other investments is comprised of delinquent property tax receivables which were on non-accrual during all of 2004 and beginning in June 2005.

The net interest spread decreased 78 basis points to 14 basis points for the three months ended June 30, 2005, from 92 basis points for the same period in 2004 (each basis point is 0.01%). The net interest spread for the six months ended June 30, 2005 decreased relative to the same period in 2004, to 48 basis points from 101 basis points. The decrease in the net interest spread for the three months ended June 30, 2005 versus the same period in 2004 is due to declining yields on interest-earning assets, due principally from decreased income as a result of the sale of approximately \$367.2 million of securitized finance receivables during the three months ended June 30, 2005, and the sale of approximately \$219.2 million in receivables during the fourth quarter of 2004. The proceeds from the sale of these investments have generally been invested in cash and short-term securities. Additionally, net interest spread decreased due to effective interest rate adjustments recognized on a commercial loan securitization in the three months ended June 30, 2004.

The decrease in the Company's net interest spread for the six month period ended June 30, 2005 compared to the prior year period can also be attributed to decreased income as a result of the sale of securitized finance receivables during the six months ended June 30, 2005.

Interest Income and Interest-Earning Assets. At June 30, 2005, \$699.1 million of the investment portfolio consisted of loans and securities which pay a fixed-rate of interest, and approximately \$171.8 million of the investment portfolio was comprised of loans and securities that have coupon rates which adjust over time (subject to certain periodic and lifetime limitations) in conjunction with changes in short-term interest rates. The Company finances its investment portfolio principally with non-recourse securitization financing, but during the second quarter of 2005 added \$165.7 million of repurchase agreement financing to fund the redemption of the outstanding bonds of one securitization. At June 30, 2005, approximately \$552.8 million of fixed-rate bonds and no adjustable rate bonds were outstanding, having been replaced by repurchase agreement financing as discussed above. The following table presents a breakdown, by principal balance, of the Company's securitized finance receivables and ARM and fixed mortgage securities by type of underlying loan. This table excludes treasury bills, commercial paper, other investments and other loans, as such assets are classified in the Company's financial statements.

Investment Portfolio Composition⁽¹⁾

(\$ in millions)							
	LIBOR Based ARM Loans		CMT Based ARM Loans		Other Indices Based ARM Loans		Fixed-Rate Loans
							Total
2004, Quarter 2	\$ 215.8	\$	41.9	\$	40.8	\$ 1,443.1	\$ 1,741.6
2004, Quarter 3	196.1		38.8		39.5	1,335.8	1,610.2
2004, Quarter 4	176.7		34.5		37.6	1,112.8	1,361.6
2005, Quarter 1	163.7		32.9		34.9	1,069.1	1,300.6
2005, Quarter 2	115.8		23.0		33.0	699.1	870.9

(1) Includes only the principal amount of securitized finance receivables, ARM securities and fixed-rate mortgage securities.

Credit Exposures. The Company invests in non-recourse securitization financing or pass-through securitization structures. Generally these securitization structures use over-collateralization, subordination, third-party guarantees, reserve funds, bond insurance, mortgage pool insurance or any combination of the foregoing as a form of credit enhancement. The Company generally has retained a limited portion of the direct credit risk in these securities. In most instances the Company retained the "first-loss" credit risk on pools of loans that it securitized.

The following table summarizes the aggregate principal amount of securitized finance receivables and securities outstanding; the direct credit exposure retained by the Company (represented by the amount of over-collateralization pledged and subordinated securities owned by the Company), net of the credit reserves and discounts maintained by the Company for such exposure; and the actual credit losses incurred for each year.

The table excludes other forms of credit enhancement from which the Company benefits, and based upon the performance of the underlying loans, may provide additional protection against losses. These additional protections include loss reimbursement guarantees with a remaining balance of \$25.5 million and a remaining deductible aggregating \$0.4 million on \$27.2 million of securitized single-family mortgage loans which are subject to such reimbursement agreements; guarantees aggregating \$19.6 million on \$198.8 million of securitized commercial mortgage loans, whereby losses on such loans would need to exceed the respective guarantee amount before the Company would incur credit losses; and \$54.9 million of securitized single-family mortgage loans which are subject to various mortgage pool insurance policies whereby losses would need to exceed the remaining stop loss of at least 69% on such policies before the Company would incur losses.

Credit Reserves and Actual Credit Losses

(\$ in millions)

	Outstanding Loan Principal Balance	Credit Exposure, Net Of Credit Reserves	Actual Credit Losses	Credit Exposure, Net to Outstanding Loan Balance
2004, Quarter 2	\$ 1,716.1	\$ 48.0	\$ 8.0	2.80%
2004, Quarter 3	1,613.4	39.8	6.5	2.47%
2004, Quarter 4	1,296.5	39.9	4.6	3.08%
2005, Quarter 1	1,245.8	39.4	2.6	3.16%
2005, Quarter 2	828.9	29.0	0.5	3.50%

The following table summarizes commercial mortgage loan delinquencies as a percentage of the outstanding commercial securitized finance receivables balance for those securities in which the Company has retained a portion of the direct credit risk. The delinquencies as a percentage of the outstanding securitized finance receivables balance have decreased to 7.33% at June 30, 2005 from 15.19% at June 30, 2004 primarily due to seventeen commercial loans which became delinquent in 2004. Of these seventeen loans, fourteen were low income housing tax credit ("LIHTC") loans with an aggregate unpaid principal balance of \$70 million which were repaid in full in July and August 2004. The increase in delinquencies from 6.06% at March 31, 2005 to 7.33% at June 30, 2005 resulted from four loans becoming delinquent during the second quarter of 2005, one of which paid off subsequent to June 30, 2005. The Company monitors and evaluates its exposure to credit losses and has established reserves based upon anticipated losses, general economic conditions and trends in the investment portfolio. At June 30, 2005, management believes the level of credit reserves is appropriate for currently existing losses.

Commercial Loan Delinquency Statistics⁽¹⁾⁽²⁾

	30 to 60 days delinquent	60 to 90 days delinquent	90 days and over delinquent ⁽²⁾	Total
2004, Quarter 2	3.69%	4.05%	7.45%	15.19%
2004, Quarter 3	2.82%	0.45%	6.84%	10.11%
2004, Quarter 4	0%	0%	7.96%	7.96%
2005, Quarter 1	0.10%	0.20%	5.76%	6.06%
2005, Quarter 2	0.84%	0.71%	5.78%	7.33%

⁽¹⁾ Excludes other investments and loans held for sale or securitization.

⁽²⁾ Includes foreclosures, repossessions and real estate owned.

General and Administrative Expense. The following table presents a breakdown of general and administrative expense. Included in the first and second quarters of 2005 is an aggregate \$316 thousand of litigation related expense.

(\$ in thousands)

	Servicing	Corporate/Investment Portfolio Management	Total
2004, Quarter 2	\$ 986.8	\$ 1,028.1	\$ 2,014.9
2004, Quarter 3	930.3	916.8	1,847.1
2004, Quarter 4	557.5	859.8	1,417.3
2005, Quarter 1	525.2	966.4	1,491.6
2005, Quarter 2	360.7	1,037.7	1,398.4

RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123 (Revised 2004), Share-Based Payment (FAS 123R). This statement supersedes APB Opinion No. 25 and its related implementation guidance. The statement establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods and services. This statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. The most significant change resulting from this statement is the requirement for public companies to expense employee share-based payments under fair value as originally introduced in SFAS No. 123. This statement is effective for public companies as of the beginning of the first annual reporting period that begins after June 15, 2005, or December 15, 2005 for small business issuers. The Company will adopt this statement effective January 1, 2006. The Company presented the amount that would have been recorded in general and administrative expense for the quarter and six month period ended June 30, 2005 if the Company had adopted the provisions of FAS 123R in Note 11 above.

In June 2004, the FASB issued Emerging Issues Task Force Abstract 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" ("EITF 03-1"). EITF 03-1 provides authoritative guidance regarding determining when an investment is considered impaired and the impairment is other-than-temporary. EITF 03-1 requires that the Company evaluate whether an impairment is other-than-temporary, and, if the impairment is other-than-temporary, recognize an impairment loss equal to the excess of the amortized cost over the estimated fair value of the investment. In September 2004 the FASB delayed the effective date of paragraphs 10-20 of this issue. These paragraphs give guidance on how to evaluate and recognize an impairment loss that is other-than-temporary. The delay does not suspend the requirement to recognize other than temporary impairments as required by existing authoritative literature. On July 5, 2005, the FASB decided not to provide additional guidance on the meaning of other-than-temporary impairment and stated that the proposed FASB Staff Position ("FSP") EITF Issue No. 03-1-a, "Implementation Guidance for the Application of Paragraph 16 of EITF Issue No. 03-1," will be issued as final. The final FSP will supersede EITF 03-1. The Company does not expect the adoption of the FSP, as contained in its current draft form, to have a material effect on our consolidated financial condition, consolidated results of operations, or liquidity.

NON-GAAP INFORMATION ON SECURITIZED FINANCE RECEIVABLES AND NON-RECOURSE SECURITIZATION FINANCING

The Company finances its securitized finance receivables principally through the issuance of non-recourse securitization financing. The Company presents in its condensed consolidated financial statements the securitized finance receivables as assets, and the associated securitization financing as a liability. Because the securitization financing is recourse only to the finance receivables pledged, and is therefore not a general obligation of the Company, the risk to the Company on its investment in securitized finance receivables is limited to its net investment (*i.e.*, the excess of the finance receivables pledged over the non-recourse securitization financing). This excess is often referred to as overcollateralization. The purpose of the information presented in this section is to present the securitized finance receivables on a net investment basis, and to provide estimated fair value information using various assumptions on such net investment. The Company monitors and evaluates the performance of these securitization transactions based on the Company's net investment in such transactions, and believes the tables below will assist the investor in understanding the Company's actual investment in these transactions, the credit risk which the Company has retained on its investments, the performance of these investments, and the estimated fair value of these investments based on the assumptions set forth below.

In the tables below, the "principal balance of net investment" in securitized finance receivables represents the excess of the principal balance of the collateral pledged over the outstanding balance of the associated non-recourse securitization financing owned by third parties. The "amortized cost basis of net investment" is principal balance of net investment plus or minus premiums and discounts and related costs. The Company generally has sold the investment grade classes of the securitization financing to third parties, and has retained the portion of the securitization financing that is below investment grade.

The Company estimates the fair value of its net investment in collateralized bond securities as the present value of the projected cash flow from the collateral, adjusted for the impact of and assumed level of future prepayments and credit losses, less the projected principal and interest due on the bonds owned by third parties. The Company master services the collateral for three of its collateralized bond securities. Structured Asset Securitization Corporation (SASCO) Series 2002-9 is master-serviced by Wells Fargo Bank. CCA One Series 2 and Series 3 are master-serviced by Bank of New York. Monthly payment reports for those securities master-serviced by the Company may be found on the Company's website at www.dynexcapital.com.

Below is a summary at June 30, 2005, by each series of the Company's net investment in securitized finance receivables where the fair value exceeds \$0.5 million. The following tables show the Company's net investment in each of the securities presented below on both a principal balance and amortized cost basis, as those terms are defined above. The accompanying condensed consolidated financial statements of the Company present the securitized finance receivables as an asset, and present the associated securitization financing bond obligation as a liability. In addition, as the securitizations currently included in the Company's investment portfolio contain loans and are not themselves securities, the Company carries those investments at amortized cost. As a result, the table below is not meant to present the Company's investment in securitized finance receivables or the securitization financing in accordance with generally accepted accounting principles applicable to the Company's transactions. See below for a reconciliation of the amounts included in the table to the Company's condensed consolidated financial statements.

(amounts in thousands)

Collateralized Bond Series ⁽¹⁾	Collateral Type	Principal Balance of Securitized Finance Receivables Pledged	Principal Balance of Securitization Financing Outstanding to Third Parties	Principal Balance of Net Investment	Amortized Cost Basis of Net Investment
SASCO 2002-9 ⁽²⁾	Single family loans	\$ 195,942	\$ 165,743	\$ 30,199	\$ 33,817
MCA One Series 1	Commercial mortgage loans	66,531	61,806	4,725	1,120
CCA One Series 2	Commercial mortgage loans	212,731	190,627	22,104	13,614
CCA One Series 3	Commercial mortgage loans	338,019	298,059	39,960	46,412
		\$ 813,223	\$ 716,235	\$ 96,988	\$ 94,963

⁽¹⁾ MCA stands for Multifamily Capital Access One, Inc. (now known as Commercial Capital Access One, Inc.); and CCA stands for Commercial Capital Access One, Inc. Each such entity is a wholly-owned limited purpose subsidiary of the Company. SASCO stands for Structured Asset Securitization Corporation.

⁽²⁾ The securitization financing bonds for SASCO 2002-9 were acquired by the Company and recourse repurchase agreement financing was used to finance the acquisition of the bonds. The amounts included in this table represent the principal amount of repurchase agreement financing. The Principal Balance of Net Investment includes the amount of capital invested by the Company in the redemption of the bonds in excess of the repurchase agreement financing.

The following table reconciles the balances presented in the table above with the amounts included for securitized finance receivables and securitization financing in the accompanying consolidated financial statements.

	Securitized Finance Receivables	Securitization Financing
(amounts in thousands)		
Principal balances per the above table	\$ 813,223	\$ 716,235
Principal balance of security excluded from above table	2,250	2,292
Premiums and discounts	(1,560)	2,539
Unrealized gain	37	-
Accrued interest and other	5,852	3,747
Allowance for loan losses	(16,536)	-
Balance per consolidated financial statements	\$ 803,266	\$ 724,813

The following table summarizes the fair value of the Company's net investment in collateralized bond securities, the various assumptions made in estimating value and the cash flow received from such net investment during the six months ended June 30, 2005. As the Company does not present its investment in securitization finance receivables on a net investment basis, the table below is not meant to present the Company's investment in securitized finance receivables or securitization financing in accordance with generally accepted accounting principles applicable to the Company's transactions.

Collateralized Bond Series	Fair Value Assumptions			(\$ in thousands)	
	Weighted-average prepayment speeds	Losses	Projected cash flow Termination date	Fair value of net investment ⁽¹⁾	Cash flows received in 2005, net ⁽²⁾
SASCO 2002-9	28% CPR	0.10% annually	Anticipated call date in 2005	\$ 36,305	\$ 2,434
MCA One Series 1	⁽³⁾	2.5% annually with a 40% loss severity	Anticipated final maturity in 2018	2,828	378
CCA One Series 2	⁽⁴⁾	⁽⁵⁾	Anticipated call date in 2011	12,694	536
CCA One Series 3	⁽⁴⁾	⁽⁵⁾	Anticipated call date in 2009	16,599	201
				\$ 68,426	\$ 3,549

⁽¹⁾ Calculated as the net present value of expected future cash flows, discounted at 16%. Expected cash flows were based on the forward LIBOR curve at June 30, 2005, and incorporate the resetting of the interest rates on the adjustable rate assets to a level consistent with projected prevailing rates. Increases or decreases in interest rates and index levels from those used would impact the calculation of fair value, as would differences in actual prepayment speeds and credit losses versus the assumptions set forth above. Fair value excludes any potential value associated with the Company's right to redeem the bonds on the call date.

⁽²⁾ Cash flows received by the Company during the six months ended June 30, 2005, equal to the excess of the cash flows received on the collateral pledged, over the cash flow requirements of the collateralized bond security.

⁽³⁾ Computed at 0% CPR until maturity.

⁽⁴⁾ Computed at 0% CPR until the respective call date.

⁽⁵⁾ Assumes loans that are 60+ days delinquent liquidate within 6 months at loss severity rates ranging from 20% - 40%. A loss rate of 0.80% per annum over the remaining life of each Series is assumed for all other loans.

The above tables illustrate the Company's estimated fair value of its net investment in certain collateralized bond securities. In its consolidated financial statements, the Company carries its investments at amortized cost. Including the recorded allowance for loan losses of \$16.5 million, the Company's net investment in collateralized bond securities at June 30, 2005 was approximately \$78.4 million. This amount compares to an estimated fair value, utilizing a discount rate of 16%, of approximately \$68.4 million, as set forth in the table above. The difference between the \$78.4 million in net investment as included in the consolidated financial statements and the \$68.4 million of estimated fair value is due to the difference between the estimated fair value of such net investment and amortized cost.

The following table compares the fair value of these investments at various discount rates, but otherwise using the same assumptions as set forth for the two immediately preceding tables:

<u>Fair Value of Net Investment</u>							
Collateralized Bond Series		12%		16%		20%	25%
SASCO 2002-9	\$	37,930	\$	36,305	\$	34,953	\$ 33,556
MCA One Series 1		3,371		2,828		2,397	1,977
CCA One Series 2		15,048		12,694		10,781	8,878
CCA One Series 3		18,806		16,599		14,683	12,637
	\$	75,155	\$	68,426	\$	62,814	\$ 57,048

LIQUIDITY AND CAPITAL RESOURCES

The Company has historically financed its operations from a variety of sources. The Company's primary source today of funding its operations is principally the cash flow generated from the investment portfolio, which includes net interest income and principal payments and prepayments on these investments. From the cash flow on its investment portfolio, the Company funds its operating overhead costs, including the servicing of its delinquent property tax receivables, repays any remaining recourse debt, and makes additional investments. Coupled with its existing available cash resources, the Company believes that this source is sufficient to fund its short and long-term operational needs. In addition, while the Company was actively originating loans or accumulating assets for its investment portfolio, the Company funded these operations through short-term warehouse lines of credit with commercial and investment banks, repurchase agreements and the capital markets via the asset-backed securities market (which provides long-term non-recourse funding of the investment portfolio via the issuance of non-recourse securitization financing). Should the Company's future operations require access to sources of capital such as lines of credit and repurchase agreements, the Company believes that it would be able to access such sources.

The Company's cash flow from its investment portfolio is subject to fluctuation due to changes in interest rates, repayment rates and default rates and related losses. The Company currently has a substantial portion of its available capital invested in cash or highly, liquid, short-term instruments. At June 30, 2005, this amount was \$63 million, or more than half the Company's overall equity capital base. The Company intends to maintain excessive levels of liquidity for at least the next six months given the lack of compelling reinvestment opportunities as a result of the absolute low level of interest rates, the flat yield curve, and the historically tight spreads on fixed income instruments.

Securitization financing. Dynex, through limited-purpose finance subsidiaries, has issued non-recourse debt in the form of non-recourse securitization financing to fund the majority of its investment portfolio. The obligations under the securitization financing are payable solely from the securitized finance receivables and are otherwise non-recourse to the Company. The maturity of each class of securitization financing is directly affected by the rate of principal prepayments on the related collateral and is not subject to margin call risk. Each series is also subject to redemption according to specific terms of the respective indentures, generally on the earlier of a specified date or when the remaining balance of the bonds equals 35% or less of the original principal balance of the bonds. At June 30, 2005, Dynex had \$559.1 million of non-recourse securitization financing outstanding. Approximately \$553 million of the non-recourse securitization financing carries a fixed rate of interest, and approximately \$166 million carries a rate of interest, which adjusts monthly based on One-Month LIBOR.

FORWARD-LOOKING STATEMENTS

Certain written statements in this Form 10-Q made by the Company that are not historical fact constitute "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements contained in this Item as well as those discussed elsewhere in this Report addressing the results of operations, our operating performance, events, or developments that we expect or anticipate will occur in the future, including statements relating to investment strategies, net interest income growth, earnings or earnings per share growth, and market share, as well as statements expressing optimism or pessimism about future operating results, are forward-looking statements. The forward-looking statements are based upon management's views and assumptions as of the date of this Report, regarding future events and operating performance and are applicable only as of the dates of such statements. Such forward-looking statements may involve factors that could cause the actual results of the Company to differ materially from historical results or from any results expressed or implied by such forward-looking statements. The Company cautions the public not to place undue reliance on forward-looking statements, which may be based on assumptions and anticipated events that do not materialize.

Factors that may cause actual results to differ from historical results or from any results expressed or implied by forward-looking statements include the following:

Reinvestment Risk. The Company currently has no specific long-term reinvestment strategy. The Company continues to evaluate opportunities for the reinvestment of its capital, some of which are not typical investments for a REIT. The Company has an appreciable amount of its capital invested in cash equivalents and short-term high quality investments. Given the current low interest rate environment and the relatively flat yield curve, as measured by the difference between the yields on the two-year U.S. Treasury Note and the ten-year U.S. Treasury Bond, opportunities to reinvest capital at acceptable rates of return may not be available for an extended period of time.

Investment Portfolio Cash Flow. Cash flows from the investment portfolio fund the Company's operations and repayments of outstanding debt, and are subject to fluctuation due to changes in interest rates, repayment rates and default rates and related losses. Cash flows from the investment portfolio are likely to sequentially decline until the Company meaningfully begins to reinvest its capital. There can be no assurances that the Company will be able to find suitable investment alternatives for its capital, nor can there be assurances that the Company will meet its reinvestment and return hurdles.

Defaults. Defaults by borrowers on loans securitized by the Company may have an adverse impact on the Company's financial performance, if actual credit losses differ materially from estimates made by the Company or exceed reserves for losses recorded in the financial statements. The allowance for loan losses is calculated on the basis of historical experience and management's best estimates. Actual default rates or loss severity may differ from the Company's estimate as a result of economic conditions. Actual defaults on adjustable-rate mortgage loans may increase during a rising interest rate environment. In addition, commercial mortgage loans are generally large dollar balance loans, and a significant loan default may have an adverse impact on the Company's financial results.

Economic Conditions. The Company is affected by general economic conditions. An increase in the risk of defaults and credit risk resulting from an economic slowdown or recession or other factors could result in a decrease in the value of the Company's investments and the over-collateralization associated with its securitization transactions. These changes could have an effect on the Company's financial performance and the performance on the Company's securitized loan pools. As a result of the Company being heavily invested in short-term high quality investments, a worsening economy may potentially benefit the Company by creating opportunities for the Company to invest in assets that become distressed as a result of the worsening conditions or, if in response to these conditions, the Federal Reserve begins to lower the Federal Funds Rate and the yield curve steepens.

Third-party Servicers. Third-party servicers service the majority of the Company's investment portfolio. To the extent that these servicers are financially impaired, the performance of the Company's investment portfolio may deteriorate, and defaults and credit losses may be greater than estimated. In addition, third-party servicers are generally obligated to advance scheduled principal and interest on a loan if such loan is securitized, and to the extent the third-party servicer fails to make this advance, the Company may be required to make the advance. The actual credit losses experienced by the Company are in large part influenced by the quality of servicing by these third-party servicers.

Prepayments. Prepayments by borrowers on loans securitized by the Company may have an adverse impact on the Company's financial performance. Prepayments are expected to increase during a declining interest rate or flat yield curve environment. The Company's exposure to rapid prepayments is primarily (i) the faster amortization of premium on the investments and, to the extent applicable, amortization of bond discount, and (ii) the replacement of investments in its portfolio with lower yielding investments.

Interest Rate Fluctuations. The Company's income and cash flow depends on its ability to earn greater interest on its investments than the interest cost to finance these investments. Interest rates in the markets served by the Company generally rise or fall with interest rates as a whole. A majority of the Company's investments, including loans and securities currently pledged as securitized finance receivables and securities, are fixed-rate. The Company currently finances these fixed-rate assets through non-recourse securitization financing and repurchase agreements, approximately \$62 million of which is variable rate and resets monthly. Financing fixed-rate assets with variable-rate bonds exposes the Company to reductions in income and cash flow in a period of rising interest rates. In addition, a portion of the investments held by the Company are adjustable-rate securitized finance receivables. These investments are financed through non-recourse long-term securitization financing and recourse repurchase agreements, which reset monthly. The net interest spread for these investments could decrease during a period of rapidly rising short-term interest rates, since the investments generally have interest rates which reset on a delayed basis and have periodic interest rate caps; the related borrowing has no delayed resets or such interest rate caps.

Competition. The financial services industry is a highly competitive market in which we compete with a number of institutions with greater financial resources. In purchasing portfolio investments and in issuing securities, we compete with other mortgage REITs, investment banking firms, savings and loan associations, commercial banks, mortgage bankers, insurance companies, federal agencies and other entities, many of which have greater financial resources and a lower cost of capital than we do. Increased competition in the market and our competitors greater financial resources have adversely affected the Company, and may continue to do so. Competition may also continue to keep pressure on spreads resulting in the Company being unable to reinvest its capital at a satisfactory risk-adjusted basis.

Regulatory Changes. The Company's businesses as of and for the quarter ended June 30, 2005 were not subject to any material federal or state regulation or licensing requirements. However, changes in existing laws and regulations or in the interpretation thereof, or the introduction of new laws and regulations, could adversely affect the Company and the performance of the Company's securitized loan pools or its ability to collect on its delinquent property tax receivables. The Company is a REIT and is required to meet certain tests in order to maintain its REIT status as described in the discussion of "Federal Income Tax Considerations" in its Annual Report on Form 10-K for the year ended December 31, 2004. If the Company should fail to maintain its REIT status, it would not be able to hold certain investments and would be subject to income taxes.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk generally represents the risk of loss that may result from the potential change in the value of a financial instrument due to fluctuations in interest and foreign exchange rates and in equity and commodity prices. Market risk is inherent to both derivative and non-derivative financial instruments. Accordingly, the scope of the Company's market risk management extends beyond derivatives to include all market risk sensitive financial instruments. As a financial services company, net interest margin comprises the primary component of the Company's earnings. Additionally, cash flow from the investment portfolio represents the primary component of the Company's incoming cash flow. The Company is subject to risk resulting from interest rate fluctuations to the extent that there is a gap between the amount of the Company's interest-earning assets and the amount of interest-bearing liabilities that are prepaid, mature or re-price within specified periods. While certain investments may perform poorly in an increasing or decreasing interest rate environment, other investments may perform well, and others may not be impacted at all.

The Company focuses on the sensitivity of its cash flow, and measures such sensitivity to changes in interest rates. Changes in interest rates are defined as instantaneous, parallel, and sustained interest rate movements in 100 basis point increments. The Company estimates its net interest margin cash flow for the next twenty-four months assuming interest rates follow the forward LIBOR curve (based on ninety-day Eurodollar futures contracts) at June 30, 2005. Once the base case has been estimated, cash flows are projected for each of the defined interest rate scenarios. Those scenario results are then compared against the base case to determine the estimated change to cash flow.

The following table summarizes the Company's net interest margin cash flow sensitivity analysis at June 30, 2005. This analysis represents management's estimate of the percentage change in net interest margin cash flow given a shift in interest rates, as discussed above. Other investments are excluded from this analysis because they are not interest rate sensitive. The "Base" case represents the interest rate environment as it existed at June 30, 2005. At June 30, 2005, one-month LIBOR was 3.34% and six-month LIBOR was 3.71%. The analysis is heavily dependent upon the assumptions used in the model. The effect of changes in future interest rates, the shape of the yield curve or the mix of assets and liabilities may cause actual results to differ significantly from the modeled results. In addition, certain financial instruments provide a degree of "optionality." The most significant option affecting the Company's portfolio is the borrowers' option to prepay the loans. The model applies prepayment rate assumptions representing management's estimate of prepayment activity on a projected basis for each collateral pool in the investment portfolio. The model applies the same prepayment rate assumptions for all five cases indicated below. The extent to which borrowers utilize the ability to exercise their option may cause actual results to significantly differ from the analysis. Furthermore, the projected results assume no additions or subtractions to the Company's portfolio, and no change to the Company's liability structure. Historically, there have been significant changes in the Company's assets and liabilities, and there are likely to be such changes in the future.

Basis Point Increase (Decrease) in Interest Rates	Projected Change in Net Interest Margin Cash Flow From Base Case	Projected Change in Value, Expressed as a Percentage of Shareholders' Equity
+200	(18.7)%	(2.4)%
+100	(8.0)%	(1.0)%
Base	-	-
-100	4.1%	0.6%
-200	8.3%	1.1%

The Company's interest rate rise is related both to the rate of change in short-term interest rates and to the level of short-term interest rates. Approximately \$172 million of the Company's investment portfolio as of June 30, 2005 is comprised of loans or securities that have coupon rates which adjust over time (subject to certain periodic and lifetime limitations) in conjunction with changes in short-term interest rates. Approximately 66% and 13% of the adjustable rate loans underlying the Company's adjustable rate securities and securitized finance receivables are indexed to and reset based upon the level of six-month LIBOR and one-year CMT, respectively.

Generally, during a period of rising short-term interest rates, the Company's net interest spread earned on its investment portfolio will decrease. The decrease of the net interest spread results from (i) the lag in resets of the adjustable rate loans underlying the adjustable rate securities and securitized finance receivables relative to the rate resets on the associated borrowings and (ii) rate resets on the adjustable rate loans which are generally limited to 1% every six months or 2% every twelve months and subject to lifetime caps, while the associated borrowings have no such limitation. As to item (i), the Company has substantially limited its interest rate risk on such investments through (a) the issuance of fixed-rate non-recourse securitization financing which approximated \$552.8 million as of June 30, 2005, and (b) equity, which was \$152.9 million at June 30, 2005. As to item (ii), as short-term interest rates stabilize and the ARM loans reset, the net interest margin may be partially restored as the yields on the ARM loans adjust to market conditions. The remaining portion of the Company's investment portfolio as of June 30, 2005, approximately \$700 million, is comprised of loans or securities that have coupon rates that are fixed.

Item 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures.

Disclosure controls and procedures are controls and other procedures that are designed to ensure that information required to be disclosed in the Company's reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the Company's reports filed under the Exchange Act is accumulated and communicated to management, including the Company's management, as appropriate, to allow timely decisions regarding required disclosures.

As of the end of the period covered by this report, the Company carried out an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Rule 13a-15 under the Exchange Act. This evaluation was carried out under the supervision and with the participation of the Company's management, including the Company's Principal Executive Officer and Chief Financial Officer. Based upon that evaluation, the Company's management concluded that the Company's disclosure controls and procedures were effective.

In conducting its review of disclosure controls, management concluded that sufficient disclosure controls and procedures did exist to ensure that information required to be disclosed in the Company's reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

(b) Changes in internal controls.

The Company's management is also responsible for establishing and maintaining adequate internal control over financial reporting. There were no changes in the Company's internal controls or in other factors during the quarter covered by this report that could materially affect, or are reasonably likely to materially affect the Company's internal controls subsequent to the Evaluation Date, nor any significant deficiencies or material weaknesses in such internal controls requiring corrective actions.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

GLS Capital, Inc. ("GLS"), a subsidiary of the Company, and the County of Allegheny, Pennsylvania ("Allegheny County"), were defendants in a lawsuit in the Commonwealth Court of Pennsylvania (the "Commonwealth Court"), the appellate court of the state of Pennsylvania. Plaintiffs were two local businesses seeking status to represent as a class delinquent taxpayers in Allegheny County whose delinquent tax liens had been assigned to GLS. Plaintiffs challenged the right of Allegheny County and GLS to collect certain interest, costs and expenses related to delinquent property tax receivables in Allegheny County, and whether the County had the right to assign the delinquent property tax receivables to GLS and therefore employ procedures for collection enjoyed by Allegheny County under state statute. This lawsuit was related to the purchase by GLS of delinquent property tax receivables from Allegheny County in 1997, 1998, and 1999. In July 2001, the Commonwealth Court issued a ruling that addressed, among other things, (i) the right of GLS to charge to the delinquent taxpayer a rate of interest of 12% per annum versus 10% per annum on the collection of its delinquent property tax receivables, (ii) the charging of a full month's interest on a partial month's delinquency; (iii) the charging of attorney's fees to the delinquent taxpayer for the collection of such tax receivables, and (iv) the charging to the delinquent taxpayer of certain other fees and costs. The Commonwealth Court in its opinion remanded for further consideration to the lower trial court items (i), (ii) and (iv) above, and ruled that neither Allegheny County nor GLS had the right to charge attorney's fees to the delinquent taxpayer related to the collection of such tax receivables. The Commonwealth Court further ruled that Allegheny County could assign its rights in the delinquent property tax receivables to GLS, and that plaintiffs could maintain equitable class in the action. In October 2001, GLS, along with Allegheny County, filed an Application for Extraordinary Jurisdiction with the Supreme Court of Pennsylvania, Western District appealing certain aspects of the Commonwealth Court's ruling. In March 2003, the Supreme Court issued its opinion as follows: (i) the Supreme Court determined that GLS can charge delinquent taxpayers a rate of 12% per annum; (ii) the Supreme Court remanded back to the lower trial court the charging of a full month's interest on a partial month's delinquency; (iii) the Supreme Court revised the Commonwealth Court's ruling regarding recouping attorney fees for collection of the receivables indicating that the recoupment of fees requires a judicial review of collection procedures used in each case; and (iv) the Supreme Court upheld the Commonwealth Court's ruling that GLS can charge certain fees and costs, while remanding back to the lower trial court for consideration the facts of each individual case. Finally, the Supreme Court, in March 2003, remanded to the lower trial court to determine if the remaining claims can be resolved as a class action. In August 2003, the Pennsylvania legislature enacted a law amending and clarifying certain provisions of the Pennsylvania statute governing GLS' right to the collection of certain interest, costs and expenses. The law is retroactive to 1996, and amends and clarifies that as to items (ii), (iii) and (iv) noted above by the Supreme Court, that GLS can charge a full month's interest on a partial month's delinquency, that GLS can charge the taxpayer for legal fees, and that GLS can charge certain fees and costs to the taxpayer at redemption. Subsequent to the enactment of the law, challenges to the retroactivity provisions of the law were filed in separate cases, which did not include GLS as a defendant. In September 2004, the Trial Court in that litigation upheld the retroactive provisions enacted in 2003. Plaintiffs have appealed in that case. The lower trial court had reset the hearing on the class-action status for June 2005, but the hearing was delayed until no earlier than September 2005. We believe that the ultimate outcome of this litigation will not have a material impact on our financial condition, but may have a material impact on reported results for the particular period presented.

The Company and Dynex Commercial, Inc. ("DCI"), formerly an affiliate of the Company and now known as DCI Commercial, Inc., were defendants in state court in Dallas County, Texas in the matter of Basic Capital Management et al (collectively, "BCM" or "the Plaintiffs") versus Dynex Commercial, Inc. et al. The suit was filed in April 1999 originally against DCI, and in March 2000, BCM amended the complaint and added the Company as a defendant. The complaint, which was further amended during pretrial proceedings, alleged that, among other things, DCI and the Company failed to fund tenant improvement or other advances allegedly required on various loans made by DCI to BCM, which loans were subsequently acquired by the Company; that DCI breached an alleged \$160 million "master" loan commitment entered into in February 1998; and that DCI breached another alleged loan commitment of approximately \$9 million. The trial commenced in January 2004 and in February 2004, the jury in the case rendered a verdict in favor of one of the plaintiffs and against the Company on the alleged breach of the loan agreements for tenant improvements and awarded that plaintiff damages in the amount of \$0.3 million. The jury also awarded the Plaintiffs' attorneys fees in the amount of \$2.1 million. The jury entered a separate verdict against DCI in favor of BCM under two mutually exclusive damage models, for \$2.2 million and \$25.6 million, respectively. The jury found in favor of DCI on the alleged \$9 million loan commitment, but did not find in favor of DCI for counterclaims made against BCM. After considering post-trial motions, the presiding judge entered judgment in favor of the Company and DCI, effectively overturning the verdicts of the jury and dismissing damages awarded by the jury. Plaintiffs have filed an appeal with the Court of Appeals for the Fifth Judicial District of Texas at Dallas. DCI is a former affiliate of the Company, and the Company believes that it will have no obligation for amounts, if any, awarded to the plaintiffs as a result of the actions of DCI. Various briefs have been filed in the litigation, and the Company expects the appeal will be heard by the end of 2005.

On February 11, 2005, a putative class action complaint alleging violations of the federal securities laws and various state common law claims was filed against the Company, our subsidiary MERIT Securities Corporation, Stephen J. Benedetti, the Company's Executive Vice President, and Thomas H. Potts, the Company's former President and a former Director, in United States District Court for the Southern District of New York ("District Court") by the Teamsters Local 445 Freight Division Pension Fund ("Teamsters"). The lawsuit purported to be a class action on behalf of purchasers of MERIT Series 13 securitization financing bonds, which are collateralized by manufactured housing loans. On May 31, 2005, the Teamsters filed an amended class action complaint. The amended complaint dropped all state common law claims but added federal securities claims related to the MERIT Series 12 securitization financing bonds. The Company filed a motion to dismiss the amended complaint on July 15, 2005 to which Teamsters filed a response with the District Court on August 15, 2005. The Company has evaluated the allegations and believes them to be without merit and intends to vigorously defend itself against them.

Although no assurance can be given with respect to the ultimate outcome of the above litigation, the Company believes the resolution of these lawsuits will not have a material effect on our consolidated balance sheet but could materially affect our consolidated results of operations in a given year.

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

None

Item 3. Defaults Upon Senior Securities

None

Item 4. Submission of Matters to a Vote of Security Holders

On June 14, 2005, the Annual Meeting of shareholders was held to elect the members of the Board of Directors. The following table summarizes the results of those votes.

Director	For	Withheld
<u>Common Share Votes</u>		
Thomas B. Akin	11,673,825	94,063
J. Sidney Davenport	11,530,891	236,997
Daniel K. Osborne	11,575,775	192,113
Eric P. Von der Porten	11,672,232	95,656
<u>Preferred Share Votes</u>		
Leon A. Felman	5,438,608	48,056
Barry Igdaloff	5,438,608	48,056

Item 5. Other Information

None

Item 6. Exhibits

10.1	Purchase Agreement Dated May 9, 2005 (portions of this exhibit have been omitted pursuant to a request for confidential treatment)
10.2	Form of Stock Option Agreement for Non-Employee Directors under the Dynex Capital, Inc. 2004 Stock Incentive Plan.
10.3	Form of Stock Appreciation Rights Agreement for Senior Executives under the Dynex Capital, Inc. 2004 Stock Incentive Plan.
31.1	Certification of Principal Executive Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Principal Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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.

DYNEX CAPITAL, INC.

Dated: August 22, 2005

By: /s/ Stephen J. Benedetti

Stephen J. Benedetti

Executive Vice President

(authorized officer of registrant, principal accounting officer)

EXHIBIT INDEX**Exhibit No.**

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CONFIDENTIAL TREATMENT REQUESTED

Confidential material has been separately filed with the Securities and Exchange Commission under an application for confidential treatment. Terms for which confidential treatment has been requested have been omitted and marked with an asterisk [*].

PURCHASE AGREEMENT
Dated as of May 9, 2005

HIGHLAND UNDERTAKINGS, LLC

DYNEX CAPITAL, INC.,
MSC I, L.P.,
MERIT SECURITIES CORPORATION
and
ISSUED HOLDINGS CAPITAL CORPORATION,

PURCHASE OF
THE OUTSTANDING CAPITAL STOCK OF
ISSUER HOLDING CORP.
and
CERTAIN ASSETS OF
MSC I, L.P.
and
MERIT SECURITIES CORPORATION

PURCHASE AGREEMENT

This PURCHASE AGREEMENT (the "Agreement") is made as of May 9, 2005 among HIGHLAND UNDERTAKINGS, LLC, a Nevis limited liability company (together with its successors and assigns, "Highland"), DYNEX CAPITAL, INC., a Virginia corporation (together with its successors and assigns, "Dynex"), MSC I, L.P., a Virginia limited partnership (together with its successors and assigns, "MSC"), MERIT SECURITIES CORPORATION, a Virginia corporation (together with its successors and assigns, "MERIT"), and ISSUED HOLDINGS CAPITAL CORPORATION, a Virginia corporation (together with its successors and assigns, "IH Capital").

RECITALS

WHEREAS, Dynex desires to sell to Highland, and Highland desires to purchase from Dynex, in each case on the terms and conditions set forth in this Agreement, all of the issued and outstanding capital stock of Issuer Holding Corp., a Virginia corporation (together with its successors and assigns, "IHC");

WHEREAS, MSC desires to sell to IHC, and Highland desires to cause IHC to purchase from MSC, in each case immediately after the sale of all of the issued and outstanding capital stock of IHC by Dynex to Highland and on the terms and conditions set forth in this Agreement, the Class B-3 Bonds (as defined below);

WHEREAS, MERIT desires to sell to IHC, and Highland desires to cause IHC to purchase from MERIT, in each case immediately after the sale of all of the issued and outstanding capital stock of IHC by Dynex to Highland and on the terms and conditions set forth in this Agreement, the Redemption Rights (as defined below); and

WHEREAS, IH Capital desires to enter into with IHC, and Highland desires to cause IHC to enter into with IH Capital, in each case as soon as practicable after the sale of all of the issued and outstanding capital stock of IHC by Dynex to Highland and on the terms and conditions set forth in this Agreement, the Derivative Transaction (as defined below);

NOW, THEREFORE, in consideration of the mutual covenants and agreements set forth in this Agreement, and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties agree as follows:

ARTICLE ONE
DEFINITIONS AND USAGE

- -

Section 1.1 Definitions. For purposes of this Agreement, the following terms have the respective meanings set forth below:

"Affiliate" means, with respect to any Person, any other Person directly or indirectly controlling, controlled by or under direct or indirect common control with the first Person or any Subsidiary of the first Person; provided, however, that a Person shall be deemed to control another Person if the controlling Person owns 51% or more of any class of voting securities of the controlled Person or possesses, directly or indirectly, the power to direct or cause the direction of the management or policies of the controlled Person, whether through ownership of stock, by contract or otherwise.

"Available Surplus" means (i) all amounts, if any, able to be released to MERIT from the surplus account for the Series 11 Bonds pursuant to Section 7(i) of the Series 11 Supplement and (ii) all amounts, if any, able to be withdrawn by MERIT from the surplus account for the Series 12-1 Bonds pursuant to Section 12.07(d) of the Base Indenture.

"Available Surplus Documents" means the documents identified on Schedule 1.1A.

"Base Indenture" means the Indenture dated as of November 1, 1994, as amended, between MERIT and the Trustee.

"Business Day" means any day except Saturday, Sunday or any other day on which commercial banks located in Richmond, Virginia or Delray Beach, Florida are authorized by law to be closed for business.

"Class Action Lawsuit" means the securities class action lawsuit filed in the United States District Court for the Southern District of New York by Teamsters Local 445 Freight Division Pension Fund against Dynex and certain other defendants named therein, as such lawsuit may be amended from time to time.

"Class B-3 Bond Documents" means the documents identified on Schedule 1.1B.

"Class B-3 Bonds" means the MERIT Securities Corporation Collateralized Bonds, Series 11, Class B-3, due September 28, 2032 issued on May 28, 1998 with an aggregate initial principal balance of \$20,000,000 (certain of the terms of which were amended pursuant to Supplemental Indenture No. 2 to the Series 11 Supplement) owned by MSC.

"Class B-3 Bond Assignments" means the First Bond Assignment and the Second Bond Assignment.

"Class B-3 Bonds Purchase Price" has the meaning set forth in Section 3.4.

"Closing Date" has the meaning set forth in Section 2.1.

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"Code" means the Internal Revenue Code of 1986.

"Consent" means any approval, consent, ratification, waiver or other authorization.

"Contemplated Transactions" means the transactions contemplated by this Agreement.

"Contract" means any agreement, contract, obligation, promise or undertaking (whether written or oral and whether express or implied) that is legally binding.

"Damages" has the meaning set forth in Section 14.2.

"Derivative Payment Agreement" means an Agreement among IH Capital, Dynex and IHC (Post-Sale) substantially in the form of Exhibit 1.1D.

"Derivative Transaction" means the transaction contemplated by the Derivative Payment Agreement.

"Dynex" has the meaning set forth in the preamble to this Agreement.

"Dynex Closing Documents" means the IHC Stock Endorsement Certificate, the documents described in Sections 2.4(iv) and (v) and each other agreement to be executed or delivered by Dynex at the First Closing.

"Dynex Company" means each of Dynex, IH Capital, MSC and MERIT.

"Dynex Indemnified Persons" has the meaning set forth in Section 14.3.

"Escrow Agent" means a financial institution reasonably acceptable to IH Capital and Highland.

"Event of Default" means (i) an Event of Default with respect to the Public Bonds (as such terms are defined in the Series 11 Supplement), (ii) an Event of Default with respect to the Private Bonds (as such terms are defined in the Series 11 Supplement) or (iii) an Event of Default with respect to the Bonds (as such terms are defined in the Series 12-1 Supplement).

"Exchange Act" means the Securities Exchange Act of 1934.

"Financial Statements" has the meaning set forth in Section 5.10.

"First Bond Assignment" means an Assignment substantially in the form of Exhibit 1.1B.

"First Closing" has the meaning set forth in Section 2.1.

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"GAAP" means United States generally accepted accounting principles applied on a consistent basis.

"Governmental Authorization" means any Consent, license, registration or permit issued, granted, given or otherwise made available by or under the authority of any Governmental Body.

"Governmental Body" means any (i) nation, state, county, city, town, borough, village, district or other jurisdiction, (ii) federal, state, local, municipal, foreign or other government, (iii) governmental or quasi-governmental authority of any nature (including any agency, branch, department, board, commission, court, tribunal or other entity exercising governmental or quasi-governmental powers), (iv) multinational organization or body, (v) body exercising, or entitled or purporting to exercise, any administrative, executive, judicial, legislative, police, regulatory or taxing authority or power or (vi) official of any of the foregoing.

"Highland" has the meaning set forth in the preamble to this Agreement.

"Highland Indemnified Persons" has the meaning set forth in Section 14.2.

"IH Capital" has the meaning set forth in the preamble to this Agreement.

"IH Capital Closing Documents" means the Derivative Payment Agreement and each other agreement to be executed or delivered by IH Capital at the Third Closing.

"IHC" has the meaning set forth in the recitals to this Agreement.

"IHC (Post-Sale)" means IHC after giving effect to the sale of the IHC Stock by Dynex to Highland pursuant to this Agreement.

"IHC Stock" means all of the issued and outstanding capital stock of IHC.

"IHC Stock Endorsement Certificate" means an Endorsement Certificate substantially in the form of Exhibit 1.1A.

"IHC Stock Purchase Price" has the meaning set forth in Section 2.3.

"Indemnified Person" has the meaning set forth in Section 14.4(a).

"Indemnifying Person" has the meaning set forth in Section 14.4(a).

"Knowledge" means, with respect to any Dynex Company, (i) the actual knowledge, after due inquiry, of any of the executive officers, the chief accounting officer or the chief legal officer of such Dynex Company and (ii) knowledge of any other fact or circumstance that would have or should have come to the attention of any of the individuals identified in

clause (i) in the course of discharging his or her duties in a reasonable and prudent manner consistent with sound business practices.

"Legal Requirement" means any federal, state, local, municipal, foreign, international, multinational or other constitution, law, ordinance, principle of common law, code, regulation, rule, Order, Governmental Authorization, statute or treaty.

"Liability" means, with respect to any Person, any liability or obligation of such Person of any kind, character or description, whether known or unknown, absolute or contingent, accrued or unaccrued, disputed or undisputed, liquidated or unliquidated, secured or unsecured, joint or several, due or to become due, vested or unvested, executory, determined, determinable or otherwise, and whether or not the same is required to be accrued on the financial statements of such Person.

"Lien" means, with respect to any asset, any lien, pledge, charge, security interest, or other encumbrance of any kind in respect of that asset, including, in the case of any security or other equity interest, any right of first refusal or any restriction on voting, transfer, the receipt of income or the exercise of any other attribute of ownership.

"Material" means (i) with respect to any event, condition, statement or other circumstance of similar import applicable to any Dynex Company, a material adverse effect on the validity, value or existence of IHC, the IHC Stock, the Class B-3 Bonds, the Redemption Rights or the Available Surplus or on the ability of such Dynex Company to consummate the Contemplated Transactions, and (ii) with respect to any event, condition, statement or other circumstance of similar import applicable to Highland, a material adverse effect on the ability of Highland to consummate the Contemplated Transactions.

"MERIT" has the meaning set forth in the preamble to this Agreement.

"MERIT Closing Documents" means the Redemption Rights Agreement and each other agreement to be executed or delivered by MERIT at the Second Closing.

"MSC" has the meaning set forth in the preamble to this Agreement.

"MSC Closing Documents" means the Class B-3 Bond Assignments and each other agreement to be executed or delivered by MSC at the Second Closing or the Third Closing.

"Order" means any order, injunction, judgment, decree, ruling, assessment or arbitration award of any Governmental Body or arbitrator.

"Person" means (i) an individual or (ii) an entity, including a corporation (either non-profit or other), partnership (either limited or general), joint venture, limited liability company, trust, estate or other unincorporated association, whether or not a legal entity.

"Proceeding" means any action, arbitration, audit, hearing, investigation, litigation or suit (whether civil, criminal, administrative, judicial or investigative, whether formal or

informal, whether public or private) commenced, brought, conducted or heard by or before, or otherwise involving, any Governmental Body or arbitrator.

"Redemption Rights" means the Series 11 Redemption Rights and the Series 12-1 Redemption Rights.

"Redemption Rights Agreement" means an Agreement between MERIT and IHC (Post-Sale) substantially in the form of Exhibit 1.1C.

"Redemption Rights Documents" means the documents identified on Schedule 1.1C.

"Redemption Rights Purchase Price" has the meaning set forth in Section 3.4.

"Representative" means, with respect to any Person, any director, officer, manager, employee, agent, consultant, advisor, accountant, financial advisor, legal counsel or other representative of that Person.

"Second Bond Assignment" means an Assignment substantially in the form of Exhibit 1.1E.

"Second Closing" has the meaning set forth in Section 3.1.

"Series 11 Bonds" means the MERIT Securities Corporation Collateralized Bonds, Series 11.

"Series 11 Redemption Rights" means MERIT's right to redeem one or more classes of the Series 11 Bonds outstanding as of the date of this Agreement pursuant to Section 9 of the Series 11 Supplement, including, without limitation, MERIT's right to cause any such redeemed bonds to remain outstanding (it being understood that MERIT has the right to redeem only those Series 11 Bonds identified on Schedule 1.1D).

"Series 11 Supplement" means the Series 11 Supplement dated as of May 1, 1998 to the Base Indenture between MERIT, as Issuer, and the Trustee, as further supplemented by (i) Supplemental Indenture No. 1 dated as of April 1, 2000 between MERIT, as Issuer, and the Trustee and (ii) Supplemental Indenture No. 2 dated as of July 1, 2001 between MERIT, as Issuer, and the Trustee.

"Series 12-1 Bonds" means the MERIT Securities Corporation Collateralized Bonds, Series 12-1.

"Series 12-1 Redemption Rights" means MERIT's right to redeem one or more classes of the Series 12-1 Bonds outstanding as of the date of this Agreement pursuant to Section 9 of the Series 12-1 Supplement, including, without limitation, MERIT's right to cause any such redeemed bonds to remain outstanding (it being understood that MERIT has the right to redeem only those Series 12-1 Bonds identified on Schedule 1.1D).

"Series 12-1 Supplement" means the Series 12-1 Supplement dated as of March 1, 1999 to the Base Indenture between MERIT, as Issuer, and the Trustee.

"Subsidiary" means, with respect to any Person, any other Person of which the first Person owns, directly or indirectly, securities or other interests having the power to elect a majority of the other Person's board of directors or similar governing body or otherwise having the power to direct or cause the direction of the management or policies of the other Person (other than securities or other interests having such power only upon the happening of a contingency that has not occurred).

"Tax" means any income, gross receipts, license, payroll, employment, excise, severance, stamp, occupation, premium, property, environmental, windfall profit, customs, vehicle, airplane, boat, vessel or other title or registration, capital stock, franchise, employees' income withholding, foreign or domestic withholding, social security, unemployment, disability, real property, personal property, sales, use, transfer, value added, alternative, add-on minimum and other tax, fee, assessment, levy, tariff, charge or duty of any kind whatsoever and any interest, penalty, addition or additional amount thereon imposed, assessed or collected by or under the authority of any Governmental Body or payable under any tax-sharing agreement or any other Contract.

"Tax Return" means any return (including any information return), report, statement, schedule, notice, form, declaration, claim for refund or other document or information filed with or submitted to, or required to be filed with or submitted to, any Governmental Body in connection with the determination, assessment, collection or payment of any Tax or in connection with the administration, implementation or enforcement of or compliance with any Legal Requirement relating to any Tax.

"Third Closing" has the meaning set forth in Section 4.1.

"Third Party:" means a Person who is not a party to this Agreement.

"Third-Party Claim" means a claim against an Indemnified Person by a Third Party, whether or not involving a Proceeding.

"Trustee" means JPMorgan Chase Bank, a New York banking corporation (formerly known as The Chase Manhattan Bank and successor by merger to Chase Bank of Texas, National Association (formerly known as Texas Commerce Bank National Association)), as Trustee.

Section 1.2 Interpretation. In this Agreement, unless a clear contrary intention appears:

- (i) any reference to days means calendar days unless otherwise specified, and any day or deadline or end of a time period hereunder which falls on a day other than

a Business Day shall be deemed to refer to the first Business Day following such day or deadline or end of the time period, as the case may be;

(ii) any reference to an article, section, exhibit or schedule means an article or section of, or exhibit or schedule attached to, this Agreement, as the case may be, and all article and section headings are for reference purposes only and shall not affect in any way the meaning or interpretation of this Agreement;

(iii) any reference to any Legal Requirement means such Legal Requirement as amended, modified, codified, replaced or reenacted, in whole or in part, and in effect from time to time, including rules and regulations promulgated thereunder, and any reference to any section or other provision of any Legal Requirement means that provision of such Legal Requirement from time to time in effect and constituting the substantive amendment, modification, codification, replacement or reenactment of such section or other provision;

(iv) the word "including" means without limitation, the word "or" is not exclusive and is used in the inclusive sense of "and/or" and the words "herein", "hereof", "hereby", "hereto" and "hereunder" refer to this Agreement as a whole; and

(v) any reference to any document, instrument or agreement shall be deemed to refer as well to all addenda, exhibits, schedules or amendments thereto, and all words will be construed to be of such gender or number as the circumstances require.

Section 1.3 Accounting Terms And Determinations. Unless otherwise specified herein, all accounting terms used herein shall be interpreted and all accounting determinations hereunder shall be made in accordance with GAAP.

Section 1.4 Legal Representation Of The Parties. This Agreement was negotiated by the parties with the benefit of legal representation, and any rule of construction or interpretation otherwise requiring this Agreement to be construed or interpreted against a party shall not apply to any construction or interpretation hereof.

ARTICLE TWO SALE OF IHC STOCK; FIRST CLOSING

Section 2.1 First Closing. The purchase and sale of the IHC Stock provided for in this Agreement (the "First Closing") will take place (i) at the offices of McGuireWoods LLP, One James Center, 901 East Cary Street, Richmond, Virginia 23219, at 10:30 A.M. (local time) on the later of May 9, 2005 and the third Business Day following the date on which the last of the conditions set forth in Article Twelve and Article Thirteen have been satisfied or waived by the party entitled to waive the same or (ii) at such other place, time and date (if any) to which the parties may mutually agree (the "Closing Date").

Section 2.2 Sale Of IHC Stock. Upon the terms and subject to the conditions set forth in this Agreement, at the First Closing, Dynex will sell, assign, transfer and otherwise convey to Highland, and Highland will purchase and acquire from Dynex, in each case free and clear of any Lien, the IHC Stock. Highland will not assume any Liability of Dynex or any other Person in connection with such sale.

Section 2.3 IHC Stock Purchase Price. The purchase price for the IHC Stock (the "IHC Stock Purchase Price") will be \$[*].

Section 2.4 First Closing Obligations (Dynex). At the First Closing, Dynex will deliver to Highland:

(i) an executed copy of a lost stock certificate affidavit (or other similar agreement) relating to the loss of stock certificate #1, issued on September 4, 1996 and registered in the name of Resource Mortgage Capital, Inc. (predecessor-in-interest to Dynex), representing the IHC Stock and indemnifying IHC in connection with such loss;

(ii) stock certificate #2, issued on April 20, 2005 and registered in the name of Dynex, representing the IHC Stock;

(iii) a copy of the IHC Stock Endorsement Certificate executed by Dynex, with signature guaranteed by a commercial bank or trust company or by a member firm of a national securities exchange with all required stock transfer stamps affixed or provided for;

(iv) an executed copy of each bill of sale, contribution agreement or other transfer document pursuant to which, in each case immediately before the sale of the IHC Stock to Highland, IHC shall have transferred to Dynex all of the assets of IHC (other than the books and records relating to the Financial Statements) and Dynex shall have contributed such assets to IH Capital;

(v) an executed copy of an assignment and assumption agreement (or other similar agreement) between IHC and IH Capital pursuant to which, in each case immediately before the sale of the IHC Stock to Highland, IHC shall have assigned to IH Capital all covenants, obligations and other Liabilities of IHC and IH Capital shall have assumed all of such covenants, obligations and other Liabilities;

(vi) a certificate executed by Dynex to the effect that, except as otherwise stated in such certificate, each of Dynex' representations and warranties in this Agreement was accurate in all Material respects as of the date of this Agreement and is accurate in all Material respects as of the Closing Date as if made on the Closing Date; and

(vii) resignation letters signed by those officers and directors of IHC who were serving immediately prior to the time of the First Closing.

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Section 2.5 First Closing Obligations (Highland). At the First Closing, Highland will:

(i) deliver to Dynex a certificate executed by Highland to the effect that, except as otherwise stated in such certificate, each of Highland's representations and warranties in this Agreement was accurate in all Material respects as of the date of this Agreement and is accurate in all Material respects as of the Closing Date as if made on the Closing Date; and

(ii) pay to Dynex the IHC Stock Purchase Price in immediately available funds by wire transfer to a bank account specified by Dynex.

ARTICLE THREE

SALE OF CLASS B-3 BONDS;

SALE OF REDEMPTION RIGHTS; SECOND CLOSING

Section 3.1 Second Closing. The purchase and sale of the Class B-3 Bonds and the Redemption Rights provided for in this Agreement (the "Second Closing") will take place at the offices of McGuireWoods LLP, One James Center, 901 East Cary Street, Richmond, Virginia 23219 immediately after the First Closing.

Section 3.2 Sale Of Class B-3 Bonds. Upon the terms and subject to the conditions set forth in this Agreement, at the Second Closing, MSC will sell, assign, transfer and otherwise convey to IHC (Post-Sale), and IHC (Post-Sale) will purchase and acquire from MSC, in each case free and clear of any Lien, the Class B-3 Bonds. IHC (Post-Sale) will not assume any Liability of MSC or any other Person in connection with such sale.

Section 3.3 Sale Of Redemption Rights. Upon the terms and subject to the conditions set forth in this Agreement, at the Second Closing, MERIT will sell, assign, transfer and otherwise convey to IHC (Post-Sale), and IHC (Post-Sale) will purchase and acquire from MERIT, in each case free and clear of any Lien, the Redemption Rights. IHC (Post-Sale) will not assume any Liability of MERIT or any other Person in connection with such sale.

Section 3.4 Purchase Price. The purchase price for the Class B-3 Bonds (the "Class B-3 Bonds Purchase Price") will be \$[*]. The purchase price for the Redemption Rights (the "Redemption Rights Purchase Price") will be \$[*].

Section 3.5 Second Closing Obligations (MSC). At the Second Closing, MSC will deliver to Highland:

(i) evidence satisfactory to Highland and its legal counsel that the Class B-3 Bonds are held in account #25222035 maintained with Wachovia Bank, N.A.;

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(ii) the First Bond Assignment and such other instruments of conveyance with respect to \$12,000,000 in initial principal balance of the Class B-3 Bonds as may reasonably be requested by Highland, each in form and substance satisfactory to Highland and its legal counsel and executed by MSC;

(iii) an irrevocable instruction letter substantially in the form of Exhibit 3.5 executed by or at the direction of MSC with respect to \$12,000,000 in initial principal balance of the Class B-3 Bonds; and

(iv) a certificate executed by MSC to the effect that, except as otherwise stated in such certificate, each of MSC's representations and warranties in this Agreement was accurate in all Material respects as of the date of this Agreement and is accurate in all Material respects as of the Closing Date as if made on the Closing Date.

Section 3.6 Second Closing Obligations (MERIT). At the Second Closing, MERIT will deliver to Highland:

(i) the Redemption Rights Agreement and such other instruments of conveyance with respect to the Redemption Rights as may reasonably be requested by Highland, each in form and substance satisfactory to Highland and its legal counsel and executed by MERIT; and

(ii) a certificate executed by MERIT to the effect that, except as otherwise stated in such certificate, each of MERIT's representations and warranties in this Agreement was accurate in all Material respects as of the date of this Agreement and is accurate in all Material respects as of the Closing Date as if made on the Closing Date.

Section 3.7 Second Closing Obligations (Highland). At the Second Closing, Highland will:

(i) deliver to each of MSC and MERIT a certificate executed by Highland to the effect that, except as otherwise stated in such certificate, each of Highland's representations and warranties in this Agreement was accurate in all Material respects as of the date of this Agreement and is accurate in all Material respects as of the Closing Date as if made on the Closing Date;

(ii) cause to be paid to MSC the Class B-3 Bonds Purchase Price in immediately available funds by wire transfer to a bank account specified by MSC; and

(iii) cause to be paid to MERIT the Redemption Rights Purchase Price in immediately available funds by wire transfer to a bank account specified by MERIT.

ARTICLE FOUR
DERIVATIVE TRANSACTION; THIRD CLOSING

Section 4.1 Third Closing. The execution and delivery of the Derivative Payment Agreement provided for in this Agreement (the "Third Closing") will take place at the offices of McGuireWoods LLP, One James Center, 901 East Cary Street, Richmond, Virginia 23219 immediately after the Second Closing.

Section 4.2 Third Closing Obligations (IH Capital). At the Third Closing, IH Capital will deliver to Highland:

- (i) the Derivative Payment Agreement in form and substance satisfactory to Highland and its legal counsel and executed by IH Capital; and
- (ii) a certificate executed by IH Capital to the effect that, except as otherwise stated in such certificate, each of IH Capital's representations and warranties in this Agreement was accurate in all Material respects as of the date of this Agreement and is accurate in all Material respects as of the date of the Third Closing as if made on such date.

Section 4.3 Third Closing Obligations (MSC). At the Third Closing, MSC will deliver to Highland:

- (i) the Second Bond Assignment and such other instruments of conveyance with respect to \$8,000,000 in initial principal balance of the Class B-3 Bonds as may reasonably be requested by Highland, each in form and substance satisfactory to Highland and its legal counsel and executed by MSC; and
- (ii) an irrevocable instruction letter substantially in the form of Exhibit 4.3 executed by or at the direction of MSC with respect to \$8,000,000 in initial principal balance of the Class B-3 Bonds.

Section 4.4 Third Closing Obligations (Highland). At the Third Closing, Highland will:

- (i) cause to be delivered to IH Capital the Derivative Payment Agreement in form and substance satisfactory to IH Capital and its legal counsel and executed by IHC (Post-Sale);
- (ii) cause to be delivered to IH Capital a power of attorney executed by IHC (Post-Sale) appointing IH Capital as IHC (Post-Sale)'s attorney-in-fact for the limited purpose of continuing or terminating the financing statements attached as Schedule 5.11 (it being understood that the parties intend that IHC (Post-Sale) not have any right, title or interest in, to or under the property subject to such financing statements);

(iii) deliver to IH Capital a certificate executed by Highland to the effect that, except as otherwise stated in such certificate, each of Highland's representations and warranties in this Agreement was accurate in all Material respects as of the date of this Agreement and is accurate in all Material respects as of the date of the Third Closing as if made on such date; and

(iv) cause to be paid to IH Capital \$[*] in immediately available funds by wire transfer to a bank account specified by IH Capital.

ARTICLE FIVE
REPRESENTATIONS AND WARRANTIES OF DYNEX

Dynex represents and warrants to Highland as follows:

Section 5.1 Organization; Good Standing (Dynex). Dynex is a corporation duly organized, validly existing and in good standing under the laws of the Commonwealth of Virginia and has all necessary corporate power and authority to conduct its business as it is now being conducted and to own or use the properties and assets that it purports to own or use. Dynex has delivered to Highland complete and correct copies of its articles of incorporation and bylaws as currently in effect.

Section 5.2 Organization; Good Standing (IHC). IHC is a corporation duly organized, validly existing and in good standing under the laws of the Commonwealth of Virginia and has all necessary corporate power and authority to conduct its business as it is now being conducted and to own or use the properties and assets that it purports to own or use. IHC is duly qualified to do business as a foreign corporation and is in good standing under the laws of each state or other jurisdiction in which either the ownership or use of the properties owned or used by it, or the nature of the activities conducted by it, requires such qualification. Dynex has delivered to Highland complete and correct copies of the articles of incorporation and bylaws of IHC as currently in effect.

Section 5.3 Authority; Enforceability. Dynex has the absolute and unrestricted right, power and authority to execute and deliver this Agreement and the Dynex Closing Documents and to perform its obligations under this Agreement and the Dynex Closing Documents, and such action has been duly authorized by all necessary corporate action. Assuming the valid and binding effect on the other parties, this Agreement constitutes the legal, valid and binding obligation of Dynex, enforceable against Dynex in accordance with its terms, except that such enforcement may be subject to bankruptcy, receivership, insolvency, moratorium, reorganization, fraudulent transfer or similar laws affecting the enforcement of the rights of creditors generally and to legal and equitable limitations on the enforceability of specific remedies. Upon the execution and delivery by Dynex of the Dynex Closing Documents, and, assuming the valid and binding effect of such documents on the other parties thereto, each of the Dynex Closing Documents will constitute the legal, valid and binding obligation of Dynex, enforceable against Dynex in accordance with its terms, except that such enforcement

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may be subject to bankruptcy, receivership, insolvency, moratorium, reorganization, fraudulent transfer or similar laws affecting the enforcement of the rights of creditors generally and to legal and equitable limitations on the enforceability of specific remedies.

Section 5.4 No Conflicts. Neither the execution and delivery of this Agreement nor the consummation or performance of any of the Contemplated Transactions will, directly or indirectly (with or without notice or lapse of time), (i) conflict with or violate any provision of the articles of incorporation or bylaws of Dynex or IHC or any resolution adopted by the board of directors or shareholders of Dynex or IHC, (ii) conflict with, violate, result in a breach of, constitute a default under, give any Person the right to challenge any of the Contemplated Transactions under or give any Person the right to exercise any remedy or obtain any relief under any Legal Requirement or Order to which Dynex or IHC may be subject, (iii) conflict with, violate, result in a breach of or constitute a default under any Contract to which Dynex or IHC is a party or by which Dynex or IHC is bound or (iv) result in the imposition or creation of any Lien on or with respect to the IHC Stock or IHC, other than, in the case of clause (ii) or (iii), any such conflict, violation, breach or default that could not reasonably be expected to have a Material adverse effect.

Section 5.5 No Consents. Neither Dynex nor IHC is or will be required to give any notice to or obtain any Consent from any Person or Governmental Body in connection with the execution and delivery of this Agreement or the consummation or performance of any of the Contemplated Transactions.

Section 5.6 No Proceedings. Except for the Class Action Lawsuit and as disclosed on Schedule 5.6, there is no pending or, to the Knowledge of Dynex, threatened Proceeding (i) that has been commenced by or against Dynex that would reasonably be expected to have a Material adverse effect on Dynex or that otherwise relates to or may affect the IHC Stock or IHC, (ii) that has been commenced by or against IHC or that otherwise relates to or may affect the IHC Stock or IHC or (iii) that challenges, or that may have the effect of preventing, delaying, making illegal or otherwise interfering with, any of the Contemplated Transactions. To the Knowledge of Dynex, no event has occurred or circumstance exists that is reasonably likely to give rise to or serve as the basis for the commencement of any Proceeding related directly to the IHC Stock. Dynex has delivered to Highland or its Representatives copies of all pleadings and all Material correspondence and other documents relating to the Class Action Lawsuit since the date that such suit was filed (except to the extent such delivery would jeopardize Dynex's attorney-client privilege in connection with the Class Action Lawsuit).

Section 5.7 No Orders. Neither Dynex nor IHC is subject to any Order that relates to or may affect the IHC Stock or IHC or that challenges, or that may have the effect of preventing, delaying, making illegal or otherwise interfering with, any of the Contemplated Transactions. Neither Dynex nor IHC has received any notice or other communication (whether oral or written) from any Governmental Body or any other Person regarding the potential or proposed issuance of any such Order.

Section 5.8 Books And Records. The books of account, minute books, stock record books and other records of IHC, all of which have been made available to Highland, are complete and correct in all Material respects and have been maintained in accordance with sound business practices and the requirements of Section 13(b)(2) of the Exchange Act (regardless of whether IHC is subject to that provision), including the maintenance of an adequate system of internal accounting controls. The minute books of IHC contain accurate and complete (in all Material respects) records of all meetings held of, and corporate action taken by, the shareholders, the board of directors and any committees of the board of directors of IHC, and no meeting of any such shareholders, board of directors or committee has been held for which minutes have not been prepared or are not contained in such minute books. At the First Closing, all of such books and records will be in the possession of IHC.

Section 5.9 Capitalization. The authorized equity securities of IHC consist of 10,000 shares of common stock, no par value, of which 10,000 shares are outstanding. All of the outstanding equity securities of IHC have been duly authorized and validly issued and are fully paid and nonassessable. There are no Contracts relating to the issuance, sale or transfer of any equity securities or other securities of IHC. None of the outstanding equity securities or other securities of IHC was issued in violation of the Securities Act of 1933, as amended, or any other Legal Requirement.

Section 5.10 Financial Statements. Dynex has delivered to Highland unaudited consolidated balance sheets of IHC as of December 31, 2003 and December 31, 2004 and the related consolidated statements of income for the years then ended (collectively, the "Financial Statements"). To the Knowledge of Dynex, the Financial Statements fairly present in all material respects the financial condition and results of operations of IHC as of December 31, 2003 and December 31, 2004 and for the years then ended, all in accordance with GAAP consistently applied throughout such periods. The Financial Statements have been prepared from and are in accordance with the accounting records of IHC. IHC has also delivered to Highland copies of all letters from IHC's accountants to IHC's board of directors or the audit committee thereof during the twenty-four (24) months preceding the execution of this Agreement, together with copies of all responses thereto.

Section 5.11 Limited Assets; No Liabilities. IHC has no assets other than the books and records relating to the Financial Statements. IHC has no Liabilities (all Liabilities of IHC having been assumed by IH Capital). Except for the Liens evidenced by the financing statements attached as Schedule 5.11, there are no Liens on or with respect to any assets of IHC.

Section 5.12 The IHC Stock. Dynex is, and on the Closing Date will be, the record and beneficial owner and holder of the IHC Stock, free and clear of any Lien (and no legend or other reference to any purported Lien appears on any certificate representing the IHC Stock). Upon execution and delivery of the IHC Stock Endorsement Certificate and payment for the IHC Stock by Highland as provided in this Agreement, Highland will acquire good and valid title to the IHC Stock, free and clear of any Lien. Dynex is not a party to any agreement, understanding or arrangement relating to the IHC Stock other than this Agreement.

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Section 5.13 No Brokers Or Finders. Neither Dynex nor any of its Representatives has incurred any obligation or liability, contingent or otherwise, for brokerage or finders' fees, agents' commissions or other similar payments in connection with this Agreement or the Contemplated Transactions.

Section 5.14 Accuracy Of Information. All written information provided by Dynex to Highland or its Representatives in connection with this Agreement or the Contemplated Transactions was true and correct in all Material respects as of the date provided, and such information did not contain as of the date provided any statement that was untrue in any Material respect or omit to state a Material fact necessary to make such information, in light of the circumstances in which it was provided, not misleading. Dynex does not have Knowledge of any fact that has specific application to the IHC Stock or IHC (other than general economic or industry conditions) and that may have a Material adverse effect on the IHC Stock or IHC that has not been set forth in this Agreement or otherwise provided to Highland or its Representatives in writing.

ARTICLE SIX REPRESENTATIONS AND WARRANTIES OF MSC

MSC represents and warrants to Highland as follows:

Section 6.1 Organization; Good Standing. MSC is a limited partnership duly organized, validly existing and in good standing under the laws of the Commonwealth of Virginia and has all necessary power and authority to conduct its business as it is now being conducted and to own or use the properties and assets that it purports to own or use. MSC has delivered to Highland complete and correct copies of its charter documents as currently in effect.

Section 6.2 Authority; Enforceability. MSC has the absolute and unrestricted right, power and authority to execute and deliver this Agreement and the MSC Closing Documents and to perform its obligations under this Agreement and the MSC Closing Documents, and such action has been duly authorized by all necessary partnership action. Assuming the valid and binding effect on the other parties, this Agreement constitutes the legal, valid and binding obligation of MSC, enforceable against MSC in accordance with its terms, except that such enforcement may be subject to bankruptcy, receivership, insolvency, moratorium, reorganization, fraudulent transfer or similar laws affecting the enforcement of the rights of creditors generally and to legal and equitable limitations on the enforceability of specific remedies. Upon the execution and delivery by MSC of the MSC Closing Documents, and assuming the valid and binding effect of such documents on the other parties thereto, each of the MSC Closing Documents will constitute the legal, valid and binding obligation of MSC, enforceable against MSC in accordance with its terms, except that such enforcement may be subject to bankruptcy, receivership, insolvency, moratorium, reorganization, fraudulent transfer or similar laws affecting the enforcement of the rights of creditors generally and to legal and equitable limitations on the enforceability of specific remedies.

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Section 6.3 No Conflicts. Neither the execution and delivery of this Agreement nor the consummation or performance of any of the Contemplated Transactions will, directly or indirectly (with or without notice or lapse of time), (i) conflict with or violate any provision of the charter documents of MSC or any resolution adopted by the partners or general partner of MSC, (ii) conflict with, violate, result in a breach of, constitute a default under, give any Person the right to challenge any of the Contemplated Transactions under or give any Person the right to exercise any remedy or obtain any relief under any Legal Requirement or Order to which MSC may be subject, (iii) conflict with, violate, result in a breach of or constitute a default under any Contract to which MSC is a party or by which MSC is bound or (iv) result in the imposition or creation of any Lien on or with respect to the Class B-3 Bonds, other than, in the case of clause (ii) or (iii), any such conflict, violation, breach or default that could not reasonably be expected to have a Material adverse effect.

Section 6.4 No Consents. Except for the notices and Consents identified on Schedule 6.4, MSC is not required to give any notice to or obtain any Consent from any Person or Governmental Body in connection with the execution and delivery of this Agreement or the consummation or performance of any of the Contemplated Transactions.

Section 6.5 No Proceedings. There is no pending or, to the Knowledge of MSC, threatened Proceeding (i) that has been commenced by or against MSC that relates to the Class B-3 Bonds or that may otherwise affect the Class B-3 Bonds or (ii) that challenges, or that may have the effect of preventing, delaying, making illegal or otherwise interfering with, any of the Contemplated Transactions. To the Knowledge of MSC, no event has occurred or circumstance exists that is reasonably likely to give rise to or serve as the basis for the commencement of any Proceeding related directly to the Class B-3 Bonds.

Section 6.6 No Orders. MSC is not subject to any Order that relates to or may affect the Class B-3 Bonds or that challenges, or that may have the effect of preventing, delaying, making illegal or otherwise interfering with, any of the Contemplated Transactions. MSC has not received any notice or other communication (whether oral or written) from any Governmental Body or any other Person regarding the potential or proposed issuance of any such Order.

Section 6.7 The Class B-3 Bonds. MSC is, and on the Closing Date will be, the sole owner of the Class B-3 Bonds free and clear of any Lien. Upon execution and delivery of the Class B-3 Bond Assignments as provided in this Agreement, MSC will validly assign the Class B-3 Bonds to IHC (Post-Sale) and IHC (Post-Sale) will acquire the Class B-3 Bonds free and clear of any Lien not created by IHC (Post-Sale). MSC is not a party to any agreement, understanding or arrangement relating to the Class B-3 Bonds other than this Agreement.

Section 6.8 No Brokers Or Finders. Neither MSC nor any of its Representatives has incurred any obligation or liability, contingent or otherwise, for brokerage or finders' fees, agents' commissions or other similar payments in connection with this Agreement or the Contemplated Transactions.

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Section 6.9 Accuracy Of Information. All written information provided by MSC to Highland or its Representatives in connection with this Agreement or the Contemplated Transactions was true and correct in all Material respects as of the date provided, and such information did not contain as of the date provided any statement that was untrue in any Material respect or omit to state a Material fact necessary to make such information, in light of the circumstances in which it was provided, not misleading. MSC does not have Knowledge of any fact that has specific application to the Class B-3 Bonds (other than general economic or industry conditions) and that may have a Material adverse effect on the Class B-3 Bonds that has not been set forth in this Agreement or otherwise provided to Highland or its Representatives in writing.

ARTICLE SEVEN
REPRESENTATIONS AND WARRANTIES OF MERIT

MERIT represents and warrants to Highland as follows:

Section 7.1 Organization; Good Standing. MERIT is a corporation duly organized, validly existing and in good standing under the laws of the Commonwealth of Virginia and has all necessary corporate power and authority to conduct its business as it is now being conducted and to own or use the properties and assets that it purports to own or use. MERIT has delivered to Highland complete and correct copies of its articles of incorporation and bylaws as currently in effect.

Section 7.2 Authority; Enforceability. MERIT has the absolute and unrestricted right, power and authority to execute and deliver this Agreement and the MERIT Closing Documents and to perform its obligations under this Agreement and the MERIT Closing Documents, and such action has been duly authorized by all necessary corporate action. Assuming the valid and binding effect on the other parties, this Agreement constitutes the legal, valid and binding obligation of MERIT, enforceable against MERIT in accordance with its terms, except that such enforcement may be subject to bankruptcy, receivership, insolvency, moratorium, reorganization, fraudulent transfer or similar laws affecting the enforcement of the rights of creditors generally and to legal and equitable limitations on the enforceability of specific remedies. Upon the execution and delivery by MERIT of the MERIT Closing Documents, and assuming the valid and binding effect of such documents on the other parties thereto, each of the MERIT Closing Documents will constitute the legal, valid and binding obligation of MERIT, enforceable against MERIT in accordance with its terms, except that such enforcement may be subject to bankruptcy, receivership, insolvency, moratorium, reorganization, fraudulent transfer or similar laws affecting the enforcement of the rights of creditors generally and to legal and equitable limitations on the enforceability of specific remedies.

Section 7.3 No Conflicts. Neither the execution and delivery of this Agreement nor the consummation or performance of any of the Contemplated Transactions will, directly or indirectly (with or without notice or lapse of time), (i) conflict with or violate any provision of the articles of incorporation or bylaws of MERIT or any resolution adopted by the

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board of directors or sole shareholder of MERIT, (ii) conflict with, violate, result in a breach of, constitute a default under, give any Person the right to challenge any of the Contemplated Transactions under or give any Person the right to exercise any remedy or obtain any relief under any Legal Requirement or Order to which MERIT may be subject, (iii) conflict with, violate, result in a breach of or constitute a default under any Contract to which MERIT is a party or by which MERIT is bound or (iv) result in the imposition or creation of any Lien on or with respect to the Redemption Rights, other than, in the case of clause (ii) or (iii), any such conflict, violation, breach or default that could not reasonably be expected to have a Material adverse effect.

Section 7.4 No Consents. Except for the notices and Consents identified on Schedule 7.4, MERIT is not required to give any notice to or obtain any Consent from any Person or Governmental Body in connection with the execution and delivery of this Agreement or the consummation or performance of any of the Contemplated Transactions.

Section 7.5 No Proceedings. Except for the Class Action Lawsuit and as disclosed on Schedule 5.6, there is no pending or, to the Knowledge of MERIT, threatened Proceeding (i) that has been commenced by or against MERIT that relates to the Redemption Rights or that may otherwise affect the Redemption Rights or (ii) that challenges, or that may have the effect of preventing, delaying, making illegal or otherwise interfering with, any of the Contemplated Transactions. To the Knowledge of MERIT, no event has occurred or circumstance exists that is reasonably likely to give rise to or serve as the basis for the commencement of any Proceeding related directly to the Redemption Rights.

Section 7.6 No Orders. MERIT is not subject to any Order that relates to or may affect the Redemption Rights or that challenges, or that may have the effect of preventing, delaying, making illegal or otherwise interfering with, any of the Contemplated Transactions. MERIT has not received any notice or other communication (whether oral or written) from any Governmental Body or any other Person regarding the potential or proposed issuance of any such Order.

Section 7.7 The Class B-3 Bonds. The Class B-3 Bonds have been duly authorized, executed and delivered and are the legal, valid and binding obligations of MERIT enforceable against MERIT in accordance with their terms, except that such enforcement may be subject to bankruptcy, receivership, insolvency, moratorium, reorganization, fraudulent transfer or similar laws affecting the enforcement of the rights of creditors generally and to legal and equitable limitations on the enforceability of specific remedies.

Section 7.8 Class B-3 Bond Documents. The Class B-3 Bond Documents constitute all of the documents that govern or otherwise relate to the Class B-3 Bonds. MERIT and, to the Knowledge of MERIT, the Trustee have performed in all Material respects each obligation to be performed by them under the Class B-3 Bond Documents. Each of the Class B-3 Bond Documents is in full force and effect and constitutes the legal, valid and binding obligation of MERIT and, to the Knowledge of MERIT, the Trustee enforceable against MERIT and, to the Knowledge of MERIT, the Trustee in accordance with its terms, except that such enforcement may be subject to bankruptcy, receivership, insolvency, moratorium, reorganization,

fraudulent transfer or similar laws affecting the enforcement of the rights of creditors generally and to legal and equitable limitations on the enforceability of specific remedies. MERIT or its Representatives have delivered to Highland or its Representatives true and complete copies of the Class B-3 Bond Documents as in effect on the date of this Agreement and the Closing Date. To the Knowledge of MERIT, no event or condition exists that constitutes or would constitute (with notice or lapse of time) an Event of Default.

Section 7.9 The Redemption Rights. MERIT is, and on the Closing Date will be, the holder of the Redemption Rights free and clear of any Lien. Upon execution and delivery of the Redemption Rights Agreement as provided in this Agreement, MERIT will validly assign the Redemption Rights to IHC (Post-Sale) and IHC (Post-Sale) will acquire the Redemption Rights free and clear of any Lien not created by IHC (Post-Sale) and will be entitled to enforce the Redemption Rights against all Persons. MERIT is not a party to any agreement, understanding or arrangement relating to the Redemption Rights other than this Agreement and the Redemption Rights Documents. All of the Series 11 Bonds and Series 12-1 Bonds that are subject to the Redemption Rights are identified on Schedule 1.1D.

Section 7.10 Redemption Rights Documents. The Redemption Rights Documents constitute all of the documents that govern or otherwise relate to the Redemption Rights. MERIT and, to the Knowledge of MERIT, the Trustee have performed in all Material respects each obligation to be performed by them under the Redemption Rights Documents. Each of the Redemption Rights Documents is in full force and effect and, assuming the valid and binding effect of such documents on the other parties thereto, constitutes the legal, valid and binding obligation of MERIT and, to the Knowledge of MERIT, the Trustee enforceable against MERIT and, to the Knowledge of MERIT, the Trustee in accordance with its terms, except that such enforcement may be subject to bankruptcy, receivership, insolvency, moratorium, reorganization, fraudulent transfer or similar laws affecting the enforcement of the rights of creditors generally and to legal and equitable limitations on the enforceability of specific remedies. MERIT or its Representatives have delivered to Highland or its Representatives true and complete copies of the Redemption Rights Documents as in effect on the date of this Agreement and the Closing Date. To the Knowledge of MERIT, no event or condition exists that constitutes or would constitute (with notice or lapse of time) an Event of Default.

Section 7.11 Available Surplus Documents. The Available Surplus Documents constitute all of the documents that govern or otherwise relate to the Available Surplus. MERIT and, to the Knowledge of MERIT, the Trustee have performed in all Material respects each obligation to be performed by them under the Available Surplus Documents. Each of the Available Surplus Documents is in full force and effect and, assuming the valid and binding effect of such documents on the other parties thereto, constitutes the legal, valid and binding obligation of MERIT and, to the Knowledge of MERIT, the Trustee enforceable against MERIT and, to the Knowledge of MERIT, the Trustee in accordance with its terms, except that such enforcement may be subject to bankruptcy, receivership, insolvency, moratorium, reorganization, fraudulent transfer or similar laws affecting the enforcement of the rights of creditors generally and to legal and equitable limitations on the enforceability of specific remedies. MERIT or its Representatives have delivered to Highland or its Representatives true and complete copies of

the Available Surplus Documents as in effect on the date of this Agreement and the Closing Date.

Section 7.12 No Brokers Or Finders. Neither MERIT nor any of its Representatives has incurred any obligation or liability, contingent or otherwise, for brokerage or finders' fees, agents' commissions or other similar payments in connection with this Agreement or the Contemplated Transactions.

Section 7.13 Accuracy Of Information. All written information provided by MERIT to Highland or its Representatives in connection with this Agreement or the Contemplated Transactions was true and correct in all Material respects as of the date provided, and such information did not contain as of the date provided any statement that was untrue in any Material respect or omit to state a Material fact necessary to make such information, in light of the circumstances in which it was provided, not misleading. MERIT does not have Knowledge of any fact that has specific application to the Redemption Rights (other than general economic or industry conditions) and that may have a Material adverse effect on the Redemption Rights that has not been set forth in this Agreement or otherwise provided to Highland or its Representatives in writing.

ARTICLE EIGHT REPRESENTATIONS AND WARRANTIES OF IH CAPITAL

IH Capital represents and warrants to Highland as follows:

Section 8.1 Organization: Good Standing. IH Capital is a corporation duly organized, validly existing and in good standing under the laws of the Commonwealth of Virginia and has all necessary corporate power and authority to conduct its business as it is now being conducted and to own or use the properties and assets that it purports to own or use. IH Capital has delivered to Highland complete and correct copies of its articles of incorporation and bylaws as currently in effect.

Section 8.2 Authority: Enforceability. IH Capital has the absolute and unrestricted right, power and authority to execute and deliver this Agreement and the IH Capital Closing Documents and to perform its obligations under this Agreement and the IH Capital Closing Documents, and such action has been duly authorized by all necessary corporate action. Assuming the valid and binding effect on the other parties, this Agreement constitutes the legal, valid and binding obligation of IH Capital, enforceable against IH Capital in accordance with its terms, except that such enforcement may be subject to bankruptcy, receivership, insolvency, moratorium, reorganization, fraudulent transfer or similar laws affecting the enforcement of the rights of creditors generally and to legal and equitable limitations on the enforceability of specific remedies. Upon the execution and delivery by IH Capital of the IH Capital Closing Documents, and assuming the valid and binding effect of such documents on the other parties thereto, each of the IH Capital Closing Documents will constitute the legal, valid and binding obligation of IH Capital, enforceable against IH Capital in accordance with its terms, except that

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such enforcement may be subject to bankruptcy, receivership, insolvency, moratorium, reorganization, fraudulent transfer or similar laws affecting the enforcement of the rights of creditors generally and to legal and equitable limitations on the enforceability of specific remedies.

Section 8.3 No Conflicts. Neither the execution and delivery of this Agreement nor the consummation or performance of any of the Contemplated Transactions will, directly or indirectly (with or without notice or lapse of time), (i) conflict with or violate any provision of the articles of incorporation or bylaws of IH Capital or any resolution adopted by the board of directors or sole shareholder of IH Capital, (ii) conflict with, violate, result in a breach of, constitute a default under, give any Person the right to challenge any of the Contemplated Transactions under or give any Person the right to exercise any remedy or obtain any relief under any Legal Requirement or Order to which IH Capital may be subject, (iii) conflict with, violate, result in a breach of or constitute a default under any Contract to which IH Capital is a party or by which IH Capital is bound or (iv) result in the imposition or creation of any Lien on or with respect to the assets of IH Capital, other than, in the case of clause (ii) or (iii), any such conflict, violation, breach or default that could not reasonably be expected to have a Material adverse effect.

Section 8.4 No Consents. IH Capital is not required to give any notice to or obtain any Consent from any Person or Governmental Body in connection with the execution and delivery of this Agreement or the consummation or performance of any of the Contemplated Transactions.

Section 8.5 No Proceedings. There is no pending or, to the Knowledge of IH Capital, threatened Proceeding (i) that has been commenced by or against IH Capital that relates to the Derivative Transaction or that may otherwise affect the Derivative Transaction or (ii) that challenges, or that may have the effect of preventing, delaying, making illegal or otherwise interfering with, any of the Contemplated Transactions. To the Knowledge of IH Capital, no event has occurred or circumstance exists that is reasonably likely to give rise to or serve as the basis for the commencement of any such Proceeding.

Section 8.6 No Orders. IH Capital is not subject to any Order that relates to or may affect the Derivative Transaction or that challenges, or that may have the effect of preventing, delaying, making illegal or otherwise interfering with, any of the Contemplated Transactions. IH Capital has not received any notice or other communication (whether oral or written) from any Governmental Body or any other Person regarding the potential or proposed issuance of any such Order.

Section 8.7 No Brokers Or Finders. Neither IH Capital nor any of its Representatives has incurred any obligation or liability, contingent or otherwise, for brokerage or finders' fees, agents' commissions or other similar payments in connection with this Agreement or the Contemplated Transactions.

Section 8.8 Accuracy Of Information. All written information provided by IH Capital to Highland or its Representatives in connection with this Agreement or the

Contemplated Transactions was true and correct in all Material respects as of the date provided, and such information did not contain as of the date provided any statement that was untrue in any Material respect or omit to state a Material fact necessary to make such information, in light of the circumstances in which it was provided, not misleading. IH Capital does not have Knowledge of any fact that has specific application to the Derivative Transaction (other than general economic or industry conditions) and that may have a Material adverse effect on the interest of IHC (Post-Sale) under the Derivative Transaction that has not been set forth in this Agreement or otherwise provided to Highland or its Representatives in writing.

ARTICLE NINE REPRESENTATIONS AND WARRANTIES OF HIGHLAND

Highland represents and warrants to each Dynex Company as follows:

Section 9.1 Organization; Good Standing. Highland is a limited liability company duly organized, validly existing and in good standing under the laws of the Island of Nevis and has all necessary limited liability company power and authority to conduct its business as it is now being conducted and to own or use the properties and assets that it purports to own or use.

Section 9.2 Authority; Enforceability. Highland has the absolute and unrestricted right, power and authority to execute and deliver this Agreement and to perform its obligations under this Agreement, and such action has been duly authorized by all necessary limited liability company action. Assuming the valid and binding effect on the other parties, this Agreement constitutes the legal, valid and binding obligation of Highland, enforceable against Highland in accordance with its terms, except that such enforcement may be subject to bankruptcy, receivership, insolvency, moratorium, reorganization, fraudulent transfer or similar laws affecting the enforcement of the rights of creditors generally and to legal and equitable limitations on the enforceability of specific remedies.

Section 9.3 No Conflicts. Neither the execution and delivery by Highland of this Agreement nor the consummation or performance by Highland of any of the Contemplated Transactions will give any Person the right to prevent, delay or otherwise interfere with any of the Contemplated Transactions pursuant to (i) any provision of the articles of organization, as amended, or operating agreement of Highland, (ii) any resolution adopted by the sole manager of Highland, (iii) any Legal Requirement or Order to which Highland may be subject, or (iv) any Contract to which Highland is a party or by which Highland may be bound.

Section 9.4 No Consents. Highland is not required to give any notice to or obtain any Consent from any Person or Governmental Body in connection with the execution and delivery of this Agreement or the consummation or performance of any of the Contemplated Transactions.

Section 9.5 No Proceedings. There is no pending or, to the knowledge of Highland, threatened Proceeding that challenges, or that may have the effect of preventing,

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delaying, making illegal or otherwise interfering with, any of the Contemplated Transactions. To the knowledge of Highland, no event has occurred or circumstance exists that is reasonably likely to give rise to or serve as a basis for the commencement of any such Proceeding.

Section 9.6 No Orders. Highland is not subject to any Order that challenges, or that may have the effect of preventing, delaying, making illegal or otherwise interfering with, any of the Contemplated Transactions. Highland has not received any notice or other communication (whether oral or written) from any Governmental Body or any other Person regarding the potential or proposed issuance of any such Order.

Section 9.7 No Brokers Or Finders. Neither Highland nor any of its Representatives has incurred any obligation or liability, contingent or otherwise, for brokerage or finders' fees, agents' commissions or other similar payments in connection with this Agreement or the Contemplated Transactions.

Section 9.8 Accuracy Of Information. All written information provided by Highland to any Dynex Company (or its Representatives) in connection with this Agreement or the Contemplated Transactions was true and correct in all Material respects as of the date provided, and such information did not contain as of the date provided any statement that was untrue in any Material respect or omit to state a Material fact necessary to make such information, in light of the circumstances in which it was provided, not misleading.

Section 9.9 Patriot Act. Highland, and all of its directors, officers, Affiliates, agents and employees, at all times has been in substantial compliance with the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA Patriot Act) Act of 2001, as amended, and the rules and regulations promulgated thereunder, as applicable to Highland and its assets and properties as well as the assets and properties of its Affiliates.

Section 9.10 Anti-Money Laundering Laws. Highland, and all beneficial owners of Highland, are in substantial compliance with the requirements of Executive Order No. 13224, 66 Fed. Reg. 49079 (Sept. 25, 2001) (the "Order") and other similar requirements applicable to Highland contained in the rules and regulations of the Office of Foreign Asset Control, Department of the Treasury ("OFAC") and in any enabling legislation or other Executive Orders in respect thereof (the Order and such other rules, regulations, legislation or orders are collectively referred to as the "Orders"). Neither Highland nor any beneficial owner of Highland (i) is listed on the Specially Designated Nationals and Blocked Persons List maintained by OFAC pursuant to the Order and/or on any other list of terrorists or terrorist organizations maintained pursuant to any of the rules and regulations of OFAC or pursuant to any other applicable Orders (such lists are collectively referred to as the "Lists"), (ii) has been indicted or arrested for money laundering or for predicate crimes to money laundering or has been convicted or pled nolo contendere to charges involving money laundering or predicate crimes to money laundering, (iii) has been determined by competent authority to be subject to the prohibitions contained in the Orders or (iv) is owned or controlled by, or acts for or on behalf of, any Person on the Lists or any other Person who has been determined by competent authority to

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be subject to the prohibitions contained in the Orders. Highland has not committed an offense under the St. Kitts & Nevis Proceeds of Crime Act, as amended, the entering into and performance of the Contemplated Transactions by Highland do not constitute a violation of the St. Kitts & Nevis Proceeds of Crime Act, as amended, or any other relevant statute and Highland is not subject to any investigation by the St. Kitts & Nevis Financial Intelligence Unit. The consideration for the Contemplated Transactions is not money or other property that is the proceeds of any crime or other illicit activity. Neither the execution and delivery by Highland of this Agreement nor the consummation or performance by Highland of any of the Contemplated Transactions will contravene, or subject any Dynex Company to any liability under, the Bank Secrecy Act, 31 U.S.C. §§5311-5330 and 31 C.F.R. Part 103.

Section 9.11 Knowledge of Risks. Highland, through its officers and advisors, has carefully evaluated the financial risk associated with the Contemplated Transactions and acknowledges that it fully understands and is knowledgeable about such risks. Highland understands that a substantial portion of the collateral securing the Series 11 Bonds and the Series 12-1 Bonds is comprised of "manufactured home loans" that are likely to experience rates of delinquency and foreclosure that are higher, and may be substantially higher, than mortgage loans. Highland has such knowledge and experience in business and financial matters that it is capable of evaluating the Contemplated Transactions and the risks and merits inherent therein and of making informed decisions thereon. Highland has been given ample opportunity to ask questions of and receive answers from representatives of each Dynex Company concerning the nature and component elements generally used to assess the quality of the Series 11 Bonds (including the Class B-3 Bonds), the Series 12-1 Bonds, the Redemption Rights and the Available Surplus and to obtain additional information necessary to verify the accuracy of the information provided. Notwithstanding anything herein to the contrary, the Dynex Companies make no representation or warranty as to the realizable value of the Class B-3 Bonds, the Redemption Rights or the Available Surplus.

ARTICLE TEN COVENANTS OF THE DYNEX COMPANIES

Section 10.1 Access And Investigation. Between the date of this Agreement and the Closing Date, and upon reasonable advance notice received from Highland, each Dynex Company will, and will cause its Representatives (and Dynex will cause IHC and its Representatives), to, (i) afford Highland and its Representatives full access, during regular business hours, to such Dynex Company's personnel, Contracts, books and records and other documents and data that relate to the IHC Stock, IHC, the Class B-3 Bonds, the Redemption Rights, the Available Surplus or the Class Action Lawsuit, (ii) furnish Highland and its Representatives with copies of all such Contracts, books and records and other documents and data as Highland may reasonably request, (iii) furnish Highland and its Representatives with such additional financial and other relevant data and information that relate to the IHC Stock, IHC, the Class B-3 Bonds, the Redemption Rights, the Available Surplus or the Class Action Lawsuit as Highland may reasonably request and (iv) to the extent reasonably requested by Highland, otherwise cooperate and assist with Highland's investigation of the IHC Stock, IHC, the Class B-3 Bonds, the Redemption Rights, the Available Surplus and the Class Action

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Lawsuit. Notwithstanding anything in this Section 10.1 to the contrary, Highland shall not be given access to information if such access by Highland would jeopardize Dynex's attorney-client privilege in connection with the Class Action Lawsuit.

Section 10.2 Required Approvals. As soon as practicable after the date of this Agreement, each Dynex Company will, and Dynex will cause IHC to, make all filings required by Legal Requirements to be made by them in order to consummate the Contemplated Transactions. Between the date of this Agreement and the Closing Date, each Dynex Company will, and Dynex will cause IHC to, (i) cooperate with Highland and its Representatives in all reasonable respects with respect to all filings that Highland elects to make or is required by Legal Requirements to make in connection with the Contemplated Transactions and (ii) cooperate in all reasonable respects with Highland and its Representatives in obtaining all Consents required in connection with this Agreement or the Contemplated Transactions.

Section 10.3 No Adverse Actions; No Amendments. Between the date of this Agreement and the Closing Date, no Dynex Company will, and Dynex will cause IHC not to, without the prior consent of Highland, (i) take any action that could reasonably be expected to prevent, delay or otherwise interfere with the Contemplated Transactions, (ii) take any action that could reasonably be expected to have a Material adverse affect on the value of the IHC Stock, IHC, the Class B-3 Bonds, the Redemption Rights or the Available Surplus or (iii) amend any of the Class B-3 Bond Documents, the Redemption Rights Documents or the Available Surplus Documents in any Material respect.

Section 10.4 Notification. Between the date of this Agreement and the Closing Date, each Dynex Company will promptly notify Highland in writing if such Dynex Company (and Dynex will promptly notify Highland in writing if IHC becomes aware) of (i) any fact or condition that causes or constitutes a Material breach of any representation or warranty made by any Dynex Company in this Agreement, (ii) the occurrence after the date of this Agreement of any fact or condition that would have caused or constituted a Material breach of any such representation or warranty had such representation or warranty been made as of the time of the occurrence or discovery of such fact or condition or (iii) the occurrence of any event that could reasonably be expected to make satisfaction of the conditions in Article Twelve impossible or unlikely.

Section 10.5 No Negotiation. Between the date of this Agreement and the Closing Date, no Dynex Company will, and each Dynex Company will cause its Representatives (and Dynex will cause IHC and its Representatives) not to, directly or indirectly (i) solicit, encourage or entertain any inquiries or proposals with respect to a sale of the IHC Stock, IHC, the Class B-3 Bonds, the Redemption Rights or the Available Surplus or (ii) discuss or negotiate a sale of the IHC Stock, IHC, the Class B-3 Bonds, the Redemption Rights or the Available Surplus with any Person other than Highland and its Representatives. Dynex will notify Highland of any such inquiry or proposal within twenty-four (24) hours after any Dynex Company or IHC receives such inquiry or proposal.

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Section 10.6 Commercially Reasonable Efforts. Between the date of this Agreement and the Closing Date, each Dynex Company will use commercially reasonable efforts to cause the conditions in Article Twelve to be satisfied.

Section 10.7 Financial Statements. After the Closing Date, Dynex will render such assistance as may be reasonably requested by Highland to enable Highland to obtain, at its expense, audited financial statements for IHC as of and for the years ended December 31, 2003 and December 31, 2004. Dynex will allow Highland and its Representatives to review the books and records of the Dynex Companies to the extent reasonably necessary to prepare such financial statements.

Section 10.8 No Adverse Actions. After the Closing Date, no Dynex Company will take any action that could reasonably be expected to have a Material adverse effect on the Class B-3 Bonds, the Redemption Rights or the Available Surplus. MERIT will exercise in full any rights it may have (it being understood that MERIT may have limited rights or no such rights) under the Series 11 Supplement and the Series 12-1 Supplement to withdraw or otherwise receive the Available Surplus and will promptly distribute all Available Surplus that it withdraws or otherwise receives to IH Capital. Notwithstanding anything in this Section 10.8 to the contrary, Dynex shall be under no obligation to take any action or refrain from taking any action that it determines (based upon opinion of counsel) would constitute a breach of its obligations under the Base Indenture, the Series 11 Supplement or the Series 12-1 Supplement.

ARTICLE ELEVEN COVENANTS OF HIGHLAND

Section 11.1 Required Approvals. As soon as practicable after the date of this Agreement, Highland will make or cause to be made all filings required by Legal Requirements to be made by it or IHC (Post-Sale) in order to consummate the Contemplated Transactions. Between the date of this Agreement and the Closing Date, Highland will (i) cooperate with each Dynex Company (and its Representatives) with respect to all filings that such Dynex Company elects to make or is required by Legal Requirements to make in connection with the Contemplated Transactions and (ii) cooperate with each Dynex Company (and its Representatives) in obtaining all Consents required in connection with this Agreement or the Contemplated Transactions.

Section 11.2 Commercially Reasonable Efforts. Between the date of this Agreement and the Closing Date, Highland will use commercially reasonable efforts to cause the conditions in Article Thirteen to be satisfied.

Section 11.3 No Further Rights. The parties intend that IHC will not contain any assets when transferred to Highland other than the books and records relating to the Financial Statements. If it should be determined at any time after the Closing Date that any other assets were owned by IHC and inadvertently conveyed to Highland on the Closing Date,

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Highland hereby covenants and agrees to promptly transfer such other assets to Dynex upon discovery or notice of the existence of such other assets.

ARTICLE TWELVE
CONDITIONS PRECEDENT TO
HIGHLAND'S OBLIGATION TO CLOSE

The obligation of Highland to take (or to cause IHC Post-Sale to take) the actions required to be taken by Highland (or IHC Post-Sale) at the First Closing, the Second Closing and the Third Closing are subject to the satisfaction, on or before the Closing Date, of each of the following conditions (any of which may be waived by Highland in whole or in part):

Section 12.1 Accuracy Of Representations. Each of each Dynex Company's representations and warranties in this Agreement must have been accurate in all Material respects as of the date of this Agreement and must be accurate in all Material respects as of the Closing Date as if made on the Closing Date.

Section 12.2 Performance Of Covenants. Each Dynex Company must have performed and complied with, in each case in all Material respects, each of the covenants and obligations that it is required to perform or to comply with on or before the Closing Date pursuant to this Agreement.

Section 12.3 Required Consents. Each of the notices and Consents identified on Schedule 6.4 or Schedule 7.4 must have been given or obtained and must be in full force and effect.

Section 12.4 Additional Documents. Dynex must have delivered or caused to be delivered to Highland each of the following documents:

- (i) an opinion of Williams Mullen, counsel to each Dynex Company and IHC, dated the Closing Date, in the form of Exhibit 12.4;
- (ii) the articles of incorporation of IHC, certified as of a date not earlier than the third Business Day prior to the First Closing by the Virginia State Corporation Commission;
- (iii) a good standing certificate for IHC issued by the Virginia State Corporation Commission, dated as of a date not earlier than the third Business Day prior to the First Closing; and
- (iv) all such other documents as Highland may reasonably request for the purpose of (i) evidencing the accuracy of any representation or warranty of any Dynex Company, (ii) evidencing the performance by any Dynex Company of, or the compliance by any Dynex Company with, any covenant or obligation required to be performed or

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complied with by such Dynex Company, (iii) evidencing the satisfaction of any condition referred to in this Article Twelve or (iv) otherwise facilitating the consummation of any of the Contemplated Transactions.

Section 12.5 No Proceedings. There must not have been commenced or threatened against Highland or any Affiliate of Highland, in each case after the date of this Agreement, any Proceeding (i) that seeks damages or other relief in connection with any of the Contemplated Transactions or (ii) that challenges, or that may have the effect of preventing, delaying, making illegal or otherwise interfering with, any of the Contemplated Transactions.

Section 12.6 No Claims. There must not have been made or threatened by any Person any claim that such Person (i) is the record or beneficial owner of, has the right to acquire or to obtain beneficial ownership of or has any other interest in the IHC Stock or any other equity securities of IHC, (ii) is entitled to all or any portion of the IHC Stock Purchase Price, (iii) is the owner of, has the right to acquire or has any other interest in the Class B-3 Bonds or the Redemption Rights or (iv) is entitled to all or any portion of the Class B-3 Bonds Purchase Price or the Redemption Rights Purchase Price.

ARTICLE THIRTEEN
CONDITIONS PRECEDENT TO
EACH DYNEX COMPANY'S OBLIGATION TO CLOSE

The obligation of each Dynex Company to take (or to cause IHC to take) the actions required to be taken by such Dynex Company (or IHC) at the First Closing, the Second Closing and the Third Closing are subject to the satisfaction, on or before the Closing Date, of each of the following conditions (any of which may be waived by such Dynex Company in whole or in part):

Section 13.1 Accuracy Of Representations. Each of Highland's representations and warranties in this Agreement must have been accurate in all Material respects as of the date of this Agreement and must be accurate in all Material respects as of the Closing Date as if made on the Closing Date.

Section 13.2 Performance Of Covenants. Highland must have performed and complied with, in each case in all Material respects, each of the covenants and obligations that it is required to perform or to comply with on or before the Closing Date pursuant to this Agreement.

Section 13.3 Required Consents. Each of the notices and Consents identified on Schedule 6.4 or Schedule 7.4 must have been given or obtained and must be in full force and effect.

Section 13.4 Additional Documents. Highland must have delivered or caused to have been delivered to Dynex all such documents as any Dynex Company may reasonably

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request for the purpose of (i) enabling its counsel to provide the opinion referred to in Section 12.4, (ii) evidencing the accuracy of any representation or warranty of Highland, (iii) evidencing the performance by Highland of, or the compliance by Highland with, any covenant or obligation required to be performed or complied with by Highland, (iv) evidencing the satisfaction of any condition referred to in this Article Thirteen or (v) otherwise facilitating the consummation of any of the Contemplated Transactions.

Section 13.5 No Proceedings. There must not have been commenced or threatened against any Dynex Company or any Affiliate of any Dynex Company, in each case after the date of this Agreement, any Proceeding (i) that seeks damages or other relief in connection with any of the Contemplated Transactions or (ii) that challenges, or that may have the effect of preventing, delaying, making illegal or otherwise interfering with, any of the Contemplated Transactions.

ARTICLE FOURTEEN INDEMNIFICATION; REMEDIES

Section 14.1 Survival; Knowledge. All representations, warranties, covenants and obligations in this Agreement or in any certificate or document delivered pursuant to this Agreement will survive the First Closing, the Second Closing and the Third Closing; provided, however, that such representations and warranties (other than the representations and warranties set forth in Sections 5.1, 5.2, 5.3, 5.12, 6.1, 6.2, 6.7, 7.1, 7.2, 7.7, 7.8, 7.9, 7.10, 7.11, 8.1 and 8.2) shall expire on the second anniversary of the Closing Date. The right to indemnification, reimbursement or other remedy based on such representations, warranties, covenants and obligations will not be affected by any investigation conducted with respect to, or any knowledge acquired (or capable of being acquired) at any time, whether before or after the execution and delivery of this Agreement or the Closing Date, with respect to the accuracy or inaccuracy of any such representation or warranty or the performance of or compliance with and such covenant or obligation. The waiver of any condition based on the accuracy of any representation or warranty or on the performance of or compliance with any covenant or obligation will not affect the right to indemnification, reimbursement or other remedy based on such representations, warranties, covenants and obligations.

Section 14.2 Indemnification And Reimbursement By Each Dynex Company. Each Dynex Company, jointly and severally, will indemnify and hold harmless Highland and IHC (Post-Sale), and their respective Representatives and Affiliates, (collectively, the "Highland Indemnified Persons") from and against, and will reimburse the Highland Indemnified Persons for, any loss, liability, claim, damage or expense (including costs of investigation and defense and reasonable attorneys' fees but excluding exemplary, special, incidental or consequential damages), whether or not involving a Third-Party Claim (collectively, "Damages"), arising from or in connection with (i) any breach of any representation or warranty made by any Dynex Company in this Agreement or in any certificate or document delivered by such Dynex Company pursuant to this Agreement, (ii) any breach by any Dynex Company of any covenant or obligation of such Dynex Company in this Agreement, (iii) the Class Action Lawsuit, (iv) any

claim by any Person for brokerage or finder's fees, agents' commissions or other similar payments based upon any agreement or understanding alleged to have been made by such Person with any Dynex Company (or its Representatives) in connection with any of the Contemplated Transactions, (v) any claim by any Person or Governmental Body relating to the operation of IHC before the Closing Date (including any Proceeding that arises after the Closing Date and that relates to the operation of IHC before the Closing Date) or (vi) any claim by any Person or Governmental Body relating to the failure to obtain the Trustee's consent or agreement to the transactions described in clause (iv) or (v) of Section 2.4 or to the sale of the IHC Stock to Highland pursuant to this Agreement. Notwithstanding anything herein to the contrary, the maximum amount of the aggregate liability of the Dynex Companies for any indemnification obligations under this Article Fourteen arising from or in connection with any breach of any representation or warranty shall be (i) in the case of the IHC Stock or IHC, \$[*], (ii) in the case of the Redemption Rights, the Redemption Rights Purchase Price, (iii) in the case of the Class B-3 Bonds, the Class B-3 Bonds Purchase Price, and (iv) in the case of the Derivative Transaction, \$[*]; provided, however, that the maximum amount of the aggregate liability of the Dynex Companies for any indemnification obligations under this Article Fourteen arising from or in connection with any breach of any representation or warranty shall be \$[*]. The remedies provided in this Section 14.2 will, except with respect to Damages arising as a result of the fraud or willful misconduct of any Dynex Indemnified Person, be the exclusive remedy available to the Highland Indemnified Persons.

Section 14.3 Indemnification And Reimbursement By Highland. Highland will indemnify and hold harmless each Dynex Company and its Representatives and Affiliates (collectively, the "Dynex Indemnified Persons") from and against, and will reimburse the Dynex Indemnified Persons for, any Damages arising from or in connection with (i) any breach of any representation or warranty made by Highland in this Agreement or in any certificate or document delivered by Highland pursuant to this Agreement, (ii) any breach by Highland of any covenant or obligation of Highland in this Agreement, (iii) any claim by any Person for brokerage or finder's fees, agents' commissions or other similar payments based upon any agreement or understanding alleged to have been made by such Person with Highland or its Representatives in connection with any of the Contemplated Transactions or (iv) any claim by any Person or Governmental Body relating to the operation of IHC (Post-Sale) (it being understood that this clause (iv) shall not include the Class Action Lawsuit or any other Proceeding that arises after the Closing Date and that relates to the operation of IHC before the Closing Date). Notwithstanding anything herein to the contrary, the maximum amount of the aggregate liability of Highland for any indemnification obligations under this Article Fourteen arising from or in connection with any breach of any representation or warranty shall be \$[*]. The remedies provided in this Section 14.3 will, except with respect to Damages arising as a result of the fraud or willful misconduct of any Highland Indemnified Person, be the exclusive remedy available to the Dynex Indemnified Persons.

Section 14.4 Indemnification Procedure-Third Party Claims.

(a) Promptly after receipt by a Person entitled to indemnification under this Article Fourteen (an "Indemnified Person") of notice of the assertion of any Third-Party Claim against it, such Indemnified Person shall give notice to the Person obligated to indemnify under

this Article Fourteen (an "Indemnifying Person") of the assertion of such Third-Party Claim; provided, however, that the failure to notify the Indemnifying Person of the assertion of any Third-Party Claim will not relieve the Indemnifying Person of any liability that it may have to any Indemnified Person, except to the extent that the Indemnifying Person demonstrates that the defense of such action is prejudiced by the Indemnifying Person's failure to give such notice.

(b) If an Indemnified Person gives notice to an Indemnifying Person pursuant to Section 14.4(a) of the assertion of a Third-Party Claim:

(i) the Indemnifying Person will be entitled to participate in the defense of such Third-Party Claim and, to the extent that it wishes (unless (A) the Indemnifying Person is also a Person against whom the Third-Party Claim is made and the Indemnified Person determines in good faith that joint representation would be inappropriate or (B) the Indemnifying Person fails to provide reasonable assurance to the Indemnified Person of its financial capacity to defend such Third-Party Claim and to provide indemnification with respect to such Third-Party Claim), to assume the defense of such Third-Party Claim with counsel satisfactory to the Indemnified Person;

(ii) after notice from the Indemnifying Person to the Indemnified Person of its election to assume the defense of such Third-Party Claim, the Indemnifying Person will not, so long as it diligently conducts such defense, be liable to the Indemnified Person under this Article Fourteen for any attorneys' fees or any other expenses with respect to the defense of such Third-Party Claim, in each case subsequently incurred by the Indemnified Person in connection with the defense of such Third-Party Claim, other than reasonable costs of investigation;

(iii) if the Indemnifying Person assumes the defense of a Third-Party Claim, (A) such assumption will conclusively establish for purposes of this Agreement that the claims made in that Third-Party Claim are within the scope of and subject to indemnification pursuant to this Article Fourteen and (B) no compromise or settlement of such claims may be effected by the Indemnifying Person without the Indemnified Person's Consent unless (1) there is no finding or admission of any violation of Legal Requirements or any violation of the rights of any Person and no effect on any other claims that may be made against the Indemnified Person, (2) the sole relief provided is monetary damages that are paid in full by the Indemnifying Person and (3) the Indemnified Person will have no liability with respect to any compromise or settlement of such claims effected without its Consent; and

(iv) if notice is given to an Indemnifying Person of the assertion of any Third-Party Claim and the Indemnifying Person does not, within ten (10) days after the Indemnified Person's notice is given, give notice to the Indemnified Person of its election to assume the defense of such Third-Party Claim, the Indemnifying Person will be bound by any determination made in such Third-Party Claim or any compromise or settlement effected by the Indemnified Person.

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(c) Notwithstanding the provisions of Section 14.4(b), if an Indemnified Person determines in good faith that there is a reasonable probability that a Third-Party Claim may adversely affect it or its Affiliates other than as a result of monetary damages for which it would be entitled to indemnification under this Agreement, the Indemnified Person may, by notice to the Indemnifying Person, assume the exclusive right to defend, compromise or settle such Third-Party Claim, but the Indemnifying Person will not be bound by any determination of a Third-Party Claim so defended or any compromise or settlement effected without its Consent (which may not be unreasonably withheld).

(d) Notwithstanding the provisions of Section 16.10, each Dynex Company hereby consents to the nonexclusive jurisdiction of any court in which a Proceeding in respect of a Third-Party Claim is brought against any Highland Indemnified Person for purposes of any claim that a Highland Indemnified Person may have under this Agreement with respect to such Proceeding or the matters alleged therein and hereby agree that process may be served on any Dynex Company with respect to such a claim anywhere in the world.

(e) With respect to any Third-Party Claim subject to indemnification under this Article Fourteen, (i) the parties will keep each other fully informed as to the status of such Third-Party Claim and any related Proceedings at all stages thereof where any such party is not represented by its own counsel and (ii) the parties (each at its own expense) will render to each other such assistance as may be reasonably requested and will cooperate in good faith with each other to ensure the proper and adequate defense of such Third-Party Claim.

(f) With respect to any Third-Party Claim subject to indemnification under this Article Fourteen, the parties will cooperate in such a manner as to preserve in full (to the extent possible) the confidentiality of all Confidential Information and the attorney-client and work-product privileges. Each party agrees that (i) it will use commercially reasonable efforts, in connection with any Third-Party Claim in which it has assumed or participated in the defense, to avoid production of Confidential Information (consistent with applicable law and rules of procedure) and (ii) all communications among the parties and counsel responsible for or participating in the defense of any Third-Party Claim will, to the extent possible, be made so as to preserve any applicable attorney-client or work-product privilege.

Section 14.5 Indemnification Procedure-Other Claims. A claim for indemnification for any matter not involving a Third-Party Claim may be asserted by notice to the party from whom indemnification is sought.

ARTICLE FIFTEEN TERMINATION

Section 15.1 Termination Events. This Agreement may be terminated by notice given before the Closing Date as follows:

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(i) by mutual consent of Highland, on the one hand, and each Dynex Company, on the other hand;

(ii) by Highland if (A) any Dynex Company has breached any provision of this Agreement in any Material respect and such breach has not been waived by Highland, (B) any condition set forth in Article Twelve has not been satisfied as of the Closing Date or if satisfaction of any such condition is or becomes impossible (other than through the failure of Highland to comply with its obligations under this Agreement) and Highland has not waived such condition on or before the Closing Date or (C) the First Closing has not occurred on or before May 13, 2005 (or such later date to which the parties may agree), unless Highland is in Material breach of this Agreement; and

(iii) by any Dynex Company if (A) Highland has breached any provision of this Agreement in any Material respect and such breach has not been waived by each Dynex Company, (B) any condition set forth in Article Thirteen has not been satisfied as of the Closing Date or if satisfaction of any such condition is or becomes impossible (other than through the failure of any Dynex Company to comply with its obligations under this Agreement) and any Dynex Company has not waived such condition on or before the Closing Date or (C) the First Closing has not occurred on or before May 13, 2005 (or such later date to which the parties may agree), unless any Dynex Company is in Material breach of this Agreement.

Section 15.2 Effect of Termination. Each party's right of termination under Section 15.1 is in addition to any other rights such party may have under this Agreement or otherwise, and the exercise of a right of termination will not be an election of remedies. If this Agreement is terminated pursuant to Section 15.1, all further obligations of the parties under this Agreement will terminate; provided, however, that the obligations of the parties under Section 16.1 will survive such termination; and, provided further, that if this Agreement is terminated by a party because of a breach of this Agreement by another party or because one or more conditions to the terminating party's obligations under this Agreement are not satisfied as a result of another party's failure to comply with its obligations under this Agreement, the terminating party's rights to pursue all legal remedies will survive such termination unimpaired.

ARTICLE SIXTEEN MISCELLANEOUS PROVISIONS

Section 16.1 Expenses. Except as otherwise expressly provided in this Agreement, each party to this Agreement will bear its respective fees and expenses incurred in connection with the preparation, negotiation, execution and performance of this Agreement and the Contemplated Transactions, including all fees and expenses of its Representatives. Dynex will cause IHC not to incur any out-of-pocket expenses in connection with this Agreement. In the event of termination of this Agreement, the obligation of each party to pay its own expenses

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will be subject to any rights of such party arising from a breach of this Agreement by the other party.

Section 16.2 Confidentiality. Between the date of this Agreement and the Closing Date, the parties will maintain in confidence, and Dynex will cause IHC to maintain in confidence, any written, oral or other information obtained in confidence in connection with this Agreement or the Contemplated Transactions, unless (i) such information was already known to the disclosing party or to others not bound by a duty of confidentiality or such information becomes publicly available through no fault of such party, (ii) the use of such information is necessary or appropriate in making any filing or obtaining any consent or approval required for the consummation of the Contemplated Transactions or (iii) the furnishing or use of such information is required by or necessary or appropriate in connection with legal proceedings (and the necessity of such use shall be supported by an opinion of counsel). If the Contemplated Transactions are not consummated, each party will return or destroy as much of such written information as the other parties may reasonably request.

Section 16.3 Notices.

(a) All notices, consents, waivers and other communications hereunder must be in writing and either (i) delivered personally, (ii) sent by facsimile transmission (with written confirmation of a successful transmission), (iii) mailed by prepaid first class registered or certified mail, return receipt requested or (iv) delivered by a nationally recognized prepaid overnight courier service (return receipt requested), in each case to the appropriate addresses or facsimile numbers set forth below (or to such other addresses or facsimile numbers as any party may designate by notice to the other parties):

Dynex: Dynex Capital, Inc.
4551 Cox Road, Suite 300
Glen Allen, Virginia 23060
Attention: Steven J. Benedetti
Facsimile No: (804) 217-5860

with a copy (which shall not constitute notice) to:

R. Brian Ball, Esquire
Williams Mullen
1021 East Cary Street
Richmond, Virginia 23219
Facsimile No: (804) 783-6507

Highland: Highland Undertakings, LLC

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c/o The Kleinfeld Law Firm, LLP
SunTrust International Center, Suite 1940
One Southeast Third Avenue
Miami, Florida 33131
Attention: Carl H. Linder
Facsimile No: (350) 358-6541

with a copy (which shall not constitute notice) to:

David E. Melson, Esquire
McGuireWoods LLP
901 East Cary Street
Richmond, Virginia 23219
Facsimile No: (804) 698-2118

(b) All such notices, consents, waivers and other communications will (i) if delivered personally in the manner and to the address provided in this Section 16.3, be deemed given upon delivery, (ii) if delivered by facsimile transmission in the manner and to the facsimile number provided in this Section 16.3, be deemed given on the earlier of receipt and the first Business Day after transmission, (iii) if delivered by mail in the manner and to the address provided in this Section 16.3, be deemed given on the earlier of receipt and the fourth Business Day following mailing, and (iv) if delivered by overnight courier in the manner and to the address provided in this Section 16.3, be deemed given on the earlier of receipt and the first Business Day following the date sent by such overnight courier.

Section 16.4 Legal Fees. If a legal proceeding is brought by one party against the other party based on this Agreement, after all appeals the prevailing party shall be entitled to its reasonable attorney and paralegal fees and costs from the non-prevailing party.

Section 16.5 Entire Agreement; Modifications. This Agreement supersedes all prior agreements and understandings between the parties with respect to its subject matter (including any letter of intent or confidentiality agreement) and constitutes (along with the exhibits, schedules and other documents delivered pursuant to this Agreement) a complete and exclusive statement of the terms of the agreement between the parties with respect to its subject matter. This Agreement may not be amended or otherwise modified except by a written agreement executed by the party to be charged with such amendment or other modification.

Section 16.6 Governing Law. This Agreement shall be governed by and construed in accordance with the laws of the Commonwealth of Virginia without giving effect to any choice of law or conflict of law provision or rule (whether of the Commonwealth of Virginia or any other jurisdiction) that would require the application of any other law.

Section 16.7 Assignment; Successors; No Third-Party Rights. No party may assign any of its rights or delegate any of its obligations under this Agreement (whether by operation of law or otherwise) without the prior written consent of the other parties. Subject to

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the preceding sentence, this Agreement will be binding upon, inure to the benefit of and be enforceable by the successors and permitted assigns of the parties. Nothing expressed or referred to in this Agreement will be construed to give any Person other than the parties to this Agreement any legal or equitable right, remedy or claim under or with respect to this Agreement or any provision of this Agreement. This Agreement and all of its provisions and conditions are for the sole and exclusive benefit of the parties and their successors and assigns.

Section 16.8 Severability. If any provision of this Agreement is held invalid or unenforceable by any court of competent jurisdiction, the other provisions of this Agreement will remain in full force and effect. Any provision of this Agreement held invalid or unenforceable only in part will remain in full force and effect to the extent not held invalid or unenforceable.

Section 16.9 No Waiver. The rights and remedies of the parties are cumulative and not alternative. Neither the failure nor any delay by any party in exercising any right, power or privilege under this Agreement will operate as a waiver of such right, power or privilege, and no single or partial exercise by any party of any right, power or privilege under this Agreement will preclude any other or further exercise of such right, power or privilege or the exercise of any other right, power or privilege.

Section 16.10 Jurisdiction; Service Of Process. Any Proceeding arising out of or relating to this Agreement or any Contemplated Transaction may be brought in the courts of the Commonwealth of Virginia or, if it has or can acquire jurisdiction, in the United States District Court for the Eastern District of Virginia, and each party irrevocably submits to the exclusive jurisdiction of each such court in any such Proceeding, waives any objection it may now or hereafter have to venue or to convenience of forum, agrees that all claims in respect of any such Proceeding shall be heard and determined only in any such court and agrees not to bring any Proceeding arising out of or relating to this Agreement or any Contemplated Transaction in any other court. The parties agree that any or all of them may file a copy of this Section 16.10 with any court as written evidence of the knowing, voluntary and bargained agreement among the parties irrevocably to waive any objections to venue or to convenience of forum. Process in any Proceeding referred to in the first sentence of this Section 16.10 may be served on any party anywhere in the world.

Section 16.11 Further Assurances. The parties agree to furnish upon request to each other such further information, to execute and deliver to each other such other documents and to take such other actions as the other parties may reasonably request for the purpose of carrying out the intent of this Agreement.

Section 16.12 Counterparts. This Agreement may be executed in one or more counterpart copies, each of which will be deemed to be an original copy of this Agreement and all of which, when taken together, will be deemed to constitute one and the same agreement. The exchange of copies of this Agreement and of signature pages by facsimile transmission shall constitute effective execution and delivery of this Agreement as to the parties and may be used in lieu of the original Agreement for all purposes. Any signatures of the parties transmitted by facsimile shall be deemed to be their original signatures for all purposes.

IN WITNESS WHEREOF, Highland and each Dynex Company have executed this Agreement as of the date first written above.

HIGHLAND UNDERTAKINGS, LLC,
a Nevis limited liability company by and through its manager, GMT MANAGERS, LLC, a Nevis limited liability
company

By: _____
Sarah Petre-Mears
Co-Manager

By: _____
Edward Petre-Mears
Co-Manager

[SIGNATURES CONTINUED ON NEXT PAGE]

DYNEX CAPITAL, INC.

By: _____
Name:
Title:

MSC I, L.P.,
a Virginia limited partnership by and through its General Partner, DYNEX CAPITAL, INC.

By: _____
Name:
Title:

MERIT SECURITIES CORPORATION

By: _____
Name:
Title:

ISSUED HOLDINGS CAPITAL CORPORATION

By: _____
Name:
Title:

DYNEX CAPITAL, INC.
DIRECTOR STOCK OPTION AGREEMENT

THIS AGREEMENT, dated as of the 17th day of June, 2005 between DYNEX CAPITAL, INC. (the "Corporation"), and _____ (the "Recipient").

WHEREAS, pursuant to the DYNEX CAPITAL, INC. 2004 Stock Incentive Plan (the "Plan"), and pursuant to that certain Action-in-Writing dated April 13, 2005, the Board wishes to enable the Recipient to participate in its future success and to associate their interests with those of the Corporation and its shareholders through the grant of an option to purchase Common Stock of the Corporation under the terms outlined below; and

WHEREAS, the Recipient desires to accept said award in accordance with the terms and provisions of the Plan and this Agreement.

NOW THEREFORE, in consideration of the premises and of the mutual covenants and agreements hereinafter set forth, the Corporation and the Recipient agree as follows:

1. Grant of Option.

Subject to the terms and conditions of the Plan and subject further to the terms and conditions set forth herein, the Corporation granted to the Recipient on June 17, 2005 ("Date of Grant") the right and option to purchase from the Company all or any part of an aggregate of 5,000 shares of Common Stock at the option price of \$8.46 per share which is 110% of Fair Market Value of Common Stock on the Date of Grant. This option is not intended to be an "Incentive Stock Option" under section 422 of the Code. Such option will be exercisable as hereafter provided. Capitalized terms not otherwise defined herein have the meanings given to them in the Plan.

2. Exercise of Option.

This option shall be exercisable with respect to all of the shares subject to the option on the Date of Grant. Once this option has become exercisable in accordance with the previous sentence it shall continue to be exercisable until the termination of Recipient's rights hereunder pursuant to paragraph 6. A partial exercise of this option shall not affect Recipient's right to exercise this option with respect to the remaining shares, subject to the conditions of the Plan and this Agreement.

3. Method of Exercising and Payment for Shares.

This option shall be exercised by delivery of a written Notice of Exercise stating the number of shares the Recipient desires to exercise. The form of Notice of Exercise is attached to this Agreement as Exhibit A. The exercise date shall be the later of the date specified in the Notice of Exercise or the date such notice is received by the Corporation. Notices should be delivered to Dynex Capital, Inc., at its Corporate headquarters, Attention: Chief Financial

Officer. Such notice shall be accompanied by the payment of the option price in full, in cash or cash equivalent.

4. Termination.

This option shall terminate upon the earliest of the following events:

(a) June 17, 2010.

(b) The expiration of twelve (12) months after the date the Recipient ceases to be a member of the Board, provided, however, that if the Recipient continues to provide consulting or other material services to the Corporation, the expiration date will be twelve (12) months from the time that the Recipient no longer provides consulting or other material services to the Corporation.

(c) The expiration of twelve (12) months after the date of death of the Recipient if death occurs while the Recipient is a member of the Board. During this period, the Recipient's estate, personal representative or beneficiary shall have the right to exercise the option to the extent it is exercisable on the date of Recipient's death.

(d) The expiration of twelve (12) months after the date the Recipient is terminated from service on the Board due to disability. During this period, the Recipient shall have the right to exercise the option to the extent it is exercisable on the date of termination due to disability.

(e) The expiration of twelve (12) months after the date of the Recipient's Retirement. During this period, the Recipient shall have the right to exercise the option to the extent it is exercisable on the date of Retirement. For purposes of this Agreement, Retirement means termination from the Board in accordance with the Corporation's Corporate Governance Guidelines.

The Board shall have absolute discretion to determine whether any termination of Recipient from the Board or authorized leave of absence or absence due to military or government service is to be considered as Retirement for purposes of this Agreement and whether an authorized leave of absence or absence due to military or government service shall constitute a termination of service from the Board for the purposes of this Agreement. Any determination made by the Board with respect to any matter referred to in this paragraph 6 shall be final and conclusive.

5. Nontransferability.

This option is nontransferable except by will or the laws of descent and distribution. This option is exercisable during the Recipient's lifetime only by the Recipient.

6. Rights as a Shareholder.

The Recipient shall have no rights as a shareholder with respect to any Common Stock covered by the option prior to the exercise of the option and the issuance of shares of Common Stock.

7. Recapitalization.

If the Corporation shall effect a subdivision or consolidation of shares of Common Stock, or other capital readjustment, or the payment of a stock dividend, or other increase or decrease in the number of shares of Common Stock outstanding, without receiving compensation therefore, then (a) in the event of any increase in the number of shares of Common Stock outstanding, the number of shares of Common Stock then remaining hereunder shall be proportionately increased (except that any fractional share resulting from any such adjustment shall be excluded from the operation of this Agreement), and the exercise price per share shall be proportionately reduced) but not below the par value of such share), and (b) in the event of a reduction in the number of shares of Common Stock outstanding, the number of shares of Common Stock then remaining hereunder shall be proportionately reduced (except that any fractional share resulting from any such adjustments shall be excluded from the operation of this Agreement), and the exercise price per share shall be proportionately increased.

8. No Rights to Continued Service.

Nothing in this Agreement or in the Plan shall confer any right to continued service on the Board nor restrict the termination of service of the Recipient at any time.

9. Recipient's Agreement.

Notwithstanding any other provision of this Agreement, Recipient agrees that Recipient will not exercise this option and the Corporation shall not be obligated to issue any Common Stock hereunder, if counsel to the Corporation determines such exercise or issuance would violate any law or regulation of any governmental authority or agreement between the Corporation and any securities exchange upon which the Common Stock is listed.

10. Resolution of Disputes.

Any dispute or disagreement which shall arise under, or as a result of, or pursuant to, this Agreement shall be determined by the Board in its absolute discretion, and any determination by the Board under or pursuant to this Agreement and any interpretation by the Board of the terms of this Agreement shall be final, binding and conclusive on all persons affected thereby.

11. Amendments.

The Committee shall have the right, in its absolute discretion, to alter or amend this Agreement in any manner, and any alteration or amendment of the Agreement by the Committee shall, upon adoption thereof by the Committee, become and be binding and conclusive on all persons affected thereby without written notice to the Recipient of any alteration or amendment

of this Agreement by the Committee as promptly as practical after the adoption thereof. Notwithstanding the foregoing provisions of this paragraph 10, no alteration or amendment of this Agreement shall be made that would adversely affect the rights of the Recipient without the Recipient's consent.

12. Construction.

This Agreement has been entered into in accordance with the terms of the Plan, and wherever a conflict may arise between the terms of this Agreement and the terms of the Plan, the terms of the Plan shall control.

13. Governing Law.

This Agreement shall be governed by and construed and enforced in accordance with the laws of the Commonwealth of Virginia.

IN WITNESS WHEREOF, the Corporation has caused this Agreement to be executed by its duly authorized officer, and the Recipient has hereunto set his hand and seal, all on the day and year first above written.

If this Agreement is not signed and returned by the Recipient to the Chief Financial Officer of the Corporation (or other designated person) on or before _____, this Agreement shall become null and void.

DYNEX CAPITAL, INC.

By:
Stephen J. Benedetti
Executive Vice President

THE RECIPIENT

Date:

**DYNEX CAPITAL, INC.
2004 Stock Incentive Plan**

**STOCK OPTION
NOTICE OF EXERCISE**

Chief Financial Officer
Dynex Capital, Inc.
4551 Cox Road
Suite 300
Glen Allen, Virginia 23060
Phone: (804) 217-5800
Telecopy: (804) 217-5860

I hereby exercise _____ options pursuant to the Option Agreement dated _____, _____, at an exercise price of \$_____ per share. Enclosed is a check for the exercise price of \$_____.

Dated:
Recipient's Signature

Recipient's Name

**DYNEX CAPITAL, INC.
2004 STOCK INCENTIVE PLAN**

STOCK APPRECIATION RIGHTS AGREEMENT

THIS AGREEMENT, dated this 2nd day of January, 2005 between DYNEX CAPITAL, INC. (the "Corporation"), and _____ (the "Recipient").

WHEREAS, pursuant to the DYNEX CAPITAL, INC. 2004 Stock Incentive Plan (the "Plan"), the Committee wishes to award the Recipient for contributions to the achievement of specified objectives and results for the Corporation during the year ended December 31, 2004, and also wishes to enable the Recipient to participate in its future success and to associate their interests with those of the Corporation and its shareholders; and

WHEREAS, the Recipient desires to accept said award in accordance with the terms and provisions of the Plan and this Agreement.

NOW THEREFORE, in consideration of the premises and of the mutual covenants and agreements hereinafter set forth, the Corporation and the Recipient agree as follows:

1. Grant of SAR.

Subject to the terms and conditions of the Plan and subject further to the terms and conditions set forth herein, the Corporation hereby awards to the Recipient on January 3, 2005 ("Date of Grant") SARs with respect to _____ shares of Common Stock with an Initial Value of \$7.81 per share which is the Fair Market Value of Common Stock on the Date of Grant. These SARs will be exercisable as hereafter provided. Capitalized terms not otherwise defined herein have the meanings given to them in the Plan.

2. Exercise of SARs.

(a) Except as provided in subsections (b), (c) and (d) below, the SARs awarded in this Agreement may be exercised in whole or in part in accordance with the following schedule:

- (i) The first installment for _____ SARs may be exercised in whole or in part beginning January 3, 2006;
- (ii) The second installment for _____ SARs may be exercised in whole or in part beginning January 3, 2007;
- (iii) The third installment for _____ SARs may be exercised in whole or in part beginning January 3, 2008; and
- (iv) The fourth installment for _____ SARs may be exercised in whole or in part beginning January 3, 2009.

To the extent not exercised, installments shall accumulate and be exercisable by the Recipient until termination under section 6 below.

- (b) The Compensation Committee may in its discretion accelerate the time at which the SARs may be exercised.
- (c) Notwithstanding the foregoing, the SARs awarded by this Agreement shall immediately be fully exercisable upon a Change of Control of the Corporation and the Corporation may make a cash payment in settlement of such SARs within ten (10) business days following the Control Change Date based on the Fair Market Value of the Common Stock on the Control Change Date.
- (d) In addition, upon Retirement (as defined in section 6 below), the Recipient will become vested in the SARs in accordance with the following schedule to the extent such SARs are not fully vested in accordance with (a) above.

Years of Service With the Corporation		Vesting Percentage
5 or more	100%	
4		80%
3		60%
2		40%
1		20%

3. **Method of Exercising SARs.**

The SARs shall be exercised by delivery of a written Notice of Exercise stating the number of SARs the Recipient desires to exercise. The form of Notice of Exercise is attached to this Agreement as Exhibit A. The exercise date shall be the later of the date specified in the Notice of Exercise or the date such notice is received by the Corporation. Notices should be delivered to Dynex Capital, Inc., at its Corporate headquarters, Attention: Chief Financial Officer.

4. **Payment to Recipient.**

The payment to Recipient upon the exercise of the SARs shall be made solely in cash. Upon the exercise of the SARs, the Recipient shall receive a cash payment from the Corporation which is equal to (i) the excess of the Fair Market Value of a share of Common Stock on the date of exercise over the Initial Value times (ii) the number of SARs exercised.

5. **Certain Tax Matters.**

Unless the Recipient pays to the Corporation in cash the withholding for any federal, state, or local taxes on the income realized from the exercise of the SAR prior to or at the time of exercise, the Corporation shall withhold from the cash payment the amount of taxes to be withheld by the Corporation.

6. Termination.

The SARs granted pursuant to this Agreement shall terminate upon the earliest of the following events:

- (a) December 31, 2011.
- (b) The expiration of ninety (90) days after the date of termination of the Recipient's employment, other than termination of employment on account of death, disability or Retirement. During this period, the Recipient shall have the right to exercise the SARs to the extent it is exercisable on the Recipient's termination of employment.
- (c) The expiration of twelve (12) months after the date of death of the Recipient if death occurs while the Recipient is in the employ of the Corporation. During this period, the Recipient's estate, personal representative or beneficiary shall have the right to exercise the SARs to the extent it is exercisable on the date of Recipient's death.
- (d) The expiration of twelve (12) months after the date the Recipient's employment is terminated due to disability. During this period, the Recipient shall have the right to exercise the SARs to the extent it is exercisable on the date of termination due to disability.
- (e) The expiration of twelve (12) months after the date of the Recipient's Retirement. During this period, the Recipient shall have the right to exercise the SARs to the extent it is exercisable on the date of Retirement.

For purposes of this Agreement, Retirement means termination of his employment with the Corporation on or after age 62.

The Board or the Committee shall have absolute discretion to determine whether any termination of Recipient's employment or authorized leave of absence or absence due to military or government service is to be considered as Retirement for purposes of this Agreement and whether an authorized leave of absence or absence due to military or government service shall constitute a termination of employment for the purposes of this Agreement. Any determination made by the Board or the Committee with respect to any matter referred to in this paragraph 6 shall be final and conclusive.

7. Nontransferability.

The SARs granted under this Agreement shall be nontransferable except by will or the laws of descent and distribution. The SARs are exercisable during the Recipient's lifetime only by the Recipient.

8. Rights as a Shareholder.

The Recipient shall have no rights as a shareholder with respect to any Common Stock covered by the SARs prior to the exercise of the SAR.

9. Recapitalization.

If the Corporation shall effect a subdivision or consolidation of shares of Common Stock, or other capital readjustment, or the payment of a stock dividend, or other increase or decrease in the number of shares of Common Stock outstanding, without receiving compensation therefore, then (a) in the event of any increase in the number of shares of Common Stock outstanding, the number of SARs on Common Stock then remaining hereunder shall be proportionately increased (except that any fractional share resulting from any such adjustment shall be excluded from the operation of this Agreement), and the cash consideration payable per share shall be proportionately reduced) but not below the par value of such share), and (b) in the event of a reduction in the number of shares of Common Stock outstanding, the number of SARs on Common Stock then remaining hereunder shall be proportionately reduced (except that any fractional share resulting from any such adjustments shall be excluded from the operation of this Agreement), and the cash consideration payable per share shall be proportionately increased.

10. Merger, Consolidation or Share Exchange.

After any merger, consolidation or share exchange in which the Corporation is the surviving or resulting corporation, the Recipient shall be entitled, upon the exercise of a SAR, to receive the consideration to which the Recipient would have been entitled, if, immediately prior to such merger, consolidation or share exchange, the Recipient had been the holder of record of a number of shares of Common Stock equal to the number of SARs exercised. If the Corporation is not the surviving or resulting corporation in any merger, consolidation or share exchange, the surviving or resulting corporation shall tender SARs on terms and conditions that substantially preserve the rights and benefits under this Agreement.

11. Certain Restrictions.

(a) It is understood and recognized by the Recipient and the Corporation that the vendors, customers, employees, consultants, and agents are an integral part of the Corporation's business. The Recipient and the Corporation also recognize that an important part of the Recipient's duties with the Corporation will be the Recipient's dealings with customers, vendors and others (including other employees) having business relationships with the Corporation and its affiliates. It is therefore understood and agreed by the parties that because of the nature of the Corporation's business it is necessary to afford maximum protection to the Corporation from the loss of any such entities or individuals. Consequently, as a material inducement to and as consideration for the Corporation's grant of the SARs hereunder to the Recipient, the Recipient covenants and agrees that unless the Recipient's employment is terminated without Cause as hereinafter defined, at all times during the Recipient's employment with the Corporation or any of its affiliates (the "Employment Period") and, in the case of actions specified in (ii), (iii), and (iv) below, for a period of one year after the termination of the Recipient's employment for whatever reason, the Recipient shall not, in any capacity whatsoever, whether directly or

indirectly, through any entity, family member or otherwise, on his own behalf, or on behalf of any other person, firm, partnership, corporation, limited liability company, association or other entity (collectively, "Person"):

(i) own, manage, invest, participate or engage in any activity which compromises or is similar to the Corporation's business activities anywhere in the United States, unless (a) the ownership is less than 1% of a publicly traded entity with a market value in excess of \$100 million, or (b) specifically approved in writing by the President or Chairman of the Board;

(ii) suggest to, solicit, induce or persuade any vendor or customer of the Corporation or its affiliates to discontinue doing business with, or to change the terms or conditions of such relationship with the Corporation or its affiliates, or otherwise disparage, disrupt or disturb the relationship of the Corporation or its affiliates with such vendor or customer;

(iii) suggest to, solicit, induce or persuade any vendor or customer of the Corporation or its affiliates to do business with any other Person which conducts or is planning to conduct a business that is in competition with or similar to the Corporation's business activities; *provided however*, the foregoing will not apply after the Employment Period (a) to any customer that represents less than 2% of the Corporation's volume in that particular line of business over the prior twelve month period, or (b) to any vendor whose products or services are already used widely in that particular business area by other Persons;

(iv) suggest to, solicit, induce or persuade any employee or consultant of the Corporation or its affiliates to leave the employ or engagement of the Corporation or its affiliates or hire any employee of the Corporation or its affiliates; and

(v) participate in planning for or consult with any business that is or would be in competition with or similar to any business of the Corporation or its affiliates.

(b) The Recipient further covenants and agrees that for a period of one year after the Employment Period, the Recipient shall not seek employment with or be employed by any former employee of the Corporation who terminated employment with the Corporation within one year of the end of the Recipient's Employment Period, in any capacity whatsoever, whether directly or indirectly, through any Person if the Recipient and the former employee of the Corporation are employed in the same business activity as they were when they were employees of the Corporation.

(c) Reasonableness of Restrictions. Recipient has carefully read and considered the provisions of this Section 11 and having done so agrees that the restrictions set forth in this section are fair and reasonable and are reasonably required for the protection of the Corporation and its business. Notwithstanding anything to the contrary in this Section 11, the restrictions set forth in this section shall not apply after the Employment Period if the Corporation is not actively engaged in the business activity in which the Recipient was engaged by the Corporation.

(d) Invalidity, Etc. If any covenant or provision contained in any part of Section 11(a) and/or 11 (b) hereof is found by a court having jurisdiction to be unreasonable in duration, geographic scope or charter of restrictions, the covenant or provision shall not be rendered unenforceable thereby, but rather the duration, geographical scope or character of restriction, the covenant or provision shall be deemed reduced or modified with retroactive effect to render such covenant or provision reasonable and such covenant or provision shall be enforced as modified. If the court having jurisdiction will not review the covenant or provision, the parties shall mutually agree to a revision having an effect as close as permitted by law to the provision declared unenforceable. The Recipient agrees that if a court having jurisdiction determines, despite the express intent of the Recipient, that any portion of the restrictive covenants contained in Section 11 (a) and/or 11 (b) hereof are unenforceable, the remaining provisions shall be valid and enforceable.

(e) Equitable Relief. The Recipient recognizes and acknowledges that if he breaches the provisions of Section 11 (a), damages to the Corporation would be difficult if not impossible to ascertain, and because of the immediate and irreparable damage and loss that may have been caused to the Corporation for which it would have no adequate remedy, it is therefore agreed that the Corporation, in addition to and without limiting any other remedy or right it may have, shall be entitled to have an injunction or other equitable relief in a court of competent jurisdiction, enjoining any such breach, and the Recipient hereby waives any and all defenses he may have on the grounds of competence of a court to grant such an injunction or other equitable relief. The existence of this right shall not preclude the applicability or exercise of any other rights and remedies at law or in equity which the Corporation may have.

(f) Definition of "Cause". When used in this Section 11, the word "Cause" shall mean any of the following:

(i) the willful and continued failure of the Recipient to perform substantially the Recipient's duties with the Corporation (other than any such failure resulting from incapacity due to physical or mental illness), if, within 30 days of receiving a written demand for substantial performance from the Board or the President of the Corporation which specifically identifies the manner in which the Recipient has not substantially performed his duties, the Recipient shall have failed to cure such performance or to take measures to cure the performance, or

(ii) the willful engaging by the Recipient in illegal conduct or gross misconduct which is materially and demonstrably injurious to the Corporation.

For purposes of this provision, no act or failure to act, on the part of the Recipient, shall be considered "willful" unless it is done, or omitted to be done, by the Recipient in bad faith or without reasonable belief that the Recipient's action or omission was in the best interests of the Corporation. Any act, or failure to act, based upon authority given pursuant to a resolution duly adopted by the Board or a committee thereof, or based upon the advice of counsel for the Corporation shall be conclusively presumed to be done, or omitted to be done, by the Recipient in good faith and in the best interests of the Corporation. The cessation of employment of the

Recipient shall not be deemed to be for Cause unless and until there shall have been delivered to the Recipient a copy of a resolution duly adopted by the affirmative vote of not less than three-quarters of the entire membership of the Board at a meeting of the Board called and held for such purpose (after reasonable notice is provided to the Recipient and the Recipient is given an opportunity, together with counsel, to be heard before the Board), finding that, in the good faith opinion of the Board, the Recipient is guilty of the conduct described in subparagraph (i) or (ii) above, and specifying the particulars thereof in detail.

12. No Rights to Continued Employment.

Nothing in this Agreement or in the Plan shall confer any right to continued employment with the Corporation or its subsidiaries nor restrict the termination of the employment relationship with the Recipient at any time.

13. Recipient's Agreement.

Notwithstanding any other provision of this Agreement, Recipient agrees that Recipient will not exercise any SAR and the Corporation shall not be obligated to make any payment in the form of Common Stock, if counsel to the Corporation determines such exercise or payment would violate any law or regulation of any governmental authority or agreement between the Corporation and any securities exchange upon which the Common Stock is listed.

14. Other.

This Agreement does not amend or supersede the provisions of any other written employment agreement between the Corporation, including its affiliates, and the Recipient. In the event that any term or provision of this Agreement conflicts with such other employment contract, the terms and provisions of the employment contract shall control, as long as such employment contract is in effect.

15. Resolution of Disputes.

Any dispute or disagreement which shall arise under, or as a result of, or pursuant to, this Agreement other than for any dispute or disagreement relating to Section 11 shall be determined by the Board or the Committee in its absolute discretion, and any determination by the Board or the Committee under or pursuant to this Agreement and any interpretation by the Board of Directors or the Committee of the terms of this Agreement shall be final, binding and conclusive on all persons affected thereby.

16. Amendments.

The Committee shall have the right, in its absolute discretion, to alter or amend this Agreement in any manner, and any alteration or amendment of the Agreement by the Committee shall, upon adoption thereof by the Committee, become and be binding and conclusive on all persons affected thereby without written notice to the Recipient of any alteration or amendment of this Agreement by the Committee as promptly as practical after the adoption thereof.

Notwithstanding the foregoing provisions of this paragraph 16, no alteration or amendment of this Agreement shall be made that would adversely affect the rights of the Recipient without the Recipient's consent.

17. Construction.

This Agreement has been entered into in accordance with the terms of the Plan, and wherever a conflict may arise between the terms of this Agreement and the terms of the Plan, the terms of the Plan shall control.

18. Governing Law.

This Agreement shall be governed by and construed and enforced in accordance with the laws of the Commonwealth of Virginia.

IN WITNESS WHEREOF, the Corporation has caused this Agreement to be executed by its duly authorized officer, and the Recipient has hereunto set his hand and seal, all on the day and year first above written.

DYNEX CAPITAL, INC.

By:
THE RECIPIENT

Date:

DYNEX CAPITAL, INC.
2004 Stock Incentive Plan

STOCK APPRECIATION RIGHTS
NOTICE OF EXERCISE

Chief Financial Officer
Dynex Capital, Inc.
4551 Cox Road
Suite 300
Glen Allen, Virginia 23060
Phone: (804) 217-5800
Telecopy: (804) 217-5860

I hereby exercise _____ vested SARs pursuant to the SAR Agreement dated _____, _____, at an exercise price of \$_____ per share.

Dated:
Recipient's Signature

Recipient's Name

**CERTIFICATION
PURSUANT TO 17 CFR 240.13a-14
PROMULGATED UNDER
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Stephen J. Benedetti, certify that:

1. I have reviewed the Quarterly Report on Form 10-Q of Dynex Capital, Inc. for the quarter ended June 30, 2005;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. I am responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under my supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to me by others within those entities, particularly during the period in which this report is being prepared;
 - (b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report my conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. I have disclosed, based on my most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 22, 2005

/s/ Stephen J. Benedetti

Stephen J. Benedetti

Principal Executive Officer and Chief Financial Officer

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report on Form 10-Q of Dynex Capital, Inc. (the "Company") for the quarter ended June 30, 2005, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Stephen J. Benedetti, the Principal Executive Officer and the Chief Financial Officer of the Company, certify, pursuant to and for purposes of 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: August 22, 2005

/s/ Stephen J. Benedetti

Stephen J. Benedetti

Principal Executive Officer and Chief Financial Officer
