Invesco Mortgage Capital Inc.
Form 10-Q
October 31, 2013
Table of Contents

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2013

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 001-34385

INVESCO MORTGAGE CAPITAL INC.
(Exact Name of Registrant as Specified in Its Charter)

Maryland (State or Other Jurisdiction of Incorporation or Organization)	26-2749336 (I.R.S. Employer Identification No.)
1555 Peachtree Street, N.E., Suite 1800 Atlanta, Georgia	30309
(Address of Principal Executive Offices)	(Zip Code)

(404) 892-0896
(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 ý No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, 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 ý 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	ý	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 ý

As of October 29, 2013, there were 135,225,647 outstanding shares of common stock of Invesco Mortgage Capital Inc.

Table of Contents

INVESCO MORTGAGE CAPITAL INC.
TABLE OF CONTENTS

		Page
PART I FINANCIAL INFORMATION		1
Item 1.	Financial Statements	1
	Consolidated Balance Sheets as of September 30, 2013 (unaudited) and December 31, 2012	1
	Unaudited Consolidated Statements of Operations for the three and nine months ended September 30, 2013 and 2012	2
	Unaudited Consolidated Statements of Comprehensive Income (Loss) for the three and nine months ended September 30, 2013 and 2012	3
	Unaudited Consolidated Statement of Equity for the nine months ended September 30, 2013	4
	Unaudited Consolidated Statements of Cash Flows for the nine months ended September 30, 2013 and 2012	5
	Notes to Consolidated Financial Statements	6
Item 2.	Management’s Discussion and Analysis of Financial Condition and Results of Operations	38
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	57
Item 4.	Controls and Procedures	59
PART II OTHER INFORMATION		60
Item 1.	Legal Proceedings	60
Item 1A.	Risk Factors	60
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	60
Item 3.	Defaults Upon Senior Securities	60
Item 4.	Mine Safety Disclosures	60
Item 5.	Other Information	60
Item 6.	Exhibits	62

Table of Contents

PART I
ITEM 1. FINANCIAL STATEMENTS
INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

$ in thousands, except per share amounts	As of September 30, 2013 (Unaudited)	December 31, 2012
ASSETS		
Mortgage-backed securities, at fair value	18,811,679	18,470,563
Residential loans, held-for-investment, net of loan loss reserve	1,532,389	—
Commercial loans, held-for-investment, net of loan loss reserve	17,388	—
Cash and cash equivalents	199,095	286,474
Due from counterparties	8,119	—
Investment related receivable	8,912	41,429
Investments in unconsolidated ventures, at fair value	42,276	35,301
Accrued interest receivable	71,198	62,977
Derivative assets, at fair value	188,509	6,469
Deferred securitization and financing costs	14,033	—
Other investments	10,000	10,000
Other assets	1,883	1,547
Total assets (1)	20,905,481	18,914,760
LIABILITIES AND EQUITY		
Liabilities:		
Repurchase agreements	15,897,612	15,720,460
Asset-backed securities issued	1,411,897	—
Exchangeable senior notes	400,000	—
Derivative liability, at fair value	316,670	436,440
Dividends and distributions payable	71,037	79,165
Investment related payable	201,203	63,715
Accrued interest payable	19,554	15,275
Collateral held payable	21,045	—
Accounts payable and accrued expenses	3,885	877
Due to affiliate	11,457	9,308
Total liabilities (1)	18,354,360	16,325,240
Equity:		
Preferred Stock: par value $0.01 per share, 50,000,000 shares authorized; 7.75% series A cumulative redeemable, $25 liquidation preference, 5,600,000 shares issued and outstanding at September 30, 2013 and December 31, 2012, respectively	135,356	135,362
Common Stock: par value $0.01 per share, 450,000,000 shares authorized; 135,224,162 and 116,195,500 shares issued and outstanding at September 30, 2013 and December 31, 2012, respectively	1,352	1,162
Additional paid in capital	2,712,790	2,316,290
Accumulated other comprehensive income (loss)	(315,469)	86,436
Retained earnings (distributions in excess of earnings)	(9,912)	18,848
Total shareholders' equity	2,524,117	2,558,098
Non-controlling interest	27,004	31,422
Total equity	2,551,121	2,589,520

Total liabilities and equity	20,905,481	18,914,760

(1) Our consolidated balance sheets include assets of consolidated variable interest entities ("VIEs") that can only be used to settle obligations and liabilities of the VIEs for which creditors do not have recourse to the primary beneficiary (IAS Asset I LLC, an indirect subsidiary of Invesco Mortgage Capital Inc.). At September 30, 2013 and December 31, 2012, total assets of the consolidated VIEs were $1,540,150 and $0, respectively, and total liabilities of the consolidated VIEs were $1,415,784 and $0, respectively. See Note 3 for further discussion.

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

Table of Contents

INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
$ in thousands, except per share data	2013	2012	2013	2012
Interest Income				
Mortgage-backed securities	157,539	140,477	486,619	421,442
Residential loans	13,417	—	20,443	—
Commercial loans	372	—	432	—
Total interest income	171,328	140,477	507,494	421,442
Interest Expense				
Repurchase agreements	73,695	60,327	208,487	172,312
Exchangeable senior note	5,621	—	12,403	—
Asset-backed securities issued	10,266	—	15,722	—
Total interest expense	89,582	60,327	236,612	172,312
Net interest income	81,746	80,150	270,882	249,130
Provision for loan losses	87	—	751	—
Net interest income after provision for loan losses	81,659	80,150	270,131	249,130
Other Income (loss)				
Gain (loss) on sale of investments, net	(69,323)	12,836	(56,919)	24,978
Equity in earnings and fair value change in unconsolidated ventures	1,422	3,262	5,169	6,231
Realized and unrealized gain (loss) on interest rate derivative instruments	(6,887)	(808)	44,424	(2,851)
Realized and unrealized credit default swap income	297	1,348	828	2,694
Total other income (loss)	(74,491)	16,638	(6,498)	31,052
Expenses				
Management fee – related party	10,945	9,053	32,106	26,372
General and administrative	2,259	959	6,845	3,132
Total expenses	13,204	10,012	38,951	29,504
Net income (loss)	(6,036)	86,776	224,682	250,678
Net income (loss) attributable to non-controlling interest	(63)	1,026	2,392	3,025
Net income (loss) attributable to Invesco Mortgage Capital Inc.	(5,973)	85,750	222,290	247,653
Dividends to preferred shareholders	2,713	2,682	8,138	2,682
Net income (loss) attributable to common shareholders	(8,686)	83,068	214,152	244,971
Earnings (loss) per share:				
Net income (loss) attributable to common shareholders				
Basic	(0.06)	0.72	1.61	2.12
Diluted	(0.06)	0.72	1.56	2.12
Dividends declared per common share	0.50	0.65	1.80	1.95

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

Table of Contents

INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
$ in thousands, except per share data	2013	2012	2013	2012
Net income (loss)	(6,036)	86,776	224,682	250,678
Other comprehensive income (loss)				
Unrealized gain (loss) on mortgage-back securities				
Change in fair value	(10,724)	322,647	(846,292)	603,710
Reclassification adjustments for (gain) loss included in gain (loss) on sale of investments	85,754	(5,824)	140,195	(17,401)
Unrealized gain (loss) on mortgage-backed securities, net	75,030	316,823	(706,097)	586,309
Unrealized gain (loss) on derivatives				
Change in fair value	(74,098)	(60,716)	183,391	(181,280)
Reclassification adjustments for loss included in unrealized gain (loss) on interest rate derivative instruments	43,583	35,763	116,553	107,051
Unrealized gain (loss) on derivatives, net	(30,515)	(24,953)	299,944	(74,229)
Total Other comprehensive income (loss)	44,515	291,870	(406,153)	512,080
Comprehensive income (loss)	38,479	378,646	(181,471)	762,758
Less: Comprehensive income (loss) attributable to non-controlling interest	(402)	(4,585)	1,856	(9,271)
Less: Dividends to preferred shareholders	(2,713)	(2,682)	(8,138)	(2,682)
Comprehensive income (loss) attributable to common shareholders	35,364	371,379	(187,753)	750,805

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

Table of Contents

INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF EQUITY
For the nine months ended September 30, 2013
(Unaudited)

	Attributable to Common Shareholders									
$ in thousands, except per share amounts	Preferred Stock		Common Stock		Additional Paid in	Accumulated Other Comprehensive	Retained Earnings (Distributions in excess of	Total Shareholders	Non-Controlling	Total
	Shares	Amount	Shares	Amount	Capital	Income (loss)	earnings)	Equity	Interest	Equity
Balance at January 1, 2013	5,600,000	135,362	116,195,500	1,162	2,316,290	86,436	18,848	2,558,098	31,422	2,589,52
Net income	—	—	—	—	—	—	222,290	222,290	2,392	224,682
Other comprehensive loss	—	—	—	—	—	(401,905)	—	(401,905)	(4,248)	(406,153
Proceeds from issuance of common stock, net of offering costs	—	—	19,015,269	190	396,227	—	—	396,417	—	396,417
(Cost) proceeds from issuance of preferred stock, net of offering costs	—	(6)	—	—	—	—	—	(6)	—	(6
Stock awards	—	—	13,393	—	—	—	—	—	—	—
Common stock dividends	—	—	—	—	—	—	(242,912)	(242,912)	—	(242,912
Common unit dividends	—	—	—	—	—	—	—	—	(2,565)	(2,565
Preferred stock dividends	—	—	—	—	—	—	(8,138)	(8,138)	—	(8,138
Amortization of equity-based compensation	—	—	—	—	273	—	—	273	3	276
Balance at September 30, 2013	5,600,000	135,356	135,224,162	1,352	2,712,790	(315,469)	(9,912)	2,524,117	27,004	2,551,12

The accompanying notes are an integral part of this consolidated financial statement.

Table of Contents

INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine Months Ended September 30,	
$ in thousands	2013	2012
Cash Flows from Operating Activities		
Net income	224,682	250,678
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of mortgage-backed securities premiums and discounts, net	145,112	94,722
Amortization of residential loan and asset-backed securities premiums	117	—
Amortization of commercial loan origination fees	(21)	—
Origination fee received	145	—
Provision for loan losses	751	—
Unrealized loss on interest rate derivative instruments	21,810	2,851
Unrealized (gain) loss on credit default swap	743	(406)
(Gain) loss on sale of mortgage-backed securities	56,919	(24,978)
Gain on termination of interest rate swaptions	(66,234)	—
Equity in earnings and fair value change in unconsolidated ventures	(5,169)	(6,231)
Amortization of equity-based compensation	276	257
Amortization of deferred securitization and financing costs	1,647	—
Changes in operating assets and liabilities:		
Increase in accrued interest receivable	(8,538)	(7,592)
Increase in other assets	(391)	(165)
Increase (decrease) in accrued interest payable	4,279	(568)
Increase in due to affiliate	2,149	428
Increase in accounts payable and accrued expenses	3,061	64
Net cash provided by operating activities	381,338	309,060
Cash Flows from Investing Activities		
Purchase of mortgage-backed securities	(6,923,130)	(6,354,428)
(Contributions) distributions from investment in unconsolidated ventures, net	(1,806)	19,370
Principal payments from mortgage-backed securities	2,309,117	1,827,398
Proceeds from sale of mortgage-backed securities	3,507,011	1,605,902
Payment of premiums for interest rate derivative instruments	(72,723)	(2,140)
Proceeds from termination of interest rate swaptions	114,538	—
Purchase of residential loans	(1,562,818)	—
Principal payments from residential loans	28,464	—
Origination of commercial loans, net of origination fees	(17,195)	—
Net cash used in investing activities	(2,618,542)	(2,903,898)
Cash Flows from Financing Activities		
Proceeds from issuance of common stock	396,417	103
(Cost) proceeds (of) from issuance of preferred stock	(6)	135,535
Due from counterparties	(8,182)	57,172
Collateral held payable	21,045	—
Proceeds from repurchase agreements	140,364,041	111,725,441
Principal repayments of repurchase agreements	(140,159,048)	(109,101,978)
Proceeds from issuance of exchangeable senior notes	400,000	—
Proceeds from issuance of asset-backed securities	1,440,755	—

Principal repayments of asset-backed securities	(27,778)	—
Payments of deferred costs	(15,676)	—
Payments of dividends and distributions	(261,743)	(227,811)
Net cash provided by financing activities	2,149,825	2,588,462
Net change in cash	(87,379)	(6,376)
Cash, beginning of period	286,474	197,224
Cash and cash equivalents, end of period	199,095	190,848
Supplement Disclosure of Cash Flow Information		
Interest paid	231,782	172,879
Non-cash Investing and Financing Activities Information		
Net change in unrealized gain (loss) on mortgage-backed securities and derivatives	(406,153)	512,080
Net change in unconsolidated ventures	—	—
Net change in due from counterparties	63	3,851
Dividends and distributions declared not paid	71,037	78,628
(Receivable) / payable for mortgage-backed securities sold / purchased, net	150,733	(672,589)
Repurchase agreements, not settled	(27,842)	—

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

Table of Contents

INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 1 – Organization and Business Operations

Invesco Mortgage Capital Inc. (the “Company”) is a Maryland corporation focused on investing in, financing and managing residential and commercial mortgage-backed securities and mortgage loans. The Company invests in residential mortgage-backed securities (“RMBS”) for which a U.S. Government Agency such as the Government National Mortgage Association (“Ginnie Mae”), the Federal National Mortgage Association (“Fannie Mae”) or the Federal Home Loan Mortgage Corporation (“Freddie Mac”) guarantees payments of principal and interest on the securities (collectively “Agency RMBS”). The Company’s Agency RMBS investments include mortgage pass-through securities and collateralized mortgage obligations (“CMOs”). The Company also invests in RMBS that are not issued or guaranteed by a U.S. government Agency (“non-Agency RMBS”), commercial mortgage-backed securities (“CMBS”), and residential and commercial mortgage loans. The Company is externally managed and advised by Invesco Advisers, Inc. (the “Manager”), a registered investment adviser and an indirect, wholly-owned subsidiary of Invesco Ltd. (“Invesco”), a leading independent global investment management firm.

The Company conducts its business through IAS Operating Partnership LP (the “Operating Partnership”) as its sole general partner. As of September 30, 2013, the Company owned 99% of the Operating Partnership, and Invesco Investments (Bermuda) Ltd., a direct, wholly-owned subsidiary of Invesco, owned the remaining 1.0%.

The Company finances its Agency RMBS, non-Agency RMBS and CMBS investments through short-term borrowings structured as repurchase agreements. The Company has secured commitments with a number of repurchase agreement counterparties. The Company finances its residential loans through the issuance of asset-backed securities. In addition, the Company may use other sources of financing including committed borrowing facilities and other private financing.

The Company is taxed as a real estate investment trust (“REIT”) for U.S. federal income tax purposes under the provisions of the Internal Revenue Code of 1986, as amended (“Code”). To maintain the Company’s REIT qualification, the Company is generally required to distribute at least 90% of its taxable income to its shareholders annually.

Note 2 – Summary of Significant Accounting Policies

Basis of Quarterly Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“U.S. GAAP”) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X, promulgated by the Securities and Exchange Commission (the “SEC”). In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the financial position and the results of operations of the Company for the interim periods presented have been included. Certain disclosures included in the Company’s annual report on Form 10-K are not required to be included on an interim basis in the company’s quarterly reports on Forms 10-Q. The Company has condensed or omitted these disclosures. The interim consolidated financial statements should be read in conjunction with the Company’s consolidated financial statements and related notes thereto included in the Company’s annual report on Form 10-K for the year ended December 31, 2012, which was filed with the SEC on March 1, 2013. The results of operations for the period ended September 30, 2013 are not necessarily indicative of the results to be expected for the full year or any other future period.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company, its subsidiaries and VIEs in which the Company is deemed the primary beneficiary. The underlying loans owned by the VIEs are shown under residential loans on our consolidated balance sheets. The asset-backed securities (“ABS”) issued to third parties by the VIEs are shown under asset-backed securities issued. In our consolidated statements of operations, we record interest income on the residential loans owned by the VIEs and interest expense on the ABS issued by the VIEs. All intercompany balances and transactions have been eliminated.

Variable Interest Entity

A VIE is an entity that lacks one or more of the characteristics of a voting interest entity. A VIE is defined as an entity in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. The determination of whether an entity is a VIE includes both a qualitative and quantitative analysis. The Company reassesses its initial evaluation of an entity as a VIE upon the occurrence of certain reconsideration events. The entity that consolidates a VIE is known as its primary

---

beneficiary and is generally the entity with (i) the power to direct the activities that most significantly impact the VIE's economic performance, and (ii) the right to receive benefits from the VIE or the obligation to absorb losses of the VIE that could be significant to the VIE. For VIEs that do not have substantial ongoing activities, the power to direct the activities that most significantly impact the VIE's economic performance may be determined by an entity's involvement with the design of the VIE.

Use of Estimates

The accounting and reporting policies of the Company conform to U.S. GAAP. The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Examples of estimates include, but are not limited to, estimates of the fair values of financial instruments, interest income on mortgage-backed securities ("MBS"), allowance for loan losses and other-than-temporary impairment charges. Actual results may differ from those estimates.

Cash and Cash Equivalents

The Company considers all highly liquid investments that have original or remaining maturity dates of three months or less when purchased to be cash equivalents. At September 30, 2013, the Company had cash and cash equivalents, including amounts restricted, in excess of the FDIC deposit insurance limit of $250,000 per institution. The Company mitigates its risk of loss by actively monitoring its counterparties.

Underwriting Commissions and Offering Costs

Underwriting commissions and direct costs incurred in connection with the Company's initial public offering ("IPO") and subsequent stock offerings are reflected as a reduction of additional paid-in-capital.

Deferred Costs

Included in deferred costs are costs associated with the issuance of beneficial interest by consolidated VIEs incurred by the Company and costs incurred in connection with the issuance by the Company of its exchangeable senior notes. These costs may include underwriting, rating agency, legal, accounting and other fees. These deferred costs are amortized as an adjustment to interest expense using the effective interest method, based upon actual repayments of the associated beneficial interest issued to third parties and over the stated legal maturity of the exchangeable senior notes.

Repurchase Agreements

The Company finances its Agency RMBS, non-Agency RMBS and CMBS investment portfolio through the use of repurchase agreements. Repurchase agreements are treated as collateralized financing transactions and are carried at their contractual amounts, including accrued interest, as specified in the respective agreements.

In instances where the Company acquires Agency RMBS, non-Agency RMBS or CMBS through repurchase agreements with the same counterparty from whom such assets were purchased, the Company accounts for the purchase commitment and repurchase agreement on a net basis and records a forward commitment to purchase such assets as a derivative instrument if the transaction does not comply with the criteria for gross presentation. All of the following criteria must be met for gross presentation in the circumstance where the repurchase assets are financed with the same counterparty:

- the initial transfer of and repurchase financing cannot be contractually contingent;
- the repurchase financing entered into between the parties provides full recourse to the transferee and the repurchase price is fixed;
- the financial asset has an active market and the transfer is executed at market rates; and
- the repurchase agreement and financial asset do not mature simultaneously.

If the transaction complies with the criteria for gross presentation, the Company records the assets and the related financing on a gross basis on its consolidated balance sheets, and the corresponding interest income and interest expense in its consolidated statements of operations. Forward commitments are recorded at fair value with subsequent changes in fair value recognized in income. Additionally, the Company records the cash portion of its investment in Agency RMBS and non-Agency RMBS as a mortgage related receivable from the counterparty on its consolidated balance sheets.

7

Asset-Backed Debt Securities

Asset-backed debt securities are recorded at principal balance net of unamortized premiums or discounts.

Fair Value Measurements

The Company discloses the fair value of its financial instruments according to a fair value hierarchy (Levels 1, 2, and 3, as defined). In accordance with U.S. GAAP, the Company is required to provide enhanced disclosures regarding instruments in the Level 3 category (which require significant management judgment), including a separate reconciliation of the beginning and ending balances for each major category of assets and liabilities.

To determine fair value of its financial instruments, the Company generally obtains one price per instrument from its primary valuation service. If this service cannot provide a price, the Company will seek a value from other vendors. The valuation services use various observable inputs which may include a combination of benchmark yields, trades, broker/dealer quotes, issuer spreads, bids, offers and benchmark securities to determine prices. Both the Company and the pricing vendor continuously monitor market indicators and economic events to determine if any may have an impact on the valuations.

Overrides of prices from pricing vendors are rare in the current market environment and with the assets the Company holds. Examples of instances that would cause an override would be if the Company recently traded the same security or there is an indication of market activity that would cause the vendor price to be unreliable. In the rare instance where a price is adjusted, the Company has a control process to monitor the reason for such adjustment.

To gain comfort that vendor prices are representative of current market information, the Company compares the transaction prices of security purchases and sales to the valuation levels provided by the vendors. Price differences exceeding pre-defined tolerance levels are identified and investigated and may be challenged. Trends are monitored over time and if there are indications that the valuations are not comparable to market activity, the vendors are asked to provide detailed information regarding their methodology and inputs. Transparency tools are also available from the vendors which help clients observe data points and/or market inputs used for pricing securities.

In addition, the Company performs due diligence procedures on all vendors on at least an annual basis. A questionnaire is sent to vendors which requests information such as changes in methodologies, business recovery preparedness, internal controls and confirmation that evaluations are generated based on market data. Physical visits are also made to each vendor’s office.

As described in Note 11 - “Financial Instruments,” the Company evaluates the source used to provide the market price for each security and makes a determination on its categorization within the fair value hierarchy. If the price of a security is obtained from quoted prices for similar instruments or model-derived valuations whose inputs are observable, the security is classified as a level 2 security. If the inputs appear to be unobservable, the security would be classified as a level 3 security.

Additionally, U.S. GAAP permits entities to choose to measure many financial instruments and certain other items at fair value (the “fair value option”). Unrealized gains and losses on items for which the fair value option has been elected are irrevocably recognized in earnings at each subsequent reporting date.

The Company elected the fair value option for its investments in unconsolidated ventures. The Company has the one-time option to elect fair value for these financial assets on the election date. The changes in the fair value of these instruments are recorded in equity in earnings and fair value change in unconsolidated ventures in the consolidated statements of operations.

For assets representing available-for-sale investment securities, any change in fair value is reported through consolidated other comprehensive income (loss) with the exception of impairment losses, which are recorded in the consolidated statements of operations.

Securities

The Company designates securities as held-to-maturity, available-for-sale, or trading depending on its ability and intent to hold such securities to maturity. Trading and securities available-for-sale are reported at fair value, while securities held-to-maturity are reported at amortized cost. Although the Company generally intends to hold most of its RMBS and CMBS until maturity, the Company may, from time to time, sell any of its RMBS or CMBS as part of its overall management of its investment portfolio and therefore classifies its RMBS and CMBS as available-for-sale

securities.

All securities classified as available-for-sale are reported at fair value, based on market prices from third-party sources, with unrealized gains and losses excluded from earnings and reported as a separate component of shareholders' equity. When

applicable, included with available-for-sale securities are forward purchase commitments on to-be-announced securities (“TBA”). The Company records TBA purchases on the trade date and the corresponding payable is recorded as an outstanding liability as a payable for investments purchased until the settlement date of the transaction. This payable is presented in the “Investment related payable” line item on the consolidated balance sheets.

The Company considers its portfolio of Agency RMBS to be of high credit quality under the accounting guidance. For non-Agency RMBS and CMBS, the Company does not rely on ratings from third party agencies to determine the credit quality of the investment. To determine expected future losses, the Company uses internal models that analyze the individual loans underlying each security and evaluates factors including, but not limited to, delinquency status, loan-to-value ratios, borrower credit scores, occupancy status and geographic concentration to estimate the expected future cash flows and an expected yield. The Company places reliance on this internal model in determining credit quality and the corresponding accounting treatment.

While non-Agency RMBS and CMBS with expected future losses are generally purchased at a discount to par, the potential for a significant adverse change in expected cash flows remains. The Company therefore considers each security for other-than-temporary impairment at least quarterly and more frequently when economic or market conditions warrant such evaluation.

The determination of whether a security is other-than-temporarily impaired involves judgments and assumptions based on subjective and objective factors. Consideration is given to (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of recovery in fair value of the security, and (iii) the Company’s intent and ability to retain its investment in the security for a period of time sufficient to allow for any anticipated recovery in fair value.

For debt securities, the amount of the other-than-temporary impairment related to a credit loss or impairments on securities that the Company has the intent or for which it is more likely than not that the Company will need to sell before recoveries are recognized in earnings and reflected as a reduction in the cost basis of the security. The amount of the other-than-temporary impairment on debt securities related to other factors is recorded consistent with changes in the fair value of all other available-for-sale securities as a component of consolidated shareholders’ equity in other comprehensive income or loss with no change to the cost basis of the security.

Residential Loans Held-For-Investment

Loans held-for-investment include securitized residential mortgage loans held by VIEs in which the Company has determined it is the primary beneficiary and which are included in the Company's Consolidated Balance Sheets, and are carried at unpaid principal balance net of any allowance for loan losses. The Company expects that it will be required to continue to consolidate the VIEs in which such loans are held and generally does not have the authority to sell the residential loans held in the VIEs.

Commercial Loans Held-For-Investment

Commercial loans held-for-investment include mezzanine loans owned by the Company carried at cost, net of any allowance for loan losses. An allowance for loan losses will be recognized only if past and current events indicate it is probable that all amounts due will not be collected according to the terms of the loan agreement.

Interest Income Recognition

Securities

Interest income on available-for-sale MBS, which includes accretion of discounts and amortization of premiums on such MBS, is recognized over the life of the investment using the effective interest method. Management estimates, at the time of purchase, the future expected cash flows and determines the effective interest rate based on these estimated cash flows and the Company’s purchase price. As needed, these estimated cash flows are updated and a revised yield is computed based on the current amortized cost of the investment. In estimating these cash flows, there are a number of assumptions that are subject to uncertainties and contingencies, including the rate and timing of principal payments (prepayments, repurchases, defaults and liquidations), the pass through or coupon rate and interest rate fluctuations. In addition, management must use its judgment to estimate interest payment shortfalls due to delinquencies on the underlying mortgage loans. These uncertainties and contingencies are difficult to predict and are subject to future events that may impact management’s estimates and its interest income. Security transactions are recorded on the trade

date. Realized gains and losses from security transactions are determined based upon the specific identification method and recorded as gain (loss) on sale of available-for-sale securities in the consolidated statements of operations.

Table of Contents

Residential Loans

Interest income from the Company’s residential loans is recognized on an accrual basis with the related premiums being amortized into interest income using the effective interest method over the weighted average life of these loans. As needed, these estimated cash flows are updated and a revised yield is computed based on the current amortized cost of the investment. In estimating these cash flows, there are a number of assumptions that are subject to estimation, including the interest rate and timing of principal payments (prepayments, repurchases, defaults and liquidations), the timing and amount of expected credit losses, and other factors. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due or has been individually impaired, at which point the loan is placed on nonaccrual status. Interest previously accrued for loans that have been placed on non-accrual status is reversed against interest income in the period it becomes nonaccrual. Residential loans delinquent more than 90 days or in foreclosure are characterized as delinquent. Cash principal and interest that is advanced from servicers subsequent to a loan becoming greater than 90 days past due or individually impaired is recorded as a liability due to the servicer. When a delinquent loan previously placed on nonaccrual status has cured, meaning all delinquent principal and interest have been remitted by the borrower, the loan is placed back on accrual status. Alternately, nonaccrual loans may be placed back on accrual status if restructured and after the loan is considered re-performing. A restructured loan is considered re-performing when the loan has been current for at least 12 months.

Commercial loans

Interest is recognized as revenue when earned and deemed collectible or until a loan becomes past due based on the terms of the loan agreement with the related originating fees, net of origination cost, being amortized into interest income using the effective interest method over the life of the loan. Interest received subsequent to a loan becoming past due or impaired is used to reduce the outstanding loan principal balance. When a delinquent loan previously placed on nonaccrual status has cured, meaning all delinquent principal and interest have been remitted by the borrower, the loan is placed back on accrual status. Alternately, loans that have been individually impaired may be placed back on accrual status if restructured and after the loan is considered re-performing. A restructured loan is considered re-performing when the loan has been current for at least 12 months.

Allowance for Loan Losses

Residential Loans — Allowance for Loan Losses

For residential loans classified as held-for-investment, an allowance for loan losses is established based on the Company's estimate of credit losses. In calculating the allowance for loan losses, the Company assesses expected losses by estimating the probability of default and expected loss severities on the loans. Reviews are performed at least quarterly. The following factors are considered in evaluating the allowance for loan losses:

- Loan-to-value ratios, property values, credit scores, occupancy status, geographic concentration and other observable data available from third party providers;
- Historical prepayments, default rates and loss severities; and
- Trends in delinquencies, loan liquidations, foreclosure timelines, liquidation expenses, servicer advances of delinquent principal and interest, and other observable data related to the servicing of the loans.

Commercial Loans — Allowance for Loan Losses

For commercial loans classified as held-for-investment, we establish a specific allowance for loan losses for loans we have determined to be impaired at the reporting date. An individual loan is considered impaired when it is deemed probable that we will not be able to collect all amounts due according to the contractual terms of the loan.

The Company's methodology for assessing the adequacy of the allowance for loan losses begins with a formal review of each commercial loan in the portfolio to determine whether the loan is impaired. Reviews are performed at least quarterly. We consider the following factors in evaluating each loan:

- Loan to value ratios upon origination or acquisition of the loan;
- The most recent financial information available for each loan and associated properties, including net operating income, debt service coverage ratios, occupancy rates, rent rolls, as well as any other loss factors we consider relevant, such as, but not limited to, specific loan trigger events that would indicate an adverse change in expected

cash flows or payment delinquency;

- Economic trends, both macroeconomic as well as those directly affecting the properties associated with our loans, and the supply and demand of competing projects in the sub-market in which the subject property is located; and

- The loan sponsor or borrowing entity's ability to ensure that properties associated with the loan are managed and operated sufficiently.

Where an individual commercial loan is deemed to be impaired, the Company records an allowance to reduce the carrying value of the loan to the current present value of expected future cash flows discounted at the loan's effective rate, with a corresponding charge to provision for loan losses on our consolidated statements of operations.

Investments in Unconsolidated Ventures

The Company has investments in unconsolidated ventures. In circumstances where the Company has a non-controlling interest but is deemed to be able to exert significant influence over the affairs of the enterprise, the Company utilizes the equity method of accounting. Under the equity method of accounting, the initial investment is increased each period for additional capital contributions and a proportionate share of the entity's earnings and decreased for cash distributions and a proportionate share of the entity's losses.

The Company elected the fair value option for its investments in unconsolidated ventures. The election was made upon initial recognition in the financial statements. The Company has elected the fair value option for the purpose of enhancing the transparency of its financial condition. The Company measures the fair value on the basis of the net asset value per share of the investments.

Dividends and Distributions Payable

Dividends and distributions payable represent dividends declared at the consolidated balance sheet date which are payable to common shareholders, preferred shareholders and distributions declared at the consolidated balance sheet date which are payable to non-controlling interest common unit holders of the Operating Partnership, respectively.

Earnings (Loss) per Share

The Company calculates basic earnings (loss) per share by dividing net income attributable to common shareholders for the period by weighted-average shares of the Company's common stock outstanding for that period. Diluted earnings per share takes into account the effect of dilutive instruments, such as units of limited partnership interest in the Operating Partnership ("OP Units"), exchangeable debt, and unvested restricted stock, but use the average share price for the period in determining the number of incremental shares that are to be added to the weighted-average number of shares outstanding.

Comprehensive Income (Loss)

Comprehensive income (loss) is comprised of net income, as presented in the consolidated statements of operations, adjusted for changes in unrealized gains or losses on available for sale securities and changes in the fair value of derivatives accounted for as cash flow hedges.

Accounting for Derivative Financial Instruments

U.S. GAAP provides disclosure requirements for derivatives and hedging activities with the intent to provide users of financial statements with an enhanced understanding of: (i) how and why an entity uses derivative instruments; (ii) how derivative instruments and related hedged items are accounted for; and (iii) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. U.S. GAAP requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.

The Company records all derivatives on the consolidated balance sheets at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Derivatives may also be designated as hedges of the foreign currency exposure of a net investment in a foreign operation. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are

attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into derivative contracts, such as credit default swaps,

that are intended to economically hedge certain of its risk, even though hedge accounting does not apply or the Company elects not to apply hedge accounting under U.S. GAAP.

Income Taxes

The Company is taxed as a REIT. Accordingly, the Company is generally not subject to U.S. federal and applicable state and local corporate income tax to the extent that the Company makes qualifying distributions to its common shareholders, and provided the Company satisfies on a continuing basis, through actual investment and operating results, the REIT requirements including certain asset, income, distribution and stock ownership tests. If the Company fails to qualify as a REIT, and does not qualify for certain statutory relief provisions, it will be subject to U.S. federal, state and local income taxes and may be precluded from qualifying as a REIT for the subsequent four taxable years following the year in which the Company lost its REIT qualification. Accordingly, the Company's failure to qualify as a REIT could have a material adverse impact on its results of operations and amounts available for distribution to its shareholders.

A REIT's dividend paid deduction for qualifying dividends to the Company's shareholders is computed using its taxable income as opposed to net income reported on the consolidated financial statements. Taxable income, generally, will differ from net income because the determination of taxable income is based on tax regulations and not financial accounting principles.

The Company may elect to treat certain of its future subsidiaries as taxable REIT subsidiaries ("TRS"). In general, a TRS may hold assets and engage in activities that the Company cannot hold or engage in directly and generally may engage in any real estate or non-real estate-related business. A TRS is subject to U.S. federal, state and local corporate income taxes.

If a TRS generates net income, the TRS can declare dividends to the Company which will be included in its taxable income and necessitate a distribution to its shareholders. Conversely, if the Company retains earnings at a TRS level, no distribution is required and the Company can increase book equity of the consolidated entity. The Company has no adjustments regarding its tax accounting treatment of any uncertainties. The Company currently has no uncertain tax positions.

Share-Based Compensation

The Company has adopted an equity incentive plan under which its independent directors, as part of their compensation for serving as directors, are eligible to receive quarterly restricted stock awards. In addition, the Company may compensate the officers and employees of the Manager and its affiliates under this plan pursuant to the management agreement.

Share-based compensation arrangements include share options, restricted share awards, performance-based awards, share appreciation rights, and employee share purchase plans. Compensation costs relating to share-based payment transactions are recognized in the consolidated financial statements, based on the fair value of the equity or liability instruments issued on the date of grant, for awards to the Company's independent directors. Compensation related to stock awards to officers and employees of the Manager and its affiliates is recorded at the estimated fair value of the award during the vesting period. The Company makes an upward or downward adjustment to compensation expense for the difference in the fair value at the date of grant and the date the award is earned.

Dividend Reinvestment and Share Purchase Plan

The Company has implemented a dividend reinvestment and share purchase plan (the "DRSPP"). Under the terms of the DRSPP, shareholders who participate in the DRSPP may purchase shares of common stock directly from the Company. DRSPP participants may also automatically reinvest all or a portion of their dividends for additional shares of common stock.

Reclassifications

The presentation of certain prior period reported amounts has been reclassified to be consistent with the current presentation. Such reclassifications had no impact on net income or equity attributable to common shareholders.

Recent Accounting Pronouncements

In January 2013, the FASB issued Accounting Standards Update 2013-01, "Clarifying the Scope of Disclosure about Offsetting Assets and Liabilities" ("ASU 2013-01"). ASU 2013-01 clarified Accounting Standard Update 2011-11,

"Disclosures about Offsetting Assets and Liabilities" which was issued in December 2011. Entities will be required to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transaction subject to an agreement similar to a master netting arrangement. This scope would include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements. The objective of this disclosure is to facilitate comparison between those entities that prepare their financial statements on a basis of U.S. GAAP basis and those entities that prepare their financial statements on the basis of International Financial Reporting Standards

---

Table of Contents

(IFRS). The guidance was effective for periods beginning on or after January 1, 2013, and interim periods within those annual periods. The additional disclosure requirements were incorporated into Note 10 “Offsetting Assets and Liabilities”.

In February 2013, the FASB issued Accounting Standards Update 2013-02, “Reporting of Amounts Reclassified out of Accumulated Other Comprehensive Income” (“ASU 2013-02”), which adds new disclosure requirements for items reclassified out of accumulated other comprehensive income. ASU 2013-02 does not amend any existing requirements for reporting net income or other comprehensive income in the financial statements and is effective prospectively for reporting periods beginning after December 15, 2012. ASU 2013-02 increased our disclosures related to items reclassified out of accumulated other comprehensive income, but did not have an effect on our consolidated financial statements.

Recent Accounting Pronouncements Not Yet Adopted

None

Note 3 – Variable Interest Entities

During the nine months ended September 30, 2013, the Company purchased through its indirect subsidiary an interest in four securitization trusts (none during the quarter ended September 30, 2013) which the Company determined it is the primary beneficiary. The trusts initially held pools of 1,926 fixed rate residential mortgage loans having an initial aggregate principal balance of $1.5 billion and issued a series of ABS having an aggregate original principal amount of $1.5 billion payable from the cash flows generated by the pools of residential mortgage loans. $1.4 billion of ABS was sold to unaffiliated third parties and the balance was purchased by the Company. The Company's interests in the trusts consist of classes of such ABS having an aggregate original principal balance of $112.3 million, which are either subordinate in payment priority, pay interest only, or are payable from certain designated cash flows from the loans. The Company subsequently sold $5.8 million of the original principal balance to a third party.

In determining if a securitized trust should be consolidated, the Company evaluated whether it was a VIE and, if so, whether the Company’s direct involvement in the VIE reflects a controlling financial interest that would result in the Company being deemed the primary beneficiary. The Company concluded that its interest in the securitized trusts purchased during the nine months ended September 30, 2013 were VIEs because such interests included the power to direct the activities that most significantly impact the economic performance of the VIEs and the obligation to absorb losses or right to receive benefits that are potentially significant to the VIEs. Accordingly, for financial statement reporting purposes, the Company consolidated the underlying assets and liabilities of the securitization trusts at their fair value and, as such, no gain or loss was recorded upon consolidation. The securitizations are non-recourse financing of the residential mortgage loans held-for-investment. The senior securities issued by the securitization trusts and not purchased by the Company, which were sold to unaffiliated third parties, are presented in the consolidated balance sheets as “Asset-backed securities issued.”

The Company is not contractually required and has not provided any additional financial support to the VIEs for the period ended September 30, 2013. The following table presents a summary of the assets and liabilities of the VIEs. Intercompany balances have been eliminated for purposes of this presentation.

$ in thousand	September 30, 2013	December 31, 2012
Residential loans, held-for-investment	1,532,389	—
Accrued interest receivable	4,696	—
Deferred costs	3,065	—
Total assets	1,540,150	—
Accrued interest and accrued expenses payable	3,887	—
Asset-backed securities issued	1,411,897	—
Total liabilities	1,415,784	—

Note 4 – Mortgage-Backed Securities

All of the Company's MBS are classified as available-for-sale and, as such, are reported at fair value, which is determined by obtaining valuations from an independent source. If the fair value of a security is not available from a dealer or third-party pricing service, or such data appears unreliable, the Company may estimate the fair value of the security using a variety of methods including other pricing services, repurchase agreement pricing, discounted cash flow analysis, matrix pricing, option adjusted spread models and other fundamental analysis of observable market factors.

Table of Contents

The following tables present certain information about the Company's investment portfolio as of September 30, 2013 and December 31, 2012.

September 30, 2013

$ in thousands	Principal Balance	Unamortized Premium (Discount)	Amortized Cost	Unrealized Gain/ (Loss), net	Fair Value	Net Weighted Average Coupon (1)	Period-end Weighted Average Yield (2)	Quarterly Weighted Average Yield (3)
Agency RMBS:								
15 year fixed-rate	1,722,520	89,091	1,811,611	28,193	1,839,804	4.02 %	2.24 %	2.35 %
30 year fixed-rate	8,689,193	579,210	9,268,403	(246,644)	9,021,759	3.95 %	2.64 %	2.84 %
ARM	197,033	(468)	196,565	1,335	197,900	2.73 %	2.55 %	2.41 %
Hybrid ARM	977,583	(3,512)	974,071	3,236	977,307	2.56 %	2.39 %	2.19 %
Total Agency pass-through	11,586,329	664,321	12,250,650	(213,880)	12,036,770	3.82 %	2.56 %	2.73 %
Agency-CMO(4)	1,491,381	(1,004,321)	487,060	(4,416)	482,644	2.80 %	3.16 %	2.31 %
Non-Agency RMBS(5)	4,344,281	(646,859)	3,697,422	11,589	3,709,011	3.67 %	3.76 %	4.63 %
CMBS(6)	4,585,928	(2,027,009)	2,558,919	24,335	2,583,254	3.50 %	4.68 %	4.60 %
Total	22,007,919	(3,013,868)	18,994,051	(182,372)	18,811,679	3.66 %	3.10 %	3.34 %

(1) Net weighted average coupon ("WAC") as of September 30, 2013 is presented net of servicing and other fees.

(2) Average yield is based on amortized costs as of September 30, 2013 and incorporates future prepayment and loss assumptions.

(3) Average yield is based on average amortized costs for the three months ended September 30, 2013 and incorporates future prepayment and loss assumptions.

(4) Included in the Agency-CMO are interest-only securities which represent 16.4% of the balance based on fair value.

(5) The non-Agency RMBS held by the Company is 61.0% variable rate, 34.3% fixed rate, and 4.7% floating rate based on fair value.

(6) Included in the CMBS are interest-only securities and commercial real estate mezzanine loan pass-through certificates which represent 8.0% and 1.8% of the balance based on fair value, respectively.

December 31, 2012

$ in thousands	Principal Balance	Unamortized Premium (Discount)	Amortized Cost	Unrealized Gain/ (Loss), net	Fair Value	Net Weighted Average Coupon (1)	Period-end Weighted Average Yield (2)	Quarterly Weighted Average Yield (3)
Agency RMBS:								
15 year fixed-rate	1,964,999	102,058	2,067,057	63,839	2,130,896	4.09 %	2.37 %	2.37 %
30 year fixed-rate	9,168,196	601,592	9,769,788	238,949	10,008,737	4.21 %	2.89 %	2.88 %
ARM	109,937	3,464	113,401	2,365	115,766	3.15 %	2.06 %	2.02 %
Hybrid ARM	556,790	13,493	570,283	16,885	587,168	3.19 %	2.18 %	2.22 %
Total Agency pass-through	11,799,922	720,607	12,520,529	322,038	12,842,567	4.13 %	2.77 %	2.75 %
Agency-CMO(4)	1,322,043	(819,530)	502,513	1,926	504,439	2.89 %	2.35 %	1.51 %
Non-Agency RMBS(5)	3,339,683	(308,885)	3,030,798	48,238	3,079,036	4.20 %	4.61 %	4.80 %
CMBS(6)	1,868,928	24,070	1,892,998	151,523	2,044,521	5.27 %	4.96 %	4.82 %

Total	18,330,576	(383,738)	17,946,838	523,725	18,470,563	4.17 %	3.30 %	3.27 %

(1) Net WAC as of December 31, 2012 is presented net of servicing and other fees.
(2) Average yield based on amortized cost as of December 31, 2012 incorporates future prepayment and loss assumptions.

Table of Contents

(3) Average yield based on average amortized cost for the three months ended December 31, 2012 incorporates future prepayment and loss assumptions.

(4) Included in Agency-CMO are interest-only securities which represent 14.1% of the balance based on fair value.

(5) The non-Agency RMBS held by the Company is 79.2% variable rate, 15.5% fixed rate, and 5.3% floating rate based on fair value.

(6) Included in the CMBS are interest-only securities and commercial real estate mezzanine loan pass-through certificates which represent 0% and 1.1% of the balance based on fair value, respectively.

The following table summarizes our non-Agency RMBS portfolio by asset type as of September 30, 2013 and December 31, 2012, respectively:

$ in thousands	September 30, 2013	% of Non-Agency		December 31, 2012	% of Non-Agency	
Re-REMIC Senior	1,475,475	39.8	%	1,844,209	59.9	%
Prime	1,383,923	37.3	%	754,161	24.5	%
Alt-A	822,815	22.2	%	468,181	15.2	%
Subprime	26,798	0.7	%	12,485	0.4	%
Total Non-Agency	3,709,011	100.0	%	3,079,036	100.0	%

The following table summarizes certain characteristics of our senior Re-REMIC holdings as of September 30, 2013 and December 31, 2012:

	Percentage of Re-REMIC holdings at Fair Value			
Re-REMIC Subordination(1)	September 30, 2013		December 31, 2012	
0-10	3.9	%	2.1	%
10-20	3.5	%	3.2	%
20-30	14.2	%	15.0	%
30-40	25.5	%	27.0	%
40-50	39.5	%	40.4	%
50-60	8.6	%	7.6	%
60-70	4.8	%	4.7	%
Total	100.0	%	100.0	%

(1) Subordination refers to the credit enhancement provided to the senior Re-REMIC tranche by the junior Re-REMIC tranche or tranches in a resecuritization. This figure reflects the percentage of the balance of the underlying security represented by the junior tranche or tranches at the time of resecuritization. Generally, principal losses on the underlying security in excess of the subordination amount would result in principal losses on the senior Re-REMIC tranche.

The components of the carrying value of the Company's investment portfolio at September 30, 2013 and December 31, 2012 are presented below:

$ in thousands	September 30, 2013		December 31, 2012	
Principal balance	22,007,919		18,330,576	
Unamortized premium	758,256		788,716	
Unamortized discount	(3,772,124	)	(1,172,454	)
Gross unrealized gains	284,631		563,093	
Gross unrealized losses	(467,003	)	(39,368	)
Fair value	18,811,679		18,470,563	

15

Table of Contents

The following table summarizes certain characteristics of the Company's investment portfolio, at fair value, according to estimated weighted average life classifications as of September 30, 2013 and December 31, 2012:

$ in thousands	September 30, 2013	December 31, 2012
Less than one year	28,125	70,044
Greater than one year and less than five years	5,625,403	13,146,577
Greater than or equal to five years	13,158,151	5,253,942
Total	18,811,679	18,470,563

The following tables present the gross unrealized losses and estimated fair value of the Company's MBS by length of time that such securities have been in a continuous unrealized loss position at September 30, 2013 and December 31, 2012, respectively:

September 30, 2013

	Less than 12 Months		12 Months or More		Total	
$ in thousands	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Agency RMBS:						
15 year fixed-rate	155,656	(3,048)	11,583	(319)	167,239	(3,367)
30 year fixed-rate	6,274,314	(308,170)	79,392	(1,300)	6,353,706	(309,470)
ARM	34,431	(449)	—	—	34,431	(449)
Hybrid ARM	381,312	(2,818)	—	—	381,312	(2,818)
Total Agency pass-through	6,845,713	(314,485)	90,975	(1,619)	6,936,688	(316,104)
Agency-CMO	228,820	(11,884)	12,810	(4,263)	241,630	(16,147)
Non-Agency RMBS	1,434,914	(58,969)	379,751	(9,708)	1,814,665	(68,677)
CMBS	1,127,151	(66,075)	—	—	1,127,151	(66,075)
Total	9,636,598	(451,413)	483,536	(15,590)	10,120,134	(467,003)

December 31, 2012

	Less than 12 Months		12 Months or More		Total	
$ in thousands	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Agency RMBS:						
15 year fixed-rate	31,269	(279)	—	—	31,269	(279)
30 year fixed-rate	1,763,113	(6,469)	78,640	(832)	1,841,753	(7,301)
Total Agency pass-through	1,794,382	(6,748)	78,640	(832)	1,873,022	(7,580)
Agency-CMO	31,719	(7,796)	10,770	(2,812)	42,489	(10,608)
Non-Agency RMBS	516,744	(6,005)	490,503	(12,895)	1,007,247	(18,900)
CMBS	187,349	(1,267)	52,813	(1,013)	240,162	(2,280)
Total	2,530,194	(21,816)	632,726	(17,552)	3,162,920	(39,368)

Gross unrealized losses on the Company's Agency RMBS were $316.1 million at September 30, 2013. Due to the inherent credit quality of Agency RMBS, the Company determined that at September 30, 2013, any unrealized losses on its Agency RMBS portfolio are temporary.

Gross unrealized losses on the Company's MBS-CMO, non-Agency RMBS, and CMBS were $150.9 million at September 30, 2013. The Company does not consider these unrealized losses to be credit related, but rather due to non-credit related factors such as interest rate spreads, prepayment speeds, and market fluctuations. These investment securities are included in the Company's assessment for other-than-temporary impairment on at least a quarterly basis.

Table of Contents

The following table presents the impact of the Company's MBS on its accumulated other comprehensive income for the three and nine months ended September 30, 2013 and 2012.

$ in thousands	Three Months ended September 30, 2013	Three Months ended September 30, 2012	Nine Months ended September 30, 2013	Nine Months ended September 30, 2012
Accumulated other comprehensive income from investment securities:				
Unrealized gain on MBS at beginning of period	(257,402)	268,269	523,725	(1,217)
Unrealized gain (loss) on MBS, net	75,030	316,823	(706,097)	586,309
Balance at the end of period	(182,372)	585,092	(182,372)	585,092

During the three months ended September 30, 2013 and 2012, the Company reclassified $85.8 million of net unrealized losses and $5.8 million of net unrealized gains, respectively from other comprehensive income into gain (loss) on sale of investments as a result of the Company selling certain investments.
During the nine months ended September 30, 2013 and 2012, the Company reclassified $140.2 million of net unrealized losses and $17.4 million of net unrealized gains, respectively from other comprehensive income into gain on sale of investments as a result of the Company selling certain investments.

The Company assesses its investment securities for other-than-temporary impairment on at least a quarterly basis and more frequently when economic or market conditions warrant such evaluation. When the fair value of an investment is less than its amortized cost at the balance sheet date of the reporting period for which impairment is assessed, the impairment is designated as either "temporary" or "other-than-temporary." The Company evaluates each security that has had a fair value less than amortized cost for three or more consecutive months for other-than-temporary impairment. This analysis includes evaluating the individual loans in each security to determine estimated future cash flows. Individual loan characteristics reviewed include, but are not limited to, delinquency status, loan-to-value ratios, borrower credit scores, occupancy status and geographic concentration. To the extent a security is deemed impaired, the amount by which the amortized cost exceeds the security's market value would be considered other-than-temporary impairment.
The Company did not have other-than-temporary impairments for the three and nine months ended September 30, 2013 and 2012.
The following table presents components of interest income on the Company's MBS portfolio for the three and nine months ended September 30, 2013 and 2012.
For the three months ended September 30, 2013

$ in thousands	Coupon Interest	Net (Premium Amortization)/Discount Accretion	Interest Income
Agency	126,685	(40,578)	86,107
Non-Agency	39,479	2,895	42,374
CMBS	39,167	(10,050)	29,117
Other	(59)	—	(59)
Totals	205,272	(47,733)	157,539

Table of Contents

For the nine months ended September 30, 2013

$ in thousands	Coupon Interest	Net (Premium Amortization)/Discount Accretion	Interest Income
Agency	412,945	(132,648)	280,297
Non-Agency	117,215	6,038	123,253
CMBS	101,487	(18,502)	82,985
Other	84	—	84
Totals	631,731	(145,112)	486,619

For the three months ended September 30, 2012

$ in thousands	Coupon Interest	Net (Premium Amortization)/Discount Accretion	Interest Income
Agency	132,520	(42,479)	90,041
Non-Agency	26,477	4,149	30,626
CMBS	20,330	(477)	19,853
Other	(43)	—	(43)
Totals	179,284	(38,807)	140,477

For the nine months ended September 30, 2012

$ in thousands	Coupon Interest	Net (Premium Amortization)/Discount Accretion	Interest Income
Agency	382,226	(109,717)	272,509
Non-Agency	79,903	15,204	95,107
CMBS	54,146	(209)	53,937
Other	(111)	—	(111)
Totals	516,164	(94,722)	421,442

Note 5 – Residential Loans Held-for-Investment

The following table details the carrying value for residential loans held-for-investment at September 30, 2013 and December 31, 2012. These loans are held by the VIEs which the Company consolidates.

$ in thousands	September 30, 2013	December 31, 2012
Principal balance	1,498,726	—
Unamortized premium, net	34,414	—
Recorded investment	1,533,140	—
Allowance for loan losses	(751)	—
Carrying value	1,532,389	—

We consider a number of factors when evaluating the credit risks associated with our residential loans held-for-investment portfolio, including but not limited to year of origination, delinquency status and geographic concentration.

Table of Contents

The following table displays certain characteristics of the Company's residential loans held-for-investment at September 30, 2013 by year of origination.

$ in thousands	2013		2012		2011	2010	2009		Total	
Portfolio Characteristics:										
Number of Loans	1,299		600		—	—	5		1,904	
Current Principal Balance	992,778		503,747		—	—	2,201		1,498,726	
Net Weighted Average Coupon Rate	3.48	%	3.50	%	—	—	3.54	%	3.49	%
Weighted Average Maturity (years)	29.52		29.28		—	—	25.81		29.43	
Current Performance:										
Current	991,339		502,918		—	—	2,201		1,496,458	
30 Day Delinquent	1,439		829		—	—	—		2,268	
60 Days Delinquent	—		—		—	—	—		—	
90+ Days Delinquent	—		—		—	—	—		—	
Bankruptcy/Foreclosure	—		—		—	—	—		—	
Total	992,778		503,747		—	—	2,201		1,498,726	

The following table presents the five largest geographic concentrations of the Company’s residential loans at September 30, 2013 based on principal balance outstanding:

State	Percent	
California	49.9	%
Illinois	5.9	%
Massachusetts	5.7	%
Virginia	4.3	%
Maryland	4.2	%
Other states (none greater than 4%)	30.0	%
Total	100.0	%

The following table presents future minimum annual principal payments under the residential loans held-for-investment at September 30, 2013:

$ in thousands	
Scheduled Principal	September 30, 2013
Within one year	27,331
One to three years	57,835
Three to five years	62,340
Greater than or equal to five years	1,351,220
Total	1,498,726

Allowance for Loan Losses on Residential Loans

For residential loans held-for-investment, the Company establishes an allowance for loan losses. The following table summarizes the activity in the allowance for loan losses for the nine months ended September 30, 2013:

$ in thousands	September 30, 2013
Balance at beginning of period	—
Charge-offs, net	—
Provision for loan losses	751
Balance at end of period	751

During the quarter ended September 30, 2013 there were no charge-offs of residential loans.

19

Table of Contents

Note 6 – Commercial Loans Held-for-Investment

Commercial loans held-for-investment includes mezzanine loans originated by the Company. These loans are secured by the borrower’s ownership interest in a single purpose entity that owns commercial property, rather than a lien on the commercial property. As of September 30, 2013, the Company had one outstanding commercial loan which was newly originated and was not delinquent on payment. The loan was not impaired and no allowance for loan loss has been recorded.

Note 7 – Investments in Unconsolidated Ventures

The Company’s non-controlling, unconsolidated ownership interests in the following entities are accounted for under the equity method. Capital contributions, distributions, profits and losses of the entities are allocated in accordance with the terms of the entities’ operating agreements. Such allocations may differ from the stated percentage interests, if any, as a result of preferred returns and allocation formulas as described in such agreements. The Company has made the fair value election for its investments in all unconsolidated ventures. The fair value measurement for the investments in unconsolidated ventures is based on the net asset value per share of the investment, or its equivalent.

Invesco Mortgage Recovery Feeder Fund, L.P. and Invesco Mortgage Recovery Loans AIV, L.P.

The Company invested in certain non-Agency RMBS, CMBS and residential and commercial mortgage loans by contributing equity capital to the Invesco Mortgage Recovery Feeder Fund L.P. managed by the Company’s Manager (“Invesco IMRF Fund”) that received financing under the U.S. government’s Public Private Investment Program (“PPIP”). In March 2012, Invesco IMRF Fund returned substantially all of its proceeds and repaid all financing under the PPIP. The Company is awaiting final distribution from the Invesco IMRF Fund. In addition, the Manager identified a whole loan transaction for the Company, which resulted in the Company’s admission into an alternative investment vehicle, the Invesco Mortgage Recovery Loans AIV, L.P. (“AIV”). The Company has a commitment to invest up to $100.0 million in the Invesco IMRF Fund and AIV. As of September 30, 2013, $87.7 million of the Company's commitment has been called, and the Company is committed to fund $12.3 million in additional capital. The Company realized approximately $378,000 (2012: $1.4 million) and $1.3 million (2012: $2.1 million) of equity in earnings for the three and nine months ended September 30, 2013 related to these investments. The Company also had an unrealized gain of $250,000 (2012: $464,000 loss) and an unrealized gain of $1.7 million (2012: $774,000 gain) from these investments for the three and nine months ended September 30, 2013, respectively.

IMRF Loan Portfolio Member LLC

On September 30, 2011, the Company invested in a portfolio of commercial mortgage loans by contributing $16.9 million, net of distributions, of equity capital to IMRF Loan Portfolio Member LLC (“IMRF LLC”), a limited liability company managed by AIV. The Company has fully funded its commitment to IMRF LLC. The Company realized approximately $956,000 (2012: $2.5 million) and $1.0 million (2012: $3.2 million) of equity in earnings for the three and nine months ended September 30, 2013, respectively. The Company also had $163,000 (2012: $191,000) of unrealized depreciation and $1.1 million (2012: $116,000) of unrealized appreciation from these investments for the three and nine months ended September 30, 2013, respectively.

Note 8 – Borrowings

The Company has entered into repurchase agreements and issued exchangeable senior notes to finance the majority of its portfolio of investments. The following table summarizes certain characteristics of the Company’s borrowings as of September 30, 2013 and December 31, 2012:

$ in thousands	September 30, 2013			December 31, 2012		
	Amount Outstanding	Weighted Average Interest Rate	Weighted Average Remaining Maturity (days)	Amount Outstanding	Weighted Average Interest Rate	Weighted Average Remaining Maturity (days)

Agency RMBS	10,958,730	0.37	%	18	11,713,565	0.48	%	16
Non-Agency RMBS	2,995,413	1.55	%	33	2,450,960	1.75	%	23
CMBS	1,943,469	1.42	%	21	1,555,935	1.51	%	18
Exchangeable Senior Notes	400,000	5.00	%	1627	—	—	%	0
Total	16,297,612	0.83	%	60	15,720,460	0.78	%	17

20

Table of Contents

Repurchase Agreements

The repurchase agreements bear interest at a contractually agreed rate. The repurchase obligations mature and typically reinvest every thirty days to one year. Repurchase agreements are being accounted for as secured borrowings since the Company maintains effective control of the financed assets. Under the repurchase agreements, the respective lender retains the right to mark the underlying collateral to fair value. A reduction in the value of pledged assets would require the Company to provide additional collateral or fund margin calls. In addition, the repurchase agreements are subject to certain financial covenants. The Company was in compliance with these covenants at September 30, 2013.

The following tables summarize certain characteristics of the Company's repurchase agreements at September 30, 2013 and December 31, 2012:

September 30, 2013 $ in thousands Repurchase Agreement Counterparties	Amount Outstanding	Percent of Total Amount Outstanding		Company MBS Held as Collateral
Credit Suisse Securities (USA) LLC	1,701,184	10.8	%	1,999,024
Citigroup Global Markets Inc.	1,260,176	7.9	%	1,413,843
Banc of America Securities LLC	1,195,313	7.5	%	1,324,343
South Street Securities LLC	1,167,095	7.3	%	1,224,850
Wells Fargo Securities, LLC	1,094,712	6.9	%	1,263,712
Morgan Stanley & Co. Incorporated	990,095	6.2	%	1,080,265
Pierpont Securities LLC	841,971	5.3	%	892,038
JP Morgan Securities Inc.	830,199	5.2	%	967,291
RBS Securities Inc.	805,749	5.1	%	931,688
ING Financial Market LLC	683,975	4.3	%	736,322
Nomura Securities International, Inc.	591,925	3.7	%	624,060
HSBC Securities (USA) Inc	519,350	3.3	%	537,185
Industrial and Commercial Bank of China Financial Services LLC	511,155	3.2	%	540,954
Mitsubishi UFJ Securities (USA), Inc.	489,904	3.1	%	522,000
Goldman, Sachs & Co.	482,523	3.0	%	516,843
Scotia Capital	452,067	2.8	%	476,569
Royal Bank of Canada	437,539	2.8	%	489,352
Daiwa Capital Markets America Inc	411,106	2.6	%	424,867
Deutsche Bank Securities Inc.	406,303	2.6	%	463,227
BNP Paribas Securities Corp.	368,794	2.3	%	392,547
KGS-Alpha Capital Markets, L.P.	168,750	1.1	%	180,511
Barclays Capital Inc.	163,548	1.0	%	174,961
TD Securities	151,918	1.0	%	165,137
Cantor Fitzgerald & Co.	70,332	0.4	%	74,077
Mizuho Securities USA Inc.	68,179	0.4	%	80,734
Guggenheim Liquidity Services, LLC	33,750	0.2	%	35,599
Total	15,897,612	100.0	%	17,531,999

December 31, 2012 $ in thousands Repurchase Agreement Counterparties	Amount Outstanding	Percent of Total Amount Outstanding		Company MBS Held as Collateral
Credit Suisse Securities (USA) LLC	1,600,331	10.2	%	1,919,676
Morgan Stanley & Co. Incorporated	1,275,616	8.1	%	1,397,846
Nomura Securities International, Inc.	1,240,231	7.9	%	1,350,901
Mitsubishi UFJ Securities (USA), Inc.	941,671	6.0	%	990,057

Wells Fargo Securities, LLC	941,556	6.0	%	1,079,194
HSBC Securities (USA) Inc	883,726	5.6	%	918,551
South Street Securities LLC	819,524	5.2	%	871,963
CitiGroup Global Markets Inc.	780,020	5.0	%	882,517

Table of Contents

Banc of America Securities LLC	728,609	4.6	%	838,216
Scotia Capital	708,750	4.5	%	744,692
Industrial and Commercial Bank of China Financial Services LLC	634,928	4.0	%	690,783
Deutsche Bank Securities Inc.	587,919	3.7	%	666,472
ING Financial Market LLC	573,116	3.6	%	622,944
JP Morgan Securities Inc.	561,426	3.6	%	697,602
Royal Bank of Canada	560,828	3.6	%	641,079
BNP Paribas Securities Corp.	488,375	3.1	%	516,770
Goldman, Sachs & Co.	468,806	3.0	%	509,660
Daiwa Capital Markets America Inc	456,098	2.9	%	479,354
Pierpont Securities LLC	437,095	2.8	%	463,466
Barclays Capital Inc.	350,688	2.3	%	372,708
RBS Securities Inc.	348,741	2.2	%	427,183
Mizuho Securities USA Inc.	101,962	0.6	%	122,836
Cantor Fitzgerald & Co.	80,466	0.5	%	86,961
KGS-Alpha Capital Markets, L.P.	79,052	0.5	%	86,241
Guggenheim Liquidity Services, LLC	43,245	0.3	%	45,437
TD Securities	27,681	0.2	%	33,129
Total	15,720,460	100.0	%	17,456,238

Company MBS held by counterparties as security for repurchase agreements was $17.5 billion and $17.5 billion at September 30, 2013 and December 31, 2012, respectively. This represents a collateral ratio (Company MBS Held as Collateral/Amount Outstanding) of 110% and 111% respectively.

No cash collateral was held by the counterparties at September 30, 2013 and December 31, 2012.

Asset-Backed Securities Issued

During the nine months ended September 30, 2013, the Company purchased controlling interests in four securitization trusts (none during the quarter ended September 30, 2013) which it determined to be VIEs. The securitization trusts securitized residential mortgage loans with an aggregate principal balance of $1.5 billion, and issued $1.5 billion aggregate principal amount of ABS, of which $1.4 billion were sold to unaffiliated third parties and the balance was purchased by the Company. The Company subsequently sold $5.8 million of the original principal balance to a third party. As a result, the ABS issued by the securitization trusts is recorded as a non-recourse liability in the Company's consolidated balance sheets. During the nine months ended September 30, 2013, ABS held by unaffiliated third parties was paid down by $27.8 million.

Table of Contents

The carrying value of the ABS is based on its amortized cost, which is equal to the remaining principal balance net of unamortized premiums or discounts. The following table provides summary information of the carrying value of the ABS issued, along with other relevant information, at September 30, 2013.

$ in thousands	ABS Outstanding	Residential loans Held as Collateral
Principal balance	1,392,952	1,498,726
Interest-only securities	11,412	—
Unamortized premium	10,354	34,414
Unamortized discount	(2,821)	—
Loan loss reserve	—	(751)
Carrying value	1,411,897	1,532,389
Range of weighted average interest rates	2.8% - 3.3%	
Number of series	4	

The following table presents the estimated principal repayment schedule of the VIE's ABS at September 30, 2013, based on estimated cash flows of the residential mortgage loans, as adjusted for projected losses on such loans.

$ in thousands	
Estimated principal repayment	September 30, 2013
Within One Year	172,695
One to Three Years	290,454
Three to Five Years	227,926
Greater Than or Equal to Five Years	701,877
Total	1,392,952

The maturity of the VIEs' ABS is dependent upon cash flows received from the underlying residential mortgage loans. The estimated principal repayments may differ from actual amounts to the extent prepayments and/or loan losses vary. See Note 5 "Residential Loans Held-for-Investment" for a more detailed discussion of the residential loans collateralizing the VIEs' ABS.

Exchangeable Senior Notes

In the first quarter of 2013, a wholly-owned subsidiary of the Company issued $400.0 million in aggregate principal amount of Exchangeable Senior Notes (the "Notes") due 2018. The total net proceeds to the Company after deducting financing expenses was $387.9 million.

The terms of the Notes are governed by an indenture (the "Indenture") by and among the wholly-owned subsidiary, as issuer, the Company, as guarantor, and The Bank of New York Mellon Trust Company, N.A., as trustee (the "Trustee"). The Notes bear interest at 5.00% per annum, payable semi-annually in arrears on March 15 and September 15 of each year, beginning September 15, 2013. The Notes may be exchanged for shares of the Company's common stock at the applicable exchange rate at any time prior to the close of business on the second scheduled trading day prior to the maturity date. The initial exchange rate for each $1,000 aggregate principal amount of the Notes is 42.0893 shares of the Company's common stock, equivalent to an exchange price of approximately $23.76 per share, and the maximum exchange rate is 48.4027 shares of the Company's common stock, equivalent to an exchange price of approximately $20.66 per share. The initial and maximum exchange rates of the Notes are subject to adjustment in certain events.

The Notes have not been registered under the Securities Act of 1933. Pursuant to the registration rights agreement between the Company and the initial purchasers of the Notes, the Company filed a prospectus supplement in August 2013 registering for resale 605,034 shares of common stock issuable upon exchange of the Notes. The Company may be required to register additional shares of common stock issuable upon exchange of the Notes from time to time at the request of holders as required by the registration rights agreement. Accrued interest payable on the Notes is approximately $889,000 as of September 30, 2013.

Note 9 – Derivatives and Hedging Activities

Risk Management Objective of Using Derivatives

The Company is exposed to certain risks arising from both its business operations and economic conditions. The Company principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity, and credit risk primarily by

Table of Contents

managing the amount, sources, and duration of its investments, debt funding, and the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Company's derivative financial instruments are used to manage differences in the amount, timing, and duration of the Company's known or expected cash receipts and its known or expected cash payments principally related to the Company's investments and borrowings.

The Company also utilizes credit derivatives such as credit default swaps ("CDS") to provide credit event protection based on a financial index or specific security in exchange for receiving a fixed-rate fee or premium over the term of the contract. These instruments enable the Company to synthetically assume the credit risk of a reference security, portfolio of securities or index of securities. The counterparty pays a premium to the Company and the Company agrees to make a payment to compensate the counterparty for losses upon the occurrence of a specified credit event. Although contract specific, credit events generally include bankruptcy, failure to pay, restructuring, obligation acceleration, obligation default, or repudiation/moratorium. Upon the occurrence of a defined credit event, the difference between the value of the reference obligation and the CDS's notional amount is recorded as a realized loss in the statement of operations.

The Company's only CDS contract was entered into in the fourth quarter of 2010. The Company sold protection against losses on a specific pool of non-Agency RMBS in the event they exceed a specified loss limit of 25% of the balance of the non-Agency RMBS on the trade date. The maximum exposure is the remaining unpaid principal balance of the underlying RMBS in excess of the specified loss threshold. In exchange, we are paid a stated fixed rate fee of 3% of the notional amount of the CDS. The remaining notional amount of the CDS at September 30, 2013 was $57.5 million ($79.8 million at December 31, 2012), and we estimated the fair market value of the CDS to be approximately $776,000 at September 30, 2013 ($1.5 million at December 31, 2012). As of September 30, 2013, the Company has not made any payments related to the CDS contract.

At September 30, 2013 and December 31, 2012, the open CDS sold by the Company is summarized as follows:

$ in thousand	September 30, 2013	December 31, 2012
Fair value amount	776	1,519
Notional amount	57,450	79,806
Maximum potential amount of future undiscounted payments	57,450	79,806
Recourse provisions with third parties	—	—
Collateral held by counterparty	8,933	12,371

Cash Flow Hedges of Interest Rate Risk

The Company has purchased interest rate swaptions to help mitigate the potential impact of increases or decreases in interest rates on the performance of a portion of the Company's investment portfolio (referred to as "convexity risk"). The interest rate swaptions provide the Company the option to enter into interest rate swap agreements for a predetermined notional amount, stated term and pay and receive interest rates in the future. The premium paid for interest rate swaptions is reported as an asset in the Company's consolidated balance sheets. The premium is valued at an amount equal to the fair value of the swaption that would have the effect of closing the position adjusted for nonperformance risk, if any. The difference between the premium and the fair value of the swaption is reported in unrealized gain (loss) on interest rate swaps and swaptions, net in the Company's Consolidated Statements of Operations. If a swaption expires unexercised, the loss on the swaption would be equal to the premium paid. If we sell or exercise a swaption, the realized gain or loss on the swaption would be equal to the difference between the cash or the fair value of the underlying interest rate swap received and the premium paid. The Company sold swaptions during the three and nine months ended September 30, 2013, realizing a net gain of $39.0 million and $66.2 million, respectively. For the three and nine months ended September 30, 2013, the Company had $42.9 million and $19.0 million of unrealized loss, respectively, which represents the change in fair value of our interest rate swaptions that are recognized directly in earnings.

24

Table of Contents

As of September 30, 2013, the company had the following outstanding interest rate swaptions:

$ in thousands	Option					Underlying Swap			
Swaptions	Expiration	Cost	Fair Value	Average Months to Expiration	Notional Amount	Average Fixed Pay Rate		Average Receive rate	Average Term (Years)
Payer	< 6 Months	25,030	6,684	3.10	1,300,000	3.32	%	3M Libor	10.00
Payer	> 6 Months	8,200	3,651	7.58	400,000	3.76	%	3M Libor	10.00
		33,230	10,335	4.15	1,700,000	3.42	%		10.00

The following table presents information with respect to our derivative instruments:

$ in thousands	Notional Amount as of January 1, 2013	Additions	Settlement, Termination, Expiration or Exercise	Notional Amount as of September 30, 2013	Amount of Realized Gain, net on Interest Rate Derivative Instruments
Swaption Contracts	850,000	4,450,000	(3,600,000)	1,700,000	66,234
Interest Rate Swap	8,000,000	5,100,000	(300,000)	12,800,000	—
U.S. Treasury Futures Contracts	—	100,000	—	100,000	—
Total	8,850,000	9,650,000	(3,900,000)	14,600,000	66,234

The Company finances its activities primarily through repurchase agreements, which are usually settled on a short-term basis, usually from one to twelve months. At each settlement date, the Company refinances each repurchase agreement at the market interest rate at that time. Since the interest rate on its repurchase agreements change on a one to twelve month basis, the Company is exposed to changing interest rates. The Company’s objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps as part of its interest rate risk management strategy. Interest rate swaps, designated as cash flow hedges, involve the receipt of variable-rate amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the agreements without exchange of the underlying notional amount.

During the three months ended September 30, 2013, the Company recorded $298,000 of unrealized swap gains (2012: $319,000 of unrealized swap losses) in earnings as hedge ineffectiveness attributable primarily to differences in the reset dates on the Company’s swaps versus the refinancing dates of certain of its repurchase agreements.

During the nine months ended September 30, 2013, the Company recorded $591,000 of unrealized swap gains (2012: $832,000 of unrealized swap losses) in earnings as hedge ineffectiveness attributable primarily to differences in the reset dates on the Company’s swaps versus the refinancing dates of certain of its repurchase agreements.

Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest expense as interest is accrued and paid on the Company’s repurchase agreements. During the next twelve months, the Company estimates that an additional $197.6 million will be reclassified as an increase to interest expense.

The Company is hedging its exposure to the variability in future cash flows for forecasted transactions over a maximum period of 123 months.

Table of Contents

As of September 30, 2013, the Company had the following interest rate derivatives outstanding, which were designated as cash flow hedges of interest rate risk:

$ in thousands Counterparty		Notional	Maturity Date	Fixed Interest Rate in Contract	
SunTrust Bank		100,000	7/15/2014	2.79	%
Deutsche Bank AG		200,000	1/15/2015	1.08	%
Deutsche Bank AG		250,000	2/15/2015	1.14	%
Credit Suisse International		100,000	2/24/2015	3.26	%
Credit Suisse International		100,000	3/24/2015	2.76	%
Wells Fargo Bank, N.A.		100,000	7/15/2015	2.85	%
Wells Fargo Bank, N.A.		50,000	7/15/2015	2.44	%
Morgan Stanley Capital Services, LLC		300,000	1/24/2016	2.12	%
The Bank of New York Mellon		300,000	1/24/2016	2.13	%
Morgan Stanley Capital Services, LLC		300,000	4/5/2016	2.48	%
Citibank, N.A.		300,000	4/15/2016	1.67	%
Credit Suisse International		500,000	4/15/2016	2.27	%
The Bank of New York Mellon		500,000	4/15/2016	2.24	%
JPMorgan Chase Bank, N.A.		500,000	5/16/2016	2.31	%
Goldman Sachs Bank USA		500,000	5/24/2016	2.34	%
Goldman Sachs Bank USA		250,000	6/15/2016	2.67	%
Wells Fargo Bank, N.A.		250,000	6/15/2016	2.67	%
JPMorgan Chase Bank, N.A.		500,000	6/24/2016	2.51	%
Citibank, N.A.		500,000	10/15/2016	1.93	%
Deutsche Bank AG		150,000	2/5/2018	2.90	%
ING Capital Markets LLC		350,000	2/24/2018	0.95	%
Morgan Stanley Capital Services, LLC		100,000	4/5/2018	3.10	%
ING Capital Markets LLC		300,000	5/5/2018	0.79	%
JPMorgan Chase Bank, N.A.		200,000	5/15/2018	2.93	%
UBS AG		500,000	5/24/2018	1.10	%
ING Capital Markets LLC		400,000	6/5/2018	0.87	%
The Royal Bank of Scotland Plc		500,000	9/5/2018	1.04	%
CME Clearing House	(5)(6)	300,000	2/5/2021	2.50	%
CME Clearing House	(5)(6)	300,000	2/5/2021	2.69	%
Wells Fargo Bank, N.A.		200,000	3/15/2021	3.14	%
Citibank, N.A.		200,000	5/25/2021	2.83	%
HSBC Bank USA, National Association	(3)	550,000	2/24/2022	2.45	%
The Royal Bank of Scotland Plc	(4)	400,000	3/15/2023	2.39	%
UBS AG	(4)	400,000	3/15/2023	2.51	%
HSBC Bank USA, National Association		250,000	6/5/2023	1.91	%
HSBC Bank USA, National Association		250,000	7/5/2023	1.97	%
The Royal Bank of Scotland Plc		500,000	8/15/2023	1.98	%
CME Clearing House	(6)	600,000	8/24/2023	2.88	%
UBS AG	(1)	250,000	11/15/2023	2.23	%
HSBC Bank USA, National Association	(2)	500,000	12/15/2023	2.20	%
Total		12,800,000		2.12	%

(1) Forward start date of November 2013

Table of Contents

(2) Forward start date of December 2013
(3) Forward start date of February 2015
(4) Forward start date of March 2015
(5) Forward start date of February 2016
(6) Beginning June 10, 2013, regulations promulgated under The Dodd-Frank Wall Street Reform and Consumer Protection Act mandate that the Company clear new interest rate swap transactions through a central counterparty. Transactions that are centrally cleared result in the Company facing a clearing house, rather than a swap dealer, as counterparty. Central clearing requires the Company to post collateral in the form of initial and variation margin to the clearing house which reduces default risk.

At September 30, 2013, the Company’s counterparties held $8.1 million of cash margin deposits and approximately $346.0 million in Agency RMBS as collateral against its swap, CDS and futures contracts. In addition, several counterparties posted securities of approximately $171.0 million and $21.0 million of cash as collateral with the Company. Cash margin posted by the Company is classified as due from counterparties, and cash margin posted by counterparties that are restricted in use, if any, is classified as restricted cash. The Agency RMBS collateral posted by the Company is included in the total mortgage-backed securities on the Company’s consolidated balance sheets. Cash collateral that is not restricted for use by the Company is included in Cash and cash equivalents and the liability to return the collateral is included in Collateral held payable on the consolidated balance sheets. Non-cash collateral posted by counterparties to the Company would be recognized if any counterparty defaults or if the Company sold the pledged collateral. As of September 30, 2013, the Company did not recognize any non-cash collateral held as collateral.

U.S. Treasury Futures Contracts

The Company purchases or sells short U.S. Treasury futures contracts to help mitigate the potential impact of changes in interest rates on the performance of the Company's portfolio. Unrealized gains and losses associated with the short sales of the U.S. Treasury futures contracts are recognized in Realized and unrealized gain (loss) on interest rate derivative instruments in the Company's Consolidated Statements of Operations.

Tabular Disclosure of the Effect of Derivative Instruments on the Consolidated Balance Sheets

The table below presents the fair value of the Company’s derivative financial instruments, as well as their classification on the consolidated balance sheets as of September 30, 2013 and December 31, 2012.

$ in thousands

Asset Derivatives				Liability Derivatives			
As of September 30, 2013		As of December 31, 2012		As of September 30, 2013		As of December 31, 2012	
Balance Sheet	Fair Value	Balance Sheet	Fair Value	Balance Sheet	Fair Value	Balance Sheet	Fair Value
Interest rate swap asset	177,398	Interest rate swap asset	—	Interest rate swap liability	313,303	Interest rate swap liability	436,440
CDS	776	CDS	1,519	U.S. Treasury futures	3,367	U.S. Treasury futures	—
Swaption	10,335	Swaption	4,950				

Table of Contents

Tabular Disclosure of the Effect of Derivative Instruments on the Income Statement
The table below presents the effect of the Company's derivative financial instruments on the statement of operations for the three and nine months ended September 30, 2013 and 2012.
Three months ended September 30, 2013
$ in thousands

Derivative type for cash flow hedge	Amount of gain (loss) recognized in OCI on derivative (effective portion)	Location of loss reclassified from accumulated OCI into income (effective portion)	Amount of loss reclassified from accumulated OCI into income (effective portion)	Location of gain recognized in income on derivative (ineffective portion)	Amount of gain (loss) recognized in income on derivative (ineffective portion)
Interest Rate Swap	(74,098)	Interest Expense	43,583	Realized and unrealized gain (loss) on interest rate derivative instruments	298

Nine months ended September 30, 2013
$ in thousands

Derivative type for cash flow hedge	Amount of gain (loss) recognized in OCI on derivative (effective portion)	Location of loss reclassified from accumulated OCI into income (effective portion)	Amount of loss reclassified from accumulated OCI into income (effective portion)	Location of gain recognized in income on derivative (ineffective portion)	Amount of gain (loss) recognized in income on derivative (ineffective portion)
Interest Rate Swap	183,391	Interest Expense	116,553	Realized and unrealized gain (loss) on interest rate derivative instruments	591

Three months ended September 30, 2012
$ in thousands

Derivative type for cash flow hedge	Amount of gain (loss) recognized in OCI on derivative (effective portion)	Location of loss reclassified from accumulated OCI into income (effective portion)	Amount of loss reclassified from accumulated OCI into income (effective portion)	Location of loss recognized in income on derivative (ineffective portion)	Amount of gain (loss) recognized in income on derivative (ineffective portion)
Interest Rate Swap	(60,716)	Interest Expense	35,763	Realized and unrealized gain (loss) on interest rate derivative instruments	(319)

Nine months ended September 30, 2012
$ in thousands

Derivative	Amount of gain	Location of loss	Amount of loss	Location of loss

type for cash flow hedge	(loss) recognized in OCI on derivative (effective portion)	reclassified from accumulated OCI into income (effective portion)	reclassified from accumulated OCI into income (effective portion)	recognized in income on derivative (ineffective portion)	Amount of gain (loss) recognized in income on derivative (ineffective portion)
Interest Rate Swap	(181,280)	Interest Expense	107,051	Realized and unrealized gain (loss) on interest rate derivative instruments	(832)

Table of Contents

Derivative not designated as hedging instrument	Location of unrealized gain (loss) recognized in income on derivative	Amount of gain (loss) recognized in income on derivative	
		Three months ended September 30, 2013	Three months ended September 30, 2012
CDS Contract	Realized and unrealized credit default swap income	(175)	643
Swaption Contract	Realized and unrealized gain (loss) on interest rate derivative instruments	(42,891)	(489)
Futures Contract	Realized and unrealized gain (loss) on interest rate derivative instruments	(3,369)	—

Derivative not designated as hedging instrument	Location of unrealized gain (loss) recognized in income on derivative	Amount of gain (loss) recognized in income on derivative	
		Nine months ended September 30, 2013	Nine months ended September 30, 2012
CDS Contract	Realized and unrealized credit default swap income	(743)	406
Swaption Contract	Realized and unrealized gain (loss) on interest rate derivative instruments	(19,032)	(2,019)
Futures Contract	Realized and unrealized gain (loss) on interest rate derivative instruments	(3,369)	—

Credit-risk-related Contingent Features

The Company has agreements with each of its derivative counterparties. Some of those agreements contain a provision whereby if the Company defaults on any of its indebtedness, including default whereby repayment of the indebtedness has not been accelerated by the lender, then the Company could also be declared in default on its derivative obligations.

The Company's agreements with certain of its derivative counterparties provide that if the Company's net asset value declines by certain percentages over specified time periods, then the Company could be declared in default on its derivative obligations with that counterparty. The Company's agreements with certain of its derivative counterparties provide that if the Company's shareholders' equity declines by certain percentages over specified time periods, then the Company could be declared in default on its derivative obligations with that counterparty.

The Company's agreements with certain of its derivative counterparties provide that if the Company fails to maintain a minimum shareholders' equity or market value of $100 million and $80 million, respectively, then the Company could be declared in default on its derivative obligations with that counterparty.

As of September 30, 2013, the fair value of derivatives in a net liability position, which includes accrued interest but excludes any adjustment for non-performance risk related to these agreements, was $296.7 million. The Company has minimum collateral posting thresholds with certain of its derivative counterparties and has posted collateral of $346.0 million of Agency RMBS and $8.1 million of cash as of September 30, 2013. If the Company had breached any of these provisions at September 30, 2013, it could have been required to settle its obligations under the agreements at their termination value.

The Company was in compliance with all of the financial provisions of these agreements through September 30, 2013.

Table of Contents

Note 10 – Offsetting Assets and Liabilities

The following tables present information about certain assets and liabilities that are subject to master netting agreements (or similar agreements) and can potentially be offset on the Company's consolidated balance sheets at September 30, 2013 and December 31, 2012.

Offsetting of Derivative Assets

As of September 30, 2013