

PennyMac Mortgage Investment Trust
Form 10-Q
November 09, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2012

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: 001-34416

PennyMac Mortgage Investment Trust

(Exact name of registrant as specified in its charter)

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Maryland
(State or other jurisdiction of

27-0186273
(IRS Employer
Identification No.)

incorporation or organization)

6101 Condor Drive, Moorpark, California
(Address of principal executive offices)

93021
(Zip Code)

(818) 224-7442

(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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer Accelerated filer

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

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

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

| Class | Outstanding at November 7, 2012 |
|--|---------------------------------|
| Common Shares of Beneficial Interest, \$0.01 par value | 58,904,431 |

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PENNYMAC MORTGAGE INVESTMENT TRUST

FORM 10-Q

September 30, 2012

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Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

(In thousands, except share data)

| | September 30, 2012 (unaudited) | December 31, 2011 |
|---|--------------------------------------|----------------------|
| ASSETS | | |
| Cash | \$ 67,813 | \$ 14,589 |
| Short-term investments | 38,322 | 30,319 |
| United States Treasury security | | 50,000 |
| Mortgage-backed securities at fair value | | 72,813 |
| Mortgage loans acquired for sale at fair value | 847,575 | 232,016 |
| Mortgage loans at fair value | 1,089,966 | 696,266 |
| Mortgage loans under forward purchase agreements at fair value | | 129,310 |
| Real estate acquired in settlement of loans | 86,180 | 80,570 |
| Real estate acquired in settlement of loans under forward purchase agreements | | 22,979 |
| Mortgage servicing rights: | | |
| at lower of amortized cost or fair value | 63,632 | 5,282 |
| at fair value | 1,522 | 749 |
| Principal and interest collections receivable | 30,016 | 8,664 |
| Principal and interest collections receivable under forward purchase agreements | | 5,299 |
| Interest receivable | 2,932 | 2,099 |
| Due from affiliates | 2,004 | 347 |
| Other assets | 98,763 | 34,760 |
| Total assets | \$ 2,328,725 | \$ 1,386,062 |
| LIABILITIES | | |
| Assets sold under agreements to repurchase: | | |
| Securities | \$ | \$ 115,493 |
| Mortgage loans acquired for sale at fair value | 755,471 | 212,677 |
| Mortgage loans at fair value | 274,185 | 275,649 |
| Real estate acquired in settlement of loans | 11,715 | 27,494 |
| Note payable secured by mortgage loans at fair value | | 28,617 |
| Borrowings under forward purchase agreements | | 152,427 |
| Accounts payable and accrued liabilities | 63,852 | 9,198 |
| Contingent underwriting fees payable | 5,883 | 5,883 |
| Payable to affiliates | 9,812 | 12,166 |
| Income taxes payable | 23,604 | 441 |
| Total liabilities | 1,144,522 | 840,045 |
| Commitments and contingencies | | |
| SHAREHOLDERS EQUITY | | |
| Common shares of beneficial interest authorized, 500,000,000 common shares of \$0.01 par value; issued and outstanding, 58,903,681 and 28,404,554 common shares, respectively | 589 | 284 |
| Additional paid-in capital | 1,128,387 | 518,272 |

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| | | |
|--|--------------|--------------|
| Retained earnings | 55,227 | 27,461 |
| Total shareholders' equity | 1,184,203 | 546,017 |
| Total liabilities and shareholders' equity | \$ 2,328,725 | \$ 1,386,062 |

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

Table of Contents**PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME****(Unaudited)****(In thousands, except per share data)**

| | Quarter ended | | Nine months ended | |
|--|----------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2012 | 2011 | 2012 | 2011 |
| Investment Income | | | | |
| Net gain (loss) on investments: | | | | |
| Mortgage-backed securities | \$ (451) | \$ (791) | \$ 612 | \$ (2,106) |
| Mortgage loans | 26,512 | 32,311 | 64,929 | 65,594 |
| | 26,061 | 31,520 | 65,541 | 63,488 |
| Interest income: | | | | |
| Short-term investments | 13 | 24 | 32 | 82 |
| Mortgage-backed securities | 502 | 651 | 2,087 | 2,719 |
| Mortgage loans | 19,179 | 9,164 | 49,943 | 21,211 |
| Other | 36 | | 95 | |
| | 19,730 | 9,839 | 52,157 | 24,012 |
| Net gain on mortgage loans acquired for sale | 49,793 | 84 | 81,210 | 207 |
| Loan origination fees | 2,836 | 176 | 4,880 | 236 |
| Results of real estate acquired in settlement of loans | 1,288 | 352 | 7,576 | 1,527 |
| Net loan servicing fees | (511) | 14 | (1,169) | 17 |
| Other | (1) | | 56 | 4 |
| Net investment income | 99,196 | 41,985 | 210,251 | 89,491 |
| Expenses | | | | |
| Loan fulfillment fees | 17,258 | 263 | 31,097 | 336 |
| Interest | 8,282 | 5,225 | 21,659 | 10,473 |
| Loan servicing | 5,208 | 4,834 | 15,180 | 10,620 |
| Management fees | 3,672 | 2,288 | 7,964 | 5,750 |
| Compensation | 1,997 | 1,567 | 5,042 | 3,831 |
| Professional services | 1,693 | 1,656 | 3,321 | 3,648 |
| Other | 2,117 | 1,274 | 4,469 | 3,667 |
| Total expenses | 40,227 | 17,107 | 88,732 | 38,325 |
| Income before provision for income taxes | 58,969 | 24,878 | 121,519 | 51,166 |
| Provision for income taxes | 18,585 | 4,350 | 32,508 | 6,376 |
| Net income | \$ 40,384 | \$ 20,528 | \$ 89,011 | \$ 44,790 |
| Earnings per share | | | | |
| Basic | \$ 0.81 | \$ 0.73 | \$ 2.29 | \$ 1.72 |
| Diluted | \$ 0.81 | \$ 0.73 | \$ 2.29 | \$ 1.72 |

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| | | | | |
|--|---------|---------|---------|---------|
| Weighted-average shares outstanding | | | | |
| Basic | 49,078 | 27,847 | 38,398 | 25,782 |
| Diluted | 49,463 | 28,138 | 38,712 | 26,065 |
| Dividends declared per share | \$ 0.55 | \$ 0.50 | \$ 1.65 | \$ 0.92 |

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

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PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(Unaudited)

(In thousands, except share data)

| | Number of shares | Par value | Additional paid-in capital | Retained earnings | Total |
|---|------------------------|--------------|----------------------------------|----------------------|--------------|
| Balance at December 31, 2010 | 16,832,343 | \$ 168 | \$ 317,175 | \$ 2,570 | \$ 319,913 |
| Net income | | | | 44,790 | 44,790 |
| Share-based compensation | 88,711 | 1 | 2,811 | | 2,812 |
| Cash dividends declared, \$0.92 per share | | | | (25,610) | (25,610) |
| Proceeds from offerings of common shares | 10,953,500 | 110 | 197,052 | | 197,162 |
| Underwriting and offering costs | | | (8,404) | | (8,404) |
| Balance at September 30, 2011 | 27,874,554 | \$ 279 | \$ 508,634 | \$ 21,750 | \$ 530,663 |
| Balance at December 31, 2011 | 28,404,554 | \$ 284 | \$ 518,272 | \$ 27,461 | \$ 546,017 |
| Net income | | | | 89,011 | 89,011 |
| Share-based compensation | 162,734 | 2 | 3,574 | | 3,576 |
| Cash dividends declared, \$1.65 per share | | | | (61,245) | (61,245) |
| Proceeds from offerings of common shares | 30,336,393 | 303 | 607,881 | | 608,184 |
| Underwriting and offering costs | | | (1,340) | | (1,340) |
| Balance at September 30, 2012 | 58,903,681 | \$ 589 | \$ 1,128,387 | \$ 55,227 | \$ 1,184,203 |

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

Table of Contents**PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)****(In thousands)**

| | Nine months ended September 30, | |
|--|--|-------------|
| | 2012 | 2011 |
| Cash flows from operating activities | | |
| Net income | \$ 89,011 | \$ 44,790 |
| Adjustments to reconcile net income to net cash provided (used) by operating activities: | | |
| Net (gain) loss on mortgage-backed securities at fair value | (612) | 2,106 |
| Net gain on mortgage loans at fair value | (64,929) | (65,594) |
| Accrual of unearned discounts on mortgage-backed securities at fair value and capitalization of interest and advance on mortgage loans at fair value | (16,558) | (1,759) |
| Net gain on mortgage loans acquired for sale at fair value | (81,210) | (207) |
| Results of real estate acquired in settlement of loans | (7,576) | (1,527) |
| Change in fair value and amortization of mortgage servicing rights | 7,456 | 7 |
| Amortization of credit facility commitment fees | 2,002 | 1,142 |
| Accrual of costs related to forward purchase agreements | 3,421 | 2,222 |
| Share-based compensation expense | 3,576 | 2,812 |
| Purchases of mortgage loans acquired for sale at fair value | (11,967,678) | (294,410) |
| Sales of mortgage loans acquired for sale at fair value | 11,362,751 | 257,060 |
| (Increase) decrease in principal and interest collections receivable | (21,352) | 1,529 |
| Decrease (increase) in principal and interest collections receivable under forward purchase agreements | 5,299 | (9,735) |
| Increase in interest receivable | (833) | (4,675) |
| Increase in due from affiliates | (1,657) | (5,088) |
| Increase in other assets | (10,356) | (8,103) |
| Increase (decrease) in accounts payable and accrued liabilities | 16,257 | (10,764) |
| (Decrease) increase in payable to affiliates | (2,354) | 7,840 |
| Increase in income taxes payable | 23,163 | 1,831 |
| Net cash used by operating activities | (662,179) | (80,523) |
| Cash flows from investing activities | | |
| Net increase in short-term investments | (8,003) | (30,743) |
| Maturity of United States Treasury security | 50,000 | |
| Purchases of mortgage-backed securities at fair value | (112,211) | (4,974) |
| Repayments of mortgage-backed securities at fair value | 165,949 | 47,008 |
| Sales of mortgage-backed securities at fair value | 23,218 | 7,994 |
| Purchases of mortgage loans at fair value | (411,368) | (453,309) |
| Repayments of mortgage loans at fair value | 128,116 | 87,795 |
| Sales of mortgage loans at fair value | | 2,570 |
| Repayments of mortgage loans under forward purchase agreements at fair value | 14,292 | 20,040 |
| Purchases of real estate acquired in settlement of loans | (48) | (1,510) |
| Sales of real estate acquired in settlement of loans | 104,367 | 46,410 |
| Sales of real estate acquired in settlement of loans under forward purchase agreements | 9,912 | |
| Purchases of mortgage servicing rights | (23) | |
| Sales of mortgage servicing rights | 104 | |
| (Increase) decrease in margin deposits and restricted cash | (18,776) | 735 |
| Net cash used by investing activities | (54,471) | (277,984) |
| Cash flows from financing activities | | |
| Sales of securities under agreements to repurchase | 752,343 | 516,522 |
| Repurchases of securities sold under agreements to repurchase | (867,836) | (317,975) |

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| | | |
|--|----------------|----------------|
| Sales of loans under agreements to repurchase | 11,285,842 | 1,081,542 |
| Repurchases of loans sold under agreements to repurchase | (10,771,085) | (1,119,901) |
| Sales of real estate acquired in settlement of loans financed under agreement to repurchase | 10,753 | 17,108 |
| Repurchases of real estate acquired in settlement of loans financed under agreements to repurchase | (26,532) | (4,294) |
| Repayments of note payable secured by mortgage loans at fair value | (2,044) | |
| Repayments of borrowings under forward purchase agreements | (157,166) | (11,115) |
| Proceeds from issuance of common shares | 608,184 | 197,162 |
| Payment of underwriting and offering costs relating to issuance of common shares | (1,340) | (8,404) |
| Payment of dividends | (61,245) | (25,610) |
| Net cash provided by financing activities | 769,874 | 325,035 |
| | | |
| Net increase (decrease) in cash | 53,224 | (33,472) |
| Cash at beginning of period | 14,589 | 45,447 |
| | | |
| Cash at end of period | \$ 67,813 | \$ 11,975 |

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1 Organization and Basis of Presentation

PennyMac Mortgage Investment Trust (*PMT* or the *Company*) was organized in Maryland on May 18, 2009, and began operations on August 4, 2009, when it completed its initial offerings of common shares of beneficial interest (*shares*). The Company is a specialty finance company, which, through its subsidiaries (all of which are wholly-owned), invests primarily in residential mortgage loans and mortgage-related assets.

The Company is externally managed by an affiliate, PNMAC Capital Management, LLC (*PCM* or the *Manager*), an investment adviser registered with the Securities and Exchange Commission (the *SEC*) that specializes in and focuses on residential mortgage loans. Under the terms of a management agreement, PCM is entitled to be paid a management fee with a base component and a performance incentive component. Determination of the amount of management fees is discussed in Note 3 *Transactions with Related Parties*.

The Company's objective is to provide attractive risk-adjusted returns to its investors over the long-term, principally through dividends and secondarily through capital appreciation. The Company intends to achieve this objective largely by investing in distressed mortgage assets and acquiring, pooling and selling newly originated prime credit quality residential mortgage loans (*correspondent lending*).

The Company reports its results in two segments: investment activities and correspondent lending. The investment activities segment focuses on mortgage assets that are acquired and held for investment purposes and the correspondent lending segment focuses on the purchase for resale of newly originated mortgage loans.

The investment activities segment represents the Company's investments in distressed mortgage loans, real estate acquired in settlement of loans (*REO*), mortgage-backed securities (*MBS*) and mortgage servicing rights (*MSRs*). Management seeks to maximize the value of the distressed mortgage loans acquired by the Company through proprietary loan modification programs, special servicing and other initiatives focused on keeping borrowers in their homes. Where this is not possible, such as in the case of many nonperforming mortgage loans, the Company seeks to effect property resolution in a timely, orderly and economically efficient manner, including through the use of resolution alternatives to foreclosure.

The correspondent lending segment represents the Company's operations aimed at serving as an intermediary between mortgage lenders and the capital markets by purchasing, pooling and reselling newly originated prime credit quality mortgage loans either directly or in the form of *MBS*, using the services of the Manager and an affiliated company, PennyMac Loan Services, LLC (*PLS*).

The Company believes that it qualifies, and has elected to be taxed, as a real estate investment trust (*REIT*) under the Internal Revenue Code of 1986, as amended (the *Internal Revenue Code*), beginning with its taxable period ended on December 31, 2009. To maintain its tax status as a REIT, the Company plans to distribute at least 90% of its taxable income in the form of qualifying distributions to shareholders.

The Company conducts substantially all of its operations and makes substantially all of its investments through its subsidiary, PennyMac Operating Partnership, L.P. (the *Operating Partnership*), and the Operating Partnership's subsidiaries. A subsidiary of the Company is the sole general partner, and the Company is the sole limited partner, of the Operating Partnership.

The accompanying consolidated financial statements have been prepared in compliance with accounting principles generally accepted in the United States (*U.S. GAAP*) for interim financial information and with the SEC's instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, these financial statements and notes do not include all of the information required by U.S. GAAP for complete financial statements. The interim consolidated information should be read together with the Company's Annual Report on Form 10-K for the year ended December 31, 2011 (the *Annual Report*).

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Certain amounts in prior presentations have been reclassified to conform to the current presentation. For the quarter and nine months ended September 30, 2011, \$361,000 and \$628,000 in collection expenses were reclassified from other expenses to loan servicing expenses to conform to the current presentation. These reclassifications had no effect on previously reported shareholders' equity, net income or earnings per share amounts.

Preparation of financial statements in compliance with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, and revenues and expenses during the reporting period. Actual results will likely differ from those estimates.

In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the periods ended September 30, 2012 are not necessarily indicative of the results for the year ending December 31, 2012.

Note 2 Concentration of Risks

As discussed in Note 1 *Organization and Basis of Presentation* above, PMT's investing activities are centered in real estate-related assets, a substantial portion of which are distressed at acquisition. Because of the Company's investment strategy, many of the mortgage loans in its targeted asset class are purchased at discounts reflecting their distressed state or perceived higher risk of default, as well as a greater likelihood of collateral documentation deficiencies. Before the Company buys loans or other assets, PCM validates key information provided by the sellers that is necessary to determine the value of the acquired asset. A substantial portion of the distressed mortgage loans purchased by the Company has been acquired from or through one or more subsidiaries of Citigroup, Inc.

Through its management agreement with PCM and its loan servicing agreement with PLS, PMT works with borrowers to perform loss mitigation activities. Such activities include the use of loan modification programs (such as the U.S. Department of the Treasury and Housing and Urban Development's Home Affordable Modification Program (HAMP)) and workout options that PCM believes have the highest probability of successful resolution for both borrowers and PMT. Loan modification or resolution may include PMT accepting a reduction of the principal balances of certain mortgage loans in its investment portfolio. When loan modifications and other efforts are unable to cure distressed loans, the Company's objective is to effect timely acquisition and liquidation of the property securing the mortgage loan.

Because of the Company's investment focus, PMT is exposed, to a greater extent than traditional mortgage investors, to the risks that borrowers may be in financial distress and/or may have become unemployed, bankrupt or otherwise unable or unwilling to make payments when due, and to the effects of fluctuations in the residential real estate market on the performance of its investments. Factors influencing these risks include, but are not limited to:

changes in the overall economy, unemployment and residential real estate values in the markets where the properties securing the Company's mortgage loans are located;

PCM's ability to identify and the Company's loan servicers' ability to execute optimal resolutions of problem mortgage loans;

the accuracy of valuation information obtained during the Company's due diligence activities;

PCM's ability to effectively model, and to develop appropriate model assumptions that properly anticipate, future outcomes;

the level of government support for problem loan resolution and the effect of current and future proposed and enacted legislative and regulatory changes on the Company's ability to service and effect cures or resolutions to distressed loans; and

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regulatory, judicial and legislative support of the foreclosure process, and the resulting impact on the Company's ability to acquire and liquidate the real estate securing its portfolio of distressed mortgage loans in a timely manner or at all.

Due to these uncertainties, there can be no assurance that risk management activities identified and executed on PMT's behalf will prevent significant losses arising from the Company's investments in real estate-related assets.

On July 12, 2011 and December 20, 2011, the Company entered into forward purchase agreements with Citigroup Global Markets Realty Corp. (CGM), a subsidiary of Citigroup Inc., to purchase certain nonperforming residential mortgage loans and residential real property acquired in settlement of loans (collectively, the CGM Assets). The CGM Assets were acquired by CGM from unaffiliated money center banks. The commitment under the forward purchase agreement dated July 12, 2011 was settled during the quarter ended June 30, 2012. The commitment under the forward purchase agreement dated December 20, 2011 was settled during the quarter ended September 30, 2012.

The CGM Assets were included on the Company's consolidated balance sheet as *Mortgage loans under forward purchase agreements at fair value* and *Real estate acquired in settlement of loans under forward purchase agreements* and the related liabilities were included as *Borrowings under forward purchase agreements*. The CGM Assets were held by CGM within a separate trust entity deemed a variable interest entity. The Company's interests in the CGM Assets were deemed to be contractually segregated from all other interests in the trust. When assets are contractually segregated, they are often referred to as a silo. For these transactions, the silo consisted of the CGM Assets and its related liability. The Company directed all of the activities that drive the economic results of the CGM Assets. All of the changes in the fair value and cash flows of the CGM Assets were attributable solely to the Company, and such cash flows could only be used to settle the related liability.

As a result of consolidating the silo, the Company's consolidated statements of income and cash flows for the three and nine months ended September 30, 2012 includes the following amounts related to the silo:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|--|--------------------------------|-----------|------------------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| Net income: | | | | |
| Net gain on mortgage loans | \$ 105 | \$ 10,041 | \$ 9,293 | \$ 10,041 |
| Interest income on mortgage loans | \$ 146 | \$ 625 | \$ 996 | \$ 625 |
| Results of REO | \$ (4) | \$ | \$ 1,870 | \$ |
| Interest expense | \$ 100 | \$ 1,680 | \$ 2,396 | \$ 1,680 |
| Loan servicing fees | \$ 51 | \$ 542 | \$ 1,011 | \$ 542 |
| Cash flows: | | | | |
| Repayments of mortgage loans | \$ 252 | \$ 20,040 | \$ 14,292 | \$ 20,040 |
| Sales of REO | \$ | \$ | \$ 9,912 | \$ |
| Repayments of borrowings under forward purchase agreements | \$ 16,859 | \$ 11,115 | \$ 157,166 | \$ 11,115 |

The Company has no other variable interests in the trust entity, or other exposure to the creditors of the trust entity which could expose the Company to loss.

During the nine months ended September 30, 2012, the Company purchased \$411.4 million of mortgage loans at fair value and real estate acquired in settlement of loans for its investment portfolio. All of the \$411.4 million was purchased from or through one or more subsidiaries of Citigroup, Inc.

Beginning in the fourth quarter of 2011, the Company's correspondent lending activities have been experiencing substantial growth. As a result of such growth, the Company's correspondent lending segment

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contributed approximately 49% of PMT's pre-tax income during the nine months ended September 30, 2012 and the inventory of mortgage loans acquired for sale at fair value represented approximately 40% of the Company's investments at September 30, 2012.

Correspondent lending activities introduce different risks from those posed by investments in distressed assets. The Company's correspondent lending activities and the MSR's resulting from such activities are more sensitive to the level and volatility of interest rates. For example, a decline in mortgage rates generally increases the demand for home loans as borrowers refinance, but also generally leads to accelerated payoffs in the Company's mortgage servicing portfolio, which have a negative effect on the value of MSR's.

Management attempts to manage the sensitivity of earnings to the changes in market interest rates through the use of derivative financial instruments to moderate the effects of changes in the level and volatility of interest rates on the fair value of the Company's inventory of mortgage loans acquired for sale at fair value and commitments to purchase mortgage loans for sale. The Company does not presently use derivative financial instruments to moderate the effects on PMT's earnings of changes in the fair value of its investment in MSR's.

The success of the Company's interest rate risk management strategies depends in part on management's ability to predict the earnings sensitivity of its loan purchasing and its loan servicing activities in various interest rate environments. There are many market factors that affect the performance of the Company's interest rate risk management activities including interest rate volatility, the shape of the yield curve and the spread between mortgage interest rates and United States Treasury or swap rates. The success of this strategy affects PMT's net income and the effect can be either positive or negative, and can be material to the Company.

The correspondent lending segment's ability to sell loans profitably is affected by many factors, including the relative demands for such loans and MBS evidencing interests in such loans, the cost of credit enhancements and interest rate risk management, investor perceptions of such loans and MBS and the risks posed by such products.

Note 3 Transactions with Related Parties

The Company is managed externally by PCM under the terms of a management agreement that expires on August 4, 2013 and will continue to be automatically renewed for a one-year term on each anniversary date thereafter unless previously terminated. The management agreement provides for an annual review of PCM's performance under the management agreement by the Company's independent trustees. PMT's board of trustees reviews the Company's financial results, policy compliance and strategic direction.

As more fully described in the Company's Annual Report, certain of the underwriting costs incurred in the Company's initial public offering (IPO) were paid on PMT's behalf by PCM and a portion of the underwriting discount was deferred by agreement with the underwriters of the offering. PMT will reimburse PCM the underwriting costs as discussed in Note 25 *Shareholders' Equity*.

PMT pays PCM a base management fee and may pay a performance incentive fee, both payable quarterly and in arrears.

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Following is a summary of management fee expense and the related liability, included in *Payable to affiliates*, recorded by the Company for the periods presented:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|--|--------------------------------|-----------------|------------------------------------|-----------------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| Base management fee | \$ 3,672 | \$ 2,288 | \$ 7,964 | \$ 5,750 |
| Performance incentive fee | | | | |
| Total management fee incurred during the period | 3,672 | 2,288 | 7,964 | 5,750 |
| Fee paid during the period | (2,515) | (2,018) | (5,387) | (4,795) |
| Fee outstanding at beginning of period | 2,515 | 1,913 | 1,095 | 1,228 |
| Fee outstanding at period end | \$ 3,672 | \$ 2,183 | \$ 3,672 | \$ 2,183 |

The management fees are more fully described in Note 4 *Transactions with Related Parties* to the Company's Annual Report. Effective May 16, 2012, the Company amended its management agreement with PCM to change the way shareholders' equity is measured for purposes of calculating the base component of its management fee. Previously, the measure of shareholders' equity excluded unrealized gains, losses or other non-cash items reflected in the Company's financial statements. The management agreement was amended to base the management fee on shareholders' equity computed using U.S. GAAP. The method of measuring the performance incentive fee was not changed. The purpose of the amendment was to better align the Manager's base management fee with the Company's investment strategy, which, in the pursuit of attractive investment opportunities, has evolved to include nonperforming mortgage loans that generate unrealized gains and correspondent lending activity that produces non-cash income through the retention of MSR's created in the sales transactions. The amendment is expected to increase the amount of the base management fee payable by the Company to the Manager.

The Company, through its Operating Partnership, also has a loan servicing agreement with PLS. Servicing fee rates are based on the risk characteristics of the mortgage loans serviced and total servicing compensation is established at levels that management believes are competitive with those charged by other servicers or specialty servicers, as applicable.

Servicing fee rates for nonperforming loans range between 30 and 100 basis points per year on the unpaid principal balance of the mortgage loans serviced on the Company's behalf. PLS is also entitled to certain customary market-based fees and charges, including boarding and deboarding fees, liquidation and disposition fees, assumption, modification and origination fees and late charges, as well as interest on funds on deposit in custodial accounts. In the event PLS either effects a refinancing of a loan on the Company's behalf and not through a third party lender and the resulting loan is readily saleable, or originates a loan to facilitate the disposition of real estate that the Company has acquired in settlement of a loan, PLS is entitled to receive market-based fees and compensation from the Company.

PLS, on behalf of the Company, currently participates in HAMP (and other similar mortgage loan modification programs), which establishes standard loan modification guidelines for at risk homeowners and provides incentive payments to certain participants, including loan servicers, for achieving modifications and successfully remaining in the program. The loan servicing agreement entitles PLS to retain any incentive payments made to it and to which it is entitled under HAMP; provided, however, that with respect to any such incentive payments paid to PLS under HAMP in connection with a mortgage loan modification for which the Company previously paid PLS a modification fee, PLS shall reimburse the Company an amount equal to the lesser of such modification fee or such incentive payments.

In connection with the MSR's acquired in the Company's correspondent lending business, through which the Company acquires mortgage loans originated by correspondent lenders for resale to the government-sponsored

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agencies such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (FHLMC) (Fannie Mae and FHLMC, along with the Government National Mortgage Association (GNMA) are each referred to as an Agency and, collectively, as the Agencies) and other investors, PLS is entitled to base servicing fees, which range from 4 to 20 basis points per year of the unpaid principal balance of such loans, and other customary market-based fees and charges as described above.

Pursuant to the terms of a mortgage banking services agreement, PLS also provides certain mortgage banking services, including fulfillment and disposition-related services, to the Company for a fulfillment fee based on a percentage of the unpaid principal balance of the mortgage loans sold to non-affiliates where the Company is approved or licensed to sell to such non-affiliate. The fulfillment fee for such services is currently 50 basis points.

The Company is not an approved issuer of GNMA securities and therefore is not able to sell government-guaranteed or insured loans into such securities. As a result, the Company and PLS have agreed that PLS will fulfill and purchase the government-guaranteed or insured loans it acquires from correspondents. This arrangement has enabled the Company to compete with other correspondent lenders that purchase both government and conventional loans. For these government-guaranteed or insured loans, the Company does not pay a fulfillment fee, but collects interest income and a sourcing fee of three basis points for each mortgage loan it purchases from a correspondent and sells to PLS for ultimate disposition to GNMA.

Following is a summary of correspondent lending activity between the Company and PLS for the periods presented:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|--|--------------------------------|------------|------------------------------------|------------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| Sourcing fees received | \$ 747 | \$ 41 | \$ 1,448 | \$ 53 |
| Fulfillment fees relating to loans sold to nonaffiliates | \$ 17,258 | \$ 263 | \$ 31,097 | \$ 336 |
| Fair value of loans sold to PLS | \$ 2,650,097 | \$ 144,351 | \$ 5,111,185 | \$ 184,264 |
| Mortgage loans acquired for sale pending sale to PLS at period end | \$ 194,055 | \$ 10,833 | | |

The Company paid fees to PLS as described above and as provided in its loan servicing and mortgage banking agreements and recorded other expenses, including common overhead expenses incurred on its behalf by PCM and its affiliates, in accordance with the terms of its management agreement. Following is a summary of those expenses for the periods presented:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|---|--------------------------------|----------|------------------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| Loan servicing fees | \$ 5,208 | \$ 2,107 | \$ 15,180 | \$ 7,163 |
| Reimbursement of expenses incurred on PMT s behalf | 555 | 964 | 2,420 | 2,134 |
| Reimbursement of common overhead incurred by PCM and its affiliates | 1,244 | 988 | 2,474 | 2,517 |
| | \$ 7,007 | \$ 4,059 | \$ 20,074 | \$ 11,814 |
| Payments during the period(1) | \$ 12,239 | \$ 2,273 | \$ 28,896 | \$ 8,476 |

(1) Includes payments for correspondent lending activities itemized in the preceding table.

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Amounts due to affiliates are summarized below as of the dates presented:

| | September 30, 2012 | December 31, 2011 |
|---------------------------|-----------------------|----------------------|
| | (in thousands) | |
| Contingent offering costs | \$ 2,941 | \$ 2,941 |
| Management fee | 3,672 | 1,096 |
| Other expenses | 3,199 | 8,129 |
| | \$ 9,812 | \$ 12,166 |

Amounts due from affiliates totaling \$2.0 million and \$347,000 at September 30, 2012 and December 31, 2011, respectively, represent amounts receivable pursuant to loan sales to PLS and reimbursable expenses paid on the affiliates' behalf by the Company.

PCM's parent company, Private National Mortgage Acceptance Company, LLC, held 75,000 of the Company's common shares of beneficial interest at both September 30, 2012 and December 31, 2011.

Note 4 Earnings Per Share

Basic earnings per share is determined using net income divided by the weighted-average common shares outstanding during the period. Diluted earnings per share is computed by dividing net income attributable to common shareholders by the weighted-average common shares outstanding, assuming all potentially dilutive common shares were issued. In periods in which the Company records a loss, potentially dilutive common shares are excluded from the diluted loss per share calculation, as their effect on loss per share is anti-dilutive.

The Company makes grants of restricted share units which entitle the recipients to receive dividend equivalents during the vesting period on a basis equivalent to the dividends paid to holders of common shares. For purposes of calculating earnings per share, unvested share-based compensation awards containing non-forfeitable rights to dividends or dividend equivalents (collectively, "dividends") are classified as participating securities and are included in the basic earnings per share calculation using the two-class method. Under the two-class method, all earnings (distributed and undistributed) are allocated to each class of common shares and participating securities, based on their respective rights to receive dividends.

The following table summarizes the basic and diluted earnings per share calculations for the periods presented:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|--|--|-----------|------------------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands, except per share amounts) | | | |
| Basic earnings per share: | | | | |
| Net income | \$ 40,384 | \$ 20,528 | \$ 89,011 | \$ 44,790 |
| Effect of participating securities' share-based compensation instruments | (528) | (234) | (947) | (478) |
| Net income attributable to common shareholders | \$ 39,856 | \$ 20,294 | \$ 88,064 | \$ 44,312 |
| Weighted-average shares outstanding | 49,078 | 27,847 | 38,398 | 25,782 |
| Basic earnings per share | \$ 0.81 | \$ 0.73 | \$ 2.29 | \$ 1.72 |
| Diluted earnings per share: | | | | |
| Net income | \$ 40,384 | \$ 20,528 | \$ 89,011 | \$ 44,790 |
| Weighted-average shares outstanding | 49,078 | 27,847 | 38,398 | 25,782 |

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| | | | | |
|--|---------------|---------------|---------------|---------------|
| Dilutive potential common shares - shares issuable undershare-based compensation plan | 385 | 291 | 314 | 283 |
| Diluted weighted-average number of common shares outstanding | 49,463 | 28,138 | 38,712 | 26,065 |
| Diluted earnings per common share | \$ 0.81 | \$ 0.73 | \$ 2.29 | \$ 1.72 |

Table of Contents**Note 5 Loan Sales**

The Company purchases and sells mortgage loans into the secondary mortgage market without recourse for credit losses. However the Company maintains continuing involvement with the loans in the form of servicing or subservicing arrangements and the potential liability under representations and warranties it makes to purchasers and insurers of the loans.

The following table summarizes cash flows between the Company and transferees upon sale of loans in transactions whereby the Company maintains continuing involvement with the mortgage loan and period-end information relating to such loans:

| | Quarter ended September 30 | | Nine months ended September 30, | |
|---|-------------------------------|-----------|------------------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| Cash flows: | | | | |
| Proceeds from sales | \$ 3,573,762 | \$ 53,221 | \$ 6,254,411 | \$ 72,796 |
| Service fees received | \$ 3,933 | \$ 24 | \$ 6,294 | \$ 24 |
| Period-end information: | | | | |
| Unpaid principal balance of loans outstanding at period-end | \$ 6,064,614 | | | |
| Delinquencies: | | | | |
| 30-89 days | \$ 19,508 | | | |
| 90 or more days or in foreclosure or bankruptcy | \$ | | | |

Note 6 Fair Value

The Company's financial statements include assets and liabilities that are measured based on their estimated fair values. Measurement of these assets and liabilities at fair value may be on a recurring or nonrecurring basis depending on the accounting principles applicable to the specific asset or liability and whether management has elected to carry the item at its estimated fair value as discussed in the following paragraphs.

Fair Value Accounting Elections

Management identified all of its non cash financial assets, including short-term investments, United States Treasury security, MBS, and mortgage loans as well as its securities sold under agreements to repurchase and its MSR's relating to loans with initial interest rates of more than 4.5% that were acquired as a result of its correspondent lending operations to be accounted for at estimated fair value so such changes in fair value will be reflected in income as they occur and more timely reflect the results of the Company's investment performance.

For MSR's relating to mortgage loans with initial interest rates of less than or equal to 4.5% that were acquired as a result of the Company's correspondent lending operations, management has concluded that such assets present different risks to the Company than MSR's relating to mortgage loans with initial interest rates of more than 4.5% and therefore require a different risk management approach. Management's risk management efforts relating to these assets are aimed at moderating the effects of non-interest rate risks on fair value, such as the effect of changes in home prices on the assets' values. Management has identified these assets for accounting using the amortization method. Management's risk management efforts in connection with MSR's relating to mortgage loans with initial interest rates of more than 4.5% are aimed at moderating the effects of changes in interest rates on the assets' values.

For loans sold under agreements to repurchase subject to agreements made beginning in December 2010, REO financed through agreements to repurchase beginning in June 2011 and borrowings under forward purchase agreements beginning in July 2011, management has determined that historical cost accounting is more appropriate because under this method debt issuance costs are spread over the term of the debt, thereby matching the debt issuance expense to the periods benefiting from the usage of the debt.

Table of Contents**Financial Statement Items Measured at Fair Value on a Recurring Basis**

Following is a summary of financial statement items that are measured at estimated fair value on a recurring basis as of the dates presented:

| | September 30, 2012 | | | | Total |
|--|--------------------|------------|--------------|----------------|-----------|
| | Level 1 | Level 2 | Level 3 | (in thousands) | |
| Assets: | | | | | |
| Short-term investments | \$ 38,322 | \$ | \$ | \$ | 38,322 |
| Mortgage loans acquired for sale at fair value | | 847,575 | | | 847,575 |
| Mortgage loans at fair value | | | 1,089,966 | | 1,089,966 |
| Mortgage servicing rights at fair value | | | 1,522 | | 1,522 |
| Derivative financial instruments | | 902 | 40,036 | | 40,938 |
| | \$ 38,322 | \$ 848,477 | \$ 1,131,524 | \$ | 2,018,323 |
| Liabilities: | | | | | |
| Securities sold under agreements to repurchase | \$ | \$ | \$ | \$ | |
| Derivative financial instruments | | 36,203 | | | 36,203 |
| | \$ | \$ 36,203 | \$ | \$ | 36,203 |

| | December 31, 2011 | | | | Total |
|--|-------------------|------------|------------|----------------|-----------|
| | Level 1 | Level 2 | Level 3 | (in thousands) | |
| Assets: | | | | | |
| Short-term investments | \$ 30,319 | \$ | \$ | \$ | 30,319 |
| United States Treasury security | 50,000 | | | | 50,000 |
| Mortgage-backed securities at fair value | | | 72,813 | | 72,813 |
| Mortgage loans acquired for sale at fair value | | 232,016 | | | 232,016 |
| Mortgage loans at fair value | | | 696,266 | | 696,266 |
| Mortgage loans under forward purchase agreements at fair value | | | 129,310 | | 129,310 |
| Mortgage servicing rights at fair value | | | 749 | | 749 |
| Derivative financial instruments | | 1,938 | 5,772 | | 7,710 |
| | \$ 80,319 | \$ 233,954 | \$ 904,910 | \$ | 1,219,183 |
| Liabilities: | | | | | |
| Securities sold under agreements to repurchase | \$ | \$ | \$ 115,493 | \$ | 115,493 |
| | \$ | \$ | \$ 115,493 | \$ | 115,493 |

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The following is a summary of changes in Level 3 financial statement items that are measured at fair value on a recurring basis:

| | Quarter ended September 30, 2012 | | | | | |
|--|-----------------------------------|------------------------------------|---|---------------------------------|--------------------------------------|--|
| | Mortgage- backed securities | Mortgage loans at fair value | Mortgage loans under forward purchase agreements (in thousands) | Mortgage servicing rights | Interest rate lock commitments | Total |
| Assets: | | | | | | |
| Balance, June 30, 2012 | \$ 53,161 | \$ 969,954 | \$ 16,881 | \$ 1,285 | \$ 12,934 | \$ 1,054,215 |
| Purchases | | 150,773 | 5 | | | 150,778 |
| Interest rate lock commitments issued, net | | | | | 105,850 | 105,850 |
| Repayments | (998) | (43,552) | (252) | | | (44,802) |
| Capitalized interest | | 3,399 | | | | 3,399 |
| Sales | (52,133) | | | | | (52,133) |
| Servicing received as proceeds from sales of mortgage loans | | | | 363 | | 363 |
| Changes in fair value included in income arising from: | | | | | | |
| Changes in instrument-specific credit risk | | 3,262 | | | | 3,262 |
| Other factors | (30) | 23,145 | 105 | (126) | | 23,094 |
| | (30) | 26,407 | 105 | (126) | | 26,356 |
| Transfer of mortgage loans to REO | | (33,754) | | | | (33,754) |
| Transfers to mortgage loans acquired for sale | | | | | (78,748) | (78,748) |
| Transfer of mortgage loans under forward purchase agreements to mortgage loans at fair value | | 16,739 | (16,739) | | | |
| Balance, September 30, 2012 | \$ | \$ 1,089,966 | \$ | \$ 1,522 | \$ 40,036 | \$ 1,131,524 |
| Changes in fair value recognized during the period relating to assets still held at September 30, 2012 | \$ | \$ 16,187 | \$ | \$ (126) | \$ 40,036 | |
| Accumulated changes in fair value relating to assets still held at September 30, 2012 | \$ | \$ 86,734 | \$ | | \$ 40,036 | |
| | | | | | | Securities sold under agreements to repurchase (in thousands) |
| Liabilities: | | | | | | |
| Balance, June 30, 2012 | | | | | | \$ 157,289 |
| Changes in fair value included in income | | | | | | |
| Sales | | | | | | 45,377 |
| Repurchases | | | | | | (202,666) |
| Balance, September 30, 2012 | | | | | | \$ |
| Changes in fair value recognized during the period relating to liabilities still outstanding at September 30, 2012 | | | | | | \$ |

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| | Quarter ended September 30, 2011 | | | | |
|--|----------------------------------|------------------------------|---|--|------------|
| | Mortgage-backed securities | Mortgage loans at fair value | Mortgage servicing rights (in thousands) | Interest rate lock commitments | Total |
| Assets: | | | | | |
| Balance, June 30, 2011 | \$ 82,421 | \$ 657,223 | \$ 180 | \$ (4) | \$ 739,820 |
| Purchases | 22,179 | 264,749 | | | 286,928 |
| Interest rate lock commitments issued, net | | | | 1,810 | 1,810 |
| Repayments | (12,843) | (52,684) | | | (65,527) |
| Accrual of unearned discounts | 385 | | | | 385 |
| Addition of unpaid interest to mortgage loan balances in loan modifications | | 3,210 | | | 3,210 |
| Sales | (4,649) | | | | (4,649) |
| Servicing received as proceeds from sales of mortgage loans | | | 362 | | 362 |
| Changes in fair value included in income arising from: | | | | | |
| Changes in instrument-specific credit risk | | 10,640 | | | 10,640 |
| Other factors | (791) | 21,899 | (10) | | 21,098 |
| | (791) | 32,539 | (10) | | 31,738 |
| Transfer of mortgage loans to REO | | (36,857) | | | (36,857) |
| Transfer to mortgage loans acquired for sale | | | | (601) | (601) |
| Balance, September 30, 2011 | \$ 86,702 | \$ 868,180 | \$ 532 | \$ 1,205 | \$ 956,519 |
| Changes in fair value recognized during the period relating to assets still held at September 30, 2011 | \$ (791) | \$ 24,070 | \$ (10) | \$ 1,205 | \$ 24,474 |
| Accumulated changes in fair value relating to assets still held at September 30, 2011 | \$ (1,946) | \$ 53,771 | | \$ 1,205 | |
| | | | | | |
| | | | | Securities sold under agreements to repurchase (in thousands) | |
| Liabilities: | | | | | |
| Balance, June 30, 2011 | | | | \$ 70,978 | |
| Changes in fair value included in income | | | | | |
| Sales | | | | 258,608 | |
| Repurchases | | | | (266,743) | |
| Balance, September 30, 2011 | | | | \$ 62,843 | |
| Changes in fair value recognized during the period relating to liabilities still outstanding at September 30, 2011 | | | | \$ | |

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| | Nine months September 30, 2012 | | | | | |
|--|--------------------------------|---------------|----------------|-----------|-------------|--------------|
| | Mortgage- | Mortgage | Mortgage | Mortgage | Interest | Total |
| | backed | loans | forward | servicing | rate lock | |
| | securities | at fair value | purchase | rights | commitments | |
| | | | agreements | | | |
| | | | (in thousands) | | | |
| Assets: | | | | | | |
| Balance, December 31, 2011 | \$ 72,813 | \$ 696,266 | \$ 129,310 | \$ 749 | \$ 5,772 | \$ 904,910 |
| Purchases | | 411,368 | 1,076 | 20 | | 412,464 |
| Interest rate lock commitments issued, net | | | | | 132,188 | 132,188 |
| Repayments | (21,888) | (128,116) | (14,293) | | | (164,297) |
| Sales | | | | | | |
| Accrual of unearned discounts | 363 | | | | | 363 |
| Capitalization of interest | | 16,415 | | | | 16,415 |
| Sales | (52,133) | | | (79) | | (52,212) |
| Servicing received as proceeds from sales of mortgage loans | | | | 1,451 | | 1,451 |
| Changes in fair value included in income arising from: | | | | | | |
| Changes in instrument-specific credit risk | | 19,193 | | | | 19,193 |
| Other factors | 845 | 36,349 | 9,293 | (619) | | 45,868 |
| | 845 | 55,542 | 9,293 | (619) | | 65,061 |
| Transfer of mortgage loans to REO | | (79,440) | | | | (79,440) |
| Transfer from mortgage loans acquired for sale | | 18 | | | | 18 |
| Transfers to mortgages loans acquired for sale | | | | | (97,924) | (97,924) |
| Transfer of mortgage loans under forward purchase agreements to REO under forward purchase agreements | | | (7,473) | | | (7,473) |
| Transfer of mortgage loans under forward purchase agreements to mortgage loans | | 117,913 | (117,913) | | | |
| Balance, September 30, 2012 | \$ | \$ 1,089,966 | \$ | \$ 1,522 | \$ 40,036 | \$ 1,131,524 |
| Changes in fair value recognized during the period relating to assets still held at September 30, 2012 | | | | | | |
| | \$ | \$ 32,809 | \$ | \$ (619) | \$ 40,036 | \$ 72,226 |
| Accumulated changes in fair value relating to assets still held at September 30, 2012 | | | | | | |
| | \$ | \$ 86,734 | \$ | | \$ 40,036 | |

| | | | | | | Securities sold under agreements to repurchase (in thousands) |
|--|--|--|--|--|--|---|
| Liabilities: | | | | | | |
| Balance, December 31, 2011 | | | | | | \$ 115,493 |
| Changes in fair value included in income | | | | | | |
| Sales | | | | | | 752,343 |
| Repurchases | | | | | | (867,836) |

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| | |
|--|----|
| Balance, September 30, 2012 | \$ |
| Changes in fair value recognized during the period relating to liabilities still outstanding at September 30, 2012 | \$ |

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| | Nine months ended September 30, 2011 | | | | Total |
|--|--------------------------------------|------------------------------|---|--------------------------------|--|
| | Mortgage-backed securities | Mortgage loans at fair value | Mortgage servicing rights (in thousands) | Interest rate lock commitments | |
| Assets: | | | | | |
| Balance, December 31, 2010 | \$ 119,872 | \$ 364,250 | \$ | \$ | \$ 484,122 |
| Purchases | 22,179 | 625,152 | | | 647,331 |
| Interest rate lock commitments issued, net | | | | 1,946 | 1,946 |
| Repayments | (47,008) | (107,835) | | | (154,843) |
| Accrual of unearned discounts | 1,759 | | | | 1,759 |
| Addition of unpaid interest to mortgage loan balances in loan modifications | | 3,521 | | | 3,521 |
| Sales | (7,994) | (2,570) | | | (10,564) |
| Servicing received as proceeds from sales of mortgage loans | | | 539 | | 539 |
| Changes in fair value included in income arising from: | | | | | |
| Changes in instrument-specific credit risk | | 23,642 | | | 23,642 |
| Other factors | (2,106) | 44,700 | (7) | | 42,587 |
| | (2,106) | 68,342 | (7) | | 66,229 |
| Transfer of mortgage loans to REO | | (82,680) | | | (82,680) |
| Transfer to mortgage loans acquired for sale | | | | (741) | (741) |
| Balance, September 30, 2011 | \$ 86,702 | \$ 868,180 | \$ 532 | \$ 1,205 | \$ 956,619 |
| Changes in fair value recognized during the period relating to assets still held at September 30, 2011 | \$ (2,106) | \$ 48,336 | \$ (7) | \$ 1,205 | \$ 47,428 |
| Accumulated changes in fair value relating to assets still held at September 30, 2011 | \$ (1,946) | \$ 53,771 | | \$ 1,205 | |
| | | | | | Securities sold under agreements to repurchase (in thousands) |
| Liabilities: | | | | | |
| Balance, December 31, 2010 | | | | | \$ 101,202 |
| Changes in fair value included in income | | | | | |
| Sales | | | | | 1,081,542 |
| Repurchases | | | | | (1,119,901) |
| Balance, September 30, 2011 | | | | | \$ 62,843 |
| Changes in fair value recognized during the period relating to liabilities still outstanding at September 30, 2011 | | | | | \$ |

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Following are the fair values and related principal amounts due upon maturity of mortgage loans accounted for under the fair value option (including mortgage loans acquired for sale, mortgage loans at fair value and mortgage loans under forward purchase agreements at fair value) as of the dates presented:

| | Fair value | September 30, 2012 Principal amount due upon maturity (in thousands) | Difference |
|---|--------------|---|--------------|
| Mortgage loans acquired for sale: | | | |
| Current through 89 days delinquent | \$ 847,575 | \$ 799,501 | \$ 48,074 |
| 90 or more days delinquent(1) | | | |
| | 847,575 | 799,501 | 48,074 |
| Other mortgage loans at fair value(2): | | | |
| Current through 89 days delinquent | 388,051 | 619,055 | (231,004) |
| 90 or more days delinquent(1) | 701,915 | 1,325,468 | (623,553) |
| | 1,089,966 | 1,944,523 | (854,557) |
| | \$ 1,937,541 | \$ 2,744,024 | \$ (806,483) |

| | Fair value | December 31, 2011 Principal amount due upon maturity (in thousands) | Difference |
|---|--------------|--|--------------|
| Mortgage loans acquired for sale: | | | |
| Current through 89 days delinquent | \$ 232,016 | \$ 222,399 | \$ 9,617 |
| 90 or more days delinquent(1) | | | |
| | 232,016 | 222,399 | 9,617 |
| Other mortgage loans at fair value(2): | | | |
| Current through 89 days delinquent | 209,599 | 345,140 | (135,541) |
| 90 or more days delinquent(1) | 615,977 | 1,184,687 | (568,710) |
| | 825,576 | 1,529,827 | (704,251) |
| | \$ 1,057,592 | \$ 1,752,226 | \$ (694,634) |

- (1) Loans delinquent 90 or more days are placed on nonaccrual status and previously accrued interest is reversed.
(2) Includes mortgage loans at fair value and mortgage loans under forward purchase agreements at fair value.

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Following are the changes in fair value included in current period income by consolidated statement of income line item for financial statement items accounted for under the fair value option:

| | Changes in fair value included in current period income Quarter ended September 30, 2012 | | | | |
|--|---|--------------------|--|-------------------------------|-----------|
| | Net gain on investments | Interest income | Net gain on mortgage loans acquired for sale (in thousands) | Net loan servicing fees | Total |
| Assets: | | | | | |
| Short-term investments | \$ | \$ | \$ | \$ | \$ |
| Mortgage-backed securities at fair value | (451) | (91) | | | (542) |
| Mortgage loans acquired for sale at fair value | | | 49,793 | | 49,793 |
| Mortgage loans at fair value | 26,407 | | | | 26,407 |
| Mortgage loans under forward purchase agreements at fair value | 105 | | | | 105 |
| Mortgage servicing rights at fair value | | | | (126) | (126) |
| | \$ 26,061 | \$ (91) | \$ 49,793 | \$ (126) | \$ 75,637 |
| Liabilities: | | | | | |
| Securities sold under agreements to repurchase at fair value | \$ | \$ | \$ | \$ | \$ |
| | \$ | \$ | \$ | \$ | \$ |

| | Changes in fair value included in current period income Quarter ended September 30, 2011 | | | | |
|--|---|--------------------|--|----------------------------------|-----------|
| | Net gain (loss) on investments | Interest income | Net gain on mortgage loans acquired for sale (in thousands) | Net loan servicing fees | Total |
| Assets: | | | | | |
| Short-term investments | \$ | \$ | \$ | \$ | \$ |
| Mortgage-backed securities at fair value | (791) | 385 | | | (406) |
| Mortgage loans acquired for sale at fair value | | | 84 | | 84 |
| Mortgage loans at fair value | 22,270 | | | | 22,270 |
| Mortgage loans under forward purchase agreements at fair value | 10,041 | | | | 10,041 |
| Mortgage servicing rights at fair value | | | | (10) | (10) |
| | \$ 31,520 | \$ 385 | \$ 84 | \$ (10) | \$ 31,979 |
| Liabilities: | | | | | |
| Securities sold under agreements to repurchase at fair value | \$ | \$ | \$ | \$ | \$ |
| | \$ | \$ | \$ | \$ | \$ |

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| | Changes in fair value included in current period income Nine months ended September 30, 2012 | | | | |
|--|---|--------------------|---|-------------------------------|------------|
| | Net gain on investments | Interest income | Net gain on Mortgage loans acquired for sale (in thousands) | Net loan servicing fees | Total |
| Assets: | | | | | |
| Short-term investments | \$ | \$ | \$ | \$ | \$ |
| Mortgage-backed securities at fair value | 612 | 142 | | | 754 |
| Mortgage loans acquired for sale at fair value | | | 81,210 | | 81,210 |
| Mortgage loans at fair value | 55,636 | | | | 55,636 |
| Mortgage loans under forward purchase agreements at fair value | 9,293 | | | | 9,293 |
| Mortgage servicing rights at fair value | | | | (619) | (619) |
| | \$ 65,541 | \$ 142 | \$ 81,210 | \$ (619) | \$ 146,274 |
| Liabilities: | | | | | |
| Securities sold under agreements to repurchase at fair value | \$ | \$ | \$ | \$ | \$ |
| | \$ | \$ | \$ | \$ | \$ |

| | Changes in fair value included in current period income Nine months ended September 30, 2011 | | | | |
|--|---|--------------------|---|----------------------------------|-----------|
| | Net gain (loss) on investments | Interest income | Net gain on mortgage loans acquired for sale (in thousands) | Net loan servicing fees | Total |
| Assets: | | | | | |
| Short-term investments | \$ | \$ | \$ | \$ | \$ |
| Mortgage-backed securities at fair value | (2,106) | 1,759 | | | (347) |
| Mortgage loans acquired for sale at fair value | | | 207 | | 207 |
| Mortgage loans at fair value | 55,553 | | | | 55,553 |
| Mortgage loans under forward purchase agreements at fair value | 10,041 | | | | 10,041 |
| Mortgage servicing rights at fair value | | | | (7) | (7) |
| | \$ 63,488 | \$ 1,759 | \$ 207 | \$ (7) | \$ 65,447 |
| Liabilities: | | | | | |
| Securities sold under agreements to repurchase at fair value | \$ | \$ | \$ | \$ | \$ |
| | \$ | \$ | \$ | \$ | \$ |

Table of Contents**Financial Statement Items Measured at Fair Value on a Nonrecurring Basis**

Following is a summary of financial statement items that are measured at estimated fair value on a nonrecurring basis as of the dates presented:

| | Level 1 | September 30, 2012 | | Total |
|--|---------|--------------------|---------------------------|------------|
| | | Level 2 | Level 3 (in thousands) | |
| Assets: | | | | |
| Real estate asset acquired in settlement of loans | \$ | \$ | \$ 48,493 | \$ 48,493 |
| Mortgage servicing assets at lower of amortized cost or fair value | | | 63,441 | 63,441 |
| | \$ | \$ | \$ 111,934 | \$ 111,934 |

| | Level 1 | December 31, 2011 | | Total |
|---|---------|-------------------|---------------------------|-----------|
| | | Level 2 | Level 3 (in thousands) | |
| Assets: | | | | |
| Real estate asset acquired in settlement of loans | \$ | \$ | \$ 32,356 | \$ 32,356 |
| Real estate asset acquired in settlement of loans under forward purchase agreements | | | 19,836 | 19,836 |
| | \$ | \$ | \$ 52,192 | \$ 52,192 |

The following table summarizes the total gains (losses) on assets measured at estimated fair values on a nonrecurring basis for the periods indicated:

| | Net gains (losses) recognized during the period | | | |
|---|---|------------|-----------------------|------------|
| | Quarter ended | | Nine months ended | |
| | September 30, 2012 | 2011 | September 30, 2012 | 2011 |
| | (in thousands) | | | |
| Real estate asset acquired in settlement of loans | \$ (3,849) | \$ (2,736) | \$ (6,876) | \$ (4,509) |
| Real estate asset acquired in settlement of loans under forward purchase agreements | | (4) | | (4) |
| Mortgage servicing assets at lower of amortized cost or fair value | (2,881) | | (4,505) | |
| | \$ (6,730) | \$ (2,740) | \$ (11,381) | \$ (4,513) |

Real Estate Acquired in Settlement of Loans

The Company measures its investment in REO at the respective properties' estimated fair values less cost to sell on a nonrecurring basis. The value of the REO is initially established as the lesser of either (a) the fair value of the loan at the date of transfer, (b) the fair value of the real estate less estimated costs to sell as of the date of transfer or (c) the purchase price of the property. REO may be subsequently revalued due to the Company receiving greater access to the property, the property being held for an extended period or management receiving indications that the property's value may not be supported by developing market conditions. Any subsequent change in fair value to a level that is less than or equal to the value at which the property was initially recorded is recognized in *Results of real estate acquired in settlement of loans* in the consolidated statements of income.

Mortgage Servicing Rights at Lower of Amortized Cost or Fair Value

The Company evaluates its MSR at lower of amortized cost or fair value for impairment with reference to the asset's fair value. For purposes of performing its MSR impairment evaluation, the Company stratifies its MSR at lower of amortized cost or fair value based on the interest rates

borne by the mortgage loans underlying

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the MSR. Mortgage loans are grouped into note rate pools of 50 basis points for fixed-rate mortgage loans with note rates between 3% and 4.5% and a single pool for mortgage loans with note rates below 3%. MSRs relating to adjustable rate mortgage loans with initial interest rates of 4.5% or less are evaluated in a single pool. If the fair value of MSRs in any of the note rate pools is below the carrying value of the MSRs for that pool reduced by any existing valuation allowance, those MSRs are impaired.

When MSRs are impaired, the impairment is recognized in current-period earnings and the carrying value of the MSRs is adjusted using a valuation allowance. If the value of the MSRs subsequently increases, the restoration of value is recognized in current period earnings only to the extent of the valuation allowance.

Management periodically reviews the various impairment strata to determine whether the value of the impaired MSRs in a given stratum is likely to recover. When management deems recovery of the value to be unlikely in the foreseeable future, a write-down of the cost of the MSRs for that stratum to its estimated fair value is charged to the valuation allowance.

Fair Value of Financial Instruments Carried at Amortized Cost

The Company's cash balances as well as its borrowings secured by its inventory of mortgage loans acquired for sale and its investments in nonperforming loans and REO in the form of repurchase agreements and borrowings under forward purchase agreements are carried at amortized costs. The election to carry the borrowings at amortized cost is discussed in *Fair Value Accounting Elections* above.

Management has concluded that the estimated fair values of *Cash*, *Mortgage loans acquired for sale at fair value sold under agreements to repurchase*, *Mortgage loans at fair value sold under agreements to repurchase*, *Real estate acquired in settlement of loans financed under agreements to repurchase*, *Note payable secured by mortgage loans at fair value* and *Borrowings under forward purchase agreements* approximate the agreements' carrying values due to the immediate realizability of cash at its carrying amount and to the borrowing agreements' short terms and variable interest rates.

Cash is measured using Level 1 Inputs. The Company's borrowings carried at amortized cost do not have active markets or observable inputs and the fair value is measured using management's best estimate of fair value, where the inputs into the determination of fair value require significant management judgment or estimation. The Company has classified these financial instruments as Level 3 as of September 30, 2012 due to the lack of current market activity and the Company's reliance on unobservable inputs to estimate the fair value.

Valuation Process, Techniques and Assumptions

Most of the Company's assets are carried at fair value with changes in fair value recognized in current period results of operations. A substantial portion of those assets are Level 3 financial statement items which require the use of significant unobservable inputs in the estimation of the assets' values. Unobservable inputs reflect the Company's own assumptions about the factors that market participants use in pricing an asset or liability, and are based on the best information available under the circumstances.

The Manager has assigned the responsibility for estimating the fair values of Level 3 financial statement items to a specialized valuation group and has developed procedures and controls governing the valuation process relating to these assets. The estimation of fair values of the Company's financial assets are assigned to the Manager's Financial Analysis and Valuation group (the FAV group), which is responsible for valuing and monitoring the Company's investment portfolios and maintenance of its valuation policies and procedures.

The FAV group reports to the Manager's senior management valuation committee, which oversees and approves the valuations. The valuation committee includes the chief executive, financial, investment and credit officers of the Manager. The FAV group monitors the models used for valuation of the Company's Level 3 financial statement items, including the models' performance versus actual results and reports those results to the valuation committee. The results developed in the FAV group's monitoring activities are used to calibrate subsequent projections used for valuation.

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The FAV group is responsible for reporting to the valuation committee on a monthly basis on the changes in the valuation of the portfolio, including major drivers affecting the valuation and any changes in model methods and assumptions. To assess the reasonableness of its valuations, the FAV group presents an analysis of the effect on the valuation of each of the changes to the significant inputs to the models.

The following describes the methods used in estimating the fair values of Level 2 and Level 3 financial statement items:

Mortgage-Backed Securities

MBS values are presently determined based on whether the securities are issued by one of the Agencies as discussed below:

Agency MBS are categorized as Level 2 financial statement items. Fair value of Agency MBS is estimated based on quoted market prices for similar securities.

Non-Agency MBS are categorized as Level 3 financial statement items. Fair value of non-Agency MBS is estimated using broker indications of value. For indications of value received, the FAV group and a separate Capital Markets group review the price indications provided by non-affiliate brokers for completeness, accuracy and consistency across all similar MBS managed by the Manager. Bond-level analytics such as yield, weighted average life and projected prepayment and default speeds of the underlying collateral are computed. The reasonableness of the brokers' indications of value and of changes in value from period to period is evaluated in light of the analytical review performed and considering market conditions. The review of the FAV group is reported to the Manager's valuation committee as part of its review and approval of monthly valuation results. The Manager has not adjusted, and does not intend to adjust, its fair value estimates to amounts different than the brokers' indications of value.

The significant unobservable inputs used in the fair value measurement of the Company's non-Agency MBS are discount rates, prepayment speeds, default speeds and loss severities in the event of default (or collateral remaining loss percentage). Significant changes in any of those inputs in isolation could result in a significant change in fair value measurement. Changes in these assumptions are not directly correlated, as they may be separately affected by changes in collateral characteristics and performance, servicer behavior, legal and regulatory actions, economic and housing market data and market sentiment.

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Following is a quantitative summary of key inputs used by the FAV group to evaluate the reasonableness of the fair value of Level 3 MBS:

| Security Class | Key Inputs(1) | Range (Weighted Average) | |
|------------------------|---|-----------------------------|-------------------|
| | | September 30, 2012 | December 31, 2011 |
| Non-Agency subprime | Discount rate | 3.1% - 23.0% | (8.0)% |
| | Prepayment speed(2) | 0.1% - 8.4% | (4.4)% |
| | Default speed(3) | 3.6% - 19.8% | (12.3)% |
| | Collateral remaining loss percentage(4) | 23.9% - 63.7% | (47.0)% |
| Non-Agency Alt-A | Discount rate | 4.4% - 10.0% | (6.2)% |
| | Prepayment speed(2) | 0.5% - 8.9% | (5.4)% |
| | Default speed(3) | 3.0% - 11.5% | (9.7)% |
| | Collateral remaining loss percentage(4) | 11.4% - 36.4% | (26.0)% |
| Non-Agency prime jumbo | Discount rate | 6.5% - 6.5% | (6.5)% |
| | Prepayment speed(2) | 14.3% - 14.3% | (14.3)% |
| | Default speed(3) | 1.5% - 1.5% | (1.5)% |
| | Collateral remaining loss percentage(4) | 0.4% - 0.4% | (0.4)% |

- (1) Key inputs are those used to evaluate broker indications of value.
- (2) Prepayment speed is measured using Life Voluntary Conditional Prepayment Rate (CPR).
- (3) Default speed is measured using Life Constant Default Rate (CDR).
- (4) The projected future losses on the loans in the collateral groups paying to each bond expressed as a percentage of the current balance of the loans.

Mortgage Loans

Fair value of mortgage loans is estimated based on whether the mortgage loans are saleable into active markets with established counterparties and transparent pricing:

Mortgage loans that are saleable into active markets, comprised of the Company's mortgage loans acquired for sale at fair value, are categorized as Level 2 financial statement items and their fair values are estimated using their quoted market or contracted price or market price equivalent.

Loans that are not saleable into active markets, comprised of the Company's mortgage loans at fair value and mortgage loans under forward purchase agreements at fair value, are categorized as Level 3 financial statement items, and their fair values are estimated using a discounted cash flow approach. Inputs to the discounted cash flow model include current interest rates, loan amount, payment status and property type, and forecasts of future interest rates, home prices, prepayment speeds, default and loss severities. The valuation process includes the computation by stratum of loan population and a review for reasonableness of various measures such as weighted average life, projected prepayment and default speeds, and projected default and loss percentages. The FAV group

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computes the effect on the valuation of changes in input variables such as interest rates, home prices, and delinquency status to assess the reasonableness of changes in the loan valuation. The results of the estimates of fair value of Level 3 mortgage loans are reported to PCM's valuation committee as part of its review and approval of monthly valuation results.

Changes in fair value attributable to changes in instrument-specific credit risk are measured by the change in the respective loan's delinquency status at period-end from the later of the beginning of the period or acquisition date.

The significant unobservable inputs used in the fair value measurement of the Company's mortgage loans at fair value and mortgage loans under forward purchase agreements at fair value are discount rate, home price projections, voluntary prepayment speeds and default speeds. Significant changes in any of those inputs in isolation could result in a significant change to the loans' fair value measurement. Increases in home price projections are generally accompanied by an increase in voluntary prepayment speeds.

Following is a quantitative summary of key inputs used in the valuation of mortgage loans at fair value:

| Key Inputs | Range (Weighted Average) | |
|---|-----------------------------|-------------------|
| | September 30, 2012 | December 31, 2011 |
| <i>Mortgage loans at fair value</i> | | |
| Discount rate | 9.2% - 22.1% | 9.1% - 20.7% |
| | (13.5%) | (14.4%) |
| Twelve-month projected housing price index change | 0.8% - 0.5% | 0.9% - 2.3% |
| | (0.1%) | (-0.3%) |
| Prepayment speed(1) | 0.3% - 4.4% | 0.2% - 6.2% |
| | (2.3%) | (2.3%) |
| Total prepayment speed(2) | 6.2% - 27.8% | 1.0% - 33.8% |
| | (19.7%) | (25.4%) |
| <i>Mortgage loans under forward purchase agreements</i> | | |
| Discount rate | | 16.3% - 20.8% |
| | | (17.1%) |
| Twelve-month projected housing price index change | | 0.5% - 0.4% |
| | | (-0.5%) |
| Prepayment speed(1) | | 0.7% - 0.8% |
| | | (0.8%) |
| Total prepayment speed(2) | | 30.1% - 33.3% |
| | | (32.7%) |

(1) Prepayment speed is measured using Life Voluntary CPR.

(2) Total prepayment speed is measured using Life Total CPR.

Derivative Financial Instruments

The Company estimates the fair value of an interest rate lock commitment based on quoted Agency MBS prices, its estimate of the fair value of the MSRs it expects to receive in the sale of the loans and the probability that the mortgage loan will fund within the terms of the interest rate lock commitment.

The significant unobservable inputs used in the fair value measurement of the Company's interest rate lock commitments are the pull-through rate, the percentage of loans that the Company ultimately funds as a percentage of the commitments it has made, and the MSR component of the Company's estimate of the value of the mortgage loans it has committed to purchase. Significant changes in any of those inputs, in isolation, could

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result in a significant change in fair value measurement. Changes in these assumptions are generally inversely correlated as increasing interest rates have a negative effect on the fair value of mortgage loans and a positive effect on the fair value of MSR that are created in the sale of such mortgage loans.

Following is a quantitative summary of key unobservable inputs used in the valuation of interest rate lock commitments:

| | September 30, 2012 | December 31, 2011 |
|--|--------------------|-------------------|
| | Range | |
| Key Inputs | (Weighted Average) | |
| Pull-through rate | 54.7% - 100.0% | 55.0% - 98.0% |
| | (87.4%) | (78.0%) |
| MSR value expressed as: | | |
| Servicing fee multiple | 1.75% - 4.35% | 2.81% - 5.74% |
| | (4.24%) | (5.23%) |
| Percentage of unpaid principal balance | 0.44% - 1.09% | 0.70% - 1.43% |
| | (1.06%) | (1.31%) |

The Company estimates the fair value of commitments to sell loans based on quoted MBS prices. The Company estimates the fair value of the MBS options and futures it purchases and sells based on observed interest rate volatilities in the MBS market. The Company estimates the fair value of its MBS interest rate swaptions based on quoted market prices.

Real Estate Acquired in Settlement of Loans

REO is measured based on its fair value on a nonrecurring basis and is categorized as a Level 3 financial statement item. Fair value of REO is determined by using a current estimate of value from a broker's price opinion or a full appraisal, or the price given in a current contract of sale.

REO values are reviewed by PCM's staff appraisers when the Company obtains multiple indications of value and there is a significant difference among the values received. PCM's staff appraisers will attempt to resolve such difference. In circumstances where the appraisers are not able to generate adequate data to support a value conclusion, the staff appraisers will order an additional appraisal to resolve the property's value.

Mortgage Servicing Rights

MSRs are categorized as Level 3 financial statement items. The Company uses a discounted cash flow approach to estimate the fair value of MSRs. The key assumptions used in the estimation of the fair value of MSRs include prepayment and default rates of the underlying loans, the applicable discount rate, and cost to service loans. The key assumptions used in the Company's discounted cash flow model are based on market factors which management believes are consistent with assumptions and data used by market participants valuing similar MSRs. The results of the estimates of fair value of MSRs are reported to the Manager's valuation committee as part of their review and approval of monthly valuation results.

The significant unobservable inputs used in the fair value measurement of the Company's MSRs are pricing spreads, prepayment speeds (or life) and annual per-loan cost of servicing. Significant changes to any of those inputs in isolation could result in a significant change in the MSR fair value measurement. Changes in these key assumptions are not necessarily directly related.

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Following are the key inputs used in determining the fair value of MSR's at the time of initial recognition:

| Key Inputs | Quarter ended September 30, | | | |
|-----------------------------------|-----------------------------|--|----------------|--------------|
| | 2012 | | 2011 | |
| | Amortized Cost | Range (Weighted Average) Fair Value | Amortized Cost | Fair Value |
| Pricing spread(1) | 7.5% - 7.5% | 7.5% - 13.5% | 10.0% - 19.9% | 9.5% - 17.0% |
| | (7.5%) | (7.6%) | (11.7%) | (12.3%) |
| Life (in years) | 6.4 - 6.4 | 3.2 - 6.4 | 3.7 - 8.1 | 2.3 - 8.1 |
| | (6.4) | (6.3) | (7.2) | (5.7) |
| Annual total prepayment speed(2) | 8.9% - 9.4% | 8.9% - 27.1% | 5.9% - 24.4% | 7.2% - 23.1% |
| | (9.1%) | (9.5%) | (7.7%) | (11.8%) |
| Annual per-loan cost of servicing | \$68 - \$68 | \$68 - \$140 | \$53 - \$68 | \$53 - \$140 |
| | (\$68) | (\$69) | (\$68) | (\$91) |

| Key Inputs | Nine months ended September 30, | | | |
|-----------------------------------|---------------------------------|--|----------------|--------------|
| | 2012 | | 2011 | |
| | Amortized Cost | Range (Weighted Average) Fair Value | Amortized Cost | Fair Value |
| Pricing spread(1) | 7.5% - 22.8% | 7.5% - 14.6% | 10.0% - 19.9% | 9.5% - 17.0% |
| | (7.7%) | (8.1%) | (11.7%) | (12.5%) |
| Life (in years) | 2.5 - 6.7 | 2.5 - 6.7 | 3.7 - 8.1 | 2.0 - 8.2 |
| | (6.4) | (6.2) | (7.2) | (6.0) |
| Annual total prepayment speed(2) | 7.8% - 36.9% | 7.8% - 36.9% | 5.8% - 9.3% | 6.8% - 27.8% |
| | (8.9%) | (10.4%) | (7.6%) | (14.5%) |
| Annual per-loan cost of servicing | \$68 - \$140 | \$68 - \$140 | \$53 - \$68 | \$53 - \$140 |
| | (\$68) | (\$75) | (\$66) | (\$86) |

- (1) Pricing spread represents a margin that is applied to a reference interest rate's forward rate curve to develop periodic discount rates. The Company applies a pricing spread to the United States Dollar LIBOR curve for purposes of discounting cash flows relating to MSR's acquired as proceeds from the sale of mortgage loans.
- (2) Annual total prepayment speed is measured using Life Total CPR.

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Following is a quantitative summary of key assumptions used in the valuation of MSR's, and the effect on the estimated fair value from adverse changes in those assumptions as of the dates presented (weighted averages are based upon unpaid principal balance or fair value where applicable):

| Key Inputs | September 30, 2012 | | December 31, 2011 | |
|---------------------------------------|--------------------------|---------------|-------------------|--------------|
| | Range (Weighted Average) | | | |
| | Amortized cost | Fair value | Amortized cost | Fair value |
| Pricing spread(1) | 7.5% - 14.5% | 7.5% - 14.5% | 7.5% - 16.5% | 7.5% - 16.5% |
| | (7.5%) | (7.8%) | (7.5%) | (8.6%) |
| Effect on value of 5% adverse change | \$(1,114) | \$(26) | \$(89) | \$(10) |
| Effect on value of 10% adverse change | \$(2,194) | \$(52) | \$(176) | \$(20) |
| Effect on value of 20% adverse change | \$(3,968) | \$(91) | \$(341) | \$(39) |
| Average life (in years) | 2.1 - 6.8 | 2.1 - 6.8 | 3.0 - 6.9 | 1.7 - 6.9 |
| | (6.4) | (5.8) | (6.7) | (5.3) |
| Prepayment speed(2) | 8.4% - 46.5% | 10.5% - 46.5% | 6.9% - 30.8% | 8.4% - 59.0% |
| | (10.2%) | (17.1%) | (8.2%) | (16.3%) |
| Effect on value of 5% adverse change | \$(1,528) | \$(53) | \$(90) | \$(16) |
| Effect on value of 10% adverse change | \$(2,997) | \$(104) | \$(178) | \$(31) |
| Effect on value of 20% adverse change | \$(5,770) | \$(197) | \$(343) | \$(60) |
| Annual per-loan cost of servicing | \$68 - \$140 | \$68 - \$140 | \$68 - \$140 | \$68 - \$140 |
| | (\$68) | (\$75) | (\$69) | (\$89) |
| Effect on value of 5% adverse change | \$(393) | \$(13) | \$(30) | \$(4) |
| Effect on value of 10% adverse change | \$(785) | \$(26) | \$(61) | \$(9) |
| Effect on value of 20% adverse change | \$(1,571) | \$(53) | \$(122) | \$(17) |

(1) Pricing spread represents a margin that is applied to a reference interest rate's forward rate curve to develop periodic discount rates. The Company applies a pricing spread to the United States Dollar LIBOR curve for purposes of discounting cash flows relating to MSR's acquired as proceeds from the sale of mortgage loans and purchased MSR's not backed by pools of distressed mortgage loans.

(2) Prepayment speed is measured using Life Total CPR.

The preceding sensitivity analyses are limited in that they were performed as of a particular point in time; only contemplate the movements in the indicated variables; do not incorporate changes in the variables in relation to other variables; are subject to the accuracy of various models and inputs used; and do not take into account other factors that would affect the Company's overall financial performance in such scenarios, including operational adjustments made by the Manager to account for changing circumstances. For these reasons, the preceding estimates should not be viewed as earnings forecasts.

Securities Sold Under Agreements to Repurchase

Fair value of securities sold under agreements to repurchase is based on the accrued cost of the agreements, which approximates the agreements' fair values, due to the agreements' short maturities and variable interest rates.

Note 7 Short-Term Investments

The Company's short-term investments are comprised of money market accounts deposited with U.S. commercial banks.

Note 8 United States Treasury Security

The Company's investment in a United States Treasury security of \$50.0 million as of December 31, 2011 matured on January 19, 2012 and had a coupon interest rate of 0.00%.

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Note 9 Mortgage-Backed Securities at Fair Value

Investments in MBS were as follows as of the dates presented:

| Security collateral type | Unpaid Balance | Total | September 30, 2012 Fair value Credit rating | | | Non- investment grade | Yield |
|--------------------------|-------------------|-------|---|----|-----|-----------------------------|-------|
| | | | AAA | AA | BBB | | |
| Agency: | | | | | | | |
| FNMA 30-year fixed | \$ | \$ | \$ | \$ | \$ | \$ | 0.00% |
| Non-Agency: | | | | | | | |
| Non-Agency subprime | | | | | | | 0.00% |
| Non-Agency Alt-A | | | | | | | 0.00% |
| Non-Agency prime jumbo | | | | | | | 0.00% |
| | \$ | \$ | \$ | \$ | \$ | \$ | 0.00% |

| Security collateral type | Unpaid Balance | Total | December 31, 2011 Fair value Credit rating | | | Non- investment grade | Yield |
|--------------------------|-------------------|-----------|--|----------|----------|-----------------------------|-------|
| | | | AAA | AA | BBB | | |
| Non-Agency: | | | | | | | |
| Non-Agency subprime | \$ 63,712 | \$ 58,634 | \$ | \$ | \$ 920 | \$ 57,714 | 8.01% |
| Non-Agency Alt-A | 8,910 | 8,710 | 440 | | 5,362 | 2,908 | 6.23% |
| Non-Agency prime jumbo | 5,624 | 5,469 | | 5,469 | | | 6.51% |
| | \$ 78,246 | \$ 72,813 | \$ 440 | \$ 5,469 | \$ 6,282 | \$ 60,622 | 7.70% |

There were no MBS at September 30, 2012. All of the Company's MBS had remaining contractual maturities of more than ten years at December 31, 2011. At December 31, 2011, the Company had pledged all of its MBS to secure agreements to repurchase.

Note 10 Mortgage Loans Acquired for Sale at Fair Value

Mortgage loans acquired for sale at fair value is comprised of recently originated mortgage loans purchased by the Company for resale. Following is a distribution of the Company's mortgage loans acquired for sale at fair value as of the dates presented:

| Loan Type | September 30, 2012 | | December 31, 2011 | |
|----------------------------------|--------------------|--------------------------------|-------------------|--------------------------------|
| | Fair value | Unpaid principal balance | Fair value | Unpaid principal balance |
| | | | | |
| Government insured or guaranteed | \$ 194,055 | \$ 182,978 | \$ 46,266 | \$ 44,229 |
| Fixed-rate: | | | | |

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| | | | | |
|-----------------|------------|------------|------------|------------|
| Agency-eligible | 653,520 | 616,523 | 173,457 | 166,174 |
| Jumbo loans | | | 12,293 | 11,996 |
| | \$ 847,575 | \$ 799,501 | \$ 232,016 | \$ 222,399 |

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The Company is not approved by GNMA as an issuer of GNMA-guaranteed securities which are backed by government-insured or guaranteed mortgage loans. As discussed in Note 3 *Transactions with Related Parties*, the Company transfers such government insured or guaranteed mortgage loans that it purchases from correspondent lenders to PLS, which is a GNMA-approved issuer, for a sourcing fee of three basis points on the unpaid principal balance of each such loan.

Mortgage loans acquired for sale at fair value totaling \$846.9 million and \$231.7 million were pledged to secure sales of loans under agreements to repurchase at September 30, 2012 and December 31, 2011, respectively.

Note 11 Derivative Financial Instruments

Following is a summary of the distribution of the Company's derivative financial instruments which are included in *Other assets* and *Accounts payable and accrued liabilities* on the consolidated balance sheets as of the dates presented:

| Instrument | September 30, 2012 | | December 31, 2011 | |
|--------------------------------|--------------------|------------------------------|-------------------|------------|
| | Notional amount | Fair value (in thousands) | Notional amount | Fair value |
| Assets: | | | | |
| Interest rate lock commitments | \$ 2,211,367 | \$ 40,036 | \$ 563,487 | \$ 5,772 |
| Hedging derivatives: | | | | |
| MBS put options | 525,000 | 902 | 28,000 | 26 |
| MBS call options | | | 5,000 | 57 |
| MBS swaptions | | | | |
| | 525,000 | 902 | 33,000 | 83 |
| | 2,736,367 | 40,938 | 596,487 | 5,855 |
| Liability: | | | | |
| Forward sales contracts | \$ 2,453,036 | \$ 36,203 | \$ 358,291 | \$ 3,917 |

The Company is exposed to price risk arising from changes in market interest rates relative to its mortgage loans acquired for sale and to the commitments it makes to acquire loans from correspondent lenders. The Company is also exposed to such risks when it holds Agency MBS. The Company bears price risk from the time a commitment to purchase a loan is made to a correspondent lender to the time the purchased mortgage loan is sold. During these periods, the Company is exposed to losses if mortgage interest rates rise, because, when interest rates rise, the value of the purchase commitment or mortgage loan acquired for sale declines. Similarly, the Company bears price risk relative to its holdings of Agency MBS during the period it holds such securities.

The Company engages in interest rate risk management activities in an effort to reduce the variability of earnings caused by changes in market interest rates. To manage this price risk resulting from interest rate risk, the Company uses derivative financial instruments acquired with the intention of moderating the risk that changes in market interest rates will result in unfavorable changes in the value of the Company's interest rate lock commitments, inventory of mortgage loans acquired for sale and Agency MBS. The Company does not use derivative financial instruments for purposes other than in support of its risk management activities.

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The following table summarizes the notional amount activity for derivative contracts used to hedge the Company's interest rate lock commitments, inventory of mortgage loans acquired for sale and Agency MBS:

| Period/Instrument | Balance, beginning of period | Additions | Dispositions/ expirations (in thousands) | Balance, end of period | Fair value asset (liability) at period-end |
|---|------------------------------------|---------------|--|------------------------------|--|
| Quarter ended September 30, 2012 | | | | | |
| MBS put options | \$ 245,000 | \$ 320,000 | \$ (40,000) | \$ 525,000 | \$ 902 |
| MBS call options | \$ 35,000 | \$ | \$ (35,000) | \$ | \$ |
| MBS swaptions | \$ 170,000 | \$ | \$ (170,000) | \$ | \$ |
| Forward sales contracts | \$ 1,304,565 | \$ 5,261,023 | \$ (4,112,552) | \$ 2,453,036 | \$ (36,203) |
| Nine months ended September 30, 2012 | | | | | |
| MBS put options | \$ 28,000 | \$ 740,000 | \$ (243,000) | \$ 525,000 | \$ 902 |
| MBS call options | \$ 5,000 | \$ 90,000 | \$ (95,000) | \$ | \$ |
| MBS swaptions | \$ | \$ 170,000 | \$ (170,000) | \$ | \$ |
| Forward sales contracts | \$ 358,291 | \$ 12,162,517 | \$ (10,067,772) | \$ 2,453,036 | \$ (36,203) |

The Company did not have significant activity in derivative financial instruments during the quarter and nine months ended September 30, 2011.

As of September 30, 2012 and December 31, 2011, the Company had \$16.3 million and \$1.5 million, respectively, on deposit with its derivatives counterparties. Margin deposits are included in *Other assets* on the consolidated balance sheets as of September 30, 2012 and December 31, 2011.

Note 12 Mortgage Loans at Fair Value

Mortgage loans at fair value are comprised of mortgage loans not acquired for resale. Such loans may be sold at a later date pursuant to a management determination that such a sale represents the most advantageous liquidation strategy for the identified loan.

Following is a summary of the distribution of the Company's mortgage loans at fair value as of the dates presented:

| Loan Type | September 30, 2012 | | December 31, 2011 | |
|-----------------------|--------------------|--------------------------|-------------------|--------------------------|
| | Fair value | Unpaid principal balance | Fair value | Unpaid principal balance |
| (in thousands) | | | | |
| Nonperforming loans | \$ 701,915 | \$ 1,325,469 | \$ 494,711 | \$ 952,473 |
| Performing loans: | | | | |
| Fixed | 193,151 | 309,211 | 97,582 | 162,145 |
| ARM/hybrid | 133,894 | 197,542 | 73,166 | 116,693 |
| Interest rate step-up | 60,873 | 112,081 | 30,621 | 52,507 |
| Balloon | 133 | 220 | 186 | 316 |
| | 388,051 | 619,054 | 201,555 | 331,661 |
| | \$ 1,089,966 | \$ 1,944,523 | \$ 696,266 | \$ 1,284,134 |

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Following is a summary of certain concentrations of credit risk in the portfolio of mortgage loans at fair value as of the dates presented:

| Concentration | September 30, 2012 | December 31, 2011 |
|--|-------------------------------|------------------------------|
| Portion of mortgage loans originated between 2005 and 2007 | 83% | 72% |
| Percentage of fair value of mortgage loans with unpaid-principal-balance-to-current-property-value in excess of 100% | 69% | 72% |
| Percentage of mortgage loans secured by California real estate | 20% | 24% |
| States contributing 5% or more of mortgage loans | New York | |
| | Florida Illinois | New York Florida |
| | New Jersey | New Jersey |

Following is a summary of mortgage loans at fair value pledged to secure sales of loans under agreements to repurchase as of the dates presented:

| Borrowings | September 30, 2012 | December 31, 2011 |
|---|-------------------------------|------------------------------|
| | (in thousands) | |
| Mortgage loans at fair value sold under agreements to repurchase | \$ 976,559 | \$ 656,409 |
| Real estate acquired in settlement of loans sold under agreements to repurchase | \$ 10,119 | \$ 1,886 |

Note 13 Mortgage Loans Under Forward Purchase Agreements at Fair Value

Mortgage loans under forward purchase agreements at fair value are comprised of mortgage loans not acquired for resale. Such loans may be sold at a later date pursuant to a management determination that such a sale represents the most advantageous liquidation strategy for the identified loan.

Following is a summary of the distribution of the Company's mortgage loans under forward purchase agreements at fair value as of the periods presented:

| Loan Type | September 30, 2012 | | December 31, 2011 | |
|-----------------------|---------------------------|---|--------------------------|---|
| | Fair value | Unpaid principal balance | Fair value | Unpaid principal balance |
| | (in thousands) | | | |
| Nonperforming loans | \$ | \$ | \$ 121,266 | \$ 232,213 |
| Performing loans: | | | | |
| Fixed | | | 3,316 | 6,084 |
| ARM/hybrid | | | 3,965 | 6,002 |
| Interest rate step-up | | | 763 | 1,393 |
| Balloon | | | | |
| | | | 8,044 | 13,479 |
| | \$ | \$ | \$ 129,310 | \$ 245,692 |

Following is a summary of certain concentrations of credit risk in the portfolio of mortgage loans under forward purchase agreements at fair value as of the dates presented:

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| Concentration | September 30, 2012 | December 31, 2011 |
|--|-------------------------------|-----------------------------------|
| Portion of mortgage loans originated between 2005 and 2007 | 0% | 74% |
| Percentage of fair value of mortgage loans with unpaid-principal-balance-to current-property-value in excess of 100% | 0% | 74% |
| Percentage of mortgage loans secured by California real estate | 0% | 33% |
| States contributing 5% or more of mortgage loans | N/A | Florida New York New Jersey |

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At December 31, 2011, the entire balance of mortgage loans under forward purchase agreements was subject to borrowings under forward purchase agreements.

Note 14 Real Estate Acquired in Settlement of Loans

Following is a summary of the activity in REO for the periods presented:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|--|--------------------------------|-----------|------------------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| Balance at beginning of period | \$ 89,121 | \$ 48,872 | \$ 80,570 | \$ 29,685 |
| Purchases | | 914 | 48 | 2,424 |
| Transfers from mortgage loans at fair value and advances | 33,962 | 36,857 | 82,404 | 82,680 |
| Transfers from REO under forward purchase agreements | 786 | | 21,819 | |
| Results of REO: | | | | |
| Valuation adjustments, net | (3,954) | (2,779) | (8,824) | (6,764) |
| Gain on sale, net | 5,246 | 3,131 | 14,530 | 8,291 |
| | 1,292 | 352 | 5,706 | 1,527 |
| Sale proceeds | (38,981) | (17,089) | (104,367) | (46,410) |
| Balance at period end | \$ 86,180 | \$ 69,906 | \$ 86,180 | \$ 69,906 |

Following is a summary of real estate acquired in settlement of loans pledged to secure sales of loans under agreements to repurchase as of the dates presented:

| | September 30, 2012 | December 31, 2011 |
|--|-----------------------|----------------------|
| | (in thousands) | |
| Real estate acquired in settlement of loan sold under agreements to repurchase | \$ 10,119 | \$ 5,787 |
| Real estate acquired in settlement of loan sold under agreements to repurchase held in a consolidated subsidiary of the Company whose stock was pledged to secure financing of real estate held in that subsidiary | \$ 23,060 | \$ 54,212 |

Table of Contents**Note 15 Real Estate Acquired in Settlement of Loans Under Forward Purchase Agreements**

Following is a summary of the activity in REO under forward purchase agreements for the periods presented:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|--|--------------------------------|----------|------------------------------------|----------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| Balance at beginning of period | \$ 797 | \$ | \$ 22,979 | \$ |
| Purchases | | 914 | 248 | 914 |
| Transfers from mortgage loans under forward purchase agreements at fair value and advances | (10) | 8,884 | 6,633 | 8,884 |
| Transfers to REO | (786) | | (21,819) | |
| Results of REO under forward purchase agreements: | | | | |
| Valuation adjustments, net | (1) | | (449) | |
| Gain on sale, net | (3) | | 2,319 | |
| | (4) | | 1,870 | |
| Sale proceeds | 3 | | (9,911) | |
| Balance at period end | \$ | \$ 9,798 | \$ | \$ 9,798 |

Note 16 Mortgage Servicing Rights

Carried at Fair Value:

The activity in MSR carried at fair value is as follows:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|--|--------------------------------|--------|------------------------------------|--------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| Balance at beginning of period | \$ 1,285 | \$ 180 | \$ 749 | \$ |
| Additions: | | | | |
| Purchases | | | 20 | |
| MSRs resulting from loan sales | 363 | 362 | 1,451 | 539 |
| Total additions | 363 | 362 | 1,471 | 539 |
| Change in fair value: | | | | |
| Due to changes in valuation inputs or assumptions used in valuation model(1) | (62) | | (543) | |
| Other changes in fair value(2) | (64) | (10) | (76) | (7) |
| | (126) | (10) | (619) | (7) |
| Sales | | | (79) | |
| Balance at period end | \$ 1,522 | \$ 532 | \$ 1,522 | \$ 532 |

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- (1) Principally reflects changes in discount rates and prepayment speed assumptions, primarily due to changes in interest rates.
- (2) Represents changes due to realization of expected cash flows.

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Carried at Lower of Amortized Cost or Fair Value:

The activity in MSR's carried at lower of amortized cost or fair value is summarized below for the periods presented:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|--|--------------------------------|---------------|------------------------------------|---------------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| Mortgage Servicing Rights: | | | | |
| Balance at beginning of period | \$ 33,171 | \$ | \$ 5,282 | \$ |
| MSR's resulting from loan sales | 36,397 | 104 | 65,198 | 104 |
| Purchases | 6 | | 15 | |
| Sales | | | (19) | |
| Amortization | (1,437) | | (2,339) | |
| Application of valuation allowance to write down MSR's withother-than temporary impairment | | | | |
| Balance before valuation allowance at period end | 68,137 | 104 | 68,137 | 104 |
| Valuation Allowance for Impairment of Mortgage Servicing Rights: | | | | |
| Balance at beginning of period | \$ (1,624) | \$ | \$ | \$ |
| Additions | (2,881) | | (4,505) | |
| Application of valuation allowance to write down MSR's withother-than temporary impairment | | | | |
| Balance at period end | (4,505) | | (4,505) | |
| Mortgage Servicing Rights, net | \$ 63,632 | \$ 104 | \$ 63,632 | \$ 104 |
| Estimated Fair Value of MSR's at Period End | \$ 63,678 | \$ 109 | \$ 63,678 | \$ 109 |

Gain on sale of MSR's carried at lower of amortized cost or fair value is included in other income.

The following table summarizes the Company's estimate of amortization of its existing MSR's carried at lower of amortized cost or fair value. This projection was developed using the assumptions made by management in its September 30, 2012 valuation of MSR's, which will change as market conditions and portfolio composition and behavior vary. Therefore, both actual and projected amortization levels will differ from this projection in a manner and amount not presently determinable by management.

| 12-month period ended September 30, | Estimated MSR Amortization (in thousands) |
|-------------------------------------|---|
| 2013 | \$ 8,360 |
| 2014 | 7,331 |
| 2015 | 6,466 |
| 2016 | 5,824 |
| 2017 | 5,312 |
| Thereafter | 34,844 |
| Total | \$ 68,137 |

Table of Contents**Note 17 Securities Sold Under Agreements to Repurchase at Fair Value**

Following is a summary of financial information relating to securities sold under agreements to repurchase at fair value as of and for the periods presented:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|---|--------------------------------|-----------|------------------------------------|------------|
| | 2012 | 2011 | 2012 | 2011 |
| (dollar amounts in thousands) | | | | |
| Period end: | | | | |
| Balance | \$ | \$ 62,843 | \$ | \$ 62,843 |
| Weighted-average interest rate | 0.00% | 0.97% | 0.00% | 0.97% |
| Fair value of securities securing agreements to repurchase | \$ | \$ 69,500 | \$ | \$ 69,500 |
| During the period: | | | | |
| Weighted-average interest rate | 0.51% | 0.96% | 0.64% | 1.14% |
| Average balance of securities sold under agreements to repurchase | \$ 75,787 | \$ 65,364 | \$ 99,595 | \$ 80,020 |
| Maximum daily amount outstanding | \$ 157,333 | \$ 70,978 | \$ 160,334 | \$ 101,202 |
| Total interest expense | \$ 100 | \$ 161 | \$ 488 | \$ 692 |

As of December 31, 2011, the Company had \$3.8 million on deposit with its securities repurchase agreement counterparties. Margin deposits are included in *Other assets* in the consolidated balance sheets.

Note 18 Mortgage Loans Acquired for Sale Sold Under Agreements to Repurchase

Following is a summary of financial information relating to mortgage loans acquired for sale sold under agreements to repurchase as of and for the periods presented:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|--|--------------------------------|-----------|------------------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| (dollar amounts in thousands) | | | | |
| Period end: | | | | |
| Balance | \$ 755,471 | \$ 36,191 | \$ 755,471 | \$ 36,191 |
| Unused amount(1)(3) | \$ 244,529 | \$ 38,809 | \$ 244,529 | \$ 38,809 |
| Weighted-average interest rate | 2.61% | 2.64% | 2.61% | 2.64% |
| Fair value of mortgage loans acquired for sale securing agreements to repurchase | \$ 846,856 | \$ 40,496 | \$ 846,856 | \$ 40,496 |
| During the period: | | | | |
| Weighted-average interest rate during the period(2) | 2.42% | 2.65% | 2.29% | 2.60% |
| Average balance of loans sold under agreements to repurchase | \$ 462,137 | \$ 27,701 | \$ 294,857 | \$ 13,236 |
| Maximum daily amount outstanding | \$ 755,502 | \$ 48,535 | \$ 755,502 | \$ 48,535 |
| Total interest expense | \$ 3,947 | \$ 375 | \$ 7,221 | \$ 948 |

- (1) The amount the Company is able to borrow under loan repurchase agreements is tied to the fair value of unencumbered mortgage loans eligible to secure those agreements and the Company's ability to fund the agreements' margin requirements relating to the collateral sold.
- (2) Weighted-average interest rate during the periods excludes the effect of amortization of debt issuance costs of \$1.1 million and \$2.1 million during the quarter and nine months ended September 30, 2012, and \$188,000 and \$687,000 during the quarter and nine months ended September 30, 2011, respectively.
- (3) The unused amount reflects a temporary increase in one of the facilities available to the Company during September 2012. The Company received a \$100 million increase in one of its credit facilities for the period from September 26, 2012 through October 10, 2012. The increase in the credit facility has subsequently expired.

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The repurchase agreements collateralized by loans have an average remaining term of approximately 7.8 months at September 30, 2012.

Following is a summary of maturities of repurchase agreements by maturity date:

| Remaining Maturity at September 30, 2012 | Balance (in thousands) |
|--|---------------------------|
| Within 30 days | \$ |
| Over 30 to 90 days | 219,641 |
| Over 90 days to 180 days | |
| Over 180 days to 1 year | 535,830 |
| | \$ 755,471 |

The amount at risk (the fair value of the assets pledged plus the related margin deposit, less the amount advanced by the counterparty and accrued interest) relating to the Company's mortgage loans acquired for sale sold under agreements to repurchase is summarized by counterparty below as of September 30, 2012:

| Counterparty | Amount at risk (in thousands) | Weighted-average repurchase agreement maturity |
|---|----------------------------------|--|
| Citibank | \$ 19,741 | May 23, 2013 |
| Credit Suisse First Boston Mortgage Capital LLC | \$ 41,718 | October 29, 2013 |
| Bank of America, N.A | \$ 26,482 | December 5, 2012 |
| Barclays Bank PLC | \$ 8,985 | July 1, 2013 |

The Company is subject to margin calls during the period the agreements are outstanding and therefore may be required to repay a portion of the borrowings before the respective agreements mature if the value (as determined by the applicable lender) of the mortgage loans securing those agreements decreases. As of September 30, 2012 and December 31, 2011, the Company had \$6.3 million and \$1.6 million, respectively, on deposit with its loan repurchase agreement counterparties. Margin deposits are included in *Other assets* in the consolidated balance sheets.

Note 19 Mortgage Loans at Fair Value Sold Under Agreements to Repurchase

Following is a summary of financial information relating to mortgage loans at fair value sold under agreements to repurchase as of and for the periods presented:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|--|--------------------------------|------------|------------------------------------|------------|
| | 2012 | 2011 | 2012 | 2011 |
| | (dollar amounts in thousands) | | | |
| Period end: | | | | |
| Balance | \$ 274,185 | \$ 309,777 | \$ 274,185 | \$ 309,777 |
| Unused amount(1) | \$ 375,815 | \$ 180,223 | \$ 375,815 | \$ 180,223 |
| Weighted-average interest rate at end of period | 3.88% | 3.79% | 3.88% | 3.79% |
| Fair value of mortgage loans at fair value and REO securing agreements to repurchase | \$ 986,678 | \$ 662,554 | \$ 986,678 | \$ 662,554 |
| During the period: | | | | |
| Weighted-average interest rate | 4.46% | 4.30% | 4.36% | 4.08% |
| Average balance of loans sold under agreements to repurchase | \$ 333,216 | \$ 248,651 | \$ 313,726 | \$ 220,709 |
| Maximum daily amount outstanding | \$ 439,976 | \$ 309,777 | \$ 439,976 | \$ 309,777 |
| Total interest expense | \$ 3,800 | \$ 2,731 | \$ 10,411 | \$ 6,833 |

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- (1) The amount the Company is able to borrow under loan repurchase agreements is tied to the fair value of unencumbered mortgage loans eligible to secure those agreements and the Company's ability to fund the agreements' margin requirements relating to the collateral sold.

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The repurchase agreements collateralized by loans have a weighted average remaining term of approximately 6.0 months at September 30, 2012. Following is a summary of maturities of repurchase agreements by maturity date:

| Remaining Maturity at September 30, 2012 | Balance (in thousands) |
|--|---------------------------|
| Within 30 days | \$ |
| Over 30 to 90 days | 56,094 |
| Over 90 days to 180 days | |
| Over 180 days to 1 year | 218,091 |
| | \$ 274,185 |

The amount at risk (the fair value of the assets pledged plus the related margin deposit, less the amount advanced by the counterparty and accrued interest) relating to the Company's mortgage loans at fair value sold under agreements to repurchase is summarized by counterparty below as of September 30, 2012:

| Counterparty | Amount at risk (in thousands) | Weighted-average repurchase agreement maturity |
|---|----------------------------------|--|
| Citibank, N.A | \$ 622,674 | April 19, 2013 |
| Credit Suisse First Boston Mortgage Capital LLC | \$ 18,569 | June 5, 2013 |
| Wells Fargo Bank, N.A | \$ 71,495 | December 28, 2012 |

The Company is subject to margin calls during the period the agreements are outstanding and therefore may be required to repay a portion of the borrowings before the respective agreements mature if the value (as determined by the applicable lender) of the loans securing those agreements decreases. As of September 30, 2012 and December 31, 2011, the Company had \$452,000 and \$471,000, respectively, on deposit with its loan repurchase agreement counterparties. Margin deposits are included in *Other assets* in the consolidated balance sheets.

Note 20 Real Estate Acquired in Settlement of Loans Financed Under Agreements to Repurchase

Following is a summary of financial information relating to REO financed under agreements to repurchase as of and for the periods presented:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|---|--------------------------------|-----------|------------------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| | (dollar amounts in thousands) | | | |
| Period end: | | | | |
| Balance | \$ 11,715 | \$ 12,814 | \$ 11,715 | \$ 12,814 |
| Unused amount(1) | \$ 88,285 | \$ 87,186 | \$ 88,285 | \$ 87,186 |
| Weighted-average interest rate | 3.96% | 3.99% | 3.96% | 3.99% |
| Fair value of REO held in a consolidated subsidiary whose stock is pledged to secure agreements to repurchase | \$ 24,148 | \$ 26,102 | \$ 24,148 | \$ 26,102 |
| During the period: | | | | |
| Weighted-average interest rate(2) | 4.25% | 4.76% | 4.21% | 4.71% |
| Average balance of REO sold under agreements to repurchase | \$ 15,461 | \$ 12,663 | \$ 19,139 | \$ 4,725 |
| Maximum daily amount outstanding | \$ 19,909 | \$ 16,797 | \$ 27,494 | \$ 16,797 |
| Total interest expense | \$ 293 | \$ 279 | \$ 989 | \$ 319 |

(1)

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The amount the Company is able to borrow under REO repurchase agreements is tied to the fair value of unencumbered REO eligible for contribution to the subsidiary securing those agreements and the Company's ability to fund the agreements' margin requirements relating to the underlying collateral.

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(2) Weighted-average interest rate during the period excludes the effect of amortization of debt issuance costs of \$125,000 and \$375,000 during the quarter and nine months ended September 30, 2012, respectively, and \$125,000 and \$150,000 during the quarter and nine months ended September 30, 2011, respectively.

The repurchase agreement pursuant to which the Company finances REO has a remaining term of approximately 8.3 months at September 30, 2012.

The amount at risk (the fair value of the assets pledged plus the related margin deposit, less the amount advanced by the counterparty and accrued interest) relating to the Company's REO held in a consolidated subsidiary, the stock of which is pledged to secure agreements to repurchase, is summarized by counterparty below as of September 30, 2012:

| Counterparty | Amount at risk (in thousands) | Weighted-average repurchase agreement maturity |
|---|----------------------------------|--|
| Credit Suisse First Boston Mortgage Capital LLC | \$ 12,419 | June 5, 2013 |

The Company is subject to margin calls during the period the agreements are outstanding and therefore may be required to repay a portion of the borrowings before the agreements mature if the value (as determined by the applicable lender) of the underlying REOs decreases.

Note 21 Note Payable Secured by Mortgage Loans at Fair Value

Following is a summary of financial information relating to the note payable secured by mortgage loans at fair value as of and for the periods presented:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|--|--------------------------------|-----------|------------------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| | (dollar amounts in thousands) | | | |
| Period end: | | | | |
| Balance | \$ | \$ | \$ | \$ |
| Unused amount(1) | \$ | \$ 40,000 | \$ | \$ 40,000 |
| Weighted-average interest rate | 0.00% | 0.00% | 0.00% | 0.00% |
| Fair value of mortgage loans at fair value and | | | | |
| REO securing the note payable | \$ | \$ | \$ | \$ |
| During the period: | | | | |
| Weighted-average interest rate | 0.00% | 0.00% | 6.95% | 0.00% |
| Average balance | \$ | \$ | \$ 2,282 | \$ |
| Maximum daily amount outstanding | \$ | \$ | \$ 28,617 | \$ |
| Interest expense | \$ | \$ | \$ 112 | \$ |

(1) The amount the Company is able to borrow under this lending facility is tied to the fair value of unencumbered mortgage loans eligible to secure the facility and the Company's ability to fund the agreement's margin requirements relating to the collateral pledged.

The facility underlying the *Note payable secured by mortgage loans at fair value*, matured on September 26, 2012. At December 31, 2011, the Company had \$28.6 million of borrowings under the note payable and \$237,000 on deposit with its counterparty. Margin deposits are included in *Other assets* in the consolidated balance sheets.

Table of Contents**Note 22 Borrowings Under Forward Purchase Agreements**

Following is a summary of financial information relating to borrowings under forward purchase agreements as of and for the periods presented:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|--|--------------------------------|------------|------------------------------------|------------|
| | 2012 | 2011 | 2012 | 2011 |
| (dollar amounts in thousands) | | | | |
| Period end: | | | | |
| Balance | \$ | \$ 163,755 | \$ | \$ 163,755 |
| Weighted-average interest rate | 0.00% | 3.87% | 0.00% | 3.87% |
| Fair value of underlying loans and REO | \$ | \$ 162,706 | \$ | \$ 162,706 |
| During the period: | | | | |
| Weighted-average interest rate | 4.00% | 4.48% | 4.01% | 4.48% |
| Average balance | \$ 9,787 | \$ 146,708 | \$ 78,435 | \$ 49,440 |
| Maximum daily amount outstanding | \$ 16,693 | \$ 173,398 | \$ 152,428 | \$ 173,398 |
| Interest expense | \$ 100 | \$ 1,680 | \$ 2,396 | \$ 1,680 |

Note 23 Liability for Representations and Warranties

The Company's agreements with the Agencies include representations and warranties related to the loans the Company sells to the Agencies. The representations and warranties require adherence to Agency origination and underwriting guidelines, including but not limited to the validity of the lien securing the loan, property eligibility, borrower credit, income and asset requirements, and compliance with applicable federal, state and local law.

In the event of a breach of its representations and warranties, the Company may be required to either repurchase the mortgage loans with the identified defects or indemnify the investor or insurer. In such cases, the Company bears any subsequent credit loss on the mortgage loans. The Company's representations and warranties are generally not subject to stated limits of exposure. The Company's credit loss may be reduced by any recourse it has to correspondent lenders that, in turn, had sold such mortgage loans to the Company and breached similar or other representations and warranties. In such event, the Company has the right to seek a recovery of related repurchase losses from that originator.

The Company records a provision for losses relating to such the representations and warranties as part of its loan sale transactions. The method used to estimate the liability for representations and warranties is a function of the representations and warranties given and considers a combination of factors, including, but not limited to, estimated future defaults and loan repurchase rates and the potential severity of loss in the event of defaults and the probability of reimbursement by the correspondent loan seller. The Company establishes a liability at the time loans are sold and continually updates its liability estimate.

Following is a summary of the Company's liability for representations and warranties included in *Accounts payable and accrued liabilities* for the periods presented:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|------------------------------|--------------------------------|-------|------------------------------------|-------|
| | 2012 | 2011 | 2012 | 2011 |
| (in thousands) | | | | |
| Balance, beginning of period | \$ 1,249 | \$ 11 | \$ 205 | \$ |
| Provisions for losses | 1,129 | 21 | 2,173 | 32 |
| Incurred losses | | | | |
| Balance, end of period | \$ 2,378 | \$ 32 | \$ 2,378 | \$ 32 |

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The level of the liability for representations and warranties is difficult to estimate and requires considerable management judgment. The level of mortgage loan repurchase losses is dependent on economic factors, investor demand strategies, and other external conditions that may change over the lives of the underlying loans. However, management believes the amount and range of reasonably possible losses in relation to the recorded liability is not material to the Company's financial condition or results of operations. The current unpaid principal balance of loans sold by the Company to date represents the maximum exposure to repurchases related to representations and warranties.

Note 24 Commitments and Contingencies

From time to time, the Company may be involved in various proceedings, claims and legal actions arising in the ordinary course of business. As of September 30, 2012, the Company was not involved in any such proceedings, claims or legal actions that management believes would have a material adverse effect on the Company.

Mortgage Loan Commitments

The following table summarizes the Company's outstanding contractual loan commitments as of the date presented:

| | September 30, 2012 |
|---|-------------------------------|
| | (in thousands) |
| Commitments to purchase mortgage loans: | |
| Correspondent lending | \$ 2,211,367 |
| Other mortgage loans | \$ |

Note 25 Shareholders' Equity

On May 11, 2012, the Company issued and sold 10,000,000 common shares in an underwritten public offering and received \$193.5 million of proceeds, after the underwriting discount and estimated offering expenses and the reimbursement of certain expenses. On May 17, 2012, the Company issued and sold an additional 287,706 common shares pursuant to the exercise of an option to purchase additional shares by the public offering's underwriters and received \$5.4 million of net proceeds after the underwriting discount and reimbursement of certain expenses. Proceeds from the issuance of these shares were used to fund a portion of the purchase price of portfolios of residential mortgage whole loans, to fund the continued growth of the correspondent lending business, to acquire additional mortgage loans or other investments, including those under existing forward purchase agreements, and for general corporate purposes.

On August 22, 2012, the Company issued and sold 17,250,000 common shares in an underwritten public offering and received \$357.2 million of proceeds, after the underwriting discount and estimated offering expenses and the reimbursement of net certain expenses. Proceeds from the issuance of these shares were used to fund a portion of the purchase price of portfolios of residential mortgage whole loans, to fund the continued growth of the correspondent lending business, to acquire additional mortgage loans or other investments, including those under existing forward purchase agreements, and for general corporate purposes.

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During the nine months ended September 30, 2012, the Company sold common shares under a Controlled Equity Offering Sales Agreement with Cantor Fitzgerald & Co. and under an ATM Equity OfferingSM Sales Agreement with Merrill Lynch, Pierce, Fenner & Smith Incorporated. Pursuant to the Controlled Equity Offering Sales Agreement and the ATM Equity OfferingSM, The Company sold 2,800,710 of its common shares at a weighted average price of \$18.58 per share, providing net proceeds to the Company of \$51.0 million, net of sales commissions. The sales agents received a total of approximately \$999,000, which represents an average commission of approximately 2.0% of the gross sales price.

As more fully described in the Company's Annual Report, certain of the underwriting costs incurred in the Company's IPO were paid on PMT's behalf by PCM and a portion of the underwriting discount was deferred by agreement with the underwriters of the offering. Reimbursement to PCM and payment to the underwriters of the deferred underwriting discount is both contingent on PMT's performance during any full four calendar quarter period during the 24 full calendar quarters after the date of the completion of its IPO, August 4, 2009. If PMT meets the specified performance levels during any full four calendar quarter period during the 24-quarter period, the Company will reimburse PCM approximately \$2.9 million of underwriting costs paid by PCM on the offering date and pay the underwriters approximately \$5.9 million in deferred underwriting discount. If this requirement is not satisfied by the end of such 24-quarter period, the Company's obligation to reimburse PCM and make the conditional payment of the underwriting discount will terminate. Management has concluded that these amounts are likely to be paid during the 24-quarter period and has recognized a liability for reimbursement to PCM and payment of the contingent underwriting discount as a reduction of additional paid-in capital.

Note 26 Net Gain on Mortgage Loans Acquired For Sale

Net gain on mortgage loans acquired for sale is summarized below for the periods presented:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|--|--------------------------------|---------|------------------------------------|---------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| Cash gain (loss): | | | | |
| Sales proceeds | \$ 10,360 | \$ (63) | \$ 10,677 | \$ (73) |
| Hedging activities | (17,897) | (929) | (28,720) | (1,013) |
| | (7,537) | (992) | (18,043) | (1,086) |
| Non cash gain: | | | | |
| Change in fair value of commitments to purchase loans | 27,102 | 1,209 | 34,263 | 1,205 |
| Receipt of MSR in loan sale transactions | 36,760 | 466 | 66,649 | 643 |
| Provision for losses relating to representations and warranties provided in loan sales | (1,129) | (21) | (2,173) | (32) |
| Change in fair value relating to loans and hedging derivatives held at quarter-end: | | | | |
| Mortgage loans | 23,004 | 1,067 | 34,456 | 1,151 |
| Hedging derivatives | (28,407) | (1,645) | (33,942) | (1,674) |
| | (5,403) | (578) | 514 | (523) |
| | \$ 49,793 | \$ 84 | \$ 81,210 | \$ 207 |

Table of Contents**Note 27 Net Loan Servicing Fees**

Net loan servicing fees is summarized below for the periods presented:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|--|--------------------------------|-------|------------------------------------|-------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| Servicing fees(1) | \$ 3,933 | \$ 24 | \$ 6,294 | \$ 24 |
| Effect of MSR's: | | | | |
| Amortization | (1,437) | | (2,339) | |
| Provision for impairment of MSR's carried at lower of amortized cost or fair value | (2,881) | | (4,505) | |
| Change in fair value of MSR's carried at fair value | (126) | (10) | (619) | (7) |
| | (4,444) | (10) | (7,463) | (7) |
| Net loan servicing fees | \$ (511) | \$ 14 | \$ (1,169) | \$ 17 |

(1) Includes contractually specified servicing fees.

Note 28 Share-Based Compensation Plan

The Company's equity incentive plan allows for grants of equity-based awards up to a total of 8% of PMT's issued and outstanding shares on a diluted basis at the time of the award. Restricted share units have been awarded to trustees and officers of the Company and to employees of PCM and its affiliates at no cost to the grantees. Such awards generally vest over a one- to four-year period. Expense relating to awards is included in the consolidated statements of income under the caption *Compensation*.

The table below summarizes restricted share unit activity and compensation expense for the periods presented:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|---|--------------------------------|--------------|------------------------------------|--------------|
| | 2012 | 2011 | 2012 | 2011 |
| Number of units: | | | | |
| Outstanding at beginning of period | 751,489 | 606,320 | 491,809 | 272,984 |
| Granted | | | 350,000 | 340,500 |
| Vested | (74,077) | (82,811) | (161,726) | (88,711) |
| Canceled | (11,770) | (14,200) | (14,441) | (15,464) |
| Outstanding at end of period | 665,642 | 509,309 | 665,642 | 509,309 |
| Weighted Average Grant Date Fair Value: | | | | |
| Outstanding at beginning of period | \$ 14.96 | \$ 11.91 | \$ 12.57 | \$ 6.18 |
| Granted | \$ | \$ | \$ 18.91 | \$ 16.52 |
| Vested | \$ 6.10 | \$ 9.59 | \$ 12.15 | \$ 9.82 |
| Expired or canceled | 17.11 | \$ 8.48 | \$ 16.91 | \$ 8.41 |
| Outstanding at end of period | \$ 15.92 | \$ 12.40 | \$ 15.92 | \$ 12.40 |
| Compensation expense recorded during the period | \$ 1,661,000 | \$ 1,148,000 | \$ 4,210,000 | \$ 2,812,000 |
| Period end: | | | | |
| Units available for future awards(1) | 4,014,000 | | 4,014,000 | |
| Unamortized compensation cost | \$ 6,823,000 | | \$ 6,823,000 | |

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- (1) Based on shares outstanding as of September 30, 2012. Total units available for future awards may be adjusted in accordance with the equity incentive plan based on future issuances of PMT's shares as described above.

Table of Contents**Note 29 Income Taxes**

The Company has elected to be taxed as a REIT for U.S. federal income tax purposes under Sections 856 through 860 of the Internal Revenue Code. Therefore, PMT generally will not be subject to corporate federal or state income tax to the extent that qualifying distributions are made to shareholders and the Company meets REIT requirements including certain asset, income, distribution and share ownership tests. The Company believes that it has met the distribution requirements, as it has declared dividends sufficient to distribute substantially all of its taxable income. Taxable income will generally differ from net income. The primary difference between net income and the REIT taxable income (before deduction for qualifying distributions) is the income of the taxable REIT subsidiaries (TRSs) and the method of determining the income or loss related to valuation of the mortgage loans owned by the qualified REIT subsidiary (QRS). Other differences between REIT book income and REIT taxable income are not material.

In general, cash dividends declared by the Company will be considered ordinary income to the shareholders for income tax purposes. Some portion of the dividends may be characterized as capital gain distributions or a return of capital. Most of the 2011 distributions were characterized as ordinary income and approximately 5% was characterized as capital gain.

The Company had elected to treat two of its subsidiaries as TRSs. In the quarter ended September 30, 2012, the Company revoked the election to treat its wholly owned subsidiary that is the sole general partner of its Operating Partnership (the GP) as a TRS. Only one subsidiary, PennyMac Corp. (PMC), is now treated as a TRS.

Income from a TRS is only included as a component of REIT taxable income to the extent that the TRS makes dividend distributions of income to the REIT. No dividend distributions have been made to date from PMC to the Company.

A TRS is subject to corporate federal and state income tax. Accordingly, a provision for income taxes for PMC and, for the period for which TRS treatment had been elected, the sole general partner of the Company s operating partnership is included in the consolidated statements of income.

The Company files U.S. federal and state income tax returns for both the REIT and TRSs. These returns for 2009 and forward are subject to examination by the respective tax authorities. No returns are currently under examination.

The following table details the Company s provision for income taxes which relates primarily to the TRSs, for the periods presented:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|----------------------------------|--------------------------------|----------|------------------------------------|----------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| Current expense: | | | | |
| Federal | \$ 4,199 | \$ 3,815 | \$ 7,005 | \$ 6,114 |
| State | 1,459 | 1,350 | 2,434 | 2,093 |
| Total current expense | 5,658 | 5,165 | 9,439 | 8,207 |
| Deferred expense (benefit): | | | | |
| Federal | 9,594 | (605) | 17,122 | (1,359) |
| State | 3,333 | (210) | 5,947 | (472) |
| Total deferred expense | 12,927 | (815) | 23,069 | (1,831) |
| Total provision for income taxes | \$ 18,585 | \$ 4,350 | \$ 32,508 | \$ 6,376 |

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The following table is a reconciliation of the Company's provision for income taxes at statutory rates to the provision for income taxes at the Company's effective rate:

| | Quarter ended September 30, | | 2011 | | 2012 | | Nine months ended September 30, | | 2011 | |
|--|--------------------------------|--------------|-----------------|--------------|------------------|--------------|------------------------------------|--------------|--------|------|
| | Amount | Rate | Amount | Rate | Amount | Rate | Amount | Rate | Amount | Rate |
| | (dollars in thousands) | | | | | | | | | |
| Federal income tax expense at statutory tax rate | \$ 20,639 | 35.0% | \$ 8,707 | 35.0% | \$ 42,532 | 35.0% | \$ 17,908 | 35.0% | | |
| Effect of non-taxable REIT income | (5,168) | -8.8% | (5,028) | -20.2% | (15,460) | -12.7% | (12,682) | -24.8% | | |
| State income taxes, net of federal benefit | 3,114 | 5.3% | 741 | 3.0% | 5,448 | 4.5% | 1,053 | 2.1% | | |
| Other | | 0.0% | (70) | -0.3% | (12) | 0.0% | 97 | 0.2% | | |
| Provision for income taxes | \$ 18,585 | 31.5% | \$ 4,350 | 17.5% | \$ 32,508 | 26.8% | \$ 6,376 | 12.5% | | |

The Company's components of the provision for deferred income taxes are as follows:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|--|--------------------------------|-----------------|------------------------------------|-------------------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| Real estate valuation loss | \$ (193) | \$ (815) | \$ (869) | \$ (1,831) |
| Mortgage servicing rights | 13,594 | | 24,851 | |
| Other | (474) | | (913) | |
| Total provision (benefit) for deferred income taxes | \$ 12,927 | \$ (815) | \$ 23,069 | \$ (1,831) |

The tax effects of temporary differences that gave rise to deferred income tax assets and liabilities are presented below:

| | September 30, 2012 | December 31, 2011 |
|--|-----------------------|----------------------|
| | (in thousands) | |
| Deferred income tax assets: | | |
| REO valuation loss | \$ 3,756 | \$ 2,886 |
| Other | 1,000 | 87 |
| Gross deferred tax assets | 4,756 | 2,973 |
| Deferred income tax liabilities: | | |
| Real estate valuation gain | | |
| Mortgage servicing rights | 27,387 | 2,536 |
| Gross deferred tax liabilities | 27,387 | 2,536 |
| Net deferred income tax asset (liability) | \$ (22,631) | \$ 437 |

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The net deferred income tax asset (liability) is recorded in *Income taxes payable* in the consolidated balance sheets as of September 30, 2012 and December 31, 2011.

At September 30, 2012 and December 31, 2011, the Company had no unrecognized tax benefits and does not anticipate any increase in unrecognized tax benefits. Should the accrual of any interest or penalties relative to unrecognized tax benefits be necessary, it is the Company's policy to record such accruals in the Company's income tax accounts. No such accruals existed at September 30, 2012 and December 31, 2011.

Table of Contents**Note 30 Segments and Related Information**

The Company has two business segments: investment activities and correspondent lending.

The investment activities segment represents the Company's investments in distressed mortgage loans, REO, MBS and MSRs. Management seeks to maximize the value of the mortgage loans acquired by the Company through proprietary loan modification programs, special servicing and other initiatives focused on keeping borrowers in their homes. Where this is not possible, such as in the case of many nonperforming mortgage loans, the Company seeks to effect property resolution in a timely, orderly and economically efficient manner. The Company also invests in MSRs, MBS and other mortgage-related real estate and financial assets.

The correspondent lending segment represents the Company's operations aimed at serving as an intermediary between mortgage originators, particularly mortgage lenders, and the capital markets by purchasing, pooling and reselling the loans either directly or in the form of MBS.

Through the third quarter of 2011, the Company's activities were almost exclusively within the investment activities segment. Financial highlights by operating segment for the quarter and nine months ended September 30, 2012 are as follows:

| Quarter ended September 30, 2012 | Investment activities | Correspondent lending | Intersegment elimination | Total |
|--|-----------------------|-----------------------|--------------------------|-----------|
| | | (in thousands) | | |
| Revenues: | | | | |
| Net gain on investments | \$ 26,061 | \$ | \$ | \$ 26,061 |
| Interest income | 13,586 | 6,159 | (15) | 19,730 |
| Net gain on mortgage loans acquired for sale | | 49,793 | | 49,793 |
| Other income | 775 | 2,837 | | 3,612 |
| | 40,422 | 58,789 | (15) | 99,196 |
| Expenses: | | | | |
| Loan fulfillment fees | | 17,258 | | 17,258 |
| Interest | 4,931 | 3,366 | (15) | 8,282 |
| Loan servicing expense | 5,148 | 60 | | 5,208 |
| Other | 8,801 | 678 | | 9,479 |
| | 18,880 | 21,362 | (15) | 40,227 |
| Pre-tax net income | \$ 21,542 | \$ 37,427 | \$ | \$ 58,969 |

| Nine months ended September 30, 2012 | Investment activities | Correspondent lending | Intersegment elimination | Total |
|--|-----------------------|-----------------------|--------------------------|-----------|
| | | (in thousands) | | |
| Revenues: | | | | |
| Net gain on investments | \$ 65,541 | \$ | \$ | \$ 65,541 |
| Interest income | 40,116 | 12,129 | (88) | 52,157 |
| Net gain on mortgage loans acquired for sale | | 81,210 | | 81,210 |
| Other income | 6,463 | 4,880 | | 11,343 |
| | 112,120 | 98,219 | (88) | 210,251 |
| Expenses: | | | | |

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| | | | | |
|----------------------------|--------------|------------|------------|--------------|
| Loan fulfillment fees | | 31,097 | | 31,097 |
| Interest | 15,749 | 5,998 | (88) | 21,659 |
| Loan servicing expense | 15,043 | 137 | | 15,180 |
| Other | 19,554 | 1,242 | | 20,796 |
| | 50,346 | 38,474 | (88) | 88,732 |
| Pre-tax net income | \$ 61,774 | \$ 59,745 | \$ (88) | \$ 121,519 |
| Total assets at period end | \$ 1,425,887 | \$ 911,998 | \$ (9,160) | \$ 2,328,725 |

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The accounting policies of the reportable segments are the same as those described in Note 3 *Significant Accounting Policies* to the Company's Annual Report.

Note 31 Supplemental Cash Flow Information

| | Nine months ended September 30, 2012 2011 (in thousands) | |
|--|--|------------|
| Cash paid for interest | \$ 21,952 | \$ 9,249 |
| Cash paid for income taxes | \$ 9,345 | \$ 3,841 |
| Non-cash investing activities: | | |
| Transfer of mortgage loans acquired for sale to mortgage loans at fair value | \$ 18 | \$ |
| Transfer of mortgage loans and advances to REO | \$ 82,404 | \$ 82,680 |
| Purchase of mortgage loans financed through forward purchase agreements | \$ 1,070 | \$ 171,796 |
| Transfer of mortgage loans under forward purchase agreements to mortgage loans at fair value | \$ 117,913 | \$ |
| Transfer of mortgage loans under forward purchase agreements and advances to REO under forward purchase agreements | \$ 6,633 | \$ |
| Receipt of MSR as proceeds from sales of loans | \$ 66,648 | \$ 643 |
| Purchase of REO financed through forward purchase agreements | \$ 248 | \$ 914 |
| Transfer of REO under forward purchase agreements to REO | \$ 21,819 | \$ |
| Non-cash financing activities: | | |
| Purchase of mortgage loans financed through forward purchase agreements | \$ 1,070 | \$ 171,796 |
| Purchase of REO financed through forward purchase agreements | \$ 248 | \$ 914 |
| Transfer of note payable secured by mortgage loans to mortgage loans at fair value sold under agreements to repurchase | \$ 26,573 | \$ |

Note 32 Regulatory Net Worth Requirement

PMC, an indirect subsidiary of the Company, is a seller-servicer for Fannie Mae and FHLMC. To retain its status as an approved seller-servicer, PMC is required to meet Fannie Mae's capital standards, which require PMC to maintain a minimum net worth of \$2.5 million. Management believes PMC complies with Fannie Mae's net worth requirement as of September 30, 2012.

Note 33 Subsequent Events

Management has evaluated all events or transactions through the date the Company issued these financial statements. During this period:

On October 15, 2012, the Company entered into an amendment to its master repurchase agreement, dated May 24, 2012, by and among PMC, PLS and Citibank, N.A., pursuant to which the Company, through PMC, may sell, and later repurchase, newly funded mortgage loans. Under the terms of the amendment, the maximum aggregate purchase price provided for in the repurchase agreement was increased from \$200 million to \$400 million, \$350 million of which is committed.

On November 5, 2012, PCM committed to acquire on the Company's behalf mortgage loans with purchase prices totaling approximately \$111.5 million. The pending transaction is subject to continuing due diligence and customary closing conditions. There can be no assurance that the committed amounts will ultimately be acquired or that the transactions will be completed at all.

On November 7, 2012, the Company's board of trustees declared a cash dividend of \$0.57 per share payable on November 30, 2012 to holders of record of the Company's common shares as of November 19, 2012.

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

We are a specialty finance company that invests primarily in residential mortgage loans and mortgage-related assets. Our objective is to provide attractive risk-adjusted returns to our investors over the long-term, principally through dividends and secondarily through capital appreciation. We intend to achieve this objective largely by investing in distressed mortgage assets and acquiring, pooling and selling newly originated prime credit quality residential mortgage loans (correspondent lending).

We invest in distressed mortgage loans through direct acquisitions of mortgage loan portfolios from institutions such as banks and mortgage companies. A substantial portion of the nonperforming loans we have purchased has been acquired from or through one or more subsidiaries of Citigroup, Inc.

We seek to maximize the value of the distressed mortgage loans that we acquire using means that are appropriate for the particular loan, including both proprietary and nonproprietary loan modification programs (such as the U.S. Departments of the Treasury and Housing and Urban Development's Home Affordable Modification Program (HAMP)) special servicing and other initiatives focused on avoiding foreclosure, when possible. When we are unable to effect a cure for a mortgage delinquency, our objective is to effect timely acquisition and/or liquidation of the property securing the loan through the use, in part, of short sales and deed-in-lieu of foreclosure programs. During the quarter and nine months ended September 30, 2012, we purchased \$150.8 million and \$411.4 million, respectively, of distressed mortgage loans. During the quarter and nine months ended September 30, 2012, we received proceeds from liquidation, payoffs and sales from our portfolio of distressed mortgage loans and REO totaling \$82.8 million and \$256.7 million, respectively.

Changes in the mortgage market have significantly reduced the outlets for sales of newly originated mortgage loans by mortgage lenders who have traditionally sold their loans to larger mortgage companies and banks who, in turn, sold those loans to Agencies and other investors or into securitizations. We believe that these changes are due in part to banks' anticipation of regulatory changes to loan and securitization-related capital requirements, along with a focus on retail lending; and that the changes provide us with the opportunity to act as a link between loan originators and the Agency and securitization markets.

During the quarter and nine months ended September 30, 2012, we purchased loans with fair values totaling \$6.6 billion and \$12.0 billion, respectively, in furtherance of our correspondent lending business. To the extent that we purchase loans that are insured by the U.S. Department of Housing and Urban Development's Federal Housing Administration (FHA) insured or guaranteed by the Veterans Administration, we and PLS have agreed that PLS will fulfill and purchase such loans, as PLS is a GNMA approved issuer and servicer. This arrangement has enabled us to compete with other correspondent lenders that purchase both government and conventional loans. We receive a sourcing fee from PLS of three basis points on the unpaid principal balance of each loan that we sell to PLS under such arrangement, and earn interest income on the loan for the time period we hold the loan prior to the sale to PLS. We held an inventory of mortgage loans acquired for sale totaling \$847.6 million at September 30, 2012, including mortgage loans pending sale to PLS totaling \$194.1 million. We received sourcing fees totaling \$747 thousand and \$1.4 million relating to \$2.5 billion and \$4.8 billion of loans we sold to PLS for the quarter and nine months ended September 30, 2012. We supplement these activities through participation in other mortgage-related activities, which are in various states of analysis, planning or implementation including:

Acquisition of REIT-eligible MBS. We purchased zero and \$112.2 million of MBS during the quarter and nine months ended September 30, 2012, respectively. During the quarter ended September 30, 2012, we sold all of our holdings of MBS.

Acquisition of MSRs from liquidating and other institutions. We believe that current market conditions may have adversely affected the financial condition and operations of certain owners of mortgage assets. Further, regulatory and capital issues may have contributed to their decision to reduce their portfolio of MSRs. We believe that MSR investments may allow us to earn attractive current returns and to leverage the loan servicing capabilities and efficiencies of PLS to improve the assets' value. We would also seek to leverage the loan origination capabilities of PLS provided we are able to structure

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an arrangement, including through the Federal government's Home Affordable Refinance Program (HARP 2.0), whereby we could recapture some or all of the new MSR's created upon PLS's refinance of mortgage loans relating to the acquired MSR's.

We also intend to continue to retain the MSR's that we receive as a portion of the proceeds from our sale or securitization of mortgage loans through our correspondent lending operation. We received MSR's as proceeds on sale of mortgage loans with fair values totaling \$36.8 million and \$66.6 million during the quarter and nine months ended September 30, 2012 and held MSR's with carrying values of \$65.2 million as of September 30, 2012.

Providing inventory financing of mortgage loans for mortgage lenders. We believe this activity may result in attractive investment assets for us and supplement and make our correspondent lending business more attractive to lenders from which we acquire newly originated loans. During the quarter ended September 30, 2012, we obtained a re-warehouse facility with a maximum lending commitment of \$50 million to facilitate the financing of this activity. The re-warehouse facility is committed to September 27, 2013.

To the extent that we transfer correspondent lending loans into private label securitizations in the future, we may retain a portion of the securities created in the securitization transaction.

We are externally managed by PCM, an investment adviser that specializes in, and focuses on, residential mortgage loans. Most of our mortgage loan portfolio is serviced by PLS, an affiliate of PCM.

We conduct substantially all of our operations, and make substantially all of our investments, through our Operating Partnership and its subsidiaries. We are the sole limited partner and one of our subsidiaries is the sole general partner of our Operating Partnership.

We believe that we qualify to be taxed as a REIT. We believe that we will not be subject to federal income tax on that portion of our income that is distributed to shareholders as long as we meet certain asset, income and share ownership tests. If we fail to qualify as a REIT, and do not qualify for certain statutory relief provisions, our profits will be subject to income taxes and we may be precluded from qualifying as a REIT for the four tax years following the year we lose our REIT qualification. A portion of our activities, including our correspondent lending business, is conducted in a taxable REIT subsidiary (TRS), which is subject to corporate federal and state income taxes. Accordingly, we have made a provision for income taxes with respect to the operations of our TRS. In the quarter ended September 30, 2012, we revoked the election to treat as a TRS our wholly-owned subsidiary that is the sole general partner of our operating partnership. A provision for income taxes has been made for the period for which TRS treatment had been elected for this subsidiary. We expect that the effective rate for the provision for income taxes may be volatile in future periods. Our goal is to manage the business to take full advantage of the tax benefits afforded to us as a REIT.

Observations on Current Market Opportunities

The U.S. economy continues its pattern of modest growth as reflected in recent economic data. During the third quarter of 2012, real U.S. gross domestic product expanded at an annual rate of 2.0% compared to a revised 1.3% annual rate for both the second quarter of 2012 and the third quarter of 2011. Modest economic growth and pressure on state and federal government spending continued to affect unemployment rates during 2012. The national unemployment rate was 7.8% at September 30, 2012, the first time the rate was below 8% since January 2009 and compares to a revised seasonally adjusted rate of 9.0% at September 30, 2011 and 8.5% at December 31, 2011. Declining unemployment is partially reflective of a declining workforce labor participation rate. Delinquency rates on single family residential mortgage loans linger at historically high rates. During the second quarter of 2012, delinquency rates were 10.6%, a slight reduction from the cyclical high of 11.2% during the first quarter of 2010.

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Residential real estate activity appears to be modestly improving. The seasonally adjusted annual rate of existing home sales for September 2012 was 11.0% higher than for September 2011 and the national median existing home price for all housing types was \$183,900, an 11.3% increase from September 2011. On a national level, foreclosure filings during the third quarter of 2012 decreased 5% as compared to the second quarter of 2012 and 13% as compared to the third quarter of 2011, representing the ninth consecutive quarter with an annual decrease in foreclosure activity. A previously expected increase in foreclosure activity at the national level as lenders resolve their operational issues relating to the foreclosure of delinquent loans has not yet materialized, however it is anticipated that foreclosure activity within select markets may increase during the remainder of 2012 and beyond.

Thirty-year fixed rate mortgage interest rates ranged from a high of 3.66% to a low of 3.40% during the third quarter of 2012 with the low of 3.40% representing an all-time record low for the thirty-year fixed rate mortgage (Source: the Federal Home Loan Mortgage Corporation's Weekly Primary Mortgage Market Survey). During the first nine months of 2012 mortgage interest rates have ranged from a high of 4.08% to the all-time record low of 3.40%. Mortgage interest rates during the third quarter were relatively unchanged until the Federal Reserve began its purchases of mortgage securities pursuant to a third round of quantitative easing. During the first nine months of 2011, mortgage interest rates ranged from a high of 5.05% to a low of 4.01%.

The Manager continues to see substantial volumes of distressed residential mortgage loan sales (sales of loan pools that consist of either nonperforming loans, troubled but performing loans or a combination thereof) offered for sale by a limited number of sellers. During the third quarter of 2012, our Manager reviewed 23 mortgage loan pools with unpaid principal balances totaling approximately \$3.8 billion. This compares to our Manager's review of 20 mortgage loan pools with unpaid principal balances totaling approximately \$3.6 billion during the third quarter of 2011. We acquired distressed mortgage loans with fair values totaling \$150.5 million and \$288.9 million during the quarter and nine months ended September 30, 2012, respectively.

We believe that the shifting investment and operational priorities of banks and other traditional mortgage lenders have created additional opportunities for our business. Under current market conditions, these opportunities include the purchase from mortgage lenders of newly originated mortgage loans that are eligible for sale to an Agency. These opportunities also include the purchase of newly originated mortgage loans that can be resold in the non-Agency whole loan market or securitized in the private label market as well as providing inventory financing to originators of such loans. During the quarter and nine months ended September 30, 2012, we acquired approximately \$6.6 billion and \$12.0 billion, respectively, in fair value of newly originated mortgage loans and received proceeds of approximately \$6.3 billion and \$11.4 billion, respectively, on the sale of loans.

Table of Contents**Results of Operations**

The following is a summary of our key performance measures for the periods presented:

| | Quarter ended September 30, 2012 | 2011 | Nine months ended September 30, 2012 2011 | |
|---|--|------------|--|------------|
| | (in thousands, except per share amounts) | | | |
| Net investment income | \$ 99,196 | \$ 41,985 | \$ 210,251 | \$ 89,491 |
| Pre-tax income by segment(1): | | | | |
| Investment | \$ 21,542 | \$ | \$ 61,774 | \$ |
| Correspondent lending | \$ 37,427 | \$ | \$ 59,745 | \$ |
| Net income (loss) | \$ 40,384 | \$ 20,528 | \$ 89,011 | \$ 44,790 |
| Earnings (loss) per share: | | | | |
| Basic | \$ 0.81 | \$ 0.73 | \$ 2.29 | \$ 1.72 |
| Diluted | \$ 0.81 | \$ 0.73 | \$ 2.29 | \$ 1.72 |
| Dividends per share: | | | | |
| Declared | \$ 0.55 | \$ 0.50 | \$ 1.65 | \$ 0.92 |
| Paid | \$ 0.55 | \$ 0.50 | \$ 1.65 | \$ 1.34 |
| Cash Flows: | | | | |
| Investment activities: | | | | |
| Distressed mortgage loans and REO | | | | |
| Purchases | \$ 150,778 | \$ 264,749 | \$ 411,368 | \$ 625,152 |
| Proceeds from liquidation activities | \$ 82,783 | \$ 69,773 | \$ 256,663 | \$ 156,815 |
| MBS | | | | |
| Purchases | \$ | \$ 22,179 | \$ 112,211 | \$ 22,179 |
| Proceeds from repayments and sales | \$ 167,910 | \$ 17,492 | \$ 189,167 | \$ 55,002 |
| Correspondent lending: | | | | |
| Purchases of mortgage loans for sale | \$ 6,597,138 | \$ 220,040 | \$ 11,967,678 | \$ 294,410 |
| Proceeds from sales of mortgage loans for sale: | | | | |
| Cash | | | | |
| Sales to nonaffiliate investors | \$ 3,573,762 | \$ 53,221 | \$ 6,254,411 | \$ 72,796 |
| Sales of government-insured and guaranteed loans to PLS | 2,650,097 | 144,351 | 5,108,340 | 184,264 |
| | 6,223,859 | 197,572 | 11,362,751 | 257,060 |
| MSRs | 36,760 | 466 | 66,649 | 643 |
| | \$ 6,260,619 | \$ 198,038 | \$ 11,429,400 | \$ 257,703 |
| Share price: | | | | |
| High | \$ 23.52 | \$ 17.45 | \$ 23.52 | \$ 19.31 |
| Low | \$ 19.72 | \$ 15.34 | \$ 16.69 | \$ 15.34 |
| At period end | \$ 23.37 | \$ 15.90 | \$ 23.37 | \$ 15.90 |

(1) Before the third quarter of 2011, the Company's activities were almost exclusively within the investment activities segment. During the quarter and nine months ended September 30, 2012, we recorded net income of \$40.4 million and \$89.0 million, or \$0.81 and \$2.29 per diluted share, respectively. Our net income for the quarter and nine months ended September 30, 2012 reflects net gains on our investments in financial instruments totaling \$75.9 million and \$146.8 million (comprised of net gain on investments and net gain on mortgage loans acquired for sale), including \$22.3 million and \$53.0 million of valuation gains on MBS and mortgage loans excluding mortgage loans acquired for sale, supplemented by \$19.7 million and \$52.2 million of interest income, respectively. During the quarter and nine months ended September 30, 2012, we purchased \$6.6 billion and \$12.0

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billion, respectively, in fair value of newly originated mortgage loans. We recognized gains on such loans totaling approximately \$49.8 million and \$81.2 million, respectively. At September 30, 2012, we held mortgage loans acquired for sale with fair values totaling \$847.6 million, including \$194.1 million pending sale to PLS. Growth in our earnings reflect growth in the Company's assets from \$1.2 billion at September 30, 2011 to \$2.3 billion at September 30, 2012. We achieved this growth in assets through a combination of issuance of additional common shares of beneficial interest (common shares) and by leveraging such issuances with additional borrowing capacity.

During the quarter and nine months ended September 30, 2011, we recorded net income of \$20.5 million and \$44.8 million, or \$0.73 and \$1.72 per diluted share, respectively. Our net income for the quarter and nine months ended September 30, 2011 reflected net gains on our investments in financial instruments totaling \$31.5 million and \$63.5 million (comprised of net gain on investments and net gain on mortgage loans acquired for sale), including \$23.0 million and \$48.8 million of valuation gains on MBS and mortgage loans excluding mortgage loans acquired for sale, supplemented by \$9.8 million and \$24.0 million of interest income, respectively. During the quarter and nine months ended September 30, 2011, we purchased \$220.0 million and \$294.4 million, respectively, in fair value of newly originated mortgage loans. We recognized gains on such loans totaling approximately \$84,000 and \$207,000, respectively. At September 30, 2011, we held mortgage loans acquired for sale with fair values totaling \$40.9 million.

Net Investment Income

During the quarter and nine months ended September 30, 2012, we recorded net investment income of \$99.2 million and \$210.3 million, respectively, comprised primarily of net gains on investments in financial instruments of \$75.9 million and \$146.8 million supplemented by \$19.7 million and \$52.2 million of interest income and \$1.3 million and \$7.6 million from results of REO, partially offset by negative net servicing fees of \$511,000 and \$1.2 million, respectively. This compares to net investment income of \$42.0 million and \$89.5 million recognized during the quarter and nine months ended September 30, 2011, comprised primarily of \$31.5 million and \$63.5 million of net gains on investments in financial instruments, supplemented by \$9.8 million and \$24.0 million of interest income, \$352,000 and \$1.5 million of gains from results of REO and net servicing fees of \$14,000 and \$17,000, respectively.

The growth in net investment income reflects the growth in the distressed loan portfolio, REOs and correspondent lending activities.

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Net investment income on financial instruments is summarized below for the periods presented:

| | Net gain (loss) on investments | Quarter ended September 30, 2012 | | | Total revenue/ expense (dollars in thousands) | Annualized % | | |
|--|--------------------------------------|----------------------------------|----------------------|-------------------|--|--------------------|------------------------|--------------------|
| | | Interest income/expense | Discount/ fees(1) | Total interest | | Average balance | Interest yield/cost | Total return(2) |
| | Coupon | | | | | | | |
| Assets: | | | | | | | | |
| Short-term investments | \$ | \$ 13 | \$ | \$ 13 | \$ 13 | \$ 59,589 | 0.09% | 0.09% |
| Mortgage-backed securities: | | | | | | | | |
| Fannie Mae 30-year fixed(3) | (422) | 556 | (92) | 464 | 42 | 62,307 | 2.92% | 0.27% |
| Non-Agency subprime | (159) | 15 | | 15 | (144) | 8,794 | 0.63% | (6.43)% |
| Non-Agency Alt-A | 90 | 18 | | 18 | 108 | 1,100 | 6.11% | 38.06% |
| Non-Agency prime jumbo | 40 | 5 | | 5 | 45 | 657 | 2.76% | 25.92% |
| Total mortgage-backed securities | (451) | 594 | (92) | 502 | 51 | 72,858 | 2.69% | 0.27% |
| Mortgage loans: | | | | | | | | |
| Investment portfolio: | | | | | | | | |
| At fair value | 26,407 | 12,889 | | 12,889 | 39,296 | 883,732 | 5.71% | 17.40% |
| Under forward purchase agreements at fair value | 105 | 146 | | 146 | 251 | 8,996 | 6.38% | 10.96% |
| Total investment portfolio | 26,512 | 13,035 | | 13,035 | 39,547 | 892,728 | 5.71% | 17.33% |
| Correspondent lending: | | | | | | | | |
| Acquired for sale at fair value | 49,793 | 6,144 | | 6,144 | 55,937 | 526,047 | 4.57% | 41.61% |
| Total mortgage loans | 76,305 | 19,179 | | 19,179 | 95,484 | 1,418,775 | 5.29% | 26.34% |
| Other interest | | 36 | | 36 | 36 | | | |
| | \$ 75,854 | \$ 19,822 | \$ (92) | \$ 19,730 | \$ 95,584 | \$ 1,551,222 | 4.98% | 24.11% |
| Liabilities: | | | | | | | | |
| Assets sold under agreements to repurchase: | | | | | | | | |
| Securities | \$ | \$ 99 | \$ | \$ 99 | \$ 99 | \$ 75,787 | 0.51% | |
| Mortgage loans at fair value | | 3,362 | 439 | 3,801 | 3,801 | 333,216 | 4.46% | |
| Mortgage loans acquired for sale at fair value | | 2,860 | 1,088 | 3,948 | 3,948 | 462,137 | 3.34% | |
| Real estate acquired in settlement of loans | | 168 | 125 | 293 | 293 | 15,461 | 7.41% | |
| Note payable secured by warehouse notes receivable | | | 41 | 41 | 41 | | | |
| Borrowings under forward purchase agreements | | 100 | | 100 | 100 | 9,787 | 4.00% | |
| | \$ | \$ 6,589 | \$ 1,693 | \$ 8,282 | \$ 8,282 | \$ 896,388 | 3.62% | |

(1) Amounts in this column represent accrual of unearned discounts and amortization of purchase premiums for assets and facility commitment fees for liabilities.

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- (2) Total return represents the sum of the interest yield and the net gain (loss) on the respective investments and does not take into account expenses associated with managing the asset.
- (3) Includes the fair value losses recognized on an MBS swaption purchased to reduce the risk of interest rate fluctuations with respect to indebtedness incurred to acquire such assets.

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| | Quarter ended September 30, 2011 | | | | | | Annualized % | |
|--|--------------------------------------|-------------------------|-------------------|--|--------------------|------------------------|--------------------|----------------|
| | Net gain (loss) on investments | Interest income/expense | | Total revenue/ expense (dollars in thousands) | Average balance | Interest yield/cost | Total return(2) | |
| | Coupon | Discount/ fees(1) | Total interest | | | | | |
| Assets: | | | | | | | | |
| Short-term investments | \$ | \$ 24 | \$ | \$ 24 | \$ 24 | \$ 39,472 | 0.23% | 0.23% |
| Mortgage-backed securities: | | | | | | | | |
| Non-Agency subprime | (612) | 70 | 262 | 332 | (280) | 58,468 | 2.23% | (1.87)% |
| Non-Agency Alt-A | (135) | 150 | 116 | 266 | 131 | 10,668 | 9.73% | 4.78% |
| Non-Agency prime jumbo | (44) | 46 | 7 | 53 | 9 | 6,963 | 2.96% | 0.47% |
| Total mortgage-backed securities | (791) | 266 | 385 | 651 | (140) | 76,099 | 3.35% | (0.73)% |
| Mortgage loans: | | | | | | | | |
| Investment portfolio: | | | | | | | | |
| At fair value | 32,311 | 8,745 | | 8,745 | 41,056 | 744,488 | 4.60% | 21.58% |
| Correspondent lending: | | | | | | | | |
| Acquired for sale at fair at fair value | 84 | 419 | | 419 | 503 | 30,900 | 5.30% | 6.37% |
| Total mortgage loans | 32,395 | 9,164 | | 9,164 | 41,559 | 775,388 | 4.62% | 20.97% |
| | \$ 31,604 | \$ 9,454 | \$ 385 | \$ 9,839 | \$ 41,443 | \$ 890,959 | 4.32% | 18.20% |
| Liabilities: | | | | | | | | |
| Assets sold under agreements to repurchase: | | | | | | | | |
| Securities | \$ | \$ 161 | \$ | \$ 161 | \$ 161 | \$ 65,364 | 0.96% | |
| Mortgage loans at fair value | | 2,520 | 211 | 2,731 | 2,731 | 248,651 | 4.30% | |
| Mortgage loans acquired for sale at fair value | | 187 | 187 | 374 | 374 | 27,701 | 5.30% | |
| Real estate acquired in settlement of loans | | 154 | 125 | 279 | 279 | 12,663 | 8.63% | |
| Borrowings under forward purchase agreements | | 1,680 | | 1,680 | 1,680 | 146,708 | 4.48% | |
| | \$ | \$ 4,702 | \$ 523 | \$ 5,225 | \$ 5,225 | \$ 501,087 | 4.08% | |

- (1) Amounts in this column represent accrual of unearned discounts for assets and facility commitment fees for liabilities.
- (2) Total return represents the sum of the interest yield and the net gain (loss) on the respective investments and does not take into account expenses associated with managing the asset.

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| | Nine months ended September 30, 2012 | | | | | | | |
|--|--------------------------------------|-------------------------|----------------------|---------------|--|--------------------|------------------------|--------------------|
| | Net gain (loss) on investments | Interest income/expense | | | Total revenue/ expense (dollars in thousands) | Average balance | Annualized % | |
| | | Coupon | Discount/ fees(1) | Total | | | Interest yield/cost | Total return(2) |
| Assets: | | | | | | | | |
| Short-term investments | \$ | \$ 32 | \$ | \$ 32 | \$ 32 | \$ 56,298 | 0.08% | 0.08% |
| United States Treasury security | | | | | | 3,285 | 0.00% | 0.01% |
| Mortgage-backed securities: | | | | | | | | |
| Fannie Mae 30-year fixed(3) | (233) | 1,476 | (222) | 1,254 | 1,021 | 59,726 | 2.76% | 2.25% |
| Non-Agency subprime | 496 | 181 | 378 | 559 | 1,055 | 38,802 | 1.89% | 3.57% |
| Non-Agency Alt-A | 211 | 224 | (32) | 192 | 403 | 5,048 | 4.99% | 10.49% |
| Non-Agency prime jumbo | 138 | 64 | 18 | 82 | 220 | 3,292 | 3.25% | 8.73% |
| Total mortgage-backed securities | 612 | 1,945 | 142 | 2,087 | 2,699 | 106,868 | 2.57% | 3.32% |
| Mortgage loans: | | | | | | | | |
| Investment portfolio: | | | | | | | | |
| At fair value | 55,636 | 36,855 | | 36,855 | 92,491 | 741,636 | 6.53% | 16.39% |
| Under forward purchase agreements at fair value | 9,293 | 996 | | 996 | 10,289 | 61,839 | 2.12% | 21.86% |
| Total investment portfolio | 64,929 | 37,851 | | 37,851 | 102,780 | 803,475 | 6.19% | 16.81% |
| Correspondent lending: | | | | | | | | |
| Acquired for sale at fair at fair value | 81,210 | 12,092 | | 12,092 | 93,302 | 327,075 | 4.86% | 37.48% |
| Total mortgage loans | 146,139 | 49,943 | | 49,943 | 196,082 | 1,130,550 | 5.80% | 22.79% |
| Other interest | | 95 | | 95 | 95 | | | |
| | \$ 146,751 | \$ 52,015 | \$ 142 | \$ 52,157 | \$ 198,908 | \$ 1,297,001 | 5.28% | 20.15% |
| Liabilities: | | | | | | | | |
| Assets sold under agreements to repurchase: | | | | | | | | |
| Securities | \$ | \$ 488 | \$ | \$ 488 | \$ 488 | \$ 99,595 | 0.64% | |
| Mortgage loans at fair value | | 9,379 | 1,032 | 10,411 | 10,411 | 313,726 | 4.36% | |
| Mortgage loans acquired for sale at fair value | | 5,133 | 2,088 | 7,221 | 7,221 | 294,857 | 3.22% | |
| Real estate acquired in settlement of loans | | 614 | 375 | 989 | 989 | 19,139 | 6.79% | |
| Note payable secured by mortgage loans at fair value | | 121 | (8) | 113 | 113 | 2,282 | 6.47% | |
| Note payable secured by warehouse notes receivable | | | 41 | 41 | 41 | | | |
| Borrowings under forward purchase agreements | | 2,396 | | 2,396 | 2,396 | 78,435 | 4.01% | |
| | \$ | \$ 18,131 | \$ 3,528 | \$ 21,659 | \$ 21,659 | \$ 808,034 | 3.52% | |

(1) Amounts in this column represent accrual of unearned discounts for assets and facility commitment fees for liabilities.

(2) Total return represents the sum of the interest yield and the net gain (loss) on the respective investments and does not take into account expenses associated with managing the asset.

(3)

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Includes the fair value losses recognized on an MBS swaption purchased to reduce the risk of interest rate fluctuations with respect to indebtedness incurred to acquire such assets.

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| Nine months ended September 30, 2011 | | | | | | | | | |
|---|--------------------------------------|-------------------------|----------------------|---------------|--|--------------------|------------------------|---------------|--------------------|
| | Net gain (loss) on investments | Interest income/expense | | | Total revenue/ expense (dollars in thousands) | Annualized % | | | Total return(2) |
| | | Coupon | Discount/ fees(1) | Total | | Average balance | Interest yield/cost | | |
| Assets: | | | | | | | | | |
| Short-term investments | \$ | \$ 82 | \$ | \$ 82 | \$ 82 | \$ 49,701 | 0.22% | 0.22% | |
| Mortgage-backed securities: | | | | | | | | | |
| Non-Agency subprime | (1,809) | 274 | 1,404 | 1,678 | (131) | 73,450 | 3.01% | (0.24)% | |
| Non-Agency Alt-A | (64) | 517 | 336 | 853 | 789 | 12,458 | 9.02% | 8.34% | |
| Non-Agency prime jumbo | (233) | 169 | 19 | 188 | (45) | 8,169 | 3.04% | (0.73)% | |
| Total mortgage-backed securities | (2,106) | 960 | 1,759 | 2,719 | 613 | 94,077 | 3.81% | 0.86% | |
| Mortgage loans: | | | | | | | | | |
| Investment portfolio: | | | | | | | | | |
| At fair value | 65,594 | 20,723 | | 20,723 | 86,317 | 587,626 | 4.65% | 19.37% | |
| Correspondent lending: | | | | | | | | | |
| Acquired for sale at fair value | 207 | 488 | | 488 | 695 | 14,868 | 4.32% | 6.16% | |
| Total mortgage loans | 65,801 | 21,211 | | 21,211 | 87,012 | 602,494 | 4.64% | 19.04% | |
| | \$ 63,695 | \$ 22,253 | \$ 1,759 | \$ 24,012 | \$ 87,707 | \$ 746,272 | 4.24% | 15.50% | |
| Liabilities: | | | | | | | | | |
| Assets sold under agreements to repurchase: | | | | | | | | | |
| Securities | \$ | \$ 692 | \$ | \$ 692 | \$ 692 | \$ 80,020 | 1.14% | | |
| Mortgage loans at fair value | | 6,108 | 726 | 6,834 | 6,834 | 218,216 | 4.13% | | |
| Mortgage loans acquired for sale at fair value | | 261 | 687 | 948 | 948 | 13,236 | 9.45% | | |
| Real estate acquired in settlement of loans | | 169 | 150 | 319 | 319 | 4,725 | 8.91% | | |
| Borrowings under forward purchase agreements | | 1,680 | | 1,680 | 1,680 | 49,440 | 4.48% | | |
| | \$ | \$ 8,910 | \$ 1,563 | \$ 10,473 | \$ 10,473 | \$ 365,637 | 3.78% | | |

- (1) Amounts in this column represent accrual of unearned discounts for assets and facility commitment fees for liabilities.
(2) Total return represents the sum of the interest yield and the net gain (loss) on the respective investments and does not take into account expenses associated with managing the asset.

Net Gain (Loss) on Investments

During the quarter and nine months ended September 30, 2012, we recognized net gains on financial instruments (excluding mortgage loans acquired for sale) totaling \$26.1 million and \$65.5 million, respectively. This compares to \$31.5 million and \$63.5 million for the quarter and nine months ended September 30, 2011. The increase for the quarter and nine months ended September 30, 2012 as compared to the same prior year periods is due primarily to growth in our portfolio of investments in financial instruments. The average portfolio balance of mortgage loans at fair value increased \$148.2 million or 20%, and \$215.8 million or 37%, respectively, during the quarter and nine months ended September 30, 2012 as compared to the same prior year periods.

During the quarter and nine months ended September 30, 2012, we recognized net valuation gains (losses) and gain on sale of our entire portfolio of MBS totaling \$(451,000) and \$612,000, respectively, compared to net

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valuation losses of \$791,000 and \$2.1 million, respectively, during the quarter and nine months ended September 30, 2011. The current period gains primarily reflect the liquidation of our investments in MBS.

The valuation losses we recognized during the quarter ended September 30, 2012 include losses on sale of our Agency MBS of \$1.1 million and losses on sale of our non-Agency MBS of \$29,000. The valuation losses we recorded during the same periods in 2011 reflected, in part, marketplace concerns regarding the potentially growing supply of MBS similar to those we held as a result of sales by the Federal Reserve Bank and other entities, marketplace discounting of distressed MBS resulting from expectations that involuntary prepayments of mortgages underlying the securities may remain slow or slow further due to regulatory actions relating to servicers' foreclosure activities, and marketplace concern regarding servicers' behavior with respect to advancing and modification practices.

Net gains on mortgage loans at fair value and mortgage loans under forward purchase agreements at fair value are summarized below for the periods presented:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|---------------------|--------------------------------|-----------|------------------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| Valuation changes: | | | | |
| Performing loans | \$ (5,090) | \$ 1,625 | \$ (743) | \$ 5,460 |
| Nonperforming loans | 27,953 | 22,142 | 50,807 | 45,490 |
| | 22,863 | 23,767 | 50,064 | 50,950 |
| Payoffs | 3,649 | 8,544 | 14,986 | 14,411 |
| Sales | | | (121) | 233 |
| | \$ 26,512 | \$ 32,311 | \$ 64,929 | \$ 65,594 |

The net gains on mortgage loans arising from valuation changes were due primarily to the following: changes in the value of loans as the loans moved through the resolution process and as actual home prices improved; reinstatement of nonperforming loans; improved expectation of the future speed of resolution and of the expected proportion of reinstatement for certain loan pools; and increased expectation regarding the collectability of mortgage insurance payments on certain loan pools.

During the quarter and nine months ended September 30, 2012 and 2011, we recognized gains on mortgage loan payoffs as summarized below:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|---------------------------|-----------------------------|-----------|---------------------------------|------------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| Number of loans | 197 | 228 | 614 | 496 |
| Unpaid principal balance | \$ 60,533 | \$ 77,066 | \$ 202,183 | \$ 162,679 |
| Gain recognized at payoff | \$ 3,649 | \$ 8,544 | \$ 14,986 | \$ 14,411 |

The decrease in gains recognized at payoff for the quarter ended September 30, 2012 compared to the quarter ended September 30, 2011 was due to the lower level of payoff activity for the quarter ended September 30, 2012 compared to the quarter ended September 30, 2011. Payoff gains for the quarter and nine months ended September 30, 2011 reflect the realization of gains on payoffs in 2011 of then-recently acquired pools of loans which did not recur during 2012, as well as to decreased purchases of distressed mortgage loans during 2012 as compared to 2011, resulting in decreased gains on payoffs during the third quarter of 2012.

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During the quarter and nine months ended September 30, 2012 and 2011, we recognized gains on sales of distressed mortgage loans as summarized below:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|--------------------------------|-----------------------------|------|---------------------------------|----------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| Number of loans | | | | 13 |
| Unpaid principal balance | \$ | \$ | \$ | \$ 5,524 |
| Gain (loss) recognized at sale | \$ | \$ | \$ (121) | \$ 233 |

We did not sell distressed mortgage loans during 2012. The loss amounts recorded during 2012 reflect adjustments to previously recognized gains on sale.

The following tables present a summary of loan modifications completed for the periods presented:

| | Quarter ended September 30, | | | | Nine months ended September 30, | | | |
|-------------------------------------|-------------------------------|---------------------|-----------------|---------------------|---------------------------------|---------------------|-----------------|---------------------|
| | 2012 | | 2011 | | 2012 | | 2011 | |
| | Number of loans | Balance of loans(2) | Number of loans | Balance of loans(2) | Number of loans | Balance of loans(2) | Number of loans | Balance of loans(2) |
| | (dollar amounts in thousands) | | | | | | | |
| Rate reduction | 88 | \$ 19,031 | 75 | \$ 19,145 | 356 | \$ 90,071 | 158 | \$ 37,915 |
| Term extension | 61 | \$ 15,162 | 26 | \$ 7,040 | 217 | \$ 55,948 | 52 | \$ 13,885 |
| Capitalization of interest and fees | 144 | \$ 31,317 | 100 | \$ 25,824 | 566 | \$ 134,688 | 188 | \$ 45,371 |
| Principal forbearance | 5 | \$ 1,707 | 8 | \$ 2,752 | 56 | \$ 17,277 | 18 | \$ 5,633 |
| Principal reduction | 44 | \$ 11,133 | 59 | \$ 14,719 | 250 | \$ 62,671 | 116 | \$ 28,200 |
| Total | 144 | \$ 31,317 | 105 | \$ 26,883 | 566 | \$ 134,688 | 209 | \$ 50,106 |

(1) Modification type categories are not mutually exclusive, and a modification of a single loan may be counted in multiple categories if applicable. The total number of modifications noted in the table is therefore lower than the sum of all of the categories.

(2) Before modification.

The following table summarizes the average impact of the modifications noted above to the terms of the loans modified for the periods presented:

| Category | Quarter ended September 30, | | | | Nine months ended September 30, | | | |
|-------------------------|-------------------------------|--------------------|---------------------|--------------------|---------------------------------|--------------------|---------------------|--------------------|
| | 2012 | | 2011 | | 2012 | | 2011 | |
| | Before modification | After modification | Before modification | After modification | Before modification | After modification | Before modification | After modification |
| | (Dollar amounts in thousands) | | | | | | | |
| Loan balance | \$ 217 | \$ 205 | \$ 256 | \$ 231 | \$ 238 | \$ 221 | \$ 241 | \$ 216 |
| Remaining term (months) | 289 | 341 | 312 | 341 | 305 | 360 | 316 | 344 |
| Interest rate | 6.45% | 4.40% | 6.69% | 3.96% | 6.54% | 4.14% | 6.87% | 3.81% |
| Forbeared principal | \$ | \$ 4 | \$ | \$ 3 | \$ | \$ 6 | \$ | \$ 4 |

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The effects of changes in the composition of our investments on our interest income during the periods presented are summarized below:

| | Quarter ended September 30, 2012 | | | Nine months ended September 30, 2012 | | |
|---|--|----------|-----------------|--|-----------|-----------------|
| | vs. | | | vs. | | |
| | Quarter ended September 30, 2011 | | | Nine months ended September 30, 2011 | | |
| | Increase (decrease) due to changes in | | | Increase (decrease) due to changes in | | |
| | Rate | Volume | Total change | Rate | Volume | Total change |
| | (in thousands) | | | | | |
| Short-term investments | \$ (19) | \$ 8 | \$ (11) | \$ (59) | \$ 9 | \$ (50) |
| Mortgage-backed securities: | | | | | | |
| FNMA conventional | | 464 | 464 | | 1,254 | 1,254 |
| Non-Agency subprime | (145) | (172) | (317) | (493) | (626) | (1,119) |
| Non-Agency Alt-A | (73) | (175) | (248) | (284) | (377) | (661) |
| Non-Agency prime jumbo | (3) | (45) | (48) | 12 | (118) | (106) |
| Total mortgage-backed securities | (221) | 72 | (149) | (765) | 133 | (632) |
| Mortgage loans: | | | | | | |
| Investment portfolio: | | | | | | |
| At fair value | 2,336 | 1,808 | 4,144 | 9,784 | 6,348 | 16,132 |
| Under forward purchase agreements at fair value | | 146 | 146 | | 996 | 996 |
| Total investment portfolio | 2,336 | 1,954 | 4,290 | 9,784 | 7,344 | 17,128 |
| Acquired for sale at fair value | (65) | 5,790 | 5,725 | 69 | 11,535 | 11,604 |
| Total mortgage loans | 2,271 | 7,744 | 10,015 | 9,853 | 18,879 | 28,732 |
| Other interest | | 36 | 36 | | 95 | 95 |
| | \$ 2,031 | \$ 7,860 | \$ 9,891 | \$ 9,029 | \$ 19,116 | \$ 28,145 |

In the quarter and nine months ended September 30, 2012, we earned interest income of \$19.7 million and \$52.2 million, respectively, compared to \$9.8 million and \$24.0 million for the quarter and nine months ended September 30, 2011.

We earned interest income of \$502,000 and \$2.1 million, respectively, on our portfolio of MBS during the quarter and nine months ended September 30, 2012. In the quarter and nine months ended September 30, 2011, we earned interest income of \$651,000 and \$2.7 million, respectively, on our portfolio of MBS. The quarterly reduction in interest income of \$149,000 reflects the effects of a \$3.2 million or 4% decrease in the average balance of our investment in MBS, along with a reduction in the yield we recognized on such assets from 3.35% to 2.69%. This reduction in yield was primarily due to slower repayments of the loans underlying the MBS along with reduced accruals of unearned discounts on such securities due to our assessment of the portion of the securities that would have been ultimately repaid. Our fair value estimates reflected our assessment of the amount and timing of future cash flows to be received on these bonds. Interest income on MBS decreased by \$632,000 for the nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011, also reflecting the reduced accrual of unearned discounts on the securities as well as repayments through the date of sale in excess of the acquisitions of our non-Agency MBS.

In the quarter and nine months ended September 30, 2012, we recognized interest income on mortgage loans and mortgage loans under forward purchase agreements at fair value of \$19.2 million and \$49.9 million, respectively, which compares to \$9.2 million and \$21.2 million, respectively, in the quarter and nine months ended September 30, 2011. The increases in interest income are due primarily to growth in the average balance

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of our mortgage loan portfolio of \$148.2 million and \$215.8 million, or 20% and 37% for the quarter and nine months ended September 30, 2012 when compared to the same periods in 2011. During the quarter and nine months ended September 30, 2012, we recognized annualized interest of 5.71% and 6.19%, respectively, on our portfolio of mortgage loans (excluding mortgage loans acquired for sale at fair value) as measured by the portfolio's average fair value. This compares to 4.60% and 4.65% for the quarter and nine months ended September 30, 2011. The increases in yield during the quarter and nine months ended September 30, 2012 as compared to the same periods in 2011 are due primarily to a higher proportion of our investment portfolio being comprised of performing loans along with interest income we recognize on modifications when we capture interest income through the capitalization of delinquent interest as part of the modification agreement. At September 30, 2012, our investment in performing mortgage loans had a weighted average coupon of 4.17%; at September 30, 2011, our investment in performing mortgage loans had a weighted average coupon of 4.99%.

At September 30, 2012, approximately 64% of the fair value of our portfolio of mortgage loans was nonperforming, which compares to 78% at September 30, 2011. We do not accrue interest on nonperforming loans and generally do not recognize revenues during the period we hold REO. We calculate the yield on our mortgage loan portfolio based on the portfolio's average fair value, which most closely reflects our investment in the mortgage loans. Accordingly, the yield we realize is substantially higher than would be recorded based on the loans' unpaid balances as we purchase our mortgage loans at substantial discounts to their unpaid principal balances.

The revenue benefits of nonperforming loans and REO generally take longer to realize than those of performing loans due to the time required to work with borrowers to resolve payment issues through our modification programs and to acquire and liquidate the property securing the mortgage loans. The value and returns we realize from these assets are determined by our ability to cure the borrowers' defaults, or when curing of borrower defaults is not a viable solution, by our ability to effectively manage the liquidation process. As a participant in HAMP, we are required to comply with the process specified by the HAMP program before liquidating a loan, and this may extend the liquidation process. At September 30, 2012, we held \$701.9 million in fair value of nonperforming loans and \$86.2 million in carrying value of REO.

Net Gain on Mortgage Loans Acquired for Sale

During the quarter and nine months ended September 30, 2012, we recorded a net gain of \$49.8 million and \$81.2 million, respectively, on mortgage loans acquired for sale which included approximately \$36.8 million and \$66.7 million, respectively, in fair values of MSRs received as part of the proceeds from our correspondent lending loan sales. During the quarter and nine months ended September 30, 2011, we recorded a gain of \$84,000 and \$207,000, respectively, on mortgage loans acquired for sale.

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Our gains on mortgage loans acquired for sale are summarized below:

| | Quarter ended September 30, 2012 | | Nine months ended September 30, 2011 | |
|--|-------------------------------------|------------|---|------------|
| | | | | |
| | 2011 (in thousands) | | | |
| Cash gain (loss): | | | | |
| Sales proceeds | \$ 10,360 | \$ (63) | \$ 10,677 | \$ (73) |
| Hedging activities | (17,897) | (929) | (28,720) | (1,013) |
| | (7,537) | (992) | (18,043) | (1,086) |
| Non cash gain: | | | | |
| Change in fair value of commitments to purchase loans | 27,102 | 1,209 | 34,263 | 1,205 |
| Receipt of MSR in loan sale transactions | 36,760 | 466 | 66,649 | 643 |
| Provision for losses relating to representations and warranties provided in loan sales | (1,129) | (21) | (2,173) | (32) |
| Change in fair value relating to loans and hedging derivatives held at quarter-end: | | | | |
| Mortgage loans | 23,004 | 1,067 | 34,456 | 1,151 |
| Hedging derivatives | (28,407) | (1,645) | (33,942) | (1,674) |
| | (5,403) | (578) | 514 | (523) |
| | \$ 49,793 | \$ 84 | \$ 81,210 | \$ 207 |
| Purchase price of mortgage loans acquired for sale sold during the period | \$ 6,220,583 | \$ 198,277 | \$ 11,364,625 | \$ 257,838 |
| Fair value of mortgage loans acquired for sale held at period end | \$ 847,575 | \$ 40,850 | \$ 847,575 | \$ 40,850 |

Our gain on mortgage loans acquired for sale includes both cash and non-cash elements. We receive proceeds on sale that include both cash and our estimate of the value of MSR. MSR represents the value of a contract that obligates us to service the mortgage loans we sell on behalf of the purchaser of the loan in exchange for servicing fees and the right to collect certain ancillary income from the borrower. We recognize MSR at our estimate of the fair value of the contract to service the loans. As discussed in *Net Loan Servicing Fees*, below, how much of the MSR we realize in cash relies how our initial estimates of the future cash flows accruing to the MSR are realized. As economic fundamentals influencing the loans we sell with servicing rights retained change, our estimate of the fair value of MSR will also change. As a result, we will record changes in fair value as a component of Net Loan Servicing Fees for the MSR we carry at fair value and we may recognize changes in fair value relating to our MSR carried at the lower of amortized cost or fair value depending on the relationship of the asset's fair value to its amortized cost at the measurement date.

Following are the key inputs used in determining the fair value of MSR at the time of initial recognition:

| Key Inputs | Quarter ended September 30, 2012 | | 2011 | |
|----------------------------------|-------------------------------------|--------------|----------------|--------------|
| | Amortized cost | Fair value | Amortized cost | Fair value |
| Pricing spread(1) | 7.5% - 7.5% | 7.5% - 13.5% | 10.0% - 19.9% | 9.5% - 17.0% |
| | (7.5%) | (7.6%) | (11.7%) | (12.3%) |
| Life (in years) | 6.4 - 6.4 | 3.2 - 6.4 | 3.7 - 8.1 | 2.3 - 8.1 |
| | (6.4) | (6.3) | (7.2) | (5.7) |
| Annual total prepayment speed(2) | 8.9% - 9.4% | 8.9% - 27.1% | 5.9% - 24.4% | 7.2% - 23.1% |
| | (9.1%) | (9.5%) | (7.7%) | (11.8%) |

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| | | | | |
|-----------------------------------|-----------------------|------------------------|-----------------------|------------------------|
| Annual per-loan cost of servicing | \$68 - \$68 (\$68) | \$68 - \$140 (\$69) | \$53 - \$68 (\$68) | \$53 - \$140 (\$91) |
|-----------------------------------|-----------------------|------------------------|-----------------------|------------------------|

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| Key Inputs | Nine months ended September 30, | | | |
|-----------------------------------|---------------------------------|--------------------------|----------------|--------------|
| | 2012 | Range (weighted average) | | 2011 |
| | Amortized cost | Fair value | Amortized cost | Fair value |
| Pricing spread(1) | 7.5% - 22.8% | 7.5% - 14.6% | 10.0% - 19.9% | 9.5% - 17.0% |
| | (7.7%) | (8.1%) | (11.7%) | (12.5%) |
| Life (in years) | 2.5 - 6.7 | 2.5 - 6.7 | 3.7 - 8.1 | 2.0 - 8.2 |
| | (6.4) | (6.2) | (7.2) | (6.0) |
| Annual total prepayment speed(2) | 7.8% - 36.9% | 7.8% - 36.9% | 5.8% - 9.3% | 6.8% - 27.8% |
| | (8.9%) | (10.4%) | (7.6%) | (14.5%) |
| Annual per-loan cost of servicing | \$68 - \$140 | \$68 - \$140 | \$53 - \$68 | \$53 - \$140 |
| | (\$68) | (\$75) | (\$66) | (\$86) |

(1) Pricing spread represents a margin that is applied to a reference interest rate's forward rate curve to develop periodic discount rates. The Company applies a pricing spread to the United States Dollar LIBOR curve for purposes of discounting cash flows relating to MSRs acquired as proceeds from the sale of mortgage loans.

(2) Annual total prepayment speed is measured using Life Total CPR.

We also provide for our estimate of the future losses that we may be required to incur as a result of our breach of representations and warranties provided to the purchasers of the loans we sold. We evaluate the adequacy of our estimate based on our loss experience and our assessment of future losses to be incurred relating to loans we have previously sold and which remain outstanding at the balance sheet date. As our portfolio of loans sold subject to representations and warranties grows and as economic fundamentals change, such adjustments can be material. However, we believe our current estimates represent the future losses to be incurred on our servicing portfolio of mortgage loans sold subject to representations and warranties.

Our hedging activities relating to our correspondent lending activities primarily involve forward sales of our inventory and commitments to purchase mortgage loans as well as purchases of options to sell and options to purchase MBS. We hedged the interest rate fluctuations on indebtedness incurred to acquire our investment in Agency MBS using interest rate swaption agreements. Following is a summary of the notional activity in our hedging derivatives for the periods presented:

| Period/Instrument | Balance, beginning of period | Additions | Dispositions/ expirations (in thousands) | Balance, end of period | Fair value asset (liability) at period-end |
|---|------------------------------------|---------------|--|------------------------------|--|
| Quarter ended September 30, 2012 | | | | | |
| MBS put options | \$ 245,000 | \$ 320,000 | \$ (40,000) | \$ 525,000 | \$ 902 |
| MBS call options | \$ 35,000 | \$ | \$ (35,000) | \$ | \$ |
| MBS swaptions | \$ 170,000 | \$ | \$ (170,000) | \$ | \$ |
| Forward sales contracts | \$ 1,304,565 | \$ 5,261,023 | \$ (4,112,552) | \$ 2,453,036 | \$ (36,203) |
| Nine months ended September 30, 2012 | | | | | |
| MBS put options | \$ 28,000 | \$ 740,000 | \$ (243,000) | \$ 525,000 | \$ 902 |
| MBS call options | \$ 5,000 | \$ 90,000 | \$ (95,000) | \$ | \$ |
| MBS swaptions | \$ | \$ 170,000 | \$ (170,000) | \$ | \$ |
| Forward sales contracts | \$ 358,291 | \$ 12,162,517 | \$ (10,067,772) | \$ 2,453,036 | \$ (36,203) |

Results of Real Estate Acquired in Settlement of Loans

Results of REO includes the gains or losses we record upon sale of the properties as well as valuation adjustments we record during the period we hold those properties. During the quarter and nine months ended September 30, 2012, we recorded net gains of \$1.3 million and \$7.6 million, respectively, in results of *Real estate acquired in settlement of loans* as compared to net gains totaling \$352,000 and \$1.5 million, respectively, for the quarter and nine months ended September 30, 2011.

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Results of REO are summarized below:

| | Quarter ended September 30, | | Six months ended September 30, | |
|----------------------------|--------------------------------|------------|-----------------------------------|------------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| Valuation adjustments, net | \$ (3,955) | \$ (2,779) | \$ (9,273) | \$ (6,764) |
| Gain on sale, net | 5,243 | 3,131 | 16,849 | 8,291 |
| | \$ 1,288 | \$ 352 | \$ 7,576 | \$ 1,527 |

The increase in gain between the quarter and nine months ended September 30, 2012 and the quarter and nine months ended September 30, 2011 is primarily due to the increased level of REO activity during the current year periods as compared to the prior year periods. Our investment in REO has been decreasing from its high of approximately \$103.5 million at December 31, 2012 as we liquidate the distressed assets we purchased throughout 2010 and 2011 and have not purchased distressed assets at the rate we purchased such assets during the prior year. We recorded a 17% decrease in the carrying value of REO, from approximately \$103.5 million to approximately \$86.2 million, from December 31, 2011 to September 30, 2012.

Net Loan Servicing Fees

When we sell mortgage loans, we generally enter into a contract to service the mortgage loans and recognize the value of such contracts as MSR. Under these contracts, we perform loan servicing functions in exchange for fees and the right to other compensation. The servicing functions typically performed include, among other responsibilities, collecting and remitting loan payments; responding to borrower inquiries; accounting for principal and interest, holding custodial (impound) funds for payment of property taxes and insurance premiums; counseling delinquent mortgagors; and supervising foreclosures and property dispositions. Through our Operating Partnership, we also have a loan servicing agreement with PLS by which PLS subcontracts to perform the servicing obligations on our behalf. Under the servicing agreement, PLS is entitled to base subservicing fees, which range from 4 to 20 basis points per year of the unpaid principal balance of such loans, and other customary market-based fees and charges. Such fees are included in the *Loan servicing* expenses on our *Consolidated Statements of Income*.

Net loan servicing fees are summarized below:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|---|--------------------------------|-------|------------------------------------|-------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| Servicing fees(1) | \$ 3,933 | \$ 24 | \$ 6,294 | \$ 24 |
| Effect of MSRs: | | | | |
| Amortization | (1,437) | | (2,339) | |
| Provision for impairment of MSRs carried at lower of amortized cost or fair value | (2,881) | | (4,505) | |
| Change in fair value of MSRs carried at fair value | (126) | (10) | (619) | (7) |
| | (4,444) | (10) | (7,463) | (7) |
| Net loan servicing fees | \$ (511) | \$ 14 | \$ (1,169) | \$ 17 |

(1) Includes contractually specified servicing fees.

The value of MSRs is derived from the net positive cash flows associated with the servicing contracts. The Company receives a servicing fee ranging generally from 0.250% to 0.375% annually on the remaining outstanding principal balances of the loans.

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Amortization, impairment and changes in fair value of MSR's have a significant effect on net loan servicing fees. The effect of MSR's on net loan servicing fees is driven primarily by our monthly re-estimation of the fair value of MSR's. As our investment in MSR's grows, we expect that the effect of amortization, impairment and changes in fair value will have an increasing influence on our net income. The precise fair value of MSR's cannot be readily determined because MSR's are not actively traded in standalone markets. Considerable judgment is required to estimate the fair values of these assets and the exercise of such judgment can significantly affect our earnings.

Our MSR valuation process combines the use of a discounted cash flow model and analysis of current market data to arrive at an estimate of fair value at each balance sheet date. The cash flow and prepayment assumptions used in the Manager's discounted cash flow model are based on market factors and include the historical performance of its MSR's, which the Manager believes are consistent with assumptions and data used by market participants valuing similar MSR's. The key assumptions used in the valuation of MSR's include mortgage prepayment speeds and discount rates. These variables can, and generally do, change from period to period as market conditions change. Therefore our estimate of the fair value of MSR's changes from period to period. PCM's Valuation Committee reviews and approves the fair value estimates of our MSR's.

We account for MSR's at either our estimate of the asset's fair value with changes in fair value recorded in current period earnings or using the amortization method carried at the lower of estimated amortized cost or fair value based on whether we view the underlying mortgages as being sensitive to prepayments resulting from changing market interest rates. We have identified an initial mortgage interest rate of 4.5% as the threshold for whether such mortgage loans are sensitive to changes in interest rates:

Our risk management efforts in connection with MSR's relating to mortgage loans with initial interest rates of more than 4.5% are aimed at moderating the effects of changes in interest rates on the assets' values.

For MSR's relating to mortgage loans with initial interest rates of less than or equal to 4.5% that were acquired as a result of our correspondent lending operations, we have concluded that such assets present different risks than MSR's relating to mortgage loans with initial interest rates of more than 4.5% and therefore require a different risk management approach. Our risk management efforts relating to these assets are aimed at moderating the effects of non-interest rate risks on fair value, such as the effect of changes in home prices on the assets' values. We have identified these assets for accounting using the amortization method.

Our MSR's are summarized by the basis on which we account for the assets below as of the dates presented:

| Basis of Accounting | September 30, 2012 | December 31, 2011 |
|---|-------------------------------|------------------------------|
| | (in thousands) | |
| Fair value | \$ 1,522 | \$ 749 |
| Lower of amortized cost or fair value: | | |
| Amortized cost | \$ 68,137 | \$ 5,282 |
| Valuation allowance | (4,505) | |
| Carrying value | \$ 63,632 | \$ 5,282 |
| Fair value | \$ 63,678 | \$ 5,341 |
| Total MSR: | | |
| Carrying value | \$ 65,154 | \$ 6,031 |
| Fair value | \$ 65,200 | \$ 6,090 |
| Unpaid balance of mortgage loans underlying MSR's | \$ 6,254,234 | \$ 495,031 |

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Key assumptions used in determining the fair value of MSRs and estimates of the sensitivity of MSR values to changes in these assumptions as of the dates presented are as follows:

| Key Inputs | September 30, 2012 | | December 31, 2011 | |
|---------------------------------------|--|---------------|-------------------|--------------|
| | Range (weighted average) | | | |
| | Amortized cost | Fair value | Amortized cost | Fair value |
| | (effect on value amounts in thousands) | | | |
| Pricing spread(1) | 7.5% - 14.5% | 7.5% - 14.5% | 7.5% - 16.5% | 7.5% - 16.5% |
| | (7.5%) | (7.8%) | (7.5%) | (8.6%) |
| Effect on value of 5% adverse change | \$(1,114) | \$(26) | \$(89) | \$(10) |
| Effect on value of 10% adverse change | \$(2,194) | \$(52) | \$(176) | \$(20) |
| Effect on value of 20% adverse change | \$(3,968) | \$(91) | \$(341) | \$(39) |
| Average life (in years) | 2.1 - 6.8 | 2.1 - 6.8 | 3.0 - 6.9 | 1.7 - 6.9 |
| | (6.4) | (5.8) | (6.7) | (5.3) |
| Prepayment speed(2) | 8.4% - 46.5% | 10.5% - 46.5% | 6.9% - 30.8% | 8.4% - 59.0% |
| | (10.2%) | (17.1%) | (8.2%) | (16.3%) |
| Effect on value of 5% adverse change | \$(1,528) | \$(53) | \$(90) | \$(16) |
| Effect on value of 10% adverse change | \$(2,997) | \$(104) | \$(178) | \$(31) |
| Effect on value of 20% adverse change | \$(5,770) | \$(197) | \$(343) | \$(60) |
| Annual per-loan cost of servicing | \$68 - \$140 | \$68 - \$140 | \$68 - \$140 | \$68 - \$140 |
| | (\$68) | (\$75) | (\$69) | (\$89) |
| Effect on value of 5% adverse change | \$(393) | \$(13) | \$(30) | \$(4) |
| Effect on value of 10% adverse change | \$(785) | \$(26) | \$(61) | \$(9) |
| Effect on value of 20% adverse change | \$(1,571) | \$(53) | \$(122) | \$(17) |

(1) Pricing spread represents a margin that is applied to a reference interest rate's forward rate curve to develop periodic discount rates. The Company applies a pricing spread to the United States Dollar LIBOR curve for purposes of discounting cash flows relating to MSRs acquired as proceeds from the sale of mortgage loans and purchased MSRs not backed by pools of distressed mortgage loans.

(2) Prepayment speed is measured using Life Total CPR.

Significant changes to any of those inputs in isolation could result in a significant change in the MSR fair value measurement. Changes in these key assumptions are not necessarily directly related. The preceding sensitivity analyses are limited in that they were performed as of a particular point in time; only contemplate the movements in the indicated variables; do not incorporate changes in the variables in relation to other variables; are subject to the accuracy of various models and inputs used; and do not take into account other factors that would affect our overall financial performance in such scenarios, including operational adjustments made by the Manager to account for changing circumstances. For these reasons, the preceding estimates should not be viewed as earnings forecasts.

Table of Contents**Expenses**

Our expenses are summarized below for the periods presented:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|-----------------------|--------------------------------|-----------|------------------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| Loan fulfillment fees | \$ 17,258 | \$ 263 | \$ 31,097 | \$ 336 |
| Interest | 8,282 | 5,225 | 21,659 | 10,473 |
| Loan servicing | 5,208 | 4,834 | 15,180 | 10,620 |
| Management fees | 3,672 | 2,288 | 7,964 | 5,750 |
| Compensation | 1,997 | 1,567 | 5,042 | 3,831 |
| Professional services | 1,693 | 1,656 | 3,321 | 3,648 |
| Other | 2,117 | 1,274 | 4,469 | 3,667 |
| | \$ 40,227 | \$ 17,107 | \$ 88,732 | \$ 38,325 |

Increased expenses during the quarter and nine months ended September 30, 2012 compared to the same periods in 2011 were primarily a result of the growth in the Company's investment portfolio, the use of borrowings to finance that growth and the substantial growth in our correspondent lending activities.

Loan fulfillment fees payable to an affiliate represent fees we pay to PLS for the services it performs on our behalf in connection with our acquisition, packaging and sale of mortgage loans. The fee is calculated as a percentage of the unpaid principal balance of the mortgage loans at sale to nonaffiliates where we are approved or licensed to sell to such nonaffiliates. The increase of \$17.0 million and \$30.8 million, respectively, in the fees during the quarter and nine months ended September 30, 2012 compared to the same periods in 2011 is due to the substantial growth in our correspondent lending activities. During the quarter and nine months ended September 30, 2012, we sold mortgage loans to nonaffiliates with fair values totaling approximately \$3.6 billion and \$6.3 billion, respectively, compared to \$53.2 million and \$72.8 million, respectively, during the quarter and nine months ended September 30, 2011.

The effects of changes in the composition of our borrowings on our interest expense during the periods presented are summarized below:

| | Quarter ended September 30, 2012 vs. Quarter ended September 30, 2011 Increase (decrease) due to changes in | | | Nine months ended September 30, 2012 vs. Nine months ended September 30, 2011 Increase (decrease) due to changes in | | |
|--|---|----------|-----------------------------------|---|-----------|-----------------|
| | Rate | Volume | Total change (in thousands) | Rate | Volume | Total change |
| Assets sold under agreements to repurchase: | | | | | | |
| Securities | \$ (85) | \$ 23 | \$ (62) | \$ (204) | \$ | \$ (204) |
| Mortgage loans acquired for sale at fair value | (189) | 3,763 | 3,574 | (220) | 6,493 | 6,273 |
| Mortgage loans at fair value | 109 | 961 | 1,070 | 485 | 3,092 | 3,577 |
| Real estate acquired in settlement of loans | (43) | 57 | 14 | 1 | 669 | 670 |
| Note payable secured by mortgage loans at fair value | | | | | 113 | 113 |
| Note payable secured by warehouse notes receivable | | 41 | 41 | | 41 | 41 |
| Borrowings under forward purchase agreements | (164) | (1,416) | (1,580) | 8 | 708 | 716 |
| | \$ (372) | \$ 3,429 | \$ 3,057 | \$ 70 | \$ 11,116 | \$ 11,186 |

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During the quarter and nine months ended September 30, 2012, we incurred interest expense totaling \$8.3 million and \$21.7 million, respectively, as compared to \$5.2 million and \$10.5 million during the quarter and nine months ended September 30, 2011. Our interest cost was 3.62 and 3.52%, respectively, for the quarter and nine months ended September 30, 2012 as compared to 4.08% and 3.78%, respectively, for the quarter and nine months ended September 30, 2011. The increase in interest expense reflects our increased use of borrowings in support of growth of our balance sheet throughout 2011 and 2012, partially offset by declining interest rates from 2011 to 2012 and a shift in borrowings toward financing more liquid assets which are financeable with lower borrowing rates.

Loan servicing expenses also grew substantially from \$4.8 million and \$10.6 million, respectively, in the quarter and nine months ended September 30, 2011 to \$5.2 million and \$15.2 million, respectively, in the quarter and nine months ended September 30, 2012 as our average investment in mortgage loans increased by 20% and 37%, respectively, from the quarter and nine months ended September 30, 2011 to the quarter and nine months ended September 30, 2012.

Loan servicing expenses are summarized below for the periods presented:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|----------------------------|--------------------------------|----------|------------------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| Servicing fees | | | | |
| Base | \$ 3,518 | \$ 2,793 | \$ 9,656 | \$ 6,601 |
| Activity-based | 1,395 | 1,680 | 4,257 | 3,391 |
| | 4,913 | 4,473 | 13,913 | 9,992 |
| Collection expenses | 295 | 361 | 1,267 | 628 |
| | \$ 5,208 | \$ 4,834 | \$ 15,180 | \$ 10,620 |

Compensation expense increased due to the effect on 2012 stock-based compensation expense of restricted share units granted during the second quarter of 2012 to our officers and trustees as well as certain employees of PCM and its affiliates. Professional services expense decreased during the quarter and nine months ended September 30, 2012 as compared to the quarter and nine months ended September 30, 2011 as the level of mortgage investment acquisition activity involving assets and transactions which require support in the form of due diligence and legal consultations decreased in 2012 as compared to 2011.

Income Taxes

We had elected to treat two of our subsidiaries as TRSs. In the quarter ended September 30, 2012, we revoked the election to treat our wholly owned subsidiary that is the sole general partner of our operating partnership as a TRS. As a result, beginning September 1, 2012, one subsidiary, PMC, is treated as a TRS.

A TRS is subject to corporate federal and state income tax. Income from a TRS is only included as a component of REIT taxable income to the extent that the TRS makes dividend distributions of income to the REIT. No such dividend distributions have been made to date. Accordingly, a provision for income taxes for PMC and, for the period for which TRS treatment had been elected, the sole general partner of our operating partnership is included in the accompanying *Consolidated Statements of Income*.

In general, cash dividends declared by us will be considered ordinary income to shareholders for income tax purposes. Some portion of the dividends may be characterized as capital gain distributions or a return of capital. Most of the 2011 distributions were characterized as ordinary income and approximately 5% was characterized as capital gain.

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Below is a reconciliation of U.S. GAAP net income to tax income for the year to date and the allocation between the TRS and the REIT:

| Nine months ended September 30, 2012 | U.S. GAAP net income | GAAP/Tax differences | Taxable income (in thousands) | Taxable subsidiaries | REIT |
|--|----------------------------|-------------------------|-------------------------------------|-------------------------|-----------|
| Net gain(loss) on investments | \$ 65,541 | \$ (2,430) | \$ 63,111 | \$ 38,307 | \$ 24,804 |
| Interest Income | 52,157 | 19,192 | 71,349 | 30,193 | 41,156 |
| Net gain on mortgage loans acquired for sale | 81,210 | (64,491) | 16,719 | 16,719 | |
| Loan Origination Fees | 4,880 | | 4,880 | 4,880 | |
| Results of real estate acquired in settlement of loans | 7,576 | 2,172 | 9,748 | 7,964 | 1,784 |
| Net loan servicing fees | (1,169) | 7,559 | 6,390 | 6,390 | |
| Other | 56 | (63) | (7) | 199 | (206) |
| Net investment income | 210,251 | (38,061) | 172,190 | 104,652 | 67,538 |
| Operating Expenses | 88,732 | 13,859 | 102,591 | 82,203 | 20,388 |
| Income before provision for income taxes | 121,519 | (51,920) | 69,599 | 22,449 | 47,150 |
| Provision for income taxes | 32,508 | (23,069) | 9,439 | 9,439 | |
| Net income | \$ 89,011 | \$ (28,851) | \$ 60,160 | \$ 13,010 | \$ 47,150 |

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Following is a summary of key balance sheet items as of the dates presented:

| | September 30, 2012 | December 31, 2011 |
|---|-----------------------|----------------------|
| | (in thousands) | |
| ASSETS | | |
| Cash | \$ 67,813 | \$ 14,589 |
| Investments: | | |
| Short-term investments | 38,322 | 30,319 |
| United States Treasury security | | 50,000 |
| Mortgage-backed securities at fair value | | 72,813 |
| Mortgage loans acquired for sale at fair value | 847,575 | 232,016 |
| Mortgage loans at fair value | 1,089,966 | 696,266 |
| Mortgage loans under forward purchase agreements at fair value | | 129,310 |
| Real estate acquired in settlement of loans | 86,180 | 80,570 |
| Real estate acquired in settlement of loans under forward purchase agreements | | 22,979 |
| Mortgage servicing rights | 65,154 | 6,031 |
| | 2,127,197 | 1,320,304 |
| Other assets | 133,715 | 51,169 |
| Total assets | \$ 2,328,725 | \$ 1,386,062 |
| LIABILITIES | | |
| Assets sold under agreements to repurchase: | | |
| Securities | \$ | \$ 115,493 |
| Mortgage loans acquired for sale at fair value | 755,471 | 212,677 |
| Mortgage loans at fair value | 274,185 | 275,649 |
| Real estate acquired in settlement of loans | 11,715 | 27,494 |
| Note payable secured by mortgage loans at fair value | | 28,617 |
| Borrowings under forward purchase agreements | | 152,427 |
| | 1,041,371 | 812,357 |
| Other liabilities | 103,151 | 27,688 |
| Total liabilities | 1,144,522 | 840,045 |
| SHAREHOLDERS EQUITY | 1,184,203 | 546,017 |
| Total liabilities and shareholders equity | \$ 2,328,725 | \$ 1,386,062 |

Total assets increased by approximately \$942.7 million or 68% during the period from December 31, 2011 through September 30, 2012. During the nine months ended September 30, 2012, we increased our capitalization through issuance of additional common shares for net proceeds of \$606.8 million and an increase in our borrowings outstanding by \$229.0 million. We made investments totaling \$590.0 million and received proceeds from sales and repayments of those assets as well as from the maturity of a United States Treasury security, our portfolio of MBS, mortgage loans under forward purchase agreements from sales of REO and a sale of MSRs totaling \$496.0 million. We also purchased newly-originated mortgage loans totaling approximately \$12.0 billion and received proceeds (including MSRs) from the sale of those loans totaling approximately \$11.4 billion in our correspondent lending operations. Our non-correspondent lending acquisitions are summarized below.

Table of Contents**Asset Acquisitions**

Following is a summary of our acquisitions of mortgage investments (excluding correspondent lending mortgage loans) for the periods presented:

| | Quarter ended September 30, | | Nine months ended September 30, | |
|------------------------------|--------------------------------|------------|------------------------------------|------------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| MBS | \$ | \$ 22,179 | \$ 112,211 | \$ 22,179 |
| Distressed mortgage loans(1) | | | | |
| Performing | 249 | 7,889 | 122,491 | 52,266 |
| Nonperforming | 150,529 | 256,811 | 288,882 | 572,837 |
| | 150,778 | 264,700 | 411,373 | 625,103 |
| REO | | 915 | 48 | 2,425 |
| MSRs | 36,760 | 466 | 66,649 | 643 |
| | \$ 187,538 | \$ 288,260 | \$ 590,281 | \$ 650,350 |

(1) Performance status as of the date of acquisitions.

Investment Portfolio Composition*Mortgage-Backed Securities*

We sold our investments in MBS during the quarter ended September 30, 2012. Following is a summary of our portfolio of MBS as of December 31, 2011:

| | Fair value | Principal | December 31, 2011 | Coupon | Market yield |
|---------------------------|---------------|-----------|-------------------------------|--------|-----------------|
| | | | Average life (in years) | | |
| (dollars in thousands) | | | | | |
| Security collateral type: | | | | | |
| Non-Agency subprime | \$ 58,634 | \$ 63,712 | 1.60 | 0.64% | 8.01% |
| Non-Agency Alt-A | 8,710 | 8,910 | 1.69 | 5.63% | 6.23% |
| Non-Agency prime jumbo | 5,469 | 5,624 | 0.72 | 2.72% | 6.51% |
| | \$ 72,813 | \$ 78,246 | 1.55 | 1.36% | 7.70% |

Mortgage Loans-Investment Portfolio

The relationship of the fair value of our mortgage loans at fair value (excluding mortgage loans acquired for sale at fair value) to the fair value of the real estate collateral underlying the loans is summarized below:

| | |
|--------------------|-------------------|
| September 30, 2012 | December 31, 2011 |
| Fair values | |

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| | Loan | Collateral | Loan | Collateral |
|---------------------|----------------|--------------|------------|--------------|
| | (in thousands) | | | |
| Performing loans | \$ 388,051 | \$ 583,926 | \$ 209,599 | \$ 306,978 |
| Nonperforming loans | 701,915 | 1,055,736 | 615,977 | 905,940 |
| | \$ 1,089,966 | \$ 1,639,662 | \$ 825,576 | \$ 1,212,918 |

The collateral values presented above do not represent our assessment of the amount of future cash flows to be realized from the mortgage loans and/or underlying collateral. Future cash flows will be influenced by, among other considerations, our asset disposition strategies with respect to individual loans, the costs and expenses we incur in the disposition process and changes in borrower performance and the underlying collateral values.

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Collateral values summarized above are estimated and may change over time due to various factors including changes in the real estate market, our level of access to the properties securing the loans or the condition of individual properties. Collateral values noted do not include any costs that would typically be incurred in obtaining the property in settlement of the loan, readying the property for sale or in the sale of a property.

Following is a summary of the distribution of our mortgage loans at fair value (excluding mortgage loans acquired for sale at fair value) at September 30, 2012 and December 31, 2011:

| Loan type | September 30, 2012 | | | | | | December 31, 2011 | | | | | |
|-----------------------|------------------------|---------|-----------|---------------------|---------|-----------|------------------------|---------|-----------|---------------------|---------|-----------|
| | Performing loans | | | Nonperforming loans | | | Performing loans | | | Nonperforming loans | | |
| | Average | | | Average | | | Average | | | Average | | |
| | Fair value | % total | note rate | Fair value | % total | note rate | Fair value | % total | note rate | Fair value | % total | note rate |
| | (dollars in thousands) | | | | | | (dollars in thousands) | | | | | |
| Fixed | \$ 193,151 | 50% | 5.00% | \$ 370,089 | 53% | 6.40% | \$ 100,898 | 48% | 5.56% | \$ 294,723 | 48% | 6.33% |
| ARM/Hybrid | 133,894 | 34% | 4.05% | 323,681 | 46% | 5.85% | 77,131 | 37% | 4.34% | 319,558 | 52% | 6.17% |
| Interest rate step-up | 60,873 | 16% | 2.09% | 3,469 | 0% | 3.03% | 31,384 | 15% | 2.23% | 1,430 | 0% | 4.36% |
| Balloon | 133 | 0% | 2.00% | 4,676 | 1% | 6.58% | 186 | 0% | 4.32% | 266 | 0% | 7.97% |
| | \$ 388,051 | 100% | 4.17% | \$ 701,915 | 100% | 6.14% | \$ 209,599 | 100% | 4.61% | \$ 615,977 | 100% | 6.25% |

| Lien position | September 30, 2012 | | | | | | December 31, 2011 | | | | | |
|---------------|------------------------|---------|-----------|---------------------|---------|-----------|------------------------|---------|-----------|---------------------|---------|-----------|
| | Performing loans | | | Nonperforming loans | | | Performing loans | | | Nonperforming loans | | |
| | Average | | | Average | | | Average | | | Average | | |
| | Fair value | % total | note rate | Fair value | % total | note rate | Fair value | % total | note rate | Fair value | % total | note rate |
| | (dollars in thousands) | | | | | | (dollars in thousands) | | | | | |
| 1st lien | \$ 387,758 | 100% | 4.17% | \$ 701,678 | 100% | 6.13% | \$ 209,565 | 100% | 4.60% | \$ 615,977 | 100% | 6.25% |
| 2nd lien | 292 | 0% | 6.59% | 237 | 0% | 10.90% | 33 | 0% | 9.75% | | 0% | 0% |
| Unsecured | 1 | 0% | 0.00% | | 0% | 0.00% | 1 | 0% | 0.01% | | 0% | 0% |
| | \$ 388,051 | 100% | 4.17% | \$ 701,915 | 100% | 6.14% | \$ 209,599 | 100% | 4.61% | \$ 615,977 | 100% | 6.25% |

| Occupancy | September 30, 2012 | | | | | | December 31, 2011 | | | | | |
|---------------------|------------------------|---------|-----------|---------------------|---------|-----------|------------------------|---------|-----------|---------------------|---------|-----------|
| | Performing loans | | | Nonperforming loans | | | Performing loans | | | Nonperforming loans | | |
| | Average | | | Average | | | Average | | | Average | | |
| | Fair value | % total | note rate | Fair value | % total | note rate | Fair value | % total | note rate | Fair value | % total | note rate |
| | (dollars in thousands) | | | | | | (dollars in thousands) | | | | | |
| Owner occupied | \$ 334,674 | 86% | 4.13% | \$ 510,706 | 73% | 6.02% | \$ 185,779 | 89% | 4.55% | \$ 465,425 | 76% | 6.16% |
| Investment property | 46,805 | 12% | 4.47% | 190,074 | 27% | 6.46% | 23,488 | 11% | 5.10% | 150,215 | 24% | 6.49% |
| Other | 6,572 | 2% | 4.24% | 1,135 | 0% | 4.55% | 332 | 0% | 4.05% | 337 | 0% | 7.96% |
| | \$ 388,051 | 100% | 4.17% | \$ 701,915 | 100% | 6.14% | \$ 209,599 | 100% | 4.61% | \$ 615,977 | 100% | 6.25% |

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| Loan age | September 30, 2012 | | | | | | December 31, 2011 | | | | | |
|------------------------|--------------------|---------|-----------|---------------------|---------|------------------------|-------------------|---------|-----------|---------------------|---------|-----------|
| | Performing loans | | | Nonperforming loans | | | Performing loans | | | Nonperforming loans | | |
| | Fair value | % total | Average | Fair value | % total | Average | Fair value | % total | Average | Fair value | % total | Average |
| | | | note rate | | | note rate | | | note rate | | | note rate |
| (dollars in thousands) | | | | | | (dollars in thousands) | | | | | | |
| Less than 12 months | \$ 160 | 0% | 5.51% | \$ 833 | 0% | 2.63% | \$ 33 | 0% | 5.17% | \$ | 0% | 0.00% |
| 12-35 months | 1,181 | 0% | 2.95% | 638 | 0% | 5.18% | 2,253 | 1% | 4.39% | 10,134 | 1% | 5.04% |
| 36-59 months | 60,959 | 16% | 4.75% | 123,051 | 18% | 6.38% | 94,112 | 45% | 5.11% | 287,578 | 47% | 6.43% |
| 60 months or more | 325,751 | 84% | 4.07% | 577,393 | 82% | 6.09% | 113,201 | 54% | 4.18% | 318,265 | 52% | 6.11% |
| | \$ 388,051 | 100% | 4.17% | \$ 701,915 | 100% | 6.14% | \$ 209,599 | 100% | 4.61% | \$ 615,977 | 100% | 6.25% |

| Origination | September 30, 2012 | | | | December 31, 2011 | | | |
|-------------|--------------------|---------|---------------------|---------|-------------------|---------|---------------------|---------|
| | Performing loans | | Nonperforming loans | | Performing loans | | Nonperforming loans | |
| | Fair value | % total | Fair value | % total | Fair value | % total | Fair value | % total |
| FICO score | | | | | | | | |