

Western Asset Mortgage Capital Corp  
Form 10-K  
March 11, 2016

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, D.C. 20549

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**FORM 10-K**

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

For the fiscal year ended December 31, 2015

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File Number: 001-35543

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**WESTERN ASSET MORTGAGE CAPITAL CORPORATION.**

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**27-0298092**  
(I.R.S. Employer  
Identification No.)

**Western Asset Mortgage Capital Corporation**  
**385 East Colorado Boulevard**  
**Pasadena, California 91101**  
(Address of principal executive offices)

**(626) 844-9400**  
(Registrant's telephone number, including area code)

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

| Title of Each Class            | Name of Each Exchange on Which Registered |
|--------------------------------|---|
| Common Stock, \$0.01 par value | New York Stock Exchange                   |

Securities registered pursuant to Section 12(g) of the Act: **None**

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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.

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if a 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

The aggregate market value of the registrant's common stock held by non-affiliates was \$597,351,534 based on the closing sales price on the New York Stock Exchange on June 30, 2015.

On March 8, 2016, the registrant had a total of 41,919,801 shares of common stock outstanding.

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**FORWARD-LOOKING INFORMATION**

The Company makes forward-looking statements herein and will make forward-looking statements in future filings with the Securities and Exchange Commission (the "SEC"), press releases or other written or oral communications within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act"), and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). For these statements, the Company claims the protections of the safe harbor for forward-looking statements contained in such sections. Forward-looking statements are subject to substantial risks and uncertainties, many of which are difficult to predict and are generally beyond the Company's control. These forward-looking statements include information about possible or assumed future results of the Company's business, financial condition, liquidity, results of operations, plans and objectives. When the Company uses the words "believe," "expect," "anticipate," "estimate," "plan," "continue," "intend," "should," "may" or similar expressions, the Company intends to identify forward-looking statements. Statements regarding the following subjects, among others, may be forward-looking: market trends in the Company's industry, interest rates, real estate values, the debt securities markets, the U.S. housing and the U.S. and foreign commercial real estate markets or the general economy or the market for residential and/or commercial mortgage loans; the Company's business and investment strategy; the Company's projected operating results; actions and initiatives of the U.S. Government and changes to U.S. Government policies and the execution and impact of these actions, initiatives and policies; the state of the U.S. and to a lesser extent, international economy generally or in specific geographic regions; economic trends and economic recoveries; the Company's ability to obtain and maintain financing arrangements, including securitizations; the current potential return dynamics available in residential mortgage-backed securities ("RMBS"), and commercial mortgage-backed securities ("CMBS" and collectively with RMBS, "MBS"); the level of government involvement in the U.S. mortgage market; the anticipated default rates on Agency and Non-Agency MBS (as defined herein); the loss severity on Non-Agency MBS; the return of the Non-Agency RMBS, CMBS and asset-backed securities ("ABS") securitization markets; the general volatility of the securities markets in which the Company participates; changes in the value of the Company's assets; the Company's expected portfolio of assets; the Company's expected investment and underwriting process; interest rate mismatches between the Company's target assets and any borrowings used to fund such assets; changes in interest rates and the market value of the Company's target assets; changes in prepayment rates on the Company's target assets; effects of hedging instruments on the Company's target assets; rates of default or decreased recovery rates on the Company's target assets; the degree to which the Company's hedging strategies may or may not protect the Company from interest rate and foreign currency volatility; the impact of and changes in governmental regulations, tax law and rates, accounting guidance and similar matters; the Company's ability to maintain the Company's qualification as a real estate investment trust for U.S. federal income tax purposes; the Company's ability to maintain its exemption from registration under the Investment Company Act of 1940, as amended (the "1940 Act"); the availability of opportunities to acquire Agency RMBS, Non-Agency RMBS, CMBS, Residential and Commercial Whole-Loans and other mortgage assets; the availability of opportunities to acquire ABS; the availability of qualified personnel; estimates relating to the Company's ability to make distributions to its stockholders in the future; and the Company's understanding of its competition.

The forward-looking statements are based on the Company's beliefs, assumptions and expectations of its future performance, taking into account all information currently available to it. Forward-looking statements are not predictions of future events. These beliefs, assumptions and expectations can change as a result of many possible events or factors, not all of which are known to the Company. Some of these factors, are described in "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" of this annual report on Form 10-K. These and other risks, uncertainties and factors, including those described in the annual, quarterly and current reports that the Company files with the SEC, could cause its actual results to differ materially from those included in any forward-looking statements the Company makes. All forward-looking statements speak only as of the date they are made. New risks and uncertainties arise over time and it is not possible to predict those events or how they may affect the Company. Except as required by law, the Company is not obligated to, and does not intend to, update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

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**Part I**

**Item 1. Business.**

**Our Company**

Western Asset Mortgage Capital Corporation and Subsidiaries (the "Company" unless otherwise indicated or except where the context otherwise requires "we", "us" or "our") is a Delaware corporation commencing operations in May 2012, focused on investing in, financing and managing a diversified portfolio of real estate related securities, whole loans and other financial assets. Our investment strategy is based on Western Asset Management Company's (our "Manager") perspective of which mix of portfolio assets it believes provides us with the best risk-reward opportunities at any given time. Our Manager will vary the allocation among various asset classes subject to maintaining our qualification as a REIT under the federal tax law and maintaining our exemption from the 1940 Act. These restrictions limit our ability to invest in non-real estate assets and/or assets which are not secured by real estate.

We raised approximately \$720.0 million, after subtracting underwriting commissions and offering expenses, and have invested the proceeds of our initial public offering or IPO and concurrent private placements along with proceeds from our follow-on public offerings and accompanying private placement primarily in Agency RMBS, including Mortgage pass-through certificates, Agency derivatives, Agency Interest-Only Strips, and Agency CMOs; Non-Agency RMBS; Agency CMBS, Non-Agency CMBS, Non U.S. CMBS, ABS as well as Residential and Commercial Whole-Loans. We have also used "to-be-announced" forward contracts, or TBAs, in order to invest in Agency RMBS. Pursuant to these TBAs, we agree to purchase (or deliver), for future settlement, Agency RMBS with certain principal and interest terms and certain underlying collateral.

At December 31, 2015, our investment portfolio was comprised of approximately \$1.7 billion of Agency RMBS (including approximately \$117.3 million of Agency Interest-Only Strips), approximately \$530.2 million of Non-Agency RMBS (including approximately \$84.7 million of Non-Agency Interest-Only Strips), approximately \$37.9 million of Agency CMBS (including approximately \$13.2 million of Agency CMBS Interest-Only Strips), approximately \$450.9 million of Non-Agency CMBS, approximately \$101.1 million of other securities and approximately \$218.5 million of Residential Whole-Loans. In addition, we acquired a \$14.0 million controlling financial interest in a CMBS trust, which resulted in the consolidation of the assets and liabilities of the trust. As a result of the consolidation of the CMBS trust, our holdings included a \$25.0 million securitized commercial loan.

We generate income principally from the difference between the yields earned on our investments and our cost of borrowing and any hedging activity. We use leverage as part of our business strategy in order to increase potential returns to our stockholders. We primarily finance our investments through short-term borrowings structured as repurchase agreements. We may also change our financing strategy and leverage without the consent of our stockholders.

As of December 31, 2015, we had entered into master repurchase agreements or MRAs with 26 counterparties. As of December 31, 2015, we had approximately \$2.6 billion of borrowings outstanding under our repurchase agreements collateralized by approximately \$3.0 billion of our investments. We have entered into approximately \$3.2 billion of interest rate swaps to effectively fix the interest rate of our borrowings under our repurchase agreements; net of variable-rate payment interest rate swaps of approximately \$2.3 billion, and excluding forward starting interest rate swaps of \$710.0 million. In addition, as of December 31, 2015, we also owned swaptions on approximately an incremental \$105.0 million notional of interest rate swaps. As of December 31, 2015, our aggregate debt-to-equity ratio was approximately 5.1 to 1.

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We operate and elected to be taxed as a real estate investment trust ("REIT"), commencing with our taxable year ended December 31, 2012. To comply with the REIT requirements, some of our investments were held in a taxable REIT subsidiary or "TRS". By acquiring investments or engaging in activities through the TRS, it enables us to engage in such activities without jeopardizing our REIT status. These investments or activities are not held or conducted at the REIT level and as a result would not impact our ability to maintain our qualification as a REIT. We generally will not be subject to U.S. federal income taxes on our taxable income to the extent that we annually distribute, in accordance with the REIT regulations, all of our net taxable income to stockholders and maintain our intended qualification as a REIT.

We also intend to operate our business in a manner that will permit us to maintain our exemption from registration under the 1940 Act.

## **Our Manager**

We are externally managed and advised by our Manager, an SEC-registered investment advisor and a wholly-owned subsidiary of Legg Mason, Inc., headquartered in Pasadena, California, that specializes in fixed-income asset management. From offices in Pasadena, Dubai, Hong Kong, London, Melbourne, New York, São Paulo, Singapore and Tokyo, our Manager's 821 employees provide investment services for a wide variety of global clients, including mutual funds, corporate, public, insurance, health care, union organizations and charitable foundations. As of December 31, 2015, our Manager and its investment advisory affiliates over which our Manager has operational responsibility, or its supervised affiliates, had approximately \$433.7 billion in assets under management. All of our officers are employees of our Manager, except for our interim chief financial officer who acts in such capacity under an agreement with us and her employer, FTI Consulting, Inc. In addition, two of our directors, James W. Hirschmann III and Gavin L. James, are also employees of our Manager. Our Manager is responsible for, among other duties: (i) performing all of our day-to-day functions; (ii) determining investment criteria in conjunction with our Board of Directors; (iii) sourcing, analyzing and executing investments, asset sales and financings; (iv) performing asset management duties; and (v) performing financial and accounting management.

## **Our Investment Strategy**

Our Manager's investment philosophy, which developed from a singular focus in fixed-income asset management over a variety of credit cycles and conditions, is to provide clients with diversified, tightly controlled, long-term value-oriented portfolios. Through rigorous analysis of all sectors of the fixed-income market, our Manager seeks to identify assets with the greatest risk-adjusted total value potential. In making investment decisions on our behalf, our Manager incorporates its views on the economic environment and the outlook for the mortgage markets, including relative valuation, supply and demand trends, the level of interest rates, the shape of the yield curve, prepayment rates, financing and liquidity, commercial and residential real estate prices, delinquencies, default rates, recovery of various segments of the economy and vintage of collateral, subject to maintaining our REIT qualification and our exemption from registration under the 1940 Act. We benefit from the breadth and depth of our Manager's overall investment philosophy, which focuses on a macroeconomic analysis as well as an in-depth analysis of individual assets and their relative value.

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Our target assets are Agency RMBS (including to-be-announced securities or TBAs) and Non-Agency RMBS, Agency CMBS, Non-Agency CMBS, Non U.S. CMBS, ABS, Whole-Loans and Whole-Loan securities. Our goal for 2015 was, and looking forward to 2016, is to deploy an increasing portion of our capital to expand our purchase of Non-Agency RMBS, Non-Agency CMBS, Whole-Loans and Whole-Loan securities as well as Non U.S. CMBS and ABS. This expansion resulted in a shift towards a more diversified credit sensitive portfolio. We do not have specific investment guidelines providing for precise minimum or maximum allocations to any sector other than those necessary for maintaining our qualification as a REIT and our exemption from the 1940 Act. These regulatory limits may limit our ability to shift away from Agency securities and diversify the portfolio. Our Manager has not and does not expect to purchase securities on our behalf with a view to selling them shortly after purchase. However, in order to maximize returns and manage portfolio risk while remaining opportunistic, we may dispose of securities earlier than anticipated or hold securities longer than anticipated depending upon prevailing market conditions, credit performance, availability of leverage or other factors regarding a particular asset and/or our capital position.

As of December 31, 2015, the fair value of our investment portfolio, excluding the securitized commercial loan from a consolidated VIE, was comprised of 56.4% of Agency RMBS, 17.3% of Non-Agency RMBS, 1.2% of Agency CMBS, 14.7% of Non-Agency CMBS, 3.3% of other securities and 7.1% of Residential Whole-Loans.

**Our Target Assets**

We have invested the proceeds of our IPO, concurrent private placements and follow-on public offerings and expect to continue to focus on investing in the following types of securities:

*Agency RMBS.* Agency RMBS, which are RMBS for which the principal and interest payments are guaranteed by a U.S. Government agency, such as the Government National Mortgage Association ("GNMA" or "Ginnie Mae"), or a U.S. Government-sponsored entity, such as the Federal National Mortgage Association ("FNMA" or "Fannie Mae") or the Federal Home Loan Mortgage Corporation ("FHLMC" or "Freddie Mac"). The Agency RMBS we acquire can be secured by fixed-rate mortgages, adjustable-rate mortgages or hybrid adjustable-rate mortgages. Fixed-rate mortgages have interest rates that are fixed for the term of the loan and do not adjust. The interest rates on adjustable-rate mortgages generally adjust annually (although some may adjust more frequently) to an increment over a specified interest rate index. Hybrid adjustable-rate mortgages have interest rates that are fixed for a specified period of time (typically three, five, seven or ten years) and, thereafter, adjust to an increment over a specified interest rate index. Adjustable-rate mortgages and hybrid adjustable-rate mortgages generally have periodic and lifetime constraints on the amount by which the loan interest rate can change on any predetermined interest rate reset date.

*Mortgage pass-through certificates.* Mortgage pass-through certificates are securities representing interests in "pools" of mortgage loans secured by residential real property where payments of both interest and scheduled principal, plus pre-paid principal, on the underlying loan pools are made monthly to holders of the securities, in effect "passing through" monthly payments made by the individual borrowers on the mortgage loans that underlie the securities, net of fees paid to the issuer/guarantor of the securities and servicers of the underlying mortgages.

*Interest-Only Strips or IOs.* This type of security entitles the holder only to payments of interest based on a notional principal balance. The yield to maturity of Interest-Only Strips is extremely sensitive to the rate of principal payments (particularly prepayments) on the underlying pool of mortgages. We invest in these types of securities primarily to take advantage of particularly attractive prepayment-related or structural opportunities in the MBS markets, as well as to help manage the duration of our overall portfolio

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*Inverse Interest-Only Strips or IIOs.* This type of security has a coupon with an inverse relationship to its index and is subject to caps and floors. Inverse Interest-Only MBS entitles the holder to interest only payments based on a notional principal balance, which is typically equal to a fixed rate of interest on the notional principal balance less a floating rate of interest on the notional principal balance that adjusts according to an index subject to set minimum and maximum rates. The current yield of Inverse Interest-Only MBS will generally decrease when its related index rate increases and increase when its related index rate decreases.

*Principal-Only Strips or POs.* This type of security generally only entitles the holder to receive cash flows that are derived from principal repayments of an underlying loan pool, but in the case of Non-Agency Principal-Only Strips will also include cash flows from default recoveries and excess interest. The yield to maturity of Principal-Only Strips is extremely sensitive to the rate of principal payments (particularly prepayments) on the underlying pool of mortgages. We invest in these types of securities primarily to take advantage of structural opportunities in the MBS markets.

*TBAs.* We may utilize TBAs, in order to invest in Agency RMBS. Pursuant to these TBAs, we agree to purchase (or deliver), for future settlement, Agency RMBS with certain principal and interest terms and certain underlying collateral, but the particular Agency RMBS to be delivered is not identified until shortly before the TBA settlement date. Our ability to invest in Agency RMBS through TBAs may be limited by the 75% real estate income and asset tests applicable to REITs.

*Collateralized Mortgage Obligations or CMOs.* These are securities that are structured from residential and/or commercial pass-through certificates, which receive monthly payments of principal and interest. CMOs divide the cash flows which come from the underlying mortgage pass-through certificates into different classes of securities that may have different maturities and different weighted average lives than the underlying pass-through certificates.

*Non-Agency RMBS.* RMBS that are not guaranteed by a U.S. Government agency or U.S. Government-sponsored entity, with an emphasis on securities that when originally issued were rated in the highest rating category by one or more of the nationally recognized statistical rating organizations. The mortgage loan collateral for Non-Agency RMBS consists of residential mortgage loans that do not generally conform to underwriting guidelines issued by a U.S. Government agency or U.S. Government-sponsored entity due to certain factors, including mortgage balances in excess of Agency underwriting guidelines, borrower characteristics, loan characteristics and/or level of documentation, and therefore are not issued or guaranteed by a U.S. Government agency or U.S. Government-sponsored entity. The mortgage loan collateral may be classified as subprime, Alternative-A or prime depending on the borrower's credit rating and the underlying level of documentation. Non-Agency RMBS may be secured by fixed-rate mortgages, adjustable-rate mortgages or hybrid adjustable-rate mortgages.

*Agency CMBS.* Fixed and floating rate CMBS, for which the principal and interest payments are guaranteed by a U.S. Government agency or U.S. Government-sponsored entity, but for which the underlying mortgage loans are secured by real property other than single family residences. These may include, but are not limited to Fannie Mae DUS (Delegated Underwriting and Servicing) MBS, Freddie Mac Multifamily Mortgage Participation Certificates, Ginnie Mae project loan pools, and/or CMOs structured from such collateral.

*Non-Agency CMBS.* Fixed and floating rate CMBS for which the principal and interest payments are not guaranteed by a U.S. Government agency or U.S. Government-sponsored entity. We mainly acquire legacy securities that when originally issued were rated in the highest rating category by one or more of the nationally recognized statistical rating organizations but we have also invested in subordinated debt for which the property (properties) securing the underlying mortgage collateral is located within the U. S. or the European Union. We do not have an established minimum current rating requirement for such investments.



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*Non U.S. CMBS.* CMBS which is not guaranteed by a U.S. Government agency or U.S. Government-sponsored entity and which is secured by commercial real estate located outside of the U.S. Although our Manager believes that these investments can provide attractive risk-reward opportunities and offer additional asset diversification, investing in international real estate has a number of additional risks, including but not limited to currency risk, political risk and the legal risk of investing in jurisdiction(s) with varying laws and regulations and potential tax implications. See Item 7A: Quantitative and Qualitative Disclosures about Market Risk Foreign Investment Risk and Currency Risk herein.

*Agency and Non-Agency CMBS IO and IIO Securities.* Interest-Only and Inverse Interest-Only securities for which the underlying collateral is commercial mortgages the principal and interest on which may or may not be guaranteed by a U.S. Government agency or U.S. Government-sponsored entity. Unlike single family residential mortgages in which the borrower, generally, can prepay at any time, commercial mortgages frequently limit the ability of the borrower to prepay, thereby providing a certain level of prepayment protection. Common restrictions include yield maintenance and prepayment penalties, the proceeds of which are generally at least partially allocable to these securities, as well as, defeasance.

*Risk Sharing Securities Issued by Fannie Mae and Freddie Mac.* From time to time we have and may in the future continue to invest in risk sharing securities issued by Fannie Mae and Freddie Mac. Principal and interest payments on these securities are based on the performance of a specified pool of Agency residential mortgages. The payments due on these securities, however, are not secured by the referenced mortgages, but are full faith and credit obligations of Fannie Mae or Freddie Mac respectively. Investments in these securities generally are not qualifying assets for purposes of the 75% real estate asset test applicable to REITs and generally do not generate qualifying income for purposes of the 75% real estate income test applicable to REITs. As a result, we may be limited in our ability to invest in such assets.

*ABS.* Debt and/or equity tranches of securitizations backed by various asset classes including, but not limited to, aircrafts, automobiles, credit cards, equipment, franchises, recreational vehicles and student loans. Investments in ABS generally are not qualifying assets for purposes of the 75% real estate asset test applicable to REITs and generally do not generate qualifying income for purposes of the 75% real estate income test applicable to REITs. As a result, we may be limited in our ability to invest in such assets.

*Residential Whole-Loans.* Residential Whole-Loans are mortgages secured by single family residences held directly by us or through structured Non Agency RMBS programs crafted specifically for us and other clients of our Manager. To date our Residential Whole-Loans have been mostly adjustable rate loans that do not qualify for the Consumer Finance Protection Bureau's (or CFPB) safe harbor provision for "qualifying mortgages". However, our Manager's review, relating to possible purchases of loans, includes an analysis of the loan originator's procedures and documentation for compliance with Ability to Repay requirements. These loans are held in consolidated trusts with the Company holding the beneficial interest in the trusts. The Company may in the future securitize the whole-loan interests, selling more senior interests in the pool of loans and retaining residual portions. The characteristics of the Company's Residential Whole-Loans may vary going forward.

*Commercial Whole-Loans.* Our Manager is also actively exploring opportunities to invest in small balance, \$2.5 million to \$25.0 million, Commercial Whole-Loans, including commercial mortgages and Small Business Administration or SBA loans secured primarily by real estate. While our Manager has experience in CMBS and we currently invest in Agency and Non-Agency CMBS, as well as, Non U.S. CMBS, investing in Whole-Loans backed or secured by commercial real estate assets involves complex investment, structural, regulatory and accounting issues. Some of these issues are unique to Commercial Whole-Loans as opposed to residential mortgages. Accordingly, there is no assurance of the prevalence such investments will have in our overall portfolio in the future.

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*Other investments.* In addition to MBS, our principal investment, and ABS from time to time, we may also make other investments in securities, which our Manager believes will assist us in meeting our investment objective and are consistent with our overall investment policies. These investments will normally be limited by the REIT requirements that 75% our assets be real estate assets and that 75% of our income be generated from real estate, thereby limiting our ability to invest in such assets.

**Our Financing Strategy**

The leverage that we employ is specific to each asset class and is determined based on several factors, including potential asset price volatility, margin requirements, the current cycle for interest rates, the shape of the yield curve, the outlook for interest rates and our ability to use and the effectiveness of interest rate hedges. We analyze both historical volatility and market-driven implied volatility for each asset class in order to determine potential asset price volatility. Our leverage targets attempt to risk-adjust asset classes based on each asset class's potential price volatility. The goal of our leverage strategy is to ensure that, at all times, our investment portfolio's overall leverage ratio is appropriate for the level of risk inherent in the investment portfolio.

We may fund the acquisition of our assets through the use of leverage from a number of financing sources, subject to maintaining our qualification as a REIT. We finance our investments primarily through the use of repurchase agreements.

Our operating results depend in large part on differences between the income earned on our assets and our cost of borrowing and hedging activities. We use leverage to increase potential returns to our stockholders. We currently accomplish this by borrowing against existing investments through repurchase agreements. We may also change our financing strategy and leverage without the consent of our stockholders.

The costs associated with our borrowings are generally based on prevailing market interest rates. During a period of rising interest rates, our borrowing costs generally will increase while the yields earned on our existing portfolio of leveraged fixed-rate MBS and other fixed rate securities will remain static. This could result in a decline in our net interest spread and net interest margin. The severity of any such decline would depend on our asset/liability composition at the time, as well as the magnitude and duration of the interest rate increase. Further, an increase in short-term interest rates could also have a negative impact on the market value of our assets. If either of these events happens, we could experience a decrease in net income or incur a net loss during these periods, which could adversely affect our liquidity and results of operations.

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We primarily finance our investments through repurchase agreements for which we pledge our assets. Our pledged assets are currently comprised of Agency RMBS, Non-Agency RMBS, Agency CMBS, Non-Agency CMBS, other securities and Residential Whole-Loans. Our repurchase agreements have maturities generally ranging from one to three months, but in some cases longer. The amount borrowed under our repurchase agreements is a specified percentage of the asset's fair value, which is dependent on the collateral type. The portion of the pledged collateral held by the counterparty in excess of the amount borrowed under the repurchase agreement is the margin requirement for that borrowing. Repurchase agreements involve the transfer of the pledged collateral to a counterparty at an agreed upon price in exchange for such counterparty's simultaneous agreement to return the same security back to the borrower at a future date (i.e., the maturity of the borrowing). Under our repurchase agreements, we retain beneficial ownership of the pledged collateral, while the counterparty maintains custody of such collateral. At the maturity of a repurchase financing, unless the repurchase financing is renewed with the same counterparty, we are required to repay the loan, including any accrued interest, and concurrently reacquire custody of the pledged collateral or, with the consent of the counterparty, we may renew the repurchase financing at the then prevailing market interest rate and terms. Margin calls from counterparties are routinely experienced by us when the fair value of our existing pledged collateral declines as a result of principal amortization and prepayments or due to changes in market interest rates, spreads or other market conditions. As a result, the counterparty will require that we pledge additional securities and/or cash as collateral to secure our borrowings under repurchase financing. In certain circumstances, we also may make margin calls on our counterparties when collateral values increase. As of December 31 2015, we had \$38.3 million of cash collateral held by our repurchase agreement counterparties and we have satisfied all of our margin calls.

We expect to maintain a debt to equity ratio of three to ten times the amount of our stockholders' equity, although there is no stated minimum or maximum leverage in our investment policies. To the extent the Agency MBS percentage of our portfolio decreases, our overall leverage is likely to decrease. Depending on the different cost of borrowing funds at different maturities, we will vary the maturities of our borrowed funds to attempt to produce lower borrowing costs and reduce interest rate risk. Generally, we enter into collateralized borrowings only with institutions that are rated investment grade by at least one nationally-recognized statistical rating organization. We rely on financing to acquire, on a leveraged basis, assets in which we invest. If market conditions deteriorate, our counterparties may exit the repurchase market, and tighten lending standards, or increase the amount of equity capital required to obtain financing thereby making it more difficult and costly for us to obtain financing. In the future, we may be limited or restricted in the amount of leverage we may employ by the terms and provisions of any financing or other agreements. At December 31, 2015, we had an aggregate debt-to-equity ratio, related to our repurchase agreements of approximately 5.1 to 1. Our debt-to-equity ratio is computed by dividing the sum of repurchase borrowings by total stockholders' equity.

**Our Hedging Strategy**

Subject to maintaining our qualification as a REIT for U.S. federal income purposes, we pursue various economic hedging strategies in an effort to reduce our exposure to adverse changes in interest rates and, to a more limited extent, foreign currency. The U.S. federal income tax rules applicable to REITs may require us to implement certain of these techniques through a domestic TRS that is fully subject to federal, state and local corporate income taxation.

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Our hedging activity varies in scope based on the level and volatility of interest rates, the type of assets held, including currency denomination and other changing market conditions. The majority of swaps we entered into are designed to mitigate the effects of increases in interest rates under a portion of our repurchase agreements. These swaps generally provide for fixed interest rates indexed off of the London interbank offered rate or LIBOR and effectively fix the floating interest rates. Notwithstanding the foregoing, in order to manage our hedge position with regard to our liabilities, we on occasion will enter into interest rate swaps which involve the receipt of fixed-rate amounts from a counterparty in exchange for us making variable-rate payments over the life of the interest rate swap without exchange of the underlying notional amount. We also enter into compression trades that enable us to terminate substantial amounts of swap contracts before they expire by their terms, when there has been substantial two-way (pay and receive) swap activity. These "compression trades" reduce the number of interest rate swaps outstanding. In addition to simplifying, our balance sheet, by reducing the number of interest rate swaps outstanding, we are frequently able to reduce the amount of margin required to carry such positions.

We utilize forward starting swaps and swaptions for several reasons including replacing expiring swaps, in anticipation of increasing our overall financing and reducing our exposure to future interest rate increases. Interest rate swaptions provide us the option to enter into an interest rate swap agreement for a predetermined notional amount, stated term and set pay and receive interest rates in the future.

We utilize foreign currency swaps, agreeing to pay a fixed amount of non U.S. currency such as the euro in exchange for a fixed amount of U.S. dollars as well as currency forwards. We entered into the currency swaps and forwards in order to hedge our exposure to foreign currency with respect to Non U.S. CMBS investments and the corresponding repurchase financings utilized to make such investments.

In order to enable us to maintain compliance with the REIT requirements, we have generally elected to treat the aforementioned derivative instruments as hedges for U.S. federal tax purposes. To date, however, we have not elected to apply hedge accounting for financial statement reporting purposes for our derivative instruments. As a result, we record the change in fair value of our derivatives and the associated interest and currency exchange in earnings. Additionally, we may enter into hedging transactions in the form of puts and calls or other financial instruments that we deem appropriate.

Our interest rate hedging techniques are partly based on assumed levels of prepayments of our target assets. If prepayments are slower or faster than assumed, the life of the investment will be longer or shorter, which would reduce the effectiveness of any of the interest rate hedging strategies we may use and may cause losses on such transactions. Hedging strategies, both interest rate and foreign currency, involve the use of derivative securities which are highly complex and may produce volatile returns.

We may invest in equity index derivatives such as futures, options on futures and options on indices. These instruments are used normally to hedge interest rate movements as well as credit risks and other risks associated with our portfolio which may be impacted by volatility in the equity markets. Tax and other regulatory rules may limit our overall ability to use these instruments even through a TRS. Investing in these instruments introduces equity market risks into the management of the portfolio although as noted above our Manager uses them for the purpose of hedging our overall interest rate risk. These hedging strategies involving equity index products may not be successful, and may expose us to additional losses, if expected correlations between such risks and the equity markets do not occur. The goal of our hedging strategy is to ensure that, at all times, we are appropriately hedged in accordance with the REIT requirements for the level of interest rate and currency risk inherent in our investment portfolio.

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**Risk Management Strategy**

Our overall portfolio strategy is designed to generate attractive returns to our investors through various economic cycles. We believe our broad approach to investing in the real estate market, which considers all categories of real estate assets, allows us to invest in a diversified portfolio and help mitigate our portfolio from risks that arise from investing in a single or limited collateral type. Our Manager's investment philosophy combines thorough research of investments and portfolio diversification to achieve investment returns.

**Regulation**

*REIT Qualification*

We elected to be taxed as a REIT under Section 856 through 860 of the Internal Revenue Code of 1986, as amended (the "Code"), commencing with our taxable year ended December 31, 2012. We will generally not be subject to corporate U.S. federal or state income tax to the extent that we make qualifying distributions to stockholders, and provided that we satisfy, on a continuing basis, through actual investment and operating results, the REIT requirements including certain asset, income, distribution and stock ownership tests. If we fail to qualify as a REIT, and do not qualify for certain statutory relief provisions, we 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 we lost our REIT qualification. The failure to qualify as a REIT could have a material adverse impact on our results of operations and amounts available for distribution to stockholders.

*Investment Company Act Exemption*

We conduct our operations so that we are not considered an investment company under the 1940 Act in reliance on the exemption provided by Section 3(c)(5)(C) of the 1940 Act. Section 3(c)(5)(C), as interpreted by the staff of the SEC, requires that: (i) at least 55% of our investment portfolio consist of "mortgages and other liens on and interest in real estate," or "qualifying real estate interests," and (ii) at least 80% of our investment portfolio consist of qualifying real estate interests plus "real estate-related assets." We have relied, and intend to continue to rely on current interpretations of the staff of the SEC in an effort to continue to qualify for an exemption from registration under the 1940 Act. For more information on the exemptions that we utilize refer to Item 1A, "Risk Factors" of this annual report on Form 10-K.

**Competition**

Our net income depends, in part, on our ability to acquire assets at favorable spreads over our borrowing costs. In acquiring our target assets, we compete with other REITs, specialty finance companies, savings and loan associations, banks, mortgage bankers, insurance companies, mutual funds, institutional investors, investment banking firms, financial institutions, governmental bodies and other entities. In addition, other REITs with similar asset acquisition objectives, including a number that have been recently formed and others that may be organized in the future, compete with us in acquiring assets and obtaining financing. These competitors may be significantly larger than us, may have access to greater capital and other resources or may have other advantages. In addition, some competitors may have higher risk tolerances or different risk assessments, which could allow them to consider a wider variety of investments, and establish more relationships, than us. Current market conditions may attract more competitors, which may increase the competition for sources of financing. An increase in the competition for sources of funding could adversely affect the availability and cost of financing, and thereby adversely affect the market price of our common stock.

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**Employees**

We are managed by our Manager, pursuant to the management agreement dated May 9, 2012. We have no employees. All of our officers and two of our directors, James W. Hirschmann III and Gavin L. James, are employees of our Manager, except for our interim chief financial officer, who acts in such capacity under an agreement with us and her employer, FTI Consulting, Inc. Our Manager is responsible for, among other duties: (i) performing all of our day-to-day functions; (ii) determining investment criteria in conjunction with our Board of Directors; (iii) sourcing, analysing and executing investments, asset sales and financings; (iv) performing asset management duties; and (v) performing financial and accounting management.

**Corporate Governance and Internet Address**

We emphasize the importance of professional business conduct and ethics through our corporate governance initiatives. In 2014 the Board took additional steps to enhance governance by appointing a lead independent director and adding a fourth independent director so that our Board of Directors consists of two-thirds ( $\frac{2}{3}$ ) independent directors. The audit, nominating and corporate governance, and compensation committees of our Board of Directors are composed entirely of independent directors. We have adopted corporate governance guidelines and a code of business conduct and ethics, which delineate our standards for our officers and directors.

Our internet address is [www.westernassetmcc.com](http://www.westernassetmcc.com). The information on our website is not incorporated by reference in this Annual Report on Form 10-K. We make available, free of charge through a link on our site, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to such reports, if any, as filed or furnished with the SEC, as soon as reasonably practicable after such filing or furnishing. Our site also contains our code of business conduct and ethics, corporate governance guidelines and the charters of our audit committee, nominating and corporate governance committee and compensation committee of our Board of Directors. Within the time period required by the rules of the SEC and the New York Stock Exchange, or NYSE, we will post on our website any amendment to our code of business conduct and ethics as defined in the code. Our documents filed with, or furnished to, the SEC are also available for review and copying by the public at the SEC's Public Reference Room at 100 F Street, NE., Washington, DC 20549 and at the SEC's website at [www.sec.gov](http://www.sec.gov). Information regarding the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330.

**Item 1A. Risk Factors**

*Our business and operations are subject to a number of risks and uncertainties, the occurrence of which could adversely affect our business, financial condition, results of operations and ability to make distributions to stockholders and could cause the value of our capital stock to decline.*

**Risks related to our business**

***We may not be able to successfully operate our business or generate sufficient revenue to make or sustain distributions to our stockholders.***

We cannot assure you that we will be able to continue to operate our business successfully or implement our operating policies and strategies as described herein. The results of our operations depend on several factors, including the availability of opportunities for the acquisition of assets, the level and volatility of interest rates, the availability of adequate short and long-term financing, conditions in the financial markets and economic conditions.

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***We may change any of our strategies, policies or procedures without stockholder consent.***

We may change any of our strategies, policies or procedures with respect to investments, acquisitions, growth, operations, indebtedness, capitalization, distributions, financing strategy and leverage at any time without the consent of our stockholders, which could result in an investment portfolio with a different risk profile. A change in our investment strategy may increase our exposure to interest rate risk, default risk and real estate market fluctuations. Furthermore, a change in our asset allocation could result in our making investments in asset categories different from those described herein. These changes could adversely affect our financial condition, results of operations, the market price of our common stock and our ability to make distributions to our stockholders.

***We may be unable to operate within the parameters that allow us to be excluded from regulation as a commodity pool operator, which would subject us to additional regulation and compliance requirements, and could materially adversely affect our business and financial condition.***

As a result of regulatory changes prompted by the Dodd-Frank Act, any investment fund that trades in swaps may be considered a "commodity pool," which would cause its operators to be regulated as a "commodity pool operator" (CPO). In December 2012, the Commodity Futures Trading Commission issued a no-action letter giving relief to operators of mortgage REITs from the requirements applicable to CPOs. In order to qualify, we must, among other non-operational requirements: (1) limit our initial margin and premiums for commodity interests (swaps and exchange-traded futures) to no more than 5% of the fair market value of our total assets; and (2) limit our net income from commodity interests that are not "qualifying hedging transactions" to less than 5% of our gross income. These parameters could limit the use of swaps by us below the level that our Manager would otherwise consider optimal or may lead to the registration of our Manager or directors as commodity pool operators, which will subject us to additional regulatory oversight, compliance and costs.

***Recent changes to derivatives regulation may increase the costs of hedging for the Company.***

Recently, regulations have been promulgated by U.S. and foreign regulators attempting to strengthen oversight of derivative contracts. The Dodd-Frank Act established a comprehensive new regulatory framework for derivative contracts commonly referred to as "swaps" which requires that many swaps be executed on a regulated exchange or trading platform ("mandatory exchange trading") and cleared through a central counterparty ("mandatory clearing"). In particular, certain of the swaps that the Manager may want to use to hedge the Company's exposure to fluctuations in interest rates are now subject to mandatory clearing and mandatory exchange trading. For swaps that are subject to mandatory clearing, the Company will be forced to pledge some of its assets to a clearing broker as initial margin, and for the life of such swaps, the assets pledged as initial margin generally will not be available to the Company for investment. For swaps that are subject to mandatory clearing and mandatory exchange trading, the Company likely will incur additional fees and costs for transactions in such swaps. Together, these requirements may make our Manager's hedging strategies more costly or may induce our Manager to change its hedging strategies.

***We cannot assure you that our internal controls over financial reporting will consistently be effective.***

We are responsible for establishing and maintaining adequate internal control over financial reporting designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. We cannot ensure you that there will not be any material weaknesses or significant deficiencies in our internal control over financial reporting in the future.

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***Cybersecurity risk and cyber incidents may adversely affect our business by causing a disruption to our operations, a compromise or corruption of our confidential information and/or damage to our business relationships, all of which could negatively impact our financial results.***

A cyber incident is considered to be any adverse event that threatens the confidentiality, integrity or availability of our information resources. These incidents may be an intentional attack or an unintentional event and could involve gaining unauthorized access to our information systems for purposes of misappropriating assets, stealing confidential information, corrupting data or causing operational disruption. The result of these incidents may include disrupted operations, misstated or unreliable financial data, liability for stolen assets or information, increased cybersecurity protection and insurance cost, litigation and damage to our investor relationships. As our reliance on technology has increased, so have the risks posed to both our information systems, both internal and those provided by our Manager and third party service providers. Our Manager has implemented processes, procedures and internal controls to help mitigate cybersecurity risks and cyber intrusions, but these measures, as well as our increased awareness of the nature and extent of a risk of a cyber incident, do not guarantee that our financial results, operations or confidential information will not be negatively impacted by such an incident.

**Risks related to our investing strategy**

***Mortgage loan modification, refinancing programs, reduction in mortgage insurance premiums and minimum down payments and future legislative action may adversely affect the value of, and our returns on, Agency RMBS, Non-Agency RMBS and our additional Target Assets.***

The U.S. Government, through the U.S. Federal Reserve, the Federal Housing Administration, or the FHA, and the Federal Deposit Insurance Corporation, has implemented a number of federal programs designed to assist homeowners, including the Home Affordable Modification Program, or HAMP, which provides homeowners with assistance in avoiding residential mortgage loan foreclosures, the Hope for Homeowners Program, or H4H Program, which allowed certain distressed borrowers to refinance their mortgages into FHA-insured loans in order to avoid residential mortgage loan foreclosures, and the Home Affordable Refinance Program, or HARP, which allows borrowers who are current on their mortgage payments to refinance and reduce their monthly mortgage payments at loan-to-value ratios up to 125% (and, in some cases, above 125%) without new mortgage insurance. A number of these homeowners' assistance programs have been enhanced or expanded and the HAMP and HARP programs have been extended through December 31, 2016. In addition, current administration officials and certain members of the U.S. Congress have indicated support for additional legislative relief for homeowners, including an amendment of the bankruptcy laws to permit the modification of mortgage loans in bankruptcy proceedings. Loan modifications are more likely to be used when borrowers are less able to refinance or sell their homes due to market conditions and when the potential recovery from a foreclosure is reduced due to lower property values. A significant number of loan modifications could result in a significant reduction in cash flows to the holders of the mortgage securities on an ongoing basis. Amendments to the bankruptcy laws that result in the modification of outstanding mortgage loans may adversely affect the value of and the returns on, the assets that we intend to acquire and the assets we currently hold.

Especially with Non-Agency RMBS, a significant number of loan modifications with respect to a given security, including, but not limited to, those related to principal forgiveness and coupon reduction, resulting in increased prepayment rates, could negatively impact the realized yields and cash flows on such security. These loan modification programs, future legislative or regulatory actions, including possible amendments to the bankruptcy laws, which result in the modification of outstanding residential mortgage loans, as well as changes in the requirements necessary to qualify for refinancing mortgage loans with FNMA, FHLMC or GNMA may adversely affect the value of, and the returns on, Agency RMBS and Non-Agency RMBS.



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In October 2014, the FHA announced that it would allow FNMA and FHLMC to purchase loans with three percent (3%) down payments, thereby reducing the down payment requirement for borrowers to access mortgage loans which are eligible for purchase and/or guarantee by these U.S. Government sponsored entities or GSEs. Further, in January 2015, the Obama administration announced a 50 basis point (0.50%) reduction in the annual mortgage insurance premium imposed by the FHA on mortgage loans guaranteed by GNMA. The reduction in the minimum down payment along with lowering all-in mortgage interest rates on GSE sponsored residential mortgage loans will likely increase the attractiveness of refinancing as well as purchases of new and existing homes, thereby increasing the prepayment rates on the mortgage loans underlying our existing RMBS. This may adversely affect the value of, and the returns on, these assets, especially those which we acquired at a premium.

***The federal conservatorship of FNMA and FHLMC and related efforts, along with any changes in laws and regulations affecting the relationship between these agencies and the U.S. Government, may adversely affect our business.***

The payments of principal and interest we receive on our Agency RMBS, which depend directly upon payments on the mortgages underlying such securities, are guaranteed by FNMA, FHLMC and GNMA. FNMA and FHLMC are U.S. Government-sponsored entities, or GSEs, but their guarantees are not backed by the full faith and credit of the United States. GNMA is part of a U.S. Government agency and its guarantees are backed by the full faith and credit of the United States.

In response to general market instability and, more specifically, the financial conditions of FNMA and FHLMC, in July 2008, the Housing and Economic Recovery Act of 2008, or HERA, established a new regulator for FNMA and FHLMC, the U.S. Federal Housing Finance Agency, or the FHFA. In September 2008, the U.S. Treasury, the FHFA and the U.S. Federal Reserve announced a comprehensive action plan to help stabilize the financial markets, support the availability of mortgage financing and protect taxpayers. Under this plan, among other things, the FHFA was appointed as conservator of both FNMA and FHLMC, allowing the FHFA to control the actions of the two GSEs, without forcing them to liquidate, which would be the case under receivership. Importantly, the primary focus of the plan was to increase the availability of mortgage financing by allowing these GSEs to continue to grow their guarantee business without limit, while limiting the size of their retained mortgage and Agency security portfolios and requiring that these portfolios be reduced over time.

Although the U.S. Government has committed to support the positive net worth of FNMA and FHLMC, there can be no assurance that these actions will be adequate for their needs. These uncertainties lead to questions about the availability of, and trading market for, Agency RMBS. Despite the steps taken by the U.S. Government, FNMA and FHLMC could default on their guarantee obligations which would materially and adversely affect the value of our Agency RMBS. Accordingly, if these government actions are inadequate and the GSEs continue to suffer losses or cease to exist, our business, operations and financial condition could be materially and adversely affected.

In addition, the problems faced by FNMA and FHLMC resulting in their being placed into federal conservatorship and receiving significant U.S. Government support have sparked serious debate among federal policy makers regarding the continued role of the U.S. Government in providing liquidity for mortgage loans. The future roles of FNMA and FHLMC could be significantly reduced and the nature of their guarantee obligations could be considerably limited relative to historical measurements. Any such changes to the nature of their guarantee obligations could redefine what constitutes an Agency security and could have broad adverse implications for the market and our business, operations and financial condition. If FNMA or FHLMC were eliminated, or their structures were to change radically (*i.e.*, limitation or removal of the guarantee obligation), or their market share reduced because of required price increases or lower limits on the loans they can guarantee, we could be unable to acquire additional Agency RMBS and our existing Agency RMBS could be materially and adversely impacted.

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We could be negatively affected in a number of ways depending on the manner in which related events unfold for FNMA and FHLMC. We currently rely significantly on our Agency RMBS as collateral for our financings under our repurchase agreements. Any decline in its value, or perceived market uncertainty about its value, would make it more difficult for us to obtain financing on our Agency RMBS on acceptable terms or at all, or to maintain our compliance with the terms of any financing transactions. Further, the current support provided by the U.S. Treasury to FNMA and FHLMC, and any additional support it may provide in the future, could have the effect of lowering the interest rates we expect to receive from Agency RMBS, thereby tightening the spread between the interest we earn on our Agency RMBS and the cost of financing those assets. A reduction in the supply of Agency RMBS could also negatively affect the pricing of Agency RMBS by reducing the spread between the interest we earn on our investment portfolio of Agency RMBS and our cost of financing that portfolio.

In March 2013, the U.S. Federal Housing Finance Agency announced that it would establish a new institutional body, which later became known as the Federal Mortgage Insurance Company or, FMIC, to replace FNMA and FHLMC once they wind down operations. In June 2013, in a draft bill entitled the "Secondary Mortgage Market Reform and Taxpayer Protection Act of 2013" it was proposed that the FMIC would be modeled after the Federal Deposit Insurance Corporation or FDIC and provide catastrophic reinsurance in the secondary market for mortgage-backed securities. It would also take over multi-family guarantees as the existing portfolios of FNMA and FHLMC are wound down by at least 15% annually until they are completely liquidated. Future legislation affecting the Agencies may create market uncertainty and have the effect of reducing the actual or perceived credit quality of the Agencies and the securities issued or guaranteed by them. As a result, such laws could increase the risk of loss on our investments in Agency RMBS. It also is possible that such laws could adversely impact the market for such securities and the spreads at which they trade. All of the foregoing could have a material adverse effect on our business, financial condition, results of operations, the market price of our capital stock and our ability to pay dividends to our stockholders.

In December 2013, Representative Melvin L. Watt was confirmed as the director of the FHFA, replacing then acting director Edward J. DeMarco. Throughout his tenure, Mr. DeMarco repeatedly struck down various attempts regarding debt forgiveness for homeowners. A change in leadership at the FHFA may increase the likelihood of the implementation of such a program. A program which provides for debt forgiveness on the mortgages underlying our Agency RMBS is likely to have a negative impact on the value of our Agency RMBS, our ability to finance these securities and the interest income which we earn on such securities.

As provided above, recent legislation has changed the relationship between FNMA and FHLMC and the U.S. Government. The appointment of Representative Watt as director of the FHFA as well as future legislation could further change the relationship between FNMA and FHLMC and the U.S. Government which could also nationalize, privatize, or eliminate such entities entirely. In March 2014, Senate Banking Committee Chairman Tim Johnson and Ranking Member Mike Crapo announced an agreement on their own version of GSE reform which would eventually replace FNMA and FHLMC with a new system. Any law affecting these GSEs may create market uncertainty and have the effect of reducing the actual or perceived credit quality of securities issued or guaranteed by FNMA or FHLMC. Any law affecting these GSEs may create market uncertainty and have the effect of reducing the actual or perceived credit quality of securities issued or guaranteed by FNMA or FHLMC. As a result, such laws could increase the risk of loss on our investments in Agency RMBS guaranteed by FNMA and/or FHLMC. It also is possible that such laws could adversely impact the market for such securities and spreads at which they trade. All of the foregoing could materially and adversely affect our financial condition and results of operations.

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*We are subject to the risk that U.S. Government agencies and/or GSEs may not be able to fully satisfy their guarantees of Agency RMBS or that these guarantee obligations may be repudiated, which may adversely affect the value of our assets and our ability to sell or finance these securities.*

The interest and principal payments we receive on the Agency RMBS in which we invest are guaranteed by FNMA, FHLMC or GNMA. Unlike the GNMA securities in which we may invest, the principal and interest on securities issued by FNMA and FHLMC are not guaranteed by the U.S. government. All of the Agency RMBS in which we invest depend on a steady stream of payments on the mortgages underlying the securities.

As conservator of FNMA and FHLMC, the FHFA may disaffirm or repudiate contracts (subject to certain limitations for qualified financial contracts) that FHLMC or FNMA entered into prior to the FHFA's appointment as conservator if it determines, in its sole discretion, that performance of the contract is burdensome and that disaffirmation or repudiation of the contract promotes the orderly administration of its affairs. The HERA requires the FHFA to exercise its right to disaffirm or repudiate most contracts within a reasonable period of time after its appointment as conservator. FNMA and FHLMC have disclosed that the FHFA has disaffirmed certain consulting and other contracts that these entities entered into prior to the FHFA's appointment as conservator. FHLMC and FNMA have also disclosed that the FHFA has advised that it does not intend to repudiate any guarantee obligation relating to FNMA's and FHLMC's mortgage-related securities, because the FHFA views repudiation as incompatible with the goals of the conservatorship. In addition, the HERA provides that mortgage loans and mortgage-related assets that have been transferred to a FHLMC or FNMA securitization trust must be held for the beneficial owners of the related mortgage-related securities, and cannot be used to satisfy the general creditors of FHLMC or FNMA.

If the guarantee obligations of FHLMC or FNMA were repudiated by the FHFA, payments of principal and/or interest to holders of Agency RMBS issued by FHLMC or FNMA would be reduced in the event of any borrowers' late payments or failure to pay or a servicer's failure to remit borrower payments to the trust. In that case, trust administration and servicing fees could be paid from mortgage payments prior to distributions to holders of Agency RMBS. Any actual direct compensatory damages owed due to the repudiation of FHLMC or FNMA's guarantee obligations may not be sufficient to offset any shortfalls experienced by holders of Agency RMBS. The FHFA also has the right to transfer or sell any asset or liability of FHLMC or FNMA, including its guarantee obligation, without any approval, assignment or consent. If the FHFA were to transfer FHLMC or FNMA's guarantee obligations to another party, holders of Agency RMBS would have to rely on that party for satisfaction of the guarantee obligation and would be exposed to the credit risk of that party.

In 2014, we invested in risk sharing securities issued by FNMA and FHLMC. Principal and interest payments on these securities are based on the performance of a specified pool of Agency residential mortgages. The payments due on these securities, however, are not secured by the referenced mortgages, but are full faith and credit obligations of Fannie Mae or Freddie Mac respectively. There is no implicit or explicit guarantee of these obligations by FHFA or that FHFA would satisfy such obligations if FNMA and/or FHLMC were to default.

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***We operate in a highly competitive market for investment opportunities and competition may limit our ability to acquire desirable investments in our Target Assets and could also affect the pricing of these securities.***

We operate in a highly competitive market for investment opportunities. Currently, our profitability depends, in large part, on our ability to acquire our Target Assets at attractive prices. In acquiring these assets, we compete with a variety of institutional investors, including other REITs, specialty finance companies, public and private funds (including other funds managed by our Manager), commercial and investment banks, commercial finance and insurance companies and other financial institutions. Many of our competitors are substantially larger and have considerably greater financial, technical, marketing and other resources than we do. Other REITs have recently raised, or may raise, additional capital, and may have investment objectives that overlap with ours, which may create additional competition for investment opportunities. Some competitors may have a lower cost of funds and access to funding sources that may not be available to us, such as funding from the U.S. Government. Many of our competitors are not subject to the operating constraints associated with REIT tax compliance or maintenance of an exemption from the 1940 Act. In addition, some of our competitors may have higher risk tolerances or different risk assessments, which could allow them to consider a wider variety of investments and establish more relationships than us. Furthermore, competition for investments in our Target Assets may lead to the price of such assets increasing, which may further limit our ability to generate desired returns. We cannot assure you that the competitive pressures we face will not have a material adverse effect on our business, financial condition and results of operations. Also, as a result of this competition, desirable investments in these assets may be limited in the future and we may not be able to take advantage of attractive investment opportunities from time to time, as we can provide no assurance that we will be able to identify and make investments that are consistent with our investment objectives.

***A lack of liquidity in our investments may adversely affect our business. Liquidity in fixed income markets has declined in recent years.***

The assets we acquire are not publicly traded. A lack of liquidity may result from the absence of a willing buyer or an established market for these assets, as well as legal or contractual restrictions on resale or the unavailability of financing for these assets. In addition, mortgage-related assets generally experience periods of illiquidity, especially during periods of economic stress such as the recent economic recession which resulted in increased delinquencies and defaults with respect to residential and commercial mortgage loans. The illiquidity of our investments may make it difficult for us to sell such investments if the need or desire arises. In addition, if we are required to liquidate all or a portion of our portfolio quickly, we may realize significantly less than the value at which we have previously recorded our investments. Further, we may face other restrictions on our ability to liquidate an investment in a business entity to the extent that we or our Manager has or could be attributed with material, non-public information regarding such business entity. As a result, our ability to vary our portfolio in response to changes in economic and other conditions may be relatively limited, which could adversely affect our results of operations and financial condition.

These risks have increased in recent years due to general declines in liquidity in fixed income markets. As a result of both the experience of dealers and other counterparties during the 2007-2010 credit issues and the resulting changes in regulatory and capital burdens on these entities, especially banks, market liquidity in fixed income has generally declined. Dealers and other market intermediaries are less likely to be prepared to hold bonds in inventory and take balance sheet risks, resulting in a significant reduction in market making activity. In addition many dealers have exited one or more sectors of the fixed income markets.

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***Adverse developments in the broader residential mortgage market may adversely affect the value of the assets in which we invest.***

Since 2007, the residential mortgage market in the United States has experienced a variety of unprecedented difficulties and changed economic conditions, including defaults, credit losses and liquidity concerns. Certain commercial banks, investment banks and insurance companies announced extensive losses from exposure to the residential mortgage market. These losses reduced financial industry capital, leading to reduced liquidity for some institutions. These factors have impacted investor perception of the risk associated with real estate-related assets, including Agency RMBS and other high-quality RMBS assets. As a result, values for RMBS assets, including some Agency RMBS and other AAA-rated RMBS assets, have experienced a certain amount of volatility. Further increased volatility and deterioration in the broader residential mortgage and RMBS markets may adversely affect the performance and market value of the Agency RMBS and Non-Agency RMBS in which we invest.

Our most significant investments, to date, have been Agency RMBS and to a lesser extent Non-Agency RMBS and Agency and Non-Agency CMBS. We need to rely on our securities as collateral for our financings. Any decline in their value, or perceived market uncertainty about their value, would likely make it difficult for us to obtain financing on favorable terms or at all, or maintain our compliance with terms of any financing arrangements already in place. The securities we acquire are classified for accounting purposes as available-for-sale. All assets classified as available-for-sale are reported at fair value, based on market prices from third party sources. We have elected to include any unrealized gains and losses in our earnings. If market conditions result in a decline in the fair value of our assets, our financial position and results of operations could be adversely affected.

***A prolonged economic recession and further declining real estate values could impair our assets and harm our operations.***

The risks associated with our business are more severe during economic recessions and are compounded by declining real estate values. The Non-Agency RMBS and Non-Agency CMBS in which we invest a part of our capital will be particularly sensitive to these risks. Declining real estate values will likely reduce the level of new mortgage loan originations since borrowers often use appreciation in the value of their existing properties to support the purchase of additional properties. Borrowers will also be less able to pay principal and interest on loans underlying the securities in which we invest if the value of residential and commercial real estate weakens further. Further, declining real estate values significantly increase the likelihood that we will incur losses on Non-Agency RMBS and Non-Agency CMBS in the event of default because the value of collateral on the mortgages underlying such securities may be insufficient to cover the outstanding principal amount of the loan. Any sustained period of increased payment delinquencies, foreclosures or losses could adversely affect our net interest income from Non-Agency RMBS and Non-Agency CMBS in our portfolio, which could have an adverse effect on our financial condition, results of operations and our ability to make distributions to our stockholders.

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***Our investments are subject to a significant change in prepayments speeds affecting the value of our portfolio and possibly adversely affecting yields.***

The value of our assets may be affected by prepayment rates on residential mortgage loans. We acquire RMBS and anticipate that the underlying residential mortgages loans will prepay at a projected rate generating an expected yield. If we purchase assets at a premium to par value, when borrowers prepay their residential mortgage loans faster than expected, the corresponding prepayments on the mortgage-related securities may reduce the expected yield on such securities because we will have to amortize the related premium on an accelerated basis. In the case of Agency RMBS whole pools and certain other investment grade rated securities, we will be required to make a retrospective adjustment to historical amortization. Conversely, if we purchase assets at a discount to par value, when borrowers prepay their residential mortgage loans slower than expected, the decrease in corresponding prepayments on the RMBS may reduce the expected yield on such securities because we will not be able to accrete the related discount as quickly as originally anticipated and, in the case of Agency RMBS whole pools and certain other investment grade rated securities, we will have to make a retrospective adjustment to historical amortization.

Commercial mortgages frequently limit the ability of the borrower to prepay, thereby providing a certain level of prepayment protection. Common restrictions include yield maintenance and prepayment penalties, the proceeds of which are generally at least partially allocable to these securities, as well as defeasance.

***Our investments in Non-Agency RMBS are generally subject to losses.***

In general, losses on a mortgaged property securing a mortgage loan included in a securitization will be borne first by the equity holder of the property, then by a cash reserve fund or letter of credit, if any, then by the "first loss" subordinated security holder and then by the holder of a higher-rated security. In the event of default and the exhaustion of any equity support, reserve fund, letter of credit, mezzanine loans or B-Notes, and any classes of securities junior to those in which we invest, we will not be able to recover all of our investment in the securities we purchase. In addition, if the underlying mortgage portfolio has been overvalued by the originator, or if the values subsequently decline, less collateral is available to satisfy interest and principal payments due on the related Non-Agency RMBS. The prices of lower credit quality securities are generally less sensitive to interest rate changes than more highly rated investments, but more sensitive to adverse economic downturns or individual issuer developments.

***The mortgage loans underlying the Non-Agency RMBS that we invest in are subject to defaults, foreclosure timeline extension, fraud and residential price depreciation and unfavorable modification of loan principal amount, interest rate and amortization of principal, which could result in losses to us.***

Our investments in Non-Agency RMBS are subject to the risks of defaults, foreclosure timeline extension, fraud and home price depreciation and unfavorable modification of loan principal amount, interest rate and amortization of principal, accompanying the underlying residential mortgage loans. The ability of a borrower to repay a mortgage loan secured by a residential property is dependent upon the income or assets of the borrower. A number of factors may impair borrowers' abilities to repay their loans, including:

adverse changes in national and local economic and market conditions;

changes in governmental laws and regulations, fiscal policies and zoning ordinances and the related costs of compliance with laws and regulations, fiscal policies and ordinances;

costs of remediation and liabilities associated with environmental conditions such as indoor mold;

the potential for uninsured or under-insured property losses;

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acts of God, including earthquakes, floods and other natural disasters, which may result in uninsured losses; and

acts of war or terrorism, including the consequences of terrorist attacks, such as those that occurred on September 11, 2001.

In the event of defaults on the residential mortgage loans that underlie our investments in Non-Agency RMBS and the exhaustion of any underlying or any additional credit support, we may not realize our anticipated return on our investments and we may incur a loss on these investments. In addition, our investments in Non-Agency RMBS will be backed by residential real property but, in contrast to Agency RMBS, the principal and interest will not be guaranteed by a U.S. Government agency or a GSE. The ability of a borrower to repay these loans or other financial assets is dependent upon the income or assets of these borrowers.

***We may be affected by deficiencies in foreclosure practices of third parties, as well as related delays in the foreclosure process.***

Allegations of deficiencies in foreclosure documentation and servicing and foreclosure practices by several large mortgage servicers have raised various concerns relating to foreclosure practices. As a result of these alleged deficiencies in foreclosure practices, a number of servicers temporarily suspended foreclosure proceedings beginning in the second half of 2010 while they evaluated their foreclosure practices. In addition, on February 9, 2012, a group consisting of state attorneys general and state bank and mortgage regulators in 49 states reached a settlement with the largest mortgage servicers regarding foreclosure practices in the states' various jurisdictions. On January 7, 2013, the Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System announced a settlement with a number of mortgage servicers in lieu of continuing a foreclosure review process, under which borrowers who believed they were financially harmed by the foreclosure process in 2009 and 2010 were able to request an independent review of the process. The settlement, which includes funds for both direct payments to eligible borrowers and for other assistance such as loan modifications and forgiveness of deficiency judgments, ended the case-by-case reviews. Although servicers have generally ended their suspension of foreclosures, the processing of foreclosures continues to be slow in many states due to continuing issues in the servicer foreclosure process, including efforts by servicers to comply with regulatory consent orders and requirements, recent changes in the state foreclosure laws, court rules and proceedings and the pipeline of foreclosures resulting from these delays as well as the elevated level of foreclosures caused by the housing market downturn. We may incur substantial legal fees and court costs in acquiring a property through contested foreclosure or bankruptcy proceedings. We intend to continue to monitor and review the issues raised by the alleged improper foreclosure practices.

Prior to making investments in RMBS, our Manager carefully considers many factors, including housing prices and foreclosure timelines, and estimate loss assumptions. The concerns about deficiencies in foreclosure practices of servicers and related delays in the foreclosure process may impact our loss assumptions and affect the values of, and our returns on, our investments in RMBS. We cannot predict exactly how the servicing and foreclosure matters or the resulting litigation or settlement agreements will affect our business and cannot assure you that these matters will not impair our performance and reduce the return on our investments.

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***The commercial mortgage loans underlying the CMBS we may acquire are subject to defaults, foreclosure timeline extension, fraud and commercial price depreciation and unfavorable modification of loan principal amount, interest rate and amortization of principal, which could result in losses to us.***

CMBS may be secured by a single commercial mortgage loan or a pool of commercial mortgage loans. Commercial mortgage loans may be secured by multifamily or commercial property and are subject to risks of delinquency and foreclosure, and risks of loss that may be greater than similar risks associated with loans made on the security of residential property. The ability of a borrower to repay a loan secured by an income-producing property typically is dependent primarily upon the successful operation of such property rather than upon the existence of independent income or assets of the borrower. If the net operating income of the property is reduced, the borrower's ability or willingness to repay the loan may be impaired. Net operating income of an income-producing property can be affected by, among other things,

tenant mix;

success of tenant businesses;

property management decisions;

property location and condition;

competition from comparable types of properties;

changes in laws that increase operating expenses or limit rents that may be charged;

any need to address environmental contamination at the property or the occurrence of any uninsured casualty at the property;

changes in national, regional or local economic conditions and/or specific industry segments;

declines in regional or local real estate values;

declines in regional or local rental or occupancy rates;

increases in interest rates;

real estate tax rates and other operating expenses;

changes in governmental rules, regulations and fiscal policies, including environmental legislation; and

acts of God, terrorist attacks, social unrest and civil disturbances.

***If our Manager overestimates the loss-adjusted yields of our CMBS investments, we may experience losses.***



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Our Manager will analyze any CMBS investments we may acquire based on loss-adjusted yields, taking into account estimated future losses on the mortgage loans included in the securitization's pool of loans, and the estimated impact of these losses on expected future cash flows. Our Manager's loss estimates may not prove accurate, as actual results may vary from estimates. In the event that our Manager underestimates the pool level losses relative to the price we pay for a particular CMBS investment, we may experience losses with respect to such investment.

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***We do not control the special servicing of the mortgage loans included in the CMBS in which we invest and, in such cases, the special servicer may take actions that could adversely affect our interests.***

With respect to CMBS in which we invest, overall control over the special servicing of the related underlying mortgage loans will be held by a "directing certificateholder" or a "controlling class representative," which is appointed by the holders of the most subordinate class of CMBS in such series. We may not have the right to appoint the directing certificateholder. In connection with the servicing of the specially serviced mortgage loans, the related special servicer may, at the direction of the directing certificateholder, take actions with respect to the specially serviced mortgage loans that could adversely affect our interests.

***The residential and/or commercial mortgages which we may acquire in the form of whole-loans are subject to individual borrower credit risk.***

To the extent we acquire residential or commercial first lien mortgages or whole-loans; we will be subject to individual credit risk. While such mortgages will be secured by the single family residences or commercial properties, we will rely on the borrower's willingness to make timely payments. In certain states our ability to recover against a borrower on a residential property may be limited to either recovering from the borrower or foreclosing on the property. In either case, depending on state and local laws, such recovery could take an extended period of time and expense, during which period we would not be receiving any payments, thereby negatively impacting our cash flow. Similarly, to the extent a commercial loan is non-recourse, our recovery will be limited to the underlying real property which depending on several factors, including the location of such property, could take an extended period of time and expense, thereby negatively impacting our cash flow.

***The receivables underlying the ABS we may acquire are subject to credit exposure, which could result in losses to us.***

ABS are securities backed by various asset classes including auto loans, student loans, credit card loans, equipment loans, floor plan loans and small business loans fully guaranteed as to principal and interest by the U.S. Small Business Administration, or the SBA. ABS remain subject to the credit exposure of the underlying receivables. In the event of increased rates of delinquency with respect to any receivables underlying our ABS, we may not realize our anticipated return on these investments.

***Our investments are recorded at fair value, and quoted prices or observable inputs may not be available to determine such value, resulting in the use of significant unobservable inputs to determine value.***

We expect that the values of some of our investments may not be readily determinable. We measure the fair value of these investments on at least a monthly basis. The fair value at which our assets are recorded may not be an indication of their realizable value. Ultimate realization of the value of an asset depends to a great extent on economic and other conditions that are beyond the control of our Manager, our Company or our Board of Directors. Further, fair value is only an estimate based on good faith judgment of the price at which an investment can be sold since market prices of investments can only be determined by negotiation between a willing buyer and seller. If we were to liquidate a particular asset, the realized value may be more than or less than the amount at which such asset is valued. Accordingly, the value of our common stock could be adversely affected by our determinations regarding the fair value of our investments, whether in the applicable period or in the future. Additionally, such valuations may fluctuate over short periods of time.

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Our determination of the fair value of our investments for GAAP includes inputs provided by third party dealers and pricing services. Valuations of certain investments in which we invest are often difficult to obtain. In general, dealers and pricing services heavily disclaim their valuations. Dealers may claim to furnish valuations only as an accommodation and without special compensation, and so they may disclaim any and all liability for any direct, incidental, or consequential damages arising out of any inaccuracy or incompleteness in valuations, including any act of negligence or breach of any warranty. Depending on the complexity and illiquidity of a security, valuations of the same security can vary substantially from one dealer or pricing service to another. Therefore, our results of operations for a given period could be adversely affected if our determinations regarding the fair market value of these investments are materially different than the values that we ultimately realize upon their disposal. Due to an overall increase in market volatility, the valuation process has been particularly challenging recently as market events have made valuations of certain assets more difficult, unpredictable and volatile.

***Declines in value of the assets in which we invest will adversely affect our financial position and results of operations, and make it more costly to finance these assets.***

We use our investments as collateral for our financings. Any decline in their value, or perceived market uncertainty about their value, would likely make it difficult for us to obtain financing on favorable terms or at all, or maintain our compliance with terms of any financing arrangements already in place. Our investments in mortgage-backed securities are recorded at fair value under a fair value option election at the time of purchase with changes in fair value reported in earnings. As a result, a decline in fair values of our mortgage-backed securities could reduce both our earnings and stockholders' equity. If market conditions result in a decline in the fair value of our assets, our financial position and results of operations could be adversely affected.

***An increase in interest rates may cause a decrease in the availability of certain of our Target Assets, which could adversely affect our ability to acquire assets that satisfy our investment objectives and to generate income and make distributions.***

Rising interest rates generally reduce the demand for mortgage loans due to the higher cost of borrowing. A reduction in the volume of mortgage loans originated may affect the volume of our Target Assets available to us, which could adversely affect our ability to acquire assets that satisfy our investment objectives. Rising interest rates may also cause our assets that were issued prior to an interest rate increase to provide yields that are below prevailing market interest rates. If rising interest rates cause us to be unable to acquire a sufficient volume of our Target Assets with a yield that is above our borrowing cost, our ability to satisfy our investment objectives and to generate income and make distributions may be materially and adversely affected.

The relationship between short-term and longer-term interest rates is often referred to as the "yield curve." Ordinarily, short-term interest rates are lower than longer-term interest rates. If short-term interest rates rise disproportionately relative to longer-term interest rates (a flattening of the yield curve), our borrowing costs may increase more rapidly than the interest income earned on our assets. Because our investments, on average, generally bear interest based on longer-term rates than our borrowings, a flattening of the yield curve would tend to decrease our net income and the market value of our net assets. Additionally, to the extent cash flows from investments that return scheduled and unscheduled principal are reinvested, the spread between the yields on the new investments and available borrowing rates may decline, which would likely decrease our net income. It is also possible that short-term interest rates may exceed longer-term interest rates (a yield curve inversion); in which event our borrowing costs may exceed our interest income and we could incur operating losses.

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***Increases in interest rates could adversely affect the value of our investments and cause our interest expense to increase, which could result in reduced earnings or losses and negatively affect our profitability as well as the cash available for distribution to our stockholders.***

We invest in Agency RMBS and Non-Agency RMBS. We also invest in Agency and Non-Agency CMBS and ABS. In a normal yield curve environment, investments in such assets will generally decline in value if long-term interest rates increase. Declines in market value may ultimately reduce earnings or result in losses to us, which may negatively affect cash available for distribution to our stockholders.

A significant risk associated with our Target Assets is the risk that both long-term and short-term interest rates will increase significantly. If long-term rates increased significantly, the market value of these investments would decline, and the duration and weighted average life of the investments would increase. We could realize a loss if the securities were sold. At the same time, an increase in short-term interest rates would increase the amount of interest owed on any repurchase agreements we may enter into, thereby potentially reducing the net interest margin we earn on investments and the income available for distribution to our shareholders.

Market values of our investments may decline without any general increase in interest rates for a number of reasons, such as increases or expected increases in defaults, or increases or expected increases in voluntary prepayments for those investments that are subject to prepayment risk or widening of credit spreads.

In addition, our operating results depend in large part on the difference between the income from our assets and our financing costs. We anticipate that, in most cases in a period of rising interest rates, the income from such assets will respond more slowly to interest rate fluctuations than the cost of our borrowings. Consequently, changes in interest rates, particularly short-term interest rates, may significantly influence our net income. Increases in these rates will tend to decrease our net income and market value of our assets.

***Interest rate mismatches between our RMBS backed by ARMs or hybrid ARMs and our borrowings used to fund our purchases of these assets may cause us to suffer losses.***

We may fund our RMBS with borrowings that have interest rates that adjust more frequently than the interest rate indices and repricing terms of RMBS backed by adjustable-rate mortgages, or ARMs, or hybrid ARMs. Accordingly, if short-term interest rates increase, our borrowing costs may increase faster than the interest rates on RMBS backed by ARMs or hybrid ARMs adjust. As a result, in a period of rising interest rates, we could experience a decrease in net income or a net loss.

In most cases, the interest rate indices and repricing terms of RMBS backed by ARMs or hybrid ARMs and our borrowings will not be identical, thereby potentially creating an interest rate mismatch between our investments and our borrowings. While the historical spread between relevant short-term interest rate indices has been relatively stable, there have been periods when the spread between these indices was volatile. During periods of changing interest rates, these interest rate index mismatches could reduce our net income or produce a net loss, and adversely affect the level of our dividends and the market price of our common stock.

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In addition, RMBS backed by ARMs or hybrid ARMs will typically be subject to lifetime interest rate caps that limit the amount an interest rate can increase through the maturity of the RMBS. However, our borrowings under repurchase agreements typically are not subject to similar restrictions. Accordingly, in a period of rapidly increasing interest rates, the interest rates paid on our borrowings could increase without limitation while caps could limit the interest rates on these types of RMBS. This problem is magnified for RMBS backed by ARMs or hybrid ARMs that are not fully indexed. Further, some RMBS backed by ARMs or hybrid ARMs may be subject to periodic payment caps that result in a portion of the interest being deferred and added to the principal outstanding. As a result, we may receive less cash income on these types of RMBS than we need to pay interest on our related borrowings. These factors could reduce our net interest income and cause us to suffer a loss during periods of rising interest rates.

As of December 31, 2015, none of our Agency RMBS, excluding Interest-Only Strips, were secured by ARMs or hybrid ARMs. Our Non-Agency RMBS, however, were secured by ARMs, Hybrid ARMS, pay option ARMs and fixed-rate mortgages. Further, there can be no assurance that this will not change in the future.

***Interest rate fluctuations may adversely affect the level of our net income and the value of our assets and common stock.***

Interest rates are highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond our control. Interest rate fluctuations present a variety of risks, including the risk of a narrowing of the difference between asset yields and borrowing rates, flattening or inversion of the yield curve and fluctuating prepayment rates, and may adversely affect our income and the value of our assets and common stock.

Increases in interest rates may negatively affect the market value of the fixed-rate mortgages and hybrid ARMs in which we may invest. Our investments in these mortgage-backed securities are recorded at fair value under a fair value option election at the time of purchase with changes in fair value reported in earnings and any decrease in our earnings could cause the market value of our common stock to decline. In addition, rising interest rates generally reduce the demand for consumer and commercial credit, including mortgage loans, due to the higher cost of borrowing. A reduction in the volume of mortgage loans originated may affect the volume of MBS available to us, which could affect our ability to acquire assets that satisfy our investment objectives.

Since the onset of the economic recession in 2008, the Federal Reserve has maintained an accommodative monetary policy. Recent improvements in the U.S. labor market and overall U.S. economy has led to a discussion of the return of monetary policy to a more "normal" stature. In the press release issued subsequent to the Federal Open Market Committee or FOMC meeting on December 15 and 16, 2015, the Federal Reserve agreed to set the new target range for the Federal Funds rate at 0.25 percent to 0.50 percent, up from zero to 0.25 percent. A number of members commented that it was appropriate to begin policy normalization in response to the substantial progress in the labor market toward achieving the FOMC's objective of maximum employment and their reasonable confidence that inflation would move to 2 percent over the medium term. The FOMC comments that their decision reflected both the economic outlook and the time it takes for policy actions to affect future economic outcomes. The FOMC observed that after this initial increase in the federal funds rate, the stance of monetary policy would remain accommodative. Some FOMC members said that their decision to raise the target range was a close call, particularly given the uncertainty about inflation dynamics, and emphasized the need to monitor the progress of inflation closely. Accordingly, we cannot project with certainty when and the rate at which the Federal Reserve will continue to increase the Federal Funds rate and what impact that will have on our business and operating results.

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*Changes in prepayment rates may adversely affect our profitability.*

The RMBS assets we acquire are backed by pools of residential mortgage loans. We receive payments, generally, from the payments that are made on these underlying residential mortgage loans. While commercial mortgages frequently include limitations on the ability of the borrower to prepay, residential mortgages generally do not. When borrowers prepay their residential mortgage loans at rates that are faster than expected, the net result is prepayments that are faster than expected on the related RMBS. These faster than expected payments may adversely affect our profitability.

We may purchase RMBS assets that have a higher interest rate than the then prevailing market interest rate. In exchange for this higher interest rate, we may pay a premium to par value to acquire the asset. In accordance with accounting rules, we amortize this premium over the expected term of the asset based on our prepayment assumptions. If the asset is prepaid in whole or in part at a faster than expected rate, however, we must expense all or a part of the remaining unamortized portion of the premium that was paid at the time of the purchase, which will adversely affect our profitability.

Prepayment rates generally increase when interest rates fall and decrease when interest rates rise, but changes in prepayment rates are difficult to predict. House price appreciation, while increasing the value of the collateral underlying our RMBS, may increase prepayment rates as borrowers may be able to refinance at more favorable terms. Prepayments can also occur when borrowers default on their residential mortgages and the mortgages are prepaid from the proceeds of a foreclosure sale of the property (an involuntary prepayment), or when borrowers sell the property and use the sale proceeds to prepay the mortgage as part of a physical relocation. Prepayment rates also may be affected by conditions in the housing and financial markets, increasing defaults on residential mortgage loans, which could lead to an acceleration of the payment of the related principal, general economic conditions and the relative interest rates on fixed-rate mortgages and ARMs. While we seek to manage prepayment risk, in selecting RMBS investments we must balance prepayment risk against other risks, the potential returns of each investment and the cost of hedging our risks. No strategy can completely insulate us from prepayment or other such risks, and we may deliberately retain exposure to prepayment or other risks.

In addition, a decrease in prepayment rates may adversely affect our profitability. When borrowers prepay their residential mortgage loans at slower than expected rates, prepayments on the RMBS may be slower than expected. These slower than expected payments may adversely affect our profitability. We may purchase RMBS assets that have a lower interest rate than the then prevailing market interest rate. In exchange for this lower interest rate, we may pay a discount to par value to acquire the asset. In accordance with accounting rules, we accrete this discount over the expected term of the asset based on our prepayment assumptions. If the asset is prepaid at a slower than expected rate, however, we must accrete the remaining portion of the discount at a slower than expected rate. This will extend the expected life of the asset and result in a lower than expected yield on assets purchased at a discount to par.

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***We may make investments in non U.S. dollar denominated securities, which will be subject to currency rate exposure and risks associated with the uncertainty of foreign laws and markets.***

Some of our real estate-related securities investments may be denominated in foreign currencies, and therefore, we expect to have currency risk exposure to any such foreign currencies. A change in foreign currency exchange rates may have an adverse impact on returns on our non U.S. dollar denominated investments. Although we may hedge our foreign currency risk subject to the REIT income tests, we may not be able to do so successfully and may incur losses on these investments as a result of exchange rate fluctuations. To the extent that we invest in non U.S. dollar denominated securities, in addition to risks inherent in the investment in securities generally discussed in this Form 10-K, we will also be subject to risks associated with the uncertainty of foreign laws and markets including, but not limited to, unexpected changes in regulatory requirements, political and economic instability in certain geographic locations, difficulties in managing international operations, currency exchange controls, potentially adverse tax consequences, additional accounting and control expenses and the administrative burden of complying with a wide variety of foreign laws.

***We are highly dependent on information systems and systems failures could significantly disrupt our business, which may, in turn, negatively affect the market price of our common stock and our ability to make distributions to all stockholders.***

Our business is highly dependent on communications and information systems of our Manager and other third party service providers. Any failure or interruption of our Manager's or other third party service providers' systems could cause delays or other problems in our securities trading activities, which could have a material adverse effect on our operating results and negatively affect the market price of our common stock and our ability to make distributions to our stockholders.

***Loss of our exemption from regulation pursuant to the 1940 Act would adversely affect us.***

We conduct our business so as not to become regulated as an investment company under the 1940 Act in reliance on the exemption provided by Section 3(c)(5)(C) of the 1940 Act. Section 3(c)(5)(C), as interpreted by the staff of the SEC, requires that: (i) at least 55% of our investment portfolio consist of "mortgages and other liens on and interest in real estate," or "qualifying real estate interests," and (ii) at least 80% of our investment portfolio consist of qualifying real estate interests plus "real estate-related assets." In satisfying this 55% requirement, based on pronouncements of the SEC staff, we may treat whole pool Agency RMBS as qualifying real estate interests. The SEC staff has not issued guidance with respect to whole pool Non-Agency RMBS. Accordingly, based on our own judgment and analysis of the SEC's pronouncements with respect to whole pool Agency RMBS, we may also treat Non-Agency RMBS issued with respect to an underlying pool of mortgage loans in which we hold all of the certificates issued by the pool as qualifying real estate interests. We currently treat partial pool Agency, Non-Agency RMBS and partial pool CMBS as real estate-related assets. We treat any ABS, interest rate swaps or other derivative hedging transactions we enter into as miscellaneous assets that will not exceed 20% of our total assets. We rely on guidance published by the SEC staff or on our analyses of guidance published with respect to other types of assets to determine which assets are qualifying real estate assets and real estate-related assets.

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The SEC in 2011 solicited public comment on a wide range of issues relating to Section 3(c)(5)(C), including the nature of the assets that qualify for purposes of the exemption and whether mortgage REITs should be regulated in a manner similar to investment companies. To date the staff has not issued any additional guidance. There can be no assurance that the laws and regulations governing the 1940 Act status of REITs, including the guidance of the Division of Investment Management of the SEC regarding this exemption, will not change in a manner that adversely affects our operations. To the extent that the SEC or its staff publishes new or different guidance with respect to these matters, we may be required to adjust our strategy accordingly. In addition, we may be limited in our ability to make certain investments and these limitations could require us to hold assets we might wish to sell or to sell assets we might wish to hold. To the extent that the SEC staff provides more specific guidance regarding any of the matters bearing upon the exemption we rely on from the 1940 Act, we may be required to adjust our strategy accordingly. Any additional guidance from the SEC staff could provide additional flexibility to us, or it could further inhibit our ability to pursue the strategies we have chosen.

The mortgage related investments that we acquire are limited by the provisions of the 1940 Act and the rules and regulations promulgated thereunder. If the SEC determines that any of these securities are not qualifying interests in real estate or real estate-related assets, adopts a contrary interpretation with respect to these securities or otherwise believes we do not satisfy the above exceptions or changes its interpretation of the above exceptions, we could be required to restructure our activities or sell certain of our assets. We may be required at times to adopt less efficient methods of financing certain of our mortgage related investments and we may be precluded from acquiring certain types of higher yielding securities. The net effect of these factors would be to lower our net interest income. If we fail to qualify for an exemption from registration as an investment company or an exclusion from the definition of an investment company, our ability to use leverage would be substantially reduced. Further, if the SEC determined that we were an unregistered investment company, we could be subject to monetary penalties and injunctive relief in an action brought by the SEC, we would potentially be unable to enforce contracts with third parties which could seek to obtain rescission of transactions undertaken during the period for which it was established we were an unregistered investment company. If we were required to register as an investment company, it would result in a change of our financial statement requirements. Our business will be materially and adversely affected if we fail to qualify for this exemption from regulation pursuant to the 1940 Act. In addition, the loss of our 1940 Act exemption would also permit our Manager to terminate the Management Agreement, which could result in material adverse effect on our business and results of operations.

***The downgrade of the U.S. government's or certain European countries' credit ratings and any future downgrades of the U.S. government's or certain European countries' credit ratings may materially adversely affect our business, financial condition and results of operations.***

On August 5, 2011, Standard & Poor's downgraded the U.S. government's credit rating for the first time in history. More recently, concerns over economic recession, geopolitical issues, the ability of certain European sovereigns to honor their debt obligations and the exposure of certain European financial institutions to such debt, potential deflationary pressures in Europe, slowing growth in China, rapid decline in the price of oil and certain other commodities, the availability and cost of financing, the mortgage market, uncertainty related to political events such as the government spending and tax policy and uncertain real estate market have contributed to volatility and relatively low expectations for the world economy and domestic and international markets. Because FNMA and FHLMC are in conservatorship of the U.S. government, downgrades to the U.S. government's credit rating could impact the credit risk associated with Agency MBS and, therefore, decrease the value of the Agency MBS in which we invest. In addition, the downgrade of the U.S. government's credit rating and the credit ratings of certain European countries has created broader financial turmoil and uncertainty, which has recently weighed heavily on the global banking system. Therefore, the downgrade of the U.S. government's credit rating and the credit ratings of certain European countries and any future downgrades of the U.S. government's credit rating or the credit ratings of certain European countries may materially adversely affect our business, financial condition and results of operations.



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**Risks related to financing and hedging**

*Our strategy involves significant leverage, which may amplify losses.*

Our current target leverage generally ranges between three to ten times the amount of our stockholders' equity (calculated in accordance with U.S. GAAP). We incur this leverage by borrowing against a substantial portion of the market value of our assets. By utilizing this leverage, we can enhance our returns. Nevertheless, this leverage, which is fundamental to our investment strategy, also creates significant risks.

As a result of our significant leverage, we may incur substantial losses if our borrowing costs increase. Our borrowing costs may increase for any of the following reasons:

short-term interest rates increase;

the market value of our securities decreases;

interest rate volatility increases; or

the availability of financing in the market decreases.

*There can be no assurance that our Manager will be able to prevent mismatches in the maturities of our assets and liabilities.*

Because we employ financial leverage in funding our portfolio, mismatches in the maturities of our assets and liabilities can create risk in the need to continually renew or otherwise refinance our liabilities. Our net interest margins are dependent upon a positive spread between the returns on our asset portfolio and our overall cost of funding. Our Manager actively employs portfolio-wide and security-specific risk measurement and management processes in our daily operations. Our Manager's risk management tools include software and services licensed or purchased from third parties, in addition to proprietary systems and analytical methods developed internally. There can be no assurance that these tools and the other risk management techniques described above will protect us from asset/liability risks.

*We may be subject to margin calls under our master repurchase agreements, which could result in defaults or force us to sell assets under adverse market conditions or through foreclosure.*

We have entered into master repurchase agreements with various financial institutions and borrow under these master repurchase agreements to finance the acquisition of assets for our investment portfolio. Pursuant to the terms of borrowings under our master repurchase agreements, a decline in the value of the subject assets may result in our lenders initiating margin calls. A margin call means that the lender requires us to pledge additional collateral to re-establish the ratio of the value of the collateral to the amount of the borrowing. The specific collateral value to borrowing ratio that would trigger a margin call is not set in the master repurchase agreements and will not be determined until we engage in a repurchase transaction under these agreements. Our fixed-rate securities generally are more susceptible to margin calls as increases in interest rates tend to have a greater negative affect on the market value of fixed-rate securities. If we are unable to satisfy margin calls, our lenders may foreclose on our collateral. The threat of or occurrence of a margin call could force us to sell our assets, either directly or through a foreclosure, under adverse market conditions. Because of the significant leverage we have, we may incur substantial losses upon the threat or occurrence of a margin call.

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***If a counterparty to our repurchase transactions defaults on its obligation to resell the underlying security back to us at the end of the transaction term, or if the value of the underlying security has declined as of the end of that term, or if we default on our obligations under the repurchase agreement, we will lose money on our repurchase transactions.***

When we engage in repurchase transactions, we generally sell securities to lenders (repurchase agreement counterparties) and receive cash from these lenders. The lenders are obligated to resell the same securities back to us at the end of the term of the transaction. Because the cash we receive from the lender when we initially sell the securities to the lender will be less than the value of those securities (this difference is the haircut), if the lender defaults on its obligation to resell the same securities back to us we may incur a loss on the transaction equal to the amount of the haircut (assuming there was no change in the value of the securities). We would also lose money on a repurchase transaction if the value of the underlying securities has declined as of the end of the transaction term, as we would have to repurchase the securities based on their initial value but would receive securities worth less than that amount. Further, if we default on one of our obligations under a repurchase transaction, the lender can terminate the transaction and cease entering into any other repurchase transactions with us. Our inability to post adequate collateral for a margin call by the counterparty, in a timeframe as short as the close of the same business day, could result in a condition of default under our repurchase agreements, thereby enabling the counterparty to liquidate the collateral pledged by us, which may have a material adverse effect on our financial position, results of operations and cash flows. Our repurchase agreements contain cross-default provisions, such that if a default occurs under an agreement with any specific lender, that lender could also declare a default under other repurchase agreements or other financing or derivative contracts, if any, with such lender. Further, 17 of the counterparties to our repurchase agreements held, as of December 31, 2015, collateral valued in excess of 5% of our stockholders' equity as security for our obligations under the applicable repurchase agreements. Any losses we incur on our repurchase transactions could adversely affect our earnings and thus our cash available for distribution to our stockholders.

***If a counterparty to one of our swap agreements or TBAs defaults on its obligations, we may incur losses.***

If a counterparty to one of the bilateral swap agreements that we enter into or TBAs that we enter into defaults on its obligations under the agreement, we may not receive payments due under the agreement, and thus, we may lose any unrealized gain associated with the agreement. In the case of a swap agreement, the fact that such swap agreement hedged a liability means that the liability could cease to be hedged upon the default of a counterparty. Additionally, we may also risk the loss of any collateral we have pledged to secure our obligations under a bilateral swap agreement if the counterparty, or in the case of a cleared swap, if our clearing broker, becomes insolvent or files for bankruptcy.

***Failure to procure adequate repurchase agreement financing, which generally have short terms, or to renew or replace repurchase agreement financing as it matures, would adversely affect our results of operations.***

We use repurchase agreement financing as a strategy to increase the return on our investment portfolio. However, we may not be able to achieve our desired leverage ratio for a number of reasons, including if the following events occur:

our lenders do not make repurchase agreement financing available to us at acceptable rates;

certain of our lenders exit the repurchase market;

our lenders require that we pledge additional collateral to cover our borrowings, which we may be unable to do; or

we determine that the leverage would expose us to excessive risk.

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We cannot assure you that any, or sufficient, repurchase agreement financing will be available to us on terms that are acceptable to us. In recent years, investors and financial institutions that lend in the securities repurchase market, have tightened lending standards in response to the difficulties and changed economic conditions that have materially adversely affected the MBS market. These market disruptions have been most pronounced in the Non-Agency MBS market, and the impact has also extended to Agency MBS, which has made the value of these assets unstable and relatively illiquid compared to prior periods. Any decline in their value, or perceived market uncertainty about their value, would make it more difficult for us to obtain financing on favorable terms or at all, or maintain our compliance with terms of any financing arrangements then in place. Additionally, the lenders from which we seek to obtain repurchase agreement financing may have owned or financed MBS that have declined in value and caused the lender to suffer losses as a result of the 2007 to 2010 downturn in the residential, as well as commercial, mortgage markets. If these conditions persist, these institutions may be forced to exit the repurchase market, become insolvent or further tighten lending standards or increase the amount of equity capital or haircut required to obtain financing, and in such event, could make it more difficult for us to obtain financing on favorable terms or at all. Further, the implementation of Basel III and the Dodd Frank Act will increase the regulatory capital which financial institutions must hold against repurchase financing, thereby making the cost of providing such financing more expensive. This is likely to result in less availability of repurchase financing and/or higher pricing. In the event that we cannot obtain sufficient funding on acceptable terms, there may be a negative impact on the value of our common stock and our ability to make distributions, and you may lose part or all of your investment.

As of December 31, 2015, we had amounts outstanding under repurchase agreements with 21 separate lenders and had repurchase agreements with 26 different lenders. Prior to entering into a lending relationship with any financial institution, our Manager does a thorough credit review of such potential lender. Notwithstanding the foregoing, a material adverse development involving one or more major financial institutions or the financial markets in general, in addition to the regulatory changes discussed above, could result in our lenders reducing our access to funds available under our repurchase agreements or terminating such agreements altogether. Dramatic declines in the housing market from 2007 to 2010, with decreasing home prices and increasing foreclosures and unemployment, resulted in significant asset write-downs by financial institutions, which caused many financial institutions to seek additional capital, to merge with other institutions, and, in some cases, to fail. As all of our repurchase agreements are uncommitted and renewable at the discretion of our lenders, these conditions could cause our lenders to determine to reduce or terminate our access to future borrowings at virtually any time which could materially adversely affect our business and profitability. Furthermore, if a number of our lenders became unwilling or unable continue to provide us with financing; we could be forced to sell assets in order to maintain liquidity. Forced sales under adverse market conditions may result in lower sales prices than ordinary market sales made in the normal course of business.

Furthermore, because we rely primarily on short-term borrowings, our ability to achieve our investment objective will depend not only on our ability to borrow money in sufficient amounts and on favorable terms, but also on our ability to renew or replace on a continuous basis our maturing short-term borrowings. If we are not able to renew or replace maturing borrowings due to changes in the regulatory environment or for any other reason, we will have to sell some or all of our assets, possibly under adverse market conditions which may have a material adverse effect on our financial position, results of operations and cash flows. In addition, the aforementioned changes to the regulatory capital requirements imposed on our lenders may significantly increase the cost of the financing that they provide to us. Our lenders also may revise their eligibility requirements for the types of assets they are willing to finance or the terms of such financings, based on, among other factors, the recent changes in the regulatory environment and their management of perceived risk, particularly with respect to assignee liability.

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***Our repurchase agreement financing may require us to provide additional collateral and may restrict us from leveraging our assets as fully as desired.***

We use repurchase agreements to finance acquisitions of our Target Assets. If the market value of the asset pledged or sold by us to a financing institution pursuant to a repurchase agreement declines, we may be required by the financing institution to provide additional collateral or pay down a portion of the funds advanced, but we may not have the funds available to do so, which could result in defaults. Posting additional collateral to support our credit will reduce our liquidity and limit our ability to leverage our assets, which could adversely affect our business. In the event we do not have sufficient liquidity to meet such requirements, financing institutions can accelerate repayment of our indebtedness, increase interest rates, liquidate our collateral or terminate our ability to borrow. Such a situation would likely result in a rapid deterioration of our financial condition and possibly necessitate a filing for bankruptcy protection.

On the date each month that principal payments are announced (i.e., the factor day for our Agency RMBS), the value of our Agency RMBS pledged as collateral under our repurchase agreements is reduced by the amount of the prepaid principal and, as a result, our lenders will typically initiate a margin call requiring the pledge of additional collateral or cash, in an amount equal to such prepaid principal, in order to re-establish the required ratio of borrowing to collateral value under such repurchase agreements. Accordingly, with respect to our Agency RMBS the announcement on factor day of principal prepayments is in advance of our receipt of the related scheduled payment, thereby creating a short-term receivable for us in the amount of such principal prepayments; however, under our repurchase agreements, we may receive a margin call relating to the related reduction in value of our Agency RMBS and prior to receipt of this short-term receivable, be required to post additional collateral or cash in an amount equal to the product of the advance rate of such repurchase agreement and the principal prepayment on or about factor day, which would reduce our liquidity during the period in which the short term receivable is outstanding. As a result, in order to meet any such margin calls, we could be forced to sell assets in order to maintain liquidity. Forced sales under adverse market conditions may result in lower sales prices than ordinary market sales in the normal course of business.

Further, financial institutions providing the repurchase facilities may require us to maintain a certain amount of cash uninvested or to set aside non-levered assets sufficient to maintain a specified liquidity position which would allow us to satisfy our collateral obligations. As a result, we may not be able to leverage our assets as fully as we would choose which could reduce our return on equity. If we are unable to meet these collateral obligations, our financial condition could deteriorate rapidly.

***Lenders may require us to enter into restrictive covenants relating to our operations.***

When we obtain further financing, lenders could impose restrictions on us that would affect our ability to incur additional debt, our capability to make distributions to stockholders and our flexibility to determine our operating policies. Loan documents we execute may contain negative covenants that limit, among other things, our ability to repurchase stock, distribute more than a certain amount of our funds from operations, and employ leverage beyond certain amounts.

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***Our rights under repurchase agreements may be subject to the effects of the bankruptcy laws in the event of the bankruptcy or insolvency of us or our counterparties under the repurchase agreements.***

In the event of our insolvency or bankruptcy, certain repurchase agreements may qualify for special treatment under the U.S. Bankruptcy Code, the effect of which, among other things, would be to allow the lender under the applicable repurchase agreement to avoid the automatic stay provisions of the U.S. Bankruptcy Code and to take possession of and liquidate the assets that we have pledged under their repurchase agreements. In the event of the insolvency or bankruptcy of a lender during the term of a repurchase agreement, the lender may be permitted, under applicable insolvency laws, to repudiate the contract, and our claim against the lender for damages may be treated simply as the claim of an unsecured creditor. In addition, if the lender is a broker or dealer subject to the Securities Investor Protection Act of 1970, or an insured depository institution subject to the Federal Deposit Insurance Act, our ability to exercise our rights to recover our securities under a repurchase agreement or to be compensated for any damages resulting from the lender's insolvency may be further limited by those statutes. These claims would be subject to significant delay and, if and when received, may be substantially less than the damages we actually incur.

***An increase in our borrowing costs relative to the interest that we receive on our portfolio investments may adversely affect our profitability and cash available for distribution to our stockholders.***

As long as we earn a positive spread between interest and other income we earn on our leveraged assets and our borrowing costs, we believe that we can generally increase our profitability by using greater amounts of leverage. We cannot, however, assure you that repurchase financing will remain an efficient source of long-term financing for our assets. The amount of leverage that we use may be limited because our lenders might not make funding available to us or they may require that we provide additional collateral to secure our borrowings. If our financing strategy is not viable, we will have to find alternative forms of financing for our assets which may not be available to us on acceptable terms or at acceptable rates. In addition, in response to certain interest rate and investment environments or to changes in the market liquidity, we could adopt a strategy of reducing our leverage by selling assets or not reinvesting principal payments as MBS amortize and/or prepay, thereby decreasing the outstanding amount of our related borrowings. Such an action could reduce interest income, interest expense and net income, the extent of which would be dependent on the level of reduction in assets and liabilities as well as the sale prices for which assets were sold.

As our financings mature, we will be required either to enter into new borrowings or to sell certain of our investments. Since we rely primarily on borrowings under repurchase agreements to finance our assets, our ability to achieve our investment objectives depends on our ability to borrow funds in sufficient amounts and on acceptable terms, and on our ability to renew or replace maturing borrowings on a continuous basis. Our repurchase agreement credit lines are renewable at the discretion of our lenders and, as such, do not contain guaranteed roll-over terms. Our ability to enter into repurchase transactions in the future will depend on the market value of our assets pledged to secure the specific borrowings, the availability of acceptable financing and market liquidity and other conditions existing in the lending market at that time. If we are unable to renew or replace maturing borrowings, we could be forced to sell assets in order to maintain liquidity. Forced sales under adverse market conditions could result in lower sales prices than ordinary market sales in the normal course of business. Further, an increase in short-term interest rates at the time that we seek to enter into new borrowings would reduce the spread between our returns on our assets and the cost of our borrowings. This would adversely affect our returns on our assets, which might reduce earnings and, in turn, cash available for distribution to our stockholders.

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*We may enter into hedging transactions that could expose us to contingent liabilities in the future.*

Subject to maintaining our qualification as a REIT and exemption from registration under the 1940 Act, part of our investment strategy may involve entering into economic hedging transactions that could require us to fund cash payments in certain circumstances (such as the early termination of the hedging instrument caused by an event of default or other early termination event, or the decision by a counterparty to request margin securities it is contractually owed under the terms of the hedging instrument). The amount due would be equal to the unrealized loss of the open swap positions with the respective counterparty and could also include other fees and charges. These economic losses will be reflected in our results of operations, and our ability to fund these obligations will depend on the liquidity of our assets and access to capital at the time, and the need to fund these obligations could adversely impact our financial condition.

*Hedging against interest rate exposure may adversely affect our earnings, which could reduce our cash available for distribution to our stockholders.*

Subject to maintaining our qualification as a REIT and exemption from registration under the 1940 Act, we may pursue various economic hedging strategies to seek to reduce our exposure to adverse changes in interest rates. Our hedging activity varies in scope based on the level and volatility of interest rates, the type of assets held and other changing market conditions. Interest rate hedging may fail to protect or could adversely affect us because, among other things:

interest rate hedging can be expensive, particularly during periods of rising and volatile interest rates;

available interest rate hedges may not correspond directly with the interest rate risk for which protection is sought;

due to a credit loss, the duration of the hedge may not match the duration of the related liability;

the amount of income that a REIT may earn from hedging transactions (other than hedging transactions that satisfy certain requirements of the Code or that are done through a TRS) to offset interest rate losses is limited by U.S. federal tax provisions governing REITs;

the value of derivatives used for hedging may be adjusted from time to time in accordance with accounting rules to reflect changes in fair value. Downward adjustments or "mark-to-market losses," would reduce our stockholders' equity;

the credit quality of the hedging counterparty owing money on the hedge may be downgraded to such an extent that it impairs our ability to sell or assign our side of the hedging transaction; and

the hedging counterparty owing money in the hedging transaction may default on its obligation to pay.

Our hedging transactions, which are intended to limit losses, may actually adversely affect our earnings, which could reduce our cash available for distribution to our stockholders.

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While the majority of our interest rate swaps are traded on a regulated exchange, certain hedging instruments are traded over the counter and do not trade on regulated exchanges and, therefore, are not guaranteed by an exchange or a clearing house. In addition over the counter instruments are more lightly regulated by U.S. and foreign governmental authorities. Consequently, there may be no requirements with respect to record keeping, financial responsibility or segregation of customer funds and positions. Furthermore, the enforceability of agreements underlying hedging transactions may depend on compliance with applicable statutory and commodity and other regulatory requirements and, depending on the identity of the counterparty, applicable international requirements. The business failure of a hedging counterparty with whom we enter into a hedging transaction which did not clear through a clearing house would most likely result in its default. Default by a party with whom we enter into a hedging transaction may result in the loss of unrealized profits and force us to cover our commitments, if any, at the then current market price. Although generally we seek to reserve the right to terminate our hedging positions, it may not always be possible to dispose of or close out a hedging position without the consent of the hedging counterparty and we may not be able to enter into an offsetting contract in order to cover our risk. There can be no assurance that a liquid secondary market will exist for any hedging instruments purchased or sold, and we may be required to maintain a position until exercise or expiration, which could result in losses.

**Risks associated with our relationship with our Manager**

***Our Board of Directors has approved very broad investment guidelines for our Manager and does not approve each investment and financing decision made by our Manager.***

Our Manager is authorized to follow very broad investment guidelines. Our Board of Directors periodically reviews our investment guidelines and our investment portfolio but does not, and is not required to review all of our proposed investments, except that an investment in a security structured or issued by another entity managed by our Manager must be approved by at least two-thirds ( $\frac{2}{3}$ ) of our independent directors prior to such investment. In addition, in conducting periodic reviews, our Board of Directors may rely primarily on information provided to them by our Manager. Furthermore, our Manager may use complex strategies, and transactions entered into by our Manager may be costly, difficult or impossible to unwind by the time they are reviewed by our Board of Directors. Our Manager has great latitude within the broad parameters of our investment guidelines in determining the types and amounts of Agency and Non-Agency RMBS, CMBS, ABS and other portfolio investments it may decide are attractive investments for us, which could result in investment returns that are substantially below expectations or that result in losses, which would materially and adversely affect our business operations and results. Further, decisions made and investments and financing arrangements entered into by our Manager may not fully reflect the best interests of our stockholders.

***There are conflicts of interest in our relationship with our Manager that could result in decisions that are not in the best interests of our stockholders.***

We are subject to conflicts of interest arising out of our relationship with our Manager. We do not have any employees. All of our executive officers apart from our interim chief financial officer, who acts in such capacity under an agreement with us and her employer, FTI Consulting, Inc. and two of our directors, James W. Hirschmann III and Gavin L. James, are employees of our Manager. Our Management Agreement with our Manager was negotiated between related parties and its terms, including fees and other amounts payable, may not be as favorable to us as if it had been negotiated at arm's length with an unaffiliated third party. In addition, the obligations of our Manager and its officers and personnel to engage in other business activities may reduce the time our Manager and its officers and personnel spend managing us.

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We compete for investment opportunities directly with other client portfolios managed by our Manager. Clients of our Manager may have investment mandates and objectives that target the same assets as us. A substantial number of client accounts managed by our Manager have exposure to RMBS, CMBS and our other portfolio investments and may have similar investment mandates and objectives. In addition, our Manager may have additional clients that compete directly with us for investment opportunities in the future. Our Manager has an investment allocation policy in place that is intended to ensure that no single client is intentionally favored over another and that trades are allocated in a fair and equitable manner. We may compete with our Manager or its other clients for investment or financing opportunities sourced by our Manager; however, we may either not be presented with the opportunity or have to compete with our Manager to acquire these investments or have access to these sources of financing. Our Manager and our executive officers may choose to allocate favorable investments to itself or to its or other clients instead of to us. Further, at times when there are turbulent conditions in the mortgage markets or distress in the credit markets or other times when we will need focused support and assistance from our Manager, our Manager's other clients will likewise require greater focus and attention, placing our Manager's resources in high demand. In such situations, we may not receive the level of support and assistance that we may receive if we were internally managed or if our Manager did not act as a manager for other entities. There is no assurance that our Manager's allocation policies that address some of the conflicts relating to our access to investment and financing sources will be adequate to address all of the conflicts that may arise.

We pay our Manager a management fee that is not tied to our performance. The management fee may not sufficiently incentivize our Manager to generate attractive risk-adjusted returns for us. This could hurt both our ability to make distributions to our stockholders and the market price of our common stock. Furthermore, the compensation payable to our Manager will increase as a result of future issuances of our equity securities, even if the issuances are dilutive to existing stockholders.

We have sold or issued 50,510 shares of our common stock to our Manager's deferred compensation plan, which made such investment on behalf of the beneficiaries of the plan, including certain executives and other employees of our Manager and its affiliates. We have sold 650,000 shares of common stock to our Manager in a private placement. In addition, through December 31, 2015, our Manager had received four grants of restricted stock totaling 620,677 shares, inclusive of the stock component of the December 19, 2013 dividend. To the extent our Manager elects to sell all or a portion of these shares in the future, our Manager's interests may be less aligned with our interests.

***We are dependent on our Manager and its key personnel for our success.***

We have no separate facilities and are completely reliant on our Manager. All of our executive officers apart from our interim chief financial officer, who acts in such capacity under an agreement with us and her employer, FTI Consulting, Inc. and two of our directors are employees of our Manager. Our Manager has significant discretion as to the implementation of our investment and operating policies and strategies. Accordingly, we believe that our success will depend to a significant extent upon the efforts, experience, diligence, skill and network of business contacts of the executive officers and key personnel of our Manager. The executive officers and key personnel of our Manager evaluate, negotiate, close and monitor our investments; therefore, our success depends on their continued service. The departure of any of the executive officers or key personnel of our Manager could have a material adverse effect on our performance. In addition, we offer no assurance that our Manager will remain our investment manager or that we will continue to have access to our Manager's principals and professionals. The term of our Management Agreement with our Manager expires on May 15, 2017, with automatic one-year renewals thereafter. If the Management Agreement is terminated and no suitable replacement is found to manage us, we may not be able to execute our business plan. Moreover, our Manager is not obligated to dedicate any of its personnel exclusively to us nor is it obligated to dedicate any specific portion of its time to our business, and none of our Manager's personnel are contractually dedicated to us under our Management Agreement with our Manager.



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***The Management Agreement with our Manager was not negotiated on an arm's-length basis, may not be as favorable to us as if it had been negotiated with an unaffiliated third party and may be costly and difficult to terminate.***

All of our executive officers apart from our interim chief financial officer, who acts in such capacity under an agreement with us and her employer, FTI Consulting, Inc. and two of our directors are employees of our Manager. Our Management Agreement with our Manager was negotiated between related parties and its terms, including fees payable, may not be as favorable to us as if it had been negotiated with an unaffiliated third party.

Termination of the Management Agreement with our Manager without cause is difficult and costly. Our independent directors review our Manager's performance and any fees payable to our Manager annually and the Management Agreement may be terminated annually upon the affirmative vote of at least two-thirds ( $\frac{2}{3}$ ) of our independent directors based upon: (i) our Manager's unsatisfactory performance that is materially detrimental to us; or (ii) our determination that any fees payable to our Manager are not fair, subject to our Manager's right to prevent termination based on unfair fees by accepting a reduction of management fees agreed to by at least two-thirds ( $\frac{2}{3}$ ) of our independent directors. We are required to provide our Manager 180 days prior notice of any such termination. Unless terminated for cause, we are required to pay our Manager a termination fee equal to three times the average annual management fee earned by our Manager during the prior 24-month period immediately preceding such termination, calculated as of the end of the most recently completed fiscal quarter before the date of termination. This provision increases the effective cost to us of electing not to renew, or defaulting in our obligations under, the Management Agreement, thereby adversely affecting our inclination to end our relationship with our Manager, even if we believe our Manager's performance is not satisfactory.

Our Manager is only contractually committed to serve us until May 15, 2017. The Management Agreement is automatically renewable for one-year terms; provided, however, that our Manager may terminate the Management Agreement annually upon 180 days prior notice. If the Management Agreement is terminated and no suitable replacement is found to manage us, we may not be able to execute our business plan.

Pursuant to the Management Agreement, our Manager does not assume any responsibility other than to render the services called for thereunder and is not responsible for any action of our Board of Directors in following or declining to follow its advice or recommendations. Our Manager maintains a contractual as opposed to a fiduciary relationship with us. Under the terms of the Management Agreement, our Manager, its officers, stockholders, members, managers, directors, personnel, any person controlling or controlled by our Manager and any person providing sub-advisory services to our Manager are not liable to us, our directors, our stockholders or any partners for acts or omissions performed in accordance with and pursuant to the Management Agreement, except because of acts constituting bad faith, willful misconduct, gross negligence, or reckless disregard of their duties under the Management Agreement. In addition, we indemnify our Manager, its officers, stockholders, members, managers, directors, personnel, any person controlling or controlled by our Manager and any person providing sub-advisory services to our Manager with respect to all expenses, losses, damages, liabilities, demands, charges and claims arising from acts of our Manager not constituting bad faith, willful misconduct, gross negligence, or reckless disregard of duties, performed in good faith in accordance with and pursuant to the Management Agreement.

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***Our Manager's management fee is payable regardless of our performance.***

We pay our Manager a management fee regardless of the performance of our portfolio. Our Manager's entitlement to non-performance-based compensation might reduce its incentive to devote its time and effort to seeking assets that provide attractive risk-adjusted returns for our portfolio. This in turn could hurt both our ability to make distributions to our stockholders and the market price of our common stock.

***Our Manager is subject to extensive regulation as an investment advisor, which could adversely affect its ability to manage our business.***

Our Manager is subject to regulation as an investment advisor by various regulatory authorities that are charged with protecting the interests of its clients, including us. Instances of criminal activity and fraud by participants in the investment management industry and disclosures of trading and other abuses by participants in the financial services industry have led the U.S. government and regulators to consider increasing the rules and regulations governing, and oversight of, the U.S. financial system. This activity is expected to result in changes to the laws and regulations governing the investment management industry and more aggressive enforcement of the existing laws and regulations. Our Manager could be subject to civil liability, criminal liability, or sanction, including revocation of its registration as an investment adviser, revocation of the licenses of its employees, censures, fines, or temporary suspension or permanent bar from conducting business, if it is found to have violated any of these laws or regulations. Any such liability or sanction could adversely affect its ability to manage our business. Our Manager must continually address conflicts between its interests and those of its clients, including us. In addition, the SEC and other regulators have increased their scrutiny of potential conflicts of interest. We believe our Manager has procedures and controls that are reasonably designed to address these issues. However, appropriately dealing with conflicts of interest is complex and difficult and if our Manager fails, or appears to fail, to deal appropriately with conflicts of interest, it could face litigation or regulatory proceedings or penalties, any of which could adversely affect its ability to manage our business.

In fact, in January 2014 settlements of two separate and unrelated regulatory matters involving our Manager with the United States Department of Labor and the Securities and Exchange Commission were announced. The first matter involved the trading of Non-Agency RMBS and whether certain trades complied with the cross trading rules applicable to pension plans subject to Employee Retirement Income Security Act ("ERISA") and to SEC registered funds under the 1940 Act. Our Manager settled that matter without admitting or denying the charges and paying approximately \$7.4 million in compensation to clients and approximately \$1.6 million in fines to the regulators. The second matter involved the handling of an investment which prohibited ERISA accounts from holding it which was allocated in error to certain ERISA accounts. Our Manager settled that matter without admitting or denying the charges and paying \$10 million in compensation and \$2 million in fines. Neither matter related to the Company. The settlements will not adversely affect our Manager's ability to manage the Company's affairs.

**Risks related to our common stock**

***The market price and trading volume of our common stock may vary substantially.***

Our common stock is listed on the NYSE under the symbol "WMC". The stock markets, including the NYSE, have experienced significant price and volume fluctuations over the past several years. As a result, the market price of our common stock is likely to be similarly volatile, and investors in our common stock may experience a decrease in the value of their shares. Accordingly, no assurance can be given as to the ability of our stockholders to sell their common stock or the price that our stockholders may obtain for their common stock.

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Some of the factors that could negatively affect the market price of our common stock include:

actual or anticipated variations in our quarterly operating results;

changes in our earnings estimates or publication of research reports about us or the real estate industry;

changes in market valuations of similar companies;

adverse market reaction to any increased indebtedness we incur in the future;

additions to or departures of our Manager's key personnel;

actions by our stockholders; and

speculation in the press or investment community.

Market factors unrelated to our performance could also negatively impact the market price of our common stock. One of the factors that investors may consider in deciding whether to buy or sell our common stock is our distribution rate as a percentage of our stock price relative to market interest rates. If market interest rates increase, prospective investors may seek alternative investments paying higher dividends or interest. As a result, interest rate fluctuations and conditions in the capital markets can affect the market value of our common stock. For instance, if interest rates rise, it is likely that the market price of our common stock will decrease as market rates on interest-bearing securities increase.

***For as long as we are an emerging growth company, we will not be required to comply with certain reporting requirements, including those relating to accounting standards and disclosure about our executive compensation, that apply to other public companies.***

In April 2012, President Obama signed into law the Jumpstart Our Business Startups Act, or the JOBS Act. The JOBS Act contains provisions that, among other things, relax certain reporting requirements for "emerging growth companies," including certain requirements relating to accounting standards and compensation disclosure. We are classified as an emerging growth company. For as long as we are an emerging growth company, which may be up to five full fiscal years from the date of our IPO, unlike other public companies, we will not be required to: (i) provide an auditor's attestation report on management's assessment of the effectiveness of our system of internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act; (ii) comply with any new or revised financial accounting standards applicable to public companies until such standards are also applicable to private companies under Section 102(b)(1) of the JOBS Act; (iii) comply with any new requirements adopted by the Public Company Accounting Oversight Board, or the PCAOB, requiring mandatory audit firm rotation or a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer; (iv) comply with any new audit rules adopted by the PCAOB after April 5, 2012 unless the SEC determines otherwise; (v) provide certain disclosure regarding executive compensation required of larger public companies; or (vi) hold shareholder advisory votes on executive compensation. We cannot predict if investors will find our common stock less attractive if we choose to rely on these exemptions. If some investors find our common stock less attractive as a result of any choices to reduce future disclosure, there may be a less active trading market for our common stock and our stock price may be more volatile.

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As noted above, under the JOBS Act, emerging growth companies can delay adopting new or revised accounting standards that have different effective dates for public and private companies until such time as those standards apply to private companies. We currently take advantage of such extended transition period. Since we are not required to comply with new or revised accounting standards on the relevant dates on which adoption of such standards is required for other public companies, our financial statements may not be comparable to the financial statements of companies that comply with public company effective dates. If we were to elect to comply with these public company effective dates, such election would be irrevocable pursuant to Section 107 of the JOBS Act.

***Investing in our common stock may involve a high degree of risk.***

The investments that we make in accordance with our investment objectives may result in a high amount of risk when compared to alternative investment options and volatility or loss of principal. Our investments may be highly speculative and aggressive, and therefore an investment in our common stock may not be suitable for someone with lower risk tolerance.

***Common stock eligible for future sale may have adverse effects on our share price.***

We cannot predict the effect, if any, of future sales of our common stock, or the availability of shares for future sales, on the market price of our common stock. The market price of our common stock may decline significantly when the restrictions on resale (or lock up agreements), which may attach to future sales of our common stock, by certain of our stockholders lapse. Sales of substantial amounts of common stock or the perception that such sales could occur may adversely affect the prevailing market price for our common stock.

Also, we may issue additional shares in follow-on public offerings or private placements to make new investments or for other purposes. We are not required to offer any such shares to existing stockholders on a preemptive basis. Therefore, it may not be possible for existing stockholders to participate in such future share issuances, which may dilute the existing stockholders' interests in us.

***We have not established a minimum distribution payment level and we cannot assure you of our ability to pay distributions in the future.***

We intend to pay quarterly distributions and to make distributions to our stockholders in an amount such that we distribute all or substantially all of our net taxable income, calculated in accordance with the REIT regulations, each year. We have not established a minimum distribution payment level and our ability to pay distributions may be adversely affected by a number of factors, including the risk factors described herein. All distributions will be made at the discretion of our Board of Directors and will depend on our earnings, our financial condition, debt covenants, maintenance of our REIT qualification and other factors as our Board of Directors may deem relevant from time to time. We believe that a change in any one of the following factors could adversely affect our results of operations and impair our ability to pay distributions to our stockholders:

the profitability of our existing investments and the investment of net proceeds of any subsequent offering;

our ability to make profitable investments;

margin calls or other expenses that reduce our cash flow;

decreases in the value of our portfolio or defaults in our asset portfolio; and

the fact that anticipated operating expense levels may not prove accurate, as actual results may vary from estimates.

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We cannot assure you that we will achieve investment results that will allow us to make a specified level of cash distributions or year-to-year increases in cash distributions in the future. In addition, some of our distributions may include a return in capital.

***Future offerings of debt or equity securities, which would rank senior to our common stock, may adversely affect the market price of our common stock.***

If we decide to issue debt or equity securities in the future, which would rank senior to our common stock, it is likely that they will be governed by an indenture or other instrument containing covenants restricting our operating flexibility. Additionally, any convertible or exchangeable securities that we issue in the future may have rights, preferences and privileges more favorable than those of our common stock and may result in dilution to owners of our common stock. We and, indirectly, our stockholders, will bear the cost of issuing and servicing such securities. Because our decision to issue debt or equity securities in any future offering will depend on market conditions and other factors beyond our control, we cannot predict or estimate the amount, timing or nature of our future offerings. Thus holders of our common stock will bear the risk of our future offerings reducing the market price of our common stock and diluting the value of their stock holdings in us. Furthermore, the compensation payable to our Manager will increase as a result of future issuances of our equity securities, including issuances upon exercise of the warrants, described below, even if the issuances are dilutive to existing stockholders.

***The dilutive effect of our outstanding warrants, including in certain circumstances, upon the future issuance of common stock, could have an adverse effect on the future market price of our common stock or otherwise adversely affect the interests of our common stockholders.***

On May 15, 2012, we issued and sold to certain institutional investors a number of warrants entitling them to purchase up to an aggregate of 1,115,893 shares of our common stock. These warrants had an initial exercise price of \$20.50 per share (subject to adjustment and limitation on exercise in certain circumstances) and are exercisable for seven years after the date of the warrants' issuance, or earlier upon notice of redemption by us. As a result of two follow on public offerings on October 3, 2012 and April 3, 2014 and the stock portion of our dividend declared on December 19, 2013 the exercise price of each of the outstanding warrants has been reduced to \$16.70 and the number of shares purchasable has increased to 1,232,916. The exercise of the warrants in the future would be dilutive to holders of our common stock if our book value per share or the market price of our common stock is higher than the exercise price at the time of exercise. The potential for dilution from the warrants could have an adverse effect on the future market price of our common stock.

Further, the exercise price of the warrants will be adjusted under certain circumstances, including, subject to certain exceptions, if we sell common stock (or other securities convertible into or exchangeable for our common stock) in a public offering or private placement, for cash at a price per share (after deduction of underwriting discounts or placement fees and other expenses incurred by us that are attributable to the offering) that is less than the closing price of our common stock immediately prior to: (i) the announcement of the proposed sale in the case of public offerings; or (ii) the execution of the purchase agreement in the case of private placements. Accordingly, the exercise price will be adjusted downward in connection with any future offering and increase the dilutive effect of the warrants. Furthermore, any similar public offerings or private placements of our common stock we conduct in the future will likely increase the dilutive effect of the warrants.

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**Risks related to our organization and structure**

***Our authorized but unissued shares of common and preferred stock may prevent a change in our control.***

Our amended and restated certificate of incorporation authorizes us to issue additional authorized but unissued shares of common or preferred stock. In addition, our Board of Directors may, without stockholder approval, amend our amended and restated certificate of incorporation to increase the aggregate number of our shares of stock or the number of shares of stock of any class or series that we have authority to issue and classify or reclassify any unissued shares of common or preferred stock and set the preferences, rights and other terms of the classified or reclassified shares. As a result, our Board of Directors may establish a series of shares of common or preferred stock that could delay or prevent a transaction or a change in control that might involve a premium price for our shares of common stock or otherwise be in the best interest of our stockholders.

***Ownership limitations may restrict change of control or business combination opportunities in which our stockholders might receive a premium for their shares.***

In order for us to qualify as a REIT for each taxable year after 2012, no more than 50% in value of our outstanding capital stock may be owned, directly or indirectly, by five or fewer individuals during the last half of any calendar year. "Individuals" for this purpose include natural persons, private foundations, some employee benefit plans and trusts, and some charitable trusts. To assist us in maintaining our qualification as a REIT, our amended and restated certificate of incorporation generally prohibits any person from directly or indirectly owning more than 9.8% in value or in number of shares, whichever is more restrictive, of the outstanding shares of our capital stock or more than 9.8% in value or in number of shares, whichever is more restrictive, of the outstanding shares of our common stock. This ownership limitation could have the effect of discouraging a takeover or other transaction in which holders of our common stock might receive a premium for their shares over the then prevailing market price or which holders might believe to be otherwise in their best interests.

***Provisions in our amended and restated certificate of incorporation, our amended and restated bylaws and Delaware law may have the effect of preventing or hindering a change in control and adversely affecting the market price of our common stock.***

Provisions in our amended and restated certificate of incorporation and our amended and restated bylaws and applicable provisions of the Delaware General Corporation Law may make it more difficult and expensive for a third party to acquire control of us even if a change of control would be beneficial to the interests of our stockholders. These provisions could discourage potential takeover attempts and could adversely affect the market price our common stock.

***We may pay distributions from offering proceeds, borrowings or the sale of assets to the extent that distributions exceed earnings or cash flow from our operations.***

We may pay distributions from offering proceeds, borrowings or the sale of assets to the extent that distributions exceed earnings or cash flow from our operations. Such distributions would reduce the amount of cash we have available for investing and other purposes and could be dilutive to our financial results. In addition, funding our distributions from our net proceeds may constitute a return of capital to our investors, which would have the effect of reducing each stockholder's basis in its shares of common stock.

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**Tax risks**

***Our Manager has limited experience operating a REIT and we cannot assure you that our Manager's past experience will be sufficient to successfully manage our business as a REIT.***

Our Manager has limited experience operating a REIT. The REIT provisions of the Code are complex, and any failure to comply with those provisions in a timely manner could prevent us from qualifying as a REIT or could force us to pay unexpected taxes and penalties. As a result, we cannot assure you that we will be able to successfully manage our business as a REIT, which would substantially reduce our earnings. In the event of a failure to qualify as a REIT, our net income would be reduced and we could incur a loss.

***If we do not qualify as a REIT or fail to remain qualified as a REIT, we will be subject to U.S. federal income tax as a regular corporation and could face a substantial tax liability, which would reduce the amount of cash available for distribution to our stockholders.***

We believe we have operated and intend to continue to operate in a manner that allows us to qualify as a REIT. Our ability to satisfy the asset tests depends upon our analysis of the characterization and fair market values of our assets, some of which are not susceptible to a precise determination, and for which we will not obtain independent appraisals. Our compliance with the annual REIT income and quarterly asset requirements also depends upon our ability to successfully manage the composition of our income and assets on an ongoing basis. Accordingly, there can be no assurance that the IRS will not contend that our interests in subsidiaries or in securities of other issuers will not cause a violation of the REIT requirements.

If we were to fail to qualify as a REIT in any taxable year, and we do not qualify for certain statutory relief provisions, we would be subject to U.S. federal income tax, including any applicable alternative minimum tax, on our taxable income at regular corporate rates, and dividends paid to our stockholders would not be deductible by us in computing our taxable income. Any resulting corporate tax liability could be substantial and would reduce the amount of cash available for distribution to our stockholders, which in turn could have an adverse impact on the value of our common stock. Unless we were entitled to relief under certain Code provisions, we also would be disqualified from taxation as a REIT for the four taxable years following the year in which we failed to qualify as a REIT.

***Dividends payable by REITs do not qualify for the reduced tax rates available for some dividends.***

The maximum tax rate applicable to income from "qualified dividends" payable to U.S. stockholders that are individuals, trusts and estates is currently 20%, exclusive of the 3.8% investment tax surcharge. Dividends payable by REITs, however, generally are not eligible for the qualified dividend reduced rates. Although the rules do not adversely affect the taxation of REITs or dividends payable by REITs, the more favorable rates applicable to regular corporate qualified dividends could cause investors who are individuals, trusts and estates to perceive investments in REITs to be relatively less attractive than investments in the stocks of non-REIT corporations that pay dividends, which could adversely affect the value of the stock of REITs, including our common stock.

***REIT distribution requirements could adversely affect our ability to execute our business plan.***

We generally must distribute annually at least 90% of our net taxable income, determined without regard to the dividends paid deduction and excluding net capital gains, in order for U.S. federal corporate income tax not to apply to earnings that we distribute. To the extent that we satisfy this distribution requirement, but distribute less than 100% of our REIT taxable income, we will be subject to U.S. federal corporate income tax on our undistributed REIT taxable income. In addition, we will be subject to a nondeductible 4% excise tax if the actual amount that we pay out to our stockholders in a calendar year is less than a minimum amount specified under U.S. federal tax laws. We intend to continue to make distributions to our stockholders to comply with the REIT requirements of the Code.

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From time to time, we may generate taxable income greater than our income for financial reporting purposes prepared in accordance with U.S. GAAP, or differences in timing between the recognition of taxable income and the actual receipt of cash may occur. For example, the tax code limits our ability to use capital losses to offset ordinary income, thereby requiring us to distribute such ordinary income. If we do not have other funds available in these situations we could be required to borrow funds on unfavorable terms, sell investments at disadvantageous prices or distribute amounts that would otherwise be invested in future acquisitions to make distributions sufficient to enable us to pay out enough of our taxable income to satisfy the REIT distribution requirement and to avoid corporate income tax and the nondeductible 4% excise tax in a particular year. These alternatives could increase our costs or reduce our equity. Thus, compliance with the REIT requirements may hinder our ability to grow, which could adversely affect the value of our common stock.

*Even if we remain qualified as a REIT, we may face other tax liabilities that reduce our cash flow.*

Even if we remain qualified for taxation as a REIT, we may be subject to certain U.S. federal, state and local taxes on our income and assets, including taxes on any undistributed income, tax on income from some activities conducted as a result of a foreclosure, excise taxes, state or local income, property and transfer taxes, such as mortgage recording taxes, and other taxes. In addition, in order to meet the REIT qualification requirements, prevent the recognition of certain types of non-cash income, or to avert the imposition of a 100% tax that applies to certain gains derived by a REIT from dealer property or inventory, we hold some of our assets through a TRS or other subsidiary corporation that will be subject to corporate-level income tax at regular corporate rates. The payment of any of these taxes would decrease cash available for distribution to our stockholders.

*Complying with REIT requirements may cause us to liquidate or forgo otherwise attractive opportunities.*

To qualify as a REIT, we must ensure that at the end of each calendar quarter, at least 75% of the value of our assets consists of cash, cash items, government securities and qualified real estate assets, including certain mortgage loans and securities. The remainder of our investments in securities (other than government securities and qualified real estate assets) generally cannot include more than 10% of the outstanding voting securities of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer. In addition, in general, no more than 5% of the value of our total assets (other than government securities and qualified real estate assets) can consist of the securities of any one issuer, and no more than 25% of the value of our total assets can be represented by securities of one or more TRS. If we fail to comply with these requirements at the end of any calendar quarter, we must correct the failure within 30 days after the end of the calendar quarter or qualify for certain statutory relief provisions to avoid losing our REIT qualification and suffering adverse tax consequences. As a result, we may be required to liquidate otherwise attractive investments from our investment portfolio. These actions could have the effect of reducing our income and amounts available for distribution to our stockholders.

In addition to the asset tests set forth above, to qualify as a REIT we must continually satisfy tests concerning, among other things, the sources of our income, the nature and diversification of our assets, the amounts we distribute to our stockholders and the ownership of our stock. We may be required to make distributions to stockholders at disadvantageous times or when we do not have funds readily available for distribution and may be unable to pursue investments that would be otherwise advantageous to us in order to satisfy the source-of-income or asset-diversification requirements for qualifying as a REIT. Thus, compliance with the REIT requirements may hinder our ability to make and, in certain cases, to maintain ownership of, certain attractive investments.



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*We may be required to report taxable income for certain investments in excess of the economic income we ultimately realize from them.*

We acquired and may acquire in the future mortgage-backed securities and other portfolio instruments in the secondary market for less than their face amount. In addition, pursuant to our ownership of certain mortgage-backed securities, we may be treated as holding certain debt instruments acquired in the secondary market for less than their face amount. The discount at which such securities or debt instruments are acquired may reflect doubts about their ultimate collectability rather than current market interest rates. The amount of such discount will nevertheless generally be treated as "market discount" for U.S. federal income tax purposes. Accrued market discount is reported as income when, and to the extent that, any payment of principal of the mortgage-backed security or debt instrument is made. If we collect less on the mortgage-backed security or debt instrument than our purchase price plus the market discount we had previously reported as income, we may not be able to benefit from any offsetting capital loss deductions to the extent we do not have offsetting capital gains.

In addition, pursuant to our ownership of certain mortgage-backed securities or debt instruments, we may be treated as holding distressed debt investments that are subsequently modified by agreement with the borrower. If the amendments to the outstanding debt are "significant modifications" under applicable Treasury regulations, the modified debt may be considered to have been reissued to us at a gain in a debt-for-debt exchange with the borrower. In that event, we may be required to recognize taxable gain to the extent the principal amount of the modified debt exceeds our adjusted tax basis in the unmodified debt, even if the value of the debt or the payment expectations have not changed.

Moreover, some of the mortgage-backed securities or debt instruments that we acquire may have been issued with original issue discount. We are required to report such original issue discount based on a constant yield method and will be taxed based on the assumption that all future projected payments due on such mortgage-backed securities will be made. If such mortgage-backed securities turn out not to be fully collectable, an offsetting loss deduction will become available only in the later year that uncollectability is provable.

Finally, in the event that mortgage-backed securities or any debt instruments we are treated as holding pursuant to our investments in mortgage-backed securities are delinquent as to mandatory principal and interest payments, we may nonetheless be required to continue to recognize the unpaid interest as taxable income as it accrues, despite doubt as to its ultimate collectability. Similarly, we may be required to accrue interest income with respect to subordinate mortgage-backed securities at the stated rate regardless of whether corresponding cash payments are received or are ultimately collectable. In each case, while we would in general ultimately have an offsetting loss deduction available to us when such interest was determined to be uncollectable, the utility of that deduction could depend on our having taxable income in that later year or thereafter.

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***Certain apportionment rules may affect our ability to comply with the REIT asset and gross income tests.***

The Code provides that a regular or a residual interest in a real estate mortgage investment conduit, or REMIC, is generally treated as a real estate asset for the purpose of the REIT asset tests, and any amount includible in our gross income with respect to such an interest is generally treated as interest on an obligation secured by a mortgage on real property for the purpose of the REIT gross income tests. If, however, less than 95% of the assets of a REMIC in which we hold an interest consist of real estate assets (determined as if we held such assets), we will be treated as holding our proportionate share of the assets of the REMIC for the purpose of the REIT asset tests and receiving directly our proportionate share of the income of the REMIC for the purpose of determining the amount of income from the REMIC that is treated as interest on an obligation secured by a mortgage on real property. In connection with the expanded Agency RMBS-backed HARP loan program in which we may invest, the IRS issued guidance providing that, among other things, if a REIT holds a regular interest in an "eligible REMIC," or a residual interest in an "eligible REMIC" that informs the REIT that at least 80% of the REMIC's assets constitute real estate assets, then the REIT may treat 80% of the interest in the REMIC as a real estate asset for the purpose of the REIT income and asset tests. Although the portion of the income from such a REMIC interest that does not qualify for purposes of the REIT 75% gross income test would likely be qualifying income for the purpose of the 95% REIT gross income test, the remaining 20% of the REMIC interest generally would not qualify as a real estate asset, which could adversely affect our ability to satisfy the REIT asset tests. Accordingly, owning such a REMIC interest could adversely affect our ability to qualify as a REIT.

***The "taxable mortgage pool" rules may increase the taxes that we or our stockholders may incur, and may limit the manner in which we effect future securitizations.***

Securitizations could result in the creation of taxable mortgage pools for U.S. federal income tax purposes. As a REIT, so long as we own 100% of the equity interests in a taxable mortgage pool, we generally would not be adversely affected by the characterization of the securitization as a taxable mortgage pool. Certain categories of stockholders, however, such as foreign stockholders eligible for treaty or other benefits, stockholders with net operating losses, and certain tax-exempt stockholders that are subject to unrelated business income tax, could be subject to increased taxes on a portion of their dividend income from us that is attributable to the taxable mortgage pool. In addition, to the extent that our stock is owned by tax-exempt "disqualified organizations," such as certain government-related entities and charitable remainder trusts that are not subject to tax on unrelated business income, we may incur a corporate level tax on a portion of our income from the taxable mortgage pool. In that case, we may reduce the amount of our distributions to any disqualified organization whose stock ownership gave rise to the tax. Moreover, we would be precluded from selling equity interests in these securitizations to outside investors, or selling any debt securities issued in connection with these securitizations that might be considered to be equity interests for tax purposes. These limitations may prevent us from using certain techniques to maximize our returns from securitization transactions.

***Our ability to invest in and dispose of "to be announced" securities could be limited by our election to be subject to tax as a REIT.***

We may purchase Agency RMBS through "to-be-announced" forward contracts, or TBAs. In certain instances, rather than take delivery of the Agency RMBS subject to a TBA, we may dispose of the TBA through a dollar roll transaction in which we agree to purchase similar securities in the future at a predetermined price or otherwise, which may result in the recognition of income or gains. We account for dollar roll transactions as purchases and sales of securities. The law is unclear regarding whether TBAs will be qualifying assets for the 75% asset test and whether income and gains from dispositions of TBAs will be qualifying income for the 75% gross income test. Accordingly, our ability to purchase Agency RMBS through TBAs and to dispose of TBAs, through dollar roll transactions or otherwise, could be limited.

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***The failure of securities subject to repurchase agreements to qualify as real estate assets could adversely affect our ability to qualify as a REIT.***

We enter into financing arrangements that are structured as sale and repurchase agreements pursuant to which we nominally sell certain of our securities to a counterparty and simultaneously enter into an agreement to repurchase these securities at a later date in exchange for a purchase price. Economically, these agreements are financings which are secured by the securities sold pursuant thereto. We believe that we will be treated for REIT asset and income test purposes as the owner of the securities that are the subject of any such sale and repurchase agreement notwithstanding that such agreement may transfer record ownership of the securities to the counterparty during the term of the agreement. It is possible, however, that the IRS could assert that we did not own the securities during the term of the sale and repurchase agreement, in which case we could fail to qualify as a REIT.

***Liquidation of assets may jeopardize our REIT qualification or create additional tax liability for us.***

To qualify as a REIT, we must comply with requirements regarding the composition of our assets and our sources of income. If we are compelled to liquidate our investments to repay obligations to our lenders, we may be unable to comply with these requirements, ultimately jeopardizing our qualification as a REIT, or we may be subject to a 100% tax on any resultant gain if we sell assets that are treated as dealer property or inventory.

***Complying with REIT requirements may limit our ability to hedge effectively and may cause us to incur tax liabilities.***

The REIT provisions of the Code substantially limit our ability to hedge our assets and liabilities. Any income from a hedging transaction we enter into to manage risk of interest rate changes with respect to borrowings made or to be made to acquire or carry real estate assets does not constitute "gross income" for purposes of the 75% or 95% gross income tests. To the extent that we enter into other types of hedging transactions, the income from those transactions is likely to be treated as non-qualifying income for purposes of both of the gross income tests. As a result of these rules, we limit our use of advantageous hedging techniques, and we may implement those hedges through a domestic TRS. This could increase the cost of our hedging activities because our TRS would be subject to tax on gains or expose us to greater risks associated with changes in interest rates than we would otherwise want to bear. In addition, losses in our TRS will generally not provide any tax benefit, except for being carried forward against future taxable income in the TRS.

***Qualifying as a REIT involves highly technical and complex provisions of the Code.***

Qualification as a REIT involves the application of highly technical and complex Code provisions for which only limited judicial and administrative authorities exist. Even a technical or inadvertent violation could jeopardize our REIT qualification. Our qualification as a REIT will depend on our satisfaction of certain asset, income, organizational, distribution, stockholder ownership and other requirements on a continuing basis. In addition, our ability to satisfy the requirements to qualify as a REIT depends in part on the actions of third parties over which we have no control or only limited influence, including in cases where we own an equity interest in an entity that is classified as a partnership for U.S. federal income tax purposes.

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*New legislation or administrative or judicial action, in each instance potentially with retroactive effect, could make it more difficult or impossible for us to qualify as a REIT.*

The present U.S. federal income tax treatment of REITs may be modified, possibly with retroactive effect, by legislative, judicial or administrative action at any time, which could affect the U.S. federal income tax treatment of an investment in us. The U.S. federal income tax rules dealing with REITs constantly are under review by persons involved in the legislative process, the IRS and the U.S. Treasury Department, which results in statutory changes as well as frequent revisions to regulations and interpretations. Revisions in U.S. federal tax laws and interpretations thereof could affect or cause us to change our investments and commitments and affect the tax considerations of an investment in us.

**Item 1B. Unresolved Staff Comment**

None

**Item 2. Properties**

We do not own any properties. Our executive and administrative offices are located in Pasadena, California in office space shared with our Manager.

**Item 3. Legal Proceedings**

None.

**Item 4. Mine Safety Disclosures.**

Not applicable.

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Our common stock is listed on the NYSE under the symbol "WMC". The following table sets forth the high, low and last sales prices for our common stock, as reported on the NYSE:

| <b>Period</b>  | <b>High</b> | <b>Low</b> | <b>Close</b> |
|----------------|-------------|------------|--------------|
| <b>2015</b>    |             |            |              |
| First Quarter  | \$ 15.53    | \$ 13.25   | \$ 15.08     |
| Second Quarter | \$ 15.65    | \$ 14.18   | \$ 14.77     |
| Third Quarter  | \$ 15.29    | \$ 11.07   | \$ 12.61     |
| Fourth Quarter | \$ 12.20    | \$ 9.94    | \$ 10.22     |

|                |          |          |          |
|----------------|----------|----------|----------|
| <b>2014</b>    |          |          |          |
| First Quarter  | \$ 17.05 | \$ 14.64 | \$ 15.64 |
| Second Quarter | \$ 15.68 | \$ 13.50 | \$ 14.17 |
| Third Quarter  | \$ 15.34 | \$ 13.51 | \$ 14.78 |
| Fourth Quarter | \$ 15.81 | \$ 13.91 | \$ 14.70 |

The following table summarizes our dividends declared on common stock, on a per share basis, for the years ended 2015 and 2014:

| <b>Declaration Date</b> | <b>Record Date</b> | <b>Payment Date</b> | <b>Common Stock Dividend</b> |
|-------------------------|--------------------|---------------------|------------------------------|
| <b>2015</b>             |                    |                     |                              |
| March 26, 2015          | April 6, 2015      | April 28, 2015      | \$0.67                       |
| June 18, 2015           | June 29, 2015      | July 28, 2015       | \$0.64                       |
| September 24, 2015      | October 5, 2015    | October 27, 2015    | \$0.60                       |
| December 17, 2015       | December 28, 2015  | January 26, 2016    | \$0.58                       |
| <b>2014</b>             |                    |                     |                              |
| March 20, 2014          | March 31, 2014     | April 29, 2014      | \$0.67                       |
| June 19, 2014           | June 30, 2014      | July 29, 2014       | \$0.67                       |
| September 23, 2014      | October 3, 2014    | October 28, 2014    | \$0.70                       |
| December 18, 2014       | December 29, 2014  | January 27, 2015    | \$0.70                       |

In order to maintain our qualification as a REIT, we must make annual distributions to our stockholders of at least 90% of our taxable income (not including net capital gains). We have adopted a policy of paying regular quarterly dividends on our common stock. A combination of cash and stock dividends has been paid on our common stock since our initial public offering. Dividends are declared at the discretion of the Board of Directors and depend on actual and anticipated cash from operations, our financial condition, capital requirements, the annual distribution requirements under the REIT provisions of the Internal Revenue Code and other factors the Board of Directors may consider relevant.

As of March 8, 2016, we had 7 registered holders of our common stock and 41,919,801 shares outstanding.

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**Securities Authorized for Issuance Under Equity Compensation Plans**

In conjunction with our IPO and concurrent private placement, our Board of Directors approved the Western Asset Mortgage Capital Corporation Equity Plan (the "Equity Plan") and the Western Asset Manager Equity Plan (the "Manager Equity Plan" and collectively the "Equity Incentive Plans"). For further details, see Note 11 to the consolidated financial statements included under Item 8 in this Form 10-K.

The following table presents certain information about the Equity Incentive Plans as of December 31, 2015:

| Award                   | Number of securities<br>to be<br>issued upon exercise<br>of<br>outstanding options,<br>warrants and rights | Weighted-average<br>exercise<br>price of outstanding<br>options, warrants and<br>rights | Number of securities<br>remaining available<br>for<br>future issuance<br>under<br>equity compensation<br>plans |
|-------------------------|--|---|--|
| Restricted common stock | N/A  | N/A   | 549,317  |
| Total                   |  |   | 549,317  |

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**Stockholder Return Performance**

The following graph is a comparison of the cumulative total stockholder return on the Company's common stock, the Standard & Poor's 500 Index (the "S&P 500 Index"), the Russell 2000 Index (the "Russell 2000") and the SNL Finance REIT Index (the "SNL Finance REIT"), a peer group index from May 9, 2012 (commencement of trading on the New York Stock Exchange) to December 31, 2015, and accordingly does not take into account the dividend the Company declared on December 17, 2015 and paid on January 26, 2016. The graph assumes that \$100 was invested on May 15, 2012 in the Company's common stock, the S&P 500 Index, the Russell 2000 and the SNL Finance REIT and that all dividends were reinvested without the payment of any commissions. There can be no assurance that the performance of the Company's shares will continue in line with the same or similar trends depicted in the graph below.

**Recent Sales of Unregistered Securities: Use of Proceeds from Registered Securities**

Not applicable.

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### Item 6. Selected Financial Data

The information below should be read in conjunction with "Forward Looking Statements", Item 1A. "Risk Factors," Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our financial statements and notes thereto included in Item 8. "Financial Statements and Supplementary Data," included in this Form 10-K.

The selected historical information presented for the years ended December 31, 2015, December 31, 2014, December 31, 2013 and for the period from May 15, 2012 (commencement of operations) through December 31, 2012, relates to our operations and has been derived from our audited Consolidated Statement of Operations included in this Annual Report on Form 10-K.

| in thousands except share and per share data                                    | Year Ended<br>December 31,<br>2015 | Year Ended<br>December 31,<br>2014 | Year Ended<br>December 31,<br>2013 | For the period<br>from May 15, 2012<br>(commencement of<br>operations)<br>through<br>December 31, 2012 |
|---|------------------------------------|------------------------------------|------------------------------------|--|
| <b>Operating Data:</b>  |                                    |                                    |                                    |  |
| Net Interest Income:  |                                    |                                    |                                    |  |
| Interest income   | \$ 152,704                         | \$ 149,110                         | \$ 125,328                         | \$ 53,318  |
| Interest expense  | 27,605                             | 22,263                             | 18,019                             | 8,094  |
| <b>Net Interest Income</b>  | <b>125,099</b>                     | <b>126,847</b>                     | <b>107,309</b>                     | <b>45,224</b>  |
| Other Income (Loss):  |                                    |                                    |                                    |  |
| Realized gain (loss) on sale of investments, net                                | 8,279                              | (2,178)                            | (110,712)                          | 20,754   |
| Other loss on securities  | (19,791)                           | (17,014)                           | (11,858)                           | (3,206)  |
| Unrealized gain (loss) on investments, net                                      | (34,011)                           | 189,011                            | (160,109)                          | 13,930   |
| Gain on linked transactions, net  |                                    | 1,870                              | 4,137                              |  |
| Gain (loss) on derivative instruments, net                                      | (68,895)                           | (180,496)                          | 157,547                            | (13,106)   |
| Other, net  | 2,318                              | 1,433                              | 91                                 | 11   |
| <b>Other Income (Loss), net</b>   | <b>(112,100)</b>                   | <b>(7,374)</b>                     | <b>(120,904)</b>                   | <b>18,383</b>  |
| Operating expenses  | 22,483                             | 18,760                             | 14,260                             | 6,330  |
| <b>Net income (loss) available to Common Stock and participating securities</b> | <b>\$ (9,484)</b>                  | <b>\$ 100,713</b>                  | <b>\$ (27,855)</b>                 | <b>\$ 57,277</b>   |
| <br>  |                                    |                                    |                                    |  |
| Net income (loss) per Common Share Basic  | \$ (0.25)                          | \$ 2.67                            | \$ (1.19)                          | \$ 3.64  |
| <br>  |                                    |                                    |                                    |  |
| Net income (loss) per Common Share Diluted                                      | \$ (0.25)                          | \$ 2.67                            | \$ (1.19)                          | \$ 3.63  |
| <br>  |                                    |                                    |                                    |  |
| Dividends Declared per Share of Common Stock                                    | \$ 2.49                            | \$ 2.74                            | \$ 5.10(1)                         | \$ 2.35  |
| <br>  |                                    |                                    |                                    |  |
| <b>Balance Sheet Data (at period end):</b>                                      |                                    |                                    |                                    |  |
| Total assets  | \$ 3,414,563                       | \$ 4,909,277                       | \$ 3,094,877                       | \$ 5,364,964   |



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|                   |    |           |    |           |    |           |    |           |
|-------------------|----|-----------|----|-----------|----|-----------|----|-----------|
| Total liabilities | \$ | 2,902,915 | \$ | 4,286,065 | \$ | 2,683,783 | \$ | 4,841,756 |
|-------------------|----|-----------|----|-----------|----|-----------|----|-----------|

|                            |    |         |    |         |    |         |    |         |
|----------------------------|----|---------|----|---------|----|---------|----|---------|
| Total stockholders' equity | \$ | 511,648 | \$ | 623,212 | \$ | 410,094 | \$ | 523,208 |
|----------------------------|----|---------|----|---------|----|---------|----|---------|

**Other Data:**

Cash flow provided by (used in):

|                      |    |         |    |         |    |         |    |        |
|----------------------|----|---------|----|---------|----|---------|----|--------|
| Operating activities | \$ | 133,898 | \$ | 107,374 | \$ | 179,341 | \$ | 33,518 |
|----------------------|----|---------|----|---------|----|---------|----|--------|

|                      |    |           |    |             |    |           |    |             |
|----------------------|----|-----------|----|-------------|----|-----------|----|-------------|
| Investing activities | \$ | 1,359,855 | \$ | (1,311,678) | \$ | 2,002,411 | \$ | (5,216,160) |
|----------------------|----|-----------|----|-------------|----|-----------|----|-------------|

|                      |    |             |    |           |    |             |    |           |
|----------------------|----|-------------|----|-----------|----|-------------|----|-----------|
| Financing activities | \$ | (1,516,439) | \$ | 1,203,001 | \$ | (2,189,519) | \$ | 5,238,933 |
|----------------------|----|-------------|----|-----------|----|-------------|----|-----------|

- 
- (1) Includes \$2.35 dividend per share declared on December 19, 2013, consisting of cash and stock.

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**ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

The following discussion should be read in conjunction with our financial statements and accompanying notes included in Item 8, "Financial Statements and Supplementary Data" of this annual report on Form 10-K.

**Overview**

We are organized as a Delaware corporation focused on investing in, financing and managing a diversified portfolio of real estate related securities, whole-loans and other financial assets. We are externally managed and advised by our Manager, an SEC-registered investment advisor and a wholly-owned subsidiary of Legg Mason, Inc. Our Manager is responsible for administering our business activities and our day-to-day operations, subject to the supervision of our Board of Directors.

Our portfolio is mainly comprised of Agency RMBS, including TBAs, Non-Agency RMBS, Agency CMBS, Non-Agency CMBS and Residential Whole-Loans. To a significantly lesser extent, we have invested in other securities including certain Agency obligations that are not technically mortgage-backed securities or MBS as well as certain Non U.S. CMBS and ABS investments secured by a portfolio of private student loans. In addition, our holdings included a securitized commercial loan from a consolidated VIE, although we only own a portion of the VIE. To comply with REIT requirements, some of our investments were held in a taxable REIT subsidiary or "TRS". By acquiring investments or engaging in activities through the TRS, it enables us to engage in such activities without jeopardizing our REIT status.

We use leverage, currently consisting of borrowings under repurchase agreements, as part of our business strategy in order to increase potential returns to our stockholders. We accomplish this by borrowing against existing investments primarily through repurchase agreements. We may also change our financing strategy and leverage without the consent of our stockholders.

We operate and elected to be taxed as a REIT, commencing with our taxable year ended December 31, 2012. We generally will not be subject to U.S. federal income taxes on our taxable income to the extent that we annually distribute, in accordance with the REIT regulations, all of our net taxable income to stockholders and maintain our intended qualification as a REIT. We also intend to operate our business in a manner that will permit us to maintain our exemption from registration under the 1940 Act.

**Factors Impacting Our Operating Results**

Our results of operations are affected by a number of factors and primarily depend on our net interest income, changes in the market value of our investments, derivative instruments and to a lesser extent realized gains and losses on the sale of our investments and termination of our derivative instruments. Our overall performance is also impacted by the supply and demand for our target assets in the market, the terms and availability of financing for such assets, general economic conditions, the impact of U.S Government actions that affect the real estate and mortgage sectors, and the unanticipated credit events experienced by borrowers whose loans are included in our MBS, as well as our Whole-Loan borrowers.

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Our net interest income varies primarily as a result of changes in market interest rates and constant prepayment rates (or "CPR") on our RMBS. The CPR measures the amount of unscheduled principal prepayments on RMBS as a percentage of the principal balance, and includes the conditional repayment rate (or "CRR"), which measures voluntary prepayments of mortgages collateralizing a particular RMBS and conditional default rates (or "CDR"), which measures involuntary prepayments resulting from defaults of the underlying mortgage loans. CPRs vary according to the type of investment, conditions in the financial markets, competition and other factors, none of which can be predicted with any certainty. In addition, our borrowing costs and available credit are further affected by the collateral pledged and general conditions in the credit market. Interest income on our Non-Agency RMBS is recorded using an effective yield, which reflects an estimate of expected cash flows for each security. In forecasting cash flows on our Non-Agency RMBS, we make certain assumptions about the underlying mortgage loans which include, but are not limited to, future interest rates, voluntary prepayment rates, default rates, modifications and loss severities. To the extent that our current assessment of future performance differs from our prior assessment, such changes are either reflected in the current period as other-than-temporary impairment or in the income recognized on such securities prospectively. Credit losses greater than those anticipated, or in excess of purchase discount on a given security, could have a material adverse impact on our operating results.

## **Recent Market Conditions**

Our business is affected by general U.S. residential real estate fundamentals, domestic and foreign commercial real estate fundamentals and the overall U.S. and international economic environment. In particular, our strategy is influenced by the specific characteristics of these markets, including but not limited to prepayment rates and interest rate levels. We expect the results of our operations to be affected by various factors, many of which are beyond our control. Our results of operations will primarily depend on, among other things, the level of our net interest income, the market value of our investment portfolio and the supply of and demand for mortgage-related assets. Our net interest income, which includes the amortization of purchase premiums and accretion of discounts, will vary primarily as a result of changes in interest rates, defaults and loss severity rates, borrowing costs, and prepayment speeds on our MBS and other Target Asset (as defined herein) investments. Similarly, the overall value of our investment portfolio will be impacted by these factors as well as changes in the value of residential and commercial real estate and continuing regulatory changes. We continue to shift our portfolio to more credit sensitive assets from Agency securities, which we believe given the current economic and interest rate environment, will provide a better risk adjusted return going forward.

Credit markets experienced a difficult fourth quarter of 2015, and a disappointing second half of the year for RMBS and CMBS assets. Credit concerns, underperformance and lack of liquidity in other credit markets overwhelmed the mortgage and asset backed sectors. RMBS and CMBS credit spreads widened during the quarter as fears of a global economic downturn from China's economic slowdown accelerated, combined with the price of oil which continued to slide and a lack of liquidity spread across most capital markets. As a result, the spread on RMBS and CMBS assets, relative to our interest rate swap hedges, widened during the quarter, driving a deep decline in book value. The driving forces behind swap spread tightening include regulatory changes favoring duration positioning in swaps versus other cash assets, insurance fund liability matching and a very large corporate issuance calendar. Consumer mortgage credit continued stable to modest improvement in borrower performance. Home prices also continued to modestly rise and consumer appetite for housing continued to remain stable with expanding mortgage credit availability. Despite the improvement in the mortgage credit, secondary pricing of mortgage backed assets suffered while leverage became more expensive, leading to underperformance during the second half of the year.

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In the press release issued subsequent to the Federal Open Market Committee or FOMC meeting on December 15 and 16, 2015, the Federal Reserve agreed to set the new target range for the Federal Funds rate at 0.25 percent to 0.50 percent, up from zero to 0.25 percent. A number of members commented that it was appropriate to begin policy normalization in response to the substantial progress in the labor market toward achieving the FOMC's objective of maximum employment and their reasonable confidence that inflation would move to 2 percent over the medium term. The FOMC comments that their decision reflected both the economic outlook and the time it takes for policy actions to affect future economic outcomes. The FOMC observed that after this initial increase in the federal funds rate, the stance of monetary policy would remain accommodative. Some FOMC members said that their decision to raise the target range was a close call, particularly given the uncertainty about inflation dynamics, and emphasized the need to monitor the progress of inflation closely. The FOMC has given guidance that future rate hikes will be data dependent. The Federal Reserve in its January 2016 meeting felt tighter global financial conditions could affect the U.S. economy and while they still expected to raise rates gradually, they acknowledged a weakened global economy and a steep slide in stock markets was tightening financial conditions faster than the Federal Reserve wanted. While Wall Street is skeptical the Federal Reserve will raise rates at all in 2016, we believe the size of future rate hikes and the pace will be modest and slow.

**Critical Accounting Policies**

The consolidated financial statements include our accounts, those of our consolidated subsidiary, our wholly-owned TRS and certain variable interest entities ("VIEs") in which we are the primary beneficiary. All intercompany amounts have been eliminated in consolidation. In accordance with GAAP, our consolidated financial statements require the use of estimates and assumptions that involve the exercise of judgment and use of assumptions as to future uncertainties. In accordance with SEC guidance, the following discussion addresses the accounting policies that we currently apply. Our most critical accounting policies will involve decisions and assessments that could affect our reported assets and liabilities, as well as our reported revenues and expenses. We believe that all of the decisions and assessments upon which our consolidated financial statements have been based were reasonable at the time made and based upon information available to us at that time. We have identified what we believe will be our most critical accounting policies to be the following:

**Fair value option**

We elected the fair value option for all of our investments at the date of purchase and for our securitized debt, which permits us to measure these investments and securitized debt at fair value with the change in fair value included as a component of earnings. Although we have elected the fair value option for our investments and securitized debt, we separately compute interest income on our MBS, other securities and Whole-Loans under the prescribed method based on the nature of the investment.

**Valuation of financial instruments**

We disclose the fair value of our financial instruments according to a fair value hierarchy (Levels I, II, and III, as defined below). In accordance with GAAP, we are required to provide enhanced disclosures regarding instruments in the Level III category (which require significant management judgment), including a separate reconciliation of the beginning and ending balances for each major category of assets and liabilities. GAAP establishes a framework for measuring fair value in accordance with GAAP and expands financial statement disclosure requirements for fair value measurements. GAAP further specifies a hierarchy of valuation techniques, which is based on whether the inputs into the valuation technique are observable or unobservable. The hierarchy is as follows:

Level I Quoted prices in active markets for identical assets or liabilities.

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Level II Quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.

Level III Prices are determined using significant unobservable inputs. In situations where quoted prices or observable inputs are unavailable (for example, when there is little or no market activity for an investment at the end of the period), unobservable inputs may be used.

The level in the fair value hierarchy within which a fair measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety.

When available, we use quoted market prices to determine the fair value of an asset or liability. If quoted market prices are not available, we will use independent pricing services and if the independent pricing service cannot price a particular asset or liability, we will obtain third party broker quotes. Our Manager's pricing group, which functions independently from its portfolio management personnel, corroborates the third party broker quote by comparing the broker price to alternate sources or using internal valuation techniques. If independent pricing service, or third party broker quotes are not available, we determine the fair value of the securities using valuation techniques that use, when possible, current market-based or independently-sourced market parameters, such as interest rates and when applicable, estimates of prepayments and credit losses.

Fair value under GAAP represents an exit price in the normal course of business, not a forced liquidation price. If we are forced to sell assets in a short period to meet liquidity needs, the prices we receive could be substantially less than the recorded fair values of our assets.

We perform quarterly reviews of the independent third party pricing data which may consist of a review of the daily change in the prices provided by the independent pricing vendor that exceed established tolerances or comparisons to executed transaction prices, utilizing our Manager's pricing group. Our Manager's pricing group corroborates the price differences or changes in price by comparing the vendor price to alternate sources including other independent pricing services or broker quotations. If the price change or difference cannot be corroborated, the Manager's pricing group consults with the portfolio management team for market color in reviewing such pricing data as warranted. To the extent that our Manager has information, typically in the form of broker quotations that would indicate that a price received from the independent pricing service is outside of a tolerance range, our Manager generally challenges the independent pricing service price.

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**Linked transactions**

Prior to January 1, 2015, in instances where we financed the acquisition of securities through repurchase agreements with the same counterparty from which the securities were purchased, we evaluated such transactions in accordance with GAAP. This guidance in effect prior to January 1, 2015 required that if the initial transfer of a financial asset and repurchase financing were entered into contemporaneously with, or in contemplation of, one another, such transaction would be considered linked unless all of the criteria found in the guidance were met at the inception of the transaction. If the transaction met all of the conditions, the initial transfer would be accounted for separately from the repurchase financing, and we would record the securities and the related financing on a gross basis on our Consolidated Balance Sheets with the corresponding interest income and interest expense in our Consolidated Statements of Operations. If the transaction was determined to be linked, we would record the initial transfer and repurchase financing on a net basis and record a forward commitment to purchase securities as a derivative instrument with changes in market value being recorded on our Consolidated Statements of Operations. Such forward commitments were recorded at fair value with subsequent changes through December 31, 2014 in fair value recognized in Gain (loss) on linked transactions, net on our Consolidated Statements of Operations. We refer to these transactions as Linked Transactions. Prior to January 1, 2015, when or if a transaction was no longer considered to be linked, the security and related repurchase financing reported on a gross basis. The unlinking of a transaction caused a realization event in which the fair value of the security as of the date of unlinking became the cost basis of the security. The difference between the fair value on the unlinking date and the existing cost basis of the security was the realized gain or loss. Recognition of effective yield for such security was calculated prospectively using the new cost basis. For linked transactions, we reflected purchases and sales of securities within the investing section of our Consolidated Statements of Cash Flows. Proceeds from repurchase agreement borrowings and repayments of repurchase agreement borrowings were reflected in the financing section of our Consolidated Statements of Cash Flows.

Starting in 2015, GAAP no longer requires us to segregate and treat linked transactions as derivatives. Accordingly, starting January 1, 2015, we report such securities and the corresponding repurchase agreements on a gross basis on our Consolidated Balance Sheets and with the corresponding interest income and interest expense reported on a gross basis in our Consolidated Statements of Operations. See "Recent accounting pronouncements" for details.

**Interest income recognition and Impairment**

*Agency MBS, Non-Agency MBS and other securities, excluding Interest-Only Strips, rated AA and higher at the time of purchase*

Interest income on mortgage-backed and other securities is accrued based on the respective outstanding principal balances and corresponding contractual terms. Premiums and discounts associated with Agency MBS, Non-Agency MBS and other securities, excluding Interest-Only Strips, rated AA and higher at the time of purchase, are amortized into interest income over the estimated life of such securities using the effective yield method. Adjustments to premium and discount amortization are made for actual prepayment activity. We estimate prepayments at least quarterly for our securities, and as a result, if prepayments increase (or are expected to increase), we will accelerate the rate of amortization on premiums or discounts and make a retrospective adjustment to historical amortization. Alternatively, if prepayments decrease (or are expected to decrease) we will reduce the rate of amortization on the premiums or discounts and make a retrospective adjustment to historical amortization.

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We assess our Agency MBS, Non-Agency MBS and other securities, excluding Interest-Only Strips, rated AA and higher at the time of purchase, for other-than-temporary impairment on at least a quarterly basis. 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." In deciding on whether or not a security is other-than-temporarily impaired, we consider several factors, including the nature of the investment, communications (if any) from the securitization trustee regarding the credit quality of the security, the severity and duration of the impairment, the cause of the impairment, and our intent not to sell the security and whether it is more likely than not that we will not be required to sell the security until recovery of its amortized cost basis. An other-than-temporary impairment ("OTTI") is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the security is less than its carrying amount. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a "market participant" would use and are discounted at a rate equal to the current yield used to accrete interest income. These adjustments are reflected in our Consolidated Statement of Operations as Other loss on securities.

The determination as to whether an other-than-temporary impairment exists is subject to management estimates based on consideration of both factual information available at the time of assessment as well as our estimates of the future performance and projected amount and timing of cash flows expected to be collected on the security. As a result, the timing and amount of an other-than-temporary impairment constitutes an accounting estimate that may change materially over time.

*Non-Agency MBS and other securities that are rated below AA at the time of purchase and Interest-Only Strips that are not classified as derivatives*

Interest income on Non-Agency MBS and other securities that are rated below AA at the time of purchase and Interest-Only Strips that are not classified as derivatives, are recognized based on the effective yield method. The effective yield on these securities is based on the projected cash flows from each security, which is estimated based on our observation of the then current information and events, where applicable, and will include assumptions related to interest rates, prepayment rates and the timing and amount of credit losses. On at least a quarterly basis, we review and, if appropriate, make adjustments to our cash flow projections based on input and analysis received from external sources, internal models, and our judgment about interest rates, prepayment rates, the timing and amount of credit losses, and other factors. Where appropriate, we may include in our cash flow projections the U.S Department of Justice's settlements with major residential mortgage originators, regarding certain lending practices. Changes in cash flows from those originally projected, or from those estimated at the last evaluation, may result in a prospective change in the yield/interest income recognized on such securities. Actual maturities of the securities are affected by the contractual lives of the underlying collateral, periodic payments of scheduled principal, and prepayments of principal. Therefore, actual maturities of the securities will generally be shorter than stated contractual maturities.

Based on the projected cash flow of such securities purchased at a discount to par value, we may designate a portion of such purchase discount as credit protection against future credit losses and, therefore, not accrete such amount into interest income. The amount designated as credit discount may be adjusted over time, based on the actual performance of the security, its underlying collateral, actual and projected cash flow from such collateral, economic conditions and other factors. If the performance of a security with a credit discount is more favorable than forecasted, a portion of the amount designated as credit discount may be accreted into interest income prospectively.

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In addition, an other-than-temporary impairment is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the security is less than its carrying amount. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a "market participant" would use and are discounted at a rate equal to the current yield used to accrete interest income. These adjustments are reflected in our Consolidated Statements of Operations as Other loss on securities.

Securities denominated in a foreign currency contain additional risk in that the amortized cost basis for those securities may not be recovered due to declines in currency exchange rates. We consider the length of time that the security's fair value has declined due to the decline in foreign exchange rates, when assessing other-than temporary impairment.

The determination as to whether an other-than-temporary impairment exists is subject to management estimates based on consideration of both factual information available at the time of assessment as well as our estimates of the future performance and projected amount and timing of cash flows expected to be collected on the security. As a result, the timing and amount of an other-than-temporary impairment constitutes an accounting estimate that may change materially over time.

Finally, certain of our MBS and other securities that are in an unrealized loss position at the end of the reporting period are not considered other-than-temporarily impaired because we have no intent to sell these investments, it is more likely than not that we will not be required to sell the investment before recovery of its amortized cost basis and we are not required to sell the security for regulatory or other reasons.

*Residential and Commercial Loans*

We record our purchases of residential and commercial loans as the amount paid to the seller plus any fees paid or less any fees received. All other costs incurred in connection with acquiring residential and commercial loans or committing to purchase residential and commercial loans are expensed as incurred. We amortize or accrete any premium or discount over the life of the related loan utilizing the effective interest method, based on the contractual payments terms of the loan. On at least a quarterly basis, we evaluate the collectability of both interest and principal of each loan, if circumstances warrant, to determine whether such loan is impaired. A loan is impaired when, based on current information and events, it is probable that we will be unable to collect all amounts due according to the existing contractual terms. When a loan is impaired, we do not record a loss accrual as we have elected the fair value option. However, income recognition is suspended for loans at the earlier of the date at which payments become 90-days past due or when, in the opinion of management, a full recovery of income and principal becomes doubtful. When the ultimate collectability of the principal of an impaired loan is in doubt, all payments are applied to principal under the cost recovery method. When the ultimate collectability of the principal of an impaired loan is not in doubt, contractual interest is recorded as interest income when received, under the cash basis method until an accrual is resumed when the loan becomes contractually current and performance is demonstrated to be resumed. A loan is written off when it is no longer realizable and/or legally discharged.



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**Variable Interest Entities ("VIEs")**

VIEs are defined as entities that by design either lack sufficient equity for the entity to finance its activities without additional subordinated financial support or are unable to direct the entity's activities or are not exposed to the entity's losses or entitled to its residual returns. We evaluate all of our interests in VIEs for consolidation. When the interests are determined to be variable interests, we assess whether we are deemed the primary beneficiary. The primary beneficiary of a VIE is determined to be the party that has both the power to direct the activities of a VIE that most significantly impact the VIE's economic performance and the obligation to absorb losses or the right to receive benefits of the VIE that could potentially be significant to the VIE.

To assess whether we have the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, we consider all facts and circumstances, including its role in establishing the VIE and our ongoing rights and responsibilities. This assessment includes first, identifying the activities that most significantly impact the VIE's economic performance; and second, identifying which party, if any, has power over those activities. In general, the parties that make the most significant decisions affecting the VIE or have the right to unilaterally remove those decision makers is deemed to have the power to direct the activities of a VIE.

To assess whether we have the obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE, we consider all of its economic interests. This assessment requires that we apply judgment in determining whether these interests, in the aggregate, are considered potentially significant to the VIE. Factors considered in assessing significance include: the design of the VIE, including its capitalization structure; subordination of interests; payment priority; relative share of interests held across various classes within the VIE's capital structure; and the reasons why the interests are held by us.

In instances when a VIE is owned by both us and related parties, we consider whether there is a single party in the related party group that meets both the power and losses or benefits criteria on its own as though no related party relationship existed. If one party within the related party group meets both these criteria, such reporting entity is the primary beneficiary of the VIE and no further analysis is needed. If no party within the related party group on its own meets both the power and losses or benefits criteria, but the related party group does as a whole meets these two criteria, the determination of primary beneficiary within the related party group is based upon an analysis of the facts and circumstances with the objective of determining which party is most closely associated with the VIE. Determining the primary beneficiary within the related party group requires significant judgement.

In instances when we are required to consolidate a VIE that is determined to be a qualifying collateralized financing entity, under GAAP, we will measure both the financial assets and financial liabilities of the VIE using the fair value of either the VIE's financial assets or financial liabilities, whichever is more observable.

Ongoing assessments of whether an enterprise is the primary beneficiary of a VIE is required.

**Derivatives and hedging activities**

Subject to maintaining our qualification as a REIT for U.S. federal income tax purposes, we utilize derivative financial instruments, including interest rate swaps, interest rate swaptions, mortgage put options, currency forwards, futures contracts, TBAs and Agency and Non-Agency Interest-Only Strips to hedge the interest rate and currency risk associated with our portfolio and related borrowings. Derivatives, subject to REIT requirements, are used for hedging purposes rather than speculation. We determine their fair value of our derivative positions and obtain quotations from third parties, including the Chicago Mercantile Exchange or CME, to facilitate the process of determining such fair values. If our hedging activities do not achieve the desired results, reported earnings may be adversely affected.

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GAAP requires an entity to recognize all derivatives as either assets or liabilities and to measure those instruments at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether we have 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 are classified as either hedges of the fair value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge) or hedges of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge). If we do not elect hedge accounting for a derivative instrument, which we have not, fair value adjustments are recorded in earnings immediately.

We elected not to apply hedge accounting for our derivative instruments. Accordingly, we record the change in fair value of our derivative instruments, which includes net interest rate swap payments (including accrued amounts) and net currency payments (including accrued amounts) related to interest rate swaps and currency swaps, respectively, in Gain (loss) on derivative instruments, net in our Consolidated Statements of Operations. In our Consolidated Statements of Cash Flows, premiums received and paid on termination of our interest rate swaps, excluding interest rate swaps containing an other-than-insignificant financing element and the unamortized premium of market agreed coupon ("MAC") interest rate swaps, are included in cash flows from operating activities. Alternatively, proceeds and payments on settlement of swaptions, mortgage put options, futures contracts and TBAs are included in cash flows from investing activities. Proceeds and payments on settlement of forward contracts are reflected in cash flows from financing activities in our Consolidated Statement of Cash Flows. While payments made at the time of entering MAC interest rate swaps are included in cash flows from investing activities, payments received by us upon entering MAC interest rate swaps are included in either cash flows from investing activities or cash flows financing activities, depending on whether or not the derivative instrument includes an other-than-insignificant financing element. For MAC interest rate swaps containing an other-than-insignificant financing element, all cash flows over the life of the derivative are treated as cash flows from financing activities. Return and recovery of basis activity for MAC interest rate swaps is included in cash flows from investing activities for swaps not containing an other-than-insignificant financing element in our Consolidated Statement of Cash Flows. For Agency and Non-Agency Interest-Only Strips accounted for as derivatives, the purchase, sale and recovery of basis activity is included with MBS and other securities under cash flows from investing activities in our Consolidated Statement of Cash Flows.

We evaluate the terms and conditions of our holdings of Agency and Non-Agency Interest-Only Strips and TBAs to determine if these instruments have the characteristics of an investment or should be considered a derivative under GAAP. In determining the classification of our holdings of Interest-Only Strips, we evaluate the securities to determine if the nature of the cash flows has been altered from that of the underlying mortgage collateral. Generally, Interest-Only Strips for which the security represents a strip off of a mortgage pass through security will be considered a hybrid instrument classified as a MBS investment on our Consolidated Balance Sheets utilizing the fair value option. Alternatively, those Interest-Only Strips, for which the underlying mortgage collateral has been included into a structured security that alters the cash flows from the underlying mortgage collateral, are accounted for as derivatives at fair value. Accordingly, Agency and Non-Agency Interest-Only Strips and TBAs having the characteristics of derivatives are accounted for at fair value with such changes recognized in Gain (loss) on derivative instruments, net in our Consolidated Statements of Operations, along with any interest earned or paid (including accrued amounts). The carrying value of the Agency and Non-Agency Interest-Only Strips, accounted for as derivatives, is included in Mortgage-backed securities on the Consolidated Balance Sheets. The carrying value of interest rate swaptions, currency forwards, futures contracts and TBAs is included in Derivative assets or Derivative liabilities on the Consolidated Balance Sheets.

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We evaluate all of our financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. An embedded derivative is separated from the host contract and accounted for separately when all of the guidance criteria are met. Hybrid instruments that are remeasured at fair value through earnings, including the fair value option, are not bifurcated. Derivative instruments, including derivative instruments accounted for as liabilities are recorded at fair value and are re-valued at each reporting date, with changes in the fair value together with interest earned or paid (including accrued amounts) reported in the Gain (loss) on derivative instruments, net in our Consolidated Statements of Operations. While accounted for as derivative instruments through December 31, 2014, linked transactions, including changes in fair value and interest earned or paid (including accrued amounts) were reported separately in our Consolidated Balance Sheets, Consolidated Statements of Operations and Consolidated Statements of Cash Flows. See "Warrants" below.

**Accounting standards applicable to emerging growth companies**

The JOBS Act contains provisions that relax certain requirements for "emerging growth companies" for which we qualify. For as long as we are an emerging growth company, which may be up to five full fiscal years, unlike other public companies, we will not be required to: (i) comply with any new or revised financial accounting standards applicable to public companies until such standards are also applicable to private companies under Section 102(b)(1) of the JOBS Act; (ii) provide an auditor's attestation report on management's assessment of the effectiveness of our system of internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act; (iii) comply with any new requirements adopted by the PCAOB requiring mandatory audit firm rotation or a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer; or (iv) comply with any new audit rules adopted by the PCAOB after April 5, 2012 unless the SEC determines otherwise. We currently take advantage of some of these exemptions. Our qualification for remaining an emerging growth company under the five full fiscal years expires on December 31, 2017. However, we will no longer qualify for such exemption if our gross revenue for any year equals or exceeds \$1.0 billion or more, we issue more than \$1.0 billion in non-convertible debt during the three previous years, or if we are deemed to be a large accelerated filer.

As noted above, under the JOBS Act, emerging growth companies can delay adopting new or revised accounting standards that have different effective dates for public and private companies until such time as those standards apply to private companies. We currently take advantage of such extended transition period. Since we are not required to comply with new or revised accounting standards on the relevant dates on which adoption of such standards is required for other public companies, our financial statements may not be comparable to the consolidated financial statements of companies that comply with public company effective dates. If we were to elect to comply with these public company effective dates, such election would be irrevocable pursuant to Section 107 of the JOBS Act.

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**Recent accounting pronouncements**

Accounting Standards to be Adopted in Future Periods

In May 2014, the Financial Accounting Standards Board issued guidance that changes an entity's recognition of revenue from contracts with customers. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In addition, the new guidance requires improved disclosures to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. In applying the new guidance, an entity may use either a retrospective approach to each prior reporting period or a retrospective approach with the cumulative effect recognized at the date of initial application. For a public company, the standard is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early adoption is not permitted for a public entity. For all other entities, the standard is effective for annual reporting periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2015. With certain restrictions, a nonpublic entity may elect to apply the guidance earlier. The new guidance is not expected to have a material impact on our consolidated financial statements.

In August 2014, the Financial Accounting Standards Board issued guidance that will require an entity's management to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. According to the new guidance, substantial doubt exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date the financial statements are issued. The term "probable" is used consistently with its current use in U.S. GAAP for loss contingencies. Disclosures will be required if conditions give rise to substantial doubt about the entity's ability to continue as a going concern, including whether management's plans that are intended to mitigate those conditions will alleviate the substantial doubt when implemented. The guidance is effective for annual periods ending after December 15, 2016. The effective date is the same for both public companies and all other entities. Early application is permitted. We have not elected to early adopt this guidance. Our first assessment under the new guidance will be completed for the year ending December 31, 2016.

In August 2014, the FASB issued guidance on measuring the financial assets and financial liabilities of consolidated collateralized financing entities, or CFEs. The update allows an entity to measure both the financial assets and financial liabilities of a qualifying CFE it consolidates using the fair value of either the CFE's financial assets or financial liabilities, whichever is more observable. The guidance requires certain recurring disclosures and is effective for annual periods beginning on or after December 15, 2015, with early adoption permitted as of the beginning of an annual period. Early adoption was applied, which did not have a material impact on our financial condition or results of operations.

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In January 2015, the FASB issued guidance to simplify income statement presentation by eliminating the concept of extraordinary items. U.S. GAAP currently requires that a company separately classify, disclose and present extraordinary events and transactions. The guidance eliminates the concept of extraordinary items from U.S. GAAP. Under the existing guidance, an entity is required to separately disclose extraordinary items, net of tax, in the income statement after income from continuing operations if an event or transaction is of an unusual nature and occurs infrequently. This separate, net-of-tax presentation (and corresponding earnings per share impact) will no longer be allowed. The existing requirement to separately present items that are of an unusual nature or occur infrequently on a pre-tax basis within income from continuing operations has been retained. The new guidance also requires similar separate presentation of items that are both unusual and infrequent. The standard is effective for periods beginning after December 15, 2015. The effective date is the same for both public companies and all other entities. Early adoption is permitted, but only as of the beginning of the fiscal year of adoption. Upon adoption, a reporting entity may elect prospective or retrospective application. If adopted prospectively, both the nature and amount of any subsequent adjustments to previously reported extraordinary items must be disclosed. We have not elected to early adopt this guidance. The new guidance is not expected to have a material impact on our consolidated financial statements.

In February 2015, the FASB issued guidance to simplify and reduce the number of consolidation models through the elimination of an indefinite deferral for certain entities and by placing more emphasis on risk of loss when determining a controlling financial interest. The guidance affects reporting entities that are required to evaluate whether they should consolidate certain legal entities. All legal entities are subject to reevaluation under the revised consolidation model. The standard is effective for a public company for fiscal years, and for interim periods within fiscal years beginning after December 15, 2015. The standard is effective for other entities for fiscal years beginning after December 31, 2016, and for interim periods beginning after December 15, 2017. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. We have not elected to early adopt this guidance. The new guidance is not expected to have a material impact on our consolidated financial statements.

In April 2015, the FASB issued guidance to amend the presentation of debt issuance cost related to a recognized debt liability. Under the new guidance, the debt issuance costs will be presented in the balance sheet as a direct deduction from the carrying amount of the recognized debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected under the new guidance. The standard is effective for a public company for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. The standard is effective for other entities for the fiscal years beginning December 15, 2015, and interim periods within fiscal years beginning after December 15, 2016. Early adoption is permitted. The guidance should be applied on a retrospective basis. The balance sheet of each individual period presented should be adjusted to reflect the period-specific effects of applying the new guidance. Upon adoption, an entity is required to comply with the applicable disclosures for a change in an accounting principle. These disclosures include the nature of and reason for the change in accounting principle, the transition method, a description of the prior-period information that has been retrospectively adjusted, and the effect of the change on the financial statement line items (i.e., debt issuance cost asset and the debt liability). We have not elected to early adopt this guidance. The new guidance is not expected to have a material impact on our consolidated financial statements.

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In January 2016, the FASB issued guidance to improve certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. The standard is effective for a public company for fiscal years beginning after December 15, 2017, and for interim periods within those fiscal years. The standard is effective for other entities for fiscal years beginning after December 15, 2018, and for interim periods beginning after December 15, 2019. Early adoption by public companies for fiscal years or interim periods that have not yet been issued or, by all other entities, that have not yet been made available for issuance of this guidance are permitted as of the beginning of the fiscal year of adoption, under certain restrictions. The Company should apply the guidance by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The guidance related to equity securities without readily determinable fair values should be applied prospectively to equity investments that exist at the date of adoption. We are currently assessing the impact this guidance will have on our consolidated financial statements.

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### Investments

#### Our Portfolio

The following table presents certain information about our investment portfolio at December 31, 2015 (dollars in thousands):

|  | Principal<br>Balance | Unamortized<br>Premium<br>(Discount) | Discount<br>Designated<br>as<br>Credit<br>Reserve<br>and OTTI | Amortized<br>Cost   | Unrealized<br>Gain (Loss) | Fair Value       | Net<br>Weighted<br>Average<br>Coupon(1) |
|--|----------------------|--------------------------------------|---|---------------------|---------------------------|------------------|---|
| <b>Agency RMBS 20-Year mortgage</b>                                      |                      |                                      |   |                     |                           |                  |   |
| Coupon Rate:   |                      |                                      |   |                     |                           |                  |   |
| 3.50%  | 147,477              | 8,131                                |   | 155,608             | (1,306)                   | 154,302          | 3.5%                                    |
| 4.00%  | 497,836              | 27,085                               |   | 524,921             | 8,049                     | 532,970          | 4.0%                                    |
|  | 645,313              | 35,216                               |   | 680,529             | 6,743                     | 687,272          | 3.9%                                    |
| <b>30-Year mortgage</b>  |                      |                                      |   |                     |                           |                  |   |
| Coupon Rate:   |                      |                                      |   |                     |                           |                  |   |
| 3.50%  | 107,974              | 7,884                                |   | 115,858             | (4,100)                   | 111,758          | 3.5%                                    |
| 4.00%  | 297,975              | 27,077                               |   | 325,052             | (6,807)                   | 318,245          | 4.0%                                    |
| 4.50%  | 382,168              | 28,053                               |   | 410,221             | 9,618                     | 419,839          | 4.5%                                    |
| 5.00%  | 58,873               | 7,175                                |   | 66,048              | 350                       | 66,398           | 5.0%                                    |
| 5.50%  | 2,861                | 441                                  |   | 3,302               | (107)                     | 3,195            | 5.5%                                    |
| 6.00%  | 6,163                | 712                                  |   | 6,875               | 149                       | 7,024            | 6.0%                                    |
|  | 856,014              | 71,342                               |   | 927,356             | (897)                     | 926,459          | 4.2%                                    |
| Agency RMBS IOs and IIOs(2)  | N/A                  | N/A                                  |   | 71,632              | 322                       | 71,954           | 3.1%                                    |
| Agency and Non-Agency IOs and IIOs<br>accounted for as derivatives(2)(3) | N/A                  | N/A                                  | N/A   | N/A                 | N/A                       | 59,987           | 2.5%                                    |
|  | N/A                  | N/A                                  |   | 71,632              | 322                       | 131,941          | 2.8%                                    |
| Non-Agency RMBS  | 601,233              | (16,669)                             | (141,014)   | 443,550             | 1,899                     | 445,449          | 3.7%                                    |
| Non-Agency RMBS IOs and IIOs(2)  | N/A                  | N/A                                  | N/A   | 66,600              | 14,589                    | 81,189           | 5.9%                                    |
|  | 601,233              | (16,669)                             | (141,014)   | 510,150             | 16,488                    | 526,638          | 4.5%                                    |
| Agency and Non-Agency CMBS, including<br>Non U.S.                        | 575,351              | (80,133)                             | (2,719)   | 492,499             | (16,894)                  | 475,605          | 5.0%                                    |
| CMBS Interest-Only Strips(2)   | N/A                  | N/A                                  | N/A   | 1,915               | 198                       | 2,113            | 4.7%                                    |
|  | 575,351              | (80,133)                             | (2,719)   | 494,414             | (16,696)                  | 477,718          | 5.0%                                    |
| Other securities(4)  | 81,518               | 7,433                                | (9,017)   | 102,778             | (1,679)                   | 101,099          | 4.8%                                    |
| Residential Whole-Loans  | 212,647              | 2,249                                |   | 214,896             | 3,642                     | 218,538          | 4.9%                                    |
| Securitized commercial loan  | 25,000               |                                      |   | 25,000              |                           | 25,000           | 9.0%                                    |
| <b>Total</b>   | <b>\$ 2,997,076</b>  | <b>\$ 19,438</b>                     | <b>\$ (152,750)</b>   | <b>\$ 3,026,755</b> | <b>\$ 7,923</b>           | <b>3,094,665</b> | <b>4.0%</b>                             |

(1) Net weighted average coupon as of December 31, 2015 is presented net of servicing and other fees.

(2) Agency RMBS IOs and IIOs, Non-Agency RMBS IOs and IIOs, Agency and Non-Agency IOs and IIOs, accounted for as derivatives, and Agency and Non-Agency CMBS IOs and IIOs have no principal balances and bear interest based on a notional balance. The notional balance is used solely to determine interest distributions on interest-only class of securities. At December 31, 2015, the notional balance for Agency RMBS IOs and IIOs, Non-Agency IOs and IIOs, Agency and Non-Agency IOs and IIOs, accounted for as derivatives, and CMBS IOs and IIOs was \$593.4 million, \$321.0 million, \$655.6 million and \$43.2 million, respectively.

(3)

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Interest on these securities is reported as a component of Gain (loss) on derivative instruments, net.

- (4) Other securities include residual interests in asset-backed securities which have no principal balance and an amortized cost of approximately \$22.8 million.



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The following table summarizes our MBS and other securities at fair value according to their estimated weighted average life classifications as of December 31, 2015 (dollars in thousands):

| Weighted Average Life   | Fair Value          | Net Weighted Average Coupon(1) |
|---|---------------------|--------------------------------|
| Less than or equal to three years                             | \$ 97,546           | 5.0%                           |
| Greater than three years and less than or equal to five years | 475,691             | 3.6%                           |
| Greater than five years and less than or equal to 10 years    | 1,997,282           | 3.9%                           |
| Greater than 10 years   | 280,608             | 4.6%                           |
| <b>Total</b>  | <b>\$ 2,851,127</b> | <b>4.0%</b>                    |

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(1) Net weighted average coupon as of December 31, 2015 is presented net of servicing and other fees.

### *Our Agency Portfolio*

The following table summarizes certain characteristics of our Agency RMBS portfolio by issuer and investment category as of December 31, 2015 (dollars in thousands):

|   | Principal Balance   | Amortized Cost      | Fair Value          | Net Weighted Average Coupon(1) |
|---|---------------------|---------------------|---------------------|--------------------------------|
| <b>Agency RMBS 20-Year and 30-Year</b>                                |                     |                     |                     |                                |
| Fannie Mae  | \$ 1,022,112        | \$ 1,099,205        | \$ 1,103,431        | 4.2%                           |
| Freddie Mac   | 479,215             | 508,680             | 510,300             | 3.9                            |
| <b>Total Agency RMBS 20-Year and 30-Year</b>                          | <b>1,501,327</b>    | <b>1,607,885</b>    | <b>1,613,731</b>    | <b>4.1</b>                     |
| <b>Agency RMBS IOs and IIOs(2)</b>                                    |                     |                     |                     |                                |
| Fannie Mae  | N/A                 | 29,986              | 31,262              | 3.2                            |
| Freddie Mac   | N/A                 | 22,375              | 22,211              | 2.8                            |
| Ginnie Mae  | N/A                 | 19,271              | 18,481              | 3.3                            |
| <b>Total Agency RMBS IOs and IIOs(2)</b>                              | <b>N/A</b>          | <b>71,632</b>       | <b>71,954</b>       | <b>3.1</b>                     |
| <b>Agency RMBS IOs and IIOs accounted for as derivatives(2)</b>       |                     |                     |                     |                                |
| Fannie Mae  | N/A                 | N/A                 | 16,804              | 3.0                            |
| Freddie Mac   | N/A                 | N/A                 | 4,153               | 3.5                            |
| Ginnie Mae  | N/A                 | N/A                 | 24,405              | 4.1                            |
| <b>Total Agency RMBS IOs and IIOs accounted for as derivatives(2)</b> | <b>N/A</b>          | <b>N/A</b>          | <b>45,362</b>       | <b>3.6</b>                     |
| <b>Total: Agency RMBS</b>   | <b>\$ 1,501,327</b> | <b>\$ 1,679,517</b> | <b>\$ 1,731,047</b> | <b>3.8%</b>                    |

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(1) Net weighted average coupon as of December 31, 2015 is presented net of servicing and other fees.

(2)

Agency RMBS IOs and IIOs, Agency RMBS IOs and IIOs, accounted for as derivatives have no principal balances and bear interest based on a notional balance. The notional balance is used solely to determine interest distributions on the interest-only class of securities.

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The following table details the constant prepayment rates for our Agency portfolio as of December 31, 2015, based on our Manager's estimates which are based on third party models, as adjusted by our Manager, and are updated quarterly on a prospective basis:

| Constant Prepayment Rates                             | Low   | High   |
|---|-------|--------|
| Agency RMBS   |       |        |
| 20-Year mortgage                                      | 6.64% | 24.32% |
| 30-Year mortgage                                      | 5.60% | 29.74% |
| Agency RMBS IOs and IIOs                              | 6.83% | 30.67% |
| Agency RMBS IOs and IIOs accounted for as derivatives | 5.23% | 28.81% |
| Agency CMBS and Agency CMBS IOs and IIOs(1)           | N/A   | N/A    |
| Agency CMBS IOs accounted for as derivatives(1)       | N/A   | N/A    |

(1) CMBS generally include prepayment restrictions; therefore, there are no Constant Prepayment Rates available.

### *Our Non-Agency Portfolio*

The following table presents the fair value and weighted average purchase price for each of our Non-agency RMBS categories, including IOs accounted for as derivatives, together with certain of their respective underlying loan collateral attributes and current performance metrics as of December 31, 2015 (fair value dollars in thousands):

| Category | Fair Value | Purchase Price | Life (Years) | Weighted Average |               |                    |             |
|----------|------------|----------------|--------------|------------------|---------------|--------------------|-------------|
|          |            |                |              | Original LTV     | Original FICO | 60+ Day Delinquent | 6-Month CPR |
| Prime    | \$ 86,227  | \$ 73.68       | 11.3         | 69.8%            | 724           | 19.7%              | 5.8%        |
| Alt-A    | 363,743    | 76.65          | 11.4         | 74.1%            | 707           | 20.9%              | 6.4%        |
| Subprime | 80,223     | 66.30          | 8.5          | 79.2%            | 630           | 23.0%              | 5.1%        |
| Total    | \$ 530,193 | \$ 74.60       | 10.9         | 74.2%            | 698           | 21.0%              | 6.1%        |

The following table summarizes the credit ratings of our Non-agency RMBS, Non-agency CMBS and other securities based on fair value as of December 31, 2015:

| Non-Agency RMBS  |            | Non-Agency CMBS  |            | Other Securities Credit |            |
|------------------|------------|------------------|------------|-------------------------|------------|
| Credit Rating(1) | Percentage | Credit Rating(1) | Percentage | Rating(1)               | Percentage |
| BBB              | 0.2%       | BBB              |            | BBB                     | %          |
| BBB              |            | BBB              | 0.9%       | BBB                     | %          |
| BB               |            | BB               | 5.6%       | BB                      | %          |
| BB               |            | BB               | 4.9%       | BB                      | %          |
| B+               |            | B+               | 2.0%       | B+                      | %          |
| B                | 0.9%       | B                |            | B                       | %          |
| B                | 0.2%       | B                |            | B                       | %          |
| Below B          | 80.5%      | Below B          |            | Below B                 | 11.0%      |
| Not Rated        | 18.2%      | Not Rated        |            | Not Rated               | 89.0%      |
| Total            | 100.0%     | Total            |            | Total                   | 100.0%     |

(1)

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For securities for which one or two ratings are obtained, the lower rating is used. For securities for which three ratings are obtained, the middle rating is used. Ratings are obtained either from S&P or other rating agencies, stated in terms of the S&P equivalent.

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The following table details information for our Non-Agency and other securities portfolio as of December 31, 2015, based on our Manager's estimates which are based on third party models, as adjusted by our Manager, and are updated quarterly on a prospective basis:

|   | Cumulative Default |        | Cumulative Severity |         | Cumulative 5-Year CRR(1) |        |
|---|--------------------|--------|---------------------|---------|--------------------------|--------|
|   | Low                | High   | Low                 | High    | Low                      | High   |
| Non-Agency RMBS   | 4.50%              | 50.32% | 10.00%              | 84.22%  | 2.52%                    | 12.58% |
| Non-Agency RMBS IOs and IIOs                              | 4.50%              | 42.58% | 10.00%              | 67.37%  | 5.17%                    | 10.04% |
| Non-Agency RMBS IOS and IIOs accounted for as derivatives | 4.50%              | 10.85% | 10.00%              | 54.80%  | 6.50%                    | 10.73% |
| Non-Agency CMBS   | N/A                | N/A    | N/A                 | N/A     | N/A                      | N/A    |
| Other securities  | %                  | 31.56% | %                   | 100.00% | 4.00%                    | 10.36% |

(1) Conditional Repayment Rate

The mortgages underlying our Non-Agency RMBS and Non-Agency CMBS are located in various states across the United States and other countries. The following table presents the five largest concentrations by location for the mortgages collateralizing our Non-Agency RMBS and Non-Agency CMBS as of December 31, 2015 based on fair value (dollars in thousands):

| Non-Agency RMBS |               |            | Non-Agency CMBS |               |            |
|-----------------|---------------|------------|-----------------|---------------|------------|
|                 | Concentration | Fair Value |                 | Concentration | Fair Value |
| California      | 35.0%         | \$ 185,516 | California      | 12.6%         | \$ 56,758  |
| Florida         | 8.8%          | 46,913     | New York        | 8.5%          | 38,382     |
| New York        | 7.5%          | 40,011     | Texas           | 7.5%          | 33,724     |
| Virginia        | 4.0%          | 21,227     | Germany         | 6.5%          | 29,200     |
| Maryland        | 3.7%          | 19,730     | Florida         | 6.3%          | 28,549     |

We made investments in certain Non-Agency RMBS inverse floaters. The coupon rates on these securities have an inverse relationship to a benchmark rate. When the benchmark interest rate increases the coupon payment rate will decrease because the benchmark interest rate is deducted from the coupon payment. We generally purchased these securities at a premium. Accelerated prepayments on these bonds could result in an economic loss, as we would not recover the upfront premium. The premiums are amortized into income using the effective interest rate method. As of December 31, 2015 and December 31, 2014, we held \$79.1 million and \$93.9 million, respectively, in Non-Agency RMBS inverse floaters, excluding those accounted for as linked transactions. In addition as of December 31, 2014, we held \$8.2 million in Non-Agency RMBS inverse floaters accounted for as linked transactions.

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#### *Our Whole-Loan Portfolio*

Our Residential Whole-Loans are comprised of mostly non-qualifying adjustable rate mortgages with low loan to values (or "LTV"). The following table presents certain information about our Residential Whole-Loans investment portfolio at December 31, 2015 (dollars in thousands):

| Current Coupon Rate | Number of Loans | Principal Balance | Original LTV | Weighted Average       |                       |                              | Coupon Rate |
|---------------------|-----------------|-------------------|--------------|------------------------|-----------------------|------------------------------|-------------|
|                     |                 |                   |              | Original FICO Score(1) | Expected Life (years) | Contractual Maturity (years) |             |
| 3.01 - 4.00%        | 2               | \$ 698            | 35.7%        | 766                    | 1.9                   | 29.4                         | 3.9%        |
| 4.01 - 5.00%        | 211             | 79,696            | 56.6%        | 728                    | 1.4                   | 27.5                         | 4.5%        |
| 5.01 - 6.00%        | 302             | 128,204           | 55.1%        | 723                    | 1.6                   | 27.9                         | 5.1%        |
| 6.01 - 7.00%        | 9               | 4,049             | 71.0%        | 723                    | 1.4                   | 23.4                         | 6.4%        |
| <b>Total</b>        | <b>524</b>      | <b>\$ 212,647</b> | <b>55.9%</b> | <b>725</b>             | <b>1.5</b>            | <b>27.6</b>                  | <b>4.9%</b> |

(1)

The original FICO score is not available for 139 loans with a principal balance of approximately \$58.7 million at December 31, 2015. We have excluded those loans from the weighted average computation.

The following table presents the U.S. states in which the collateral securing our Residential Whole-Loans at December 31, 2015 based on principal balance is located (dollars in thousands):

|               | State Concentration | Principal Balance |
|---------------|---------------------|-------------------|
| California    | 83.1%               | \$ 176,611        |
| Washington    | 6.8%                | 14,442            |
| Massachusetts | 5.6%                | 12,000            |
| New York      | 2.5%                | 5,399             |
| Georgia       | 0.9%                | 1,813             |
| Other         | 1.1%                | 2,382             |
| <b>Total</b>  | <b>100.0%</b>       | <b>\$ 212,647</b> |

As of December 31, 2015, all of our Residential Whole-Loans were performing.

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#### **Investment Activity**

The following tables present our investment portfolio activity, including linked transactions (Non-GAAP) for the years ended December 31, 2015, December 31, 2014 and December 31, 2013 (dollars in thousands):

|  | <b>For the year ended December 31, 2015</b> |  |                                |
|--|---|--|--------------------------------|
|  | <b>Purchases</b>                            | <b>Principal Payments<br/>and Basis Recovery</b> | <b>Proceeds from<br/>Sales</b> |
| Agency RMBS and Agency RMBS IOs and IIOs   | \$ 225,097                                  | \$ 312,734                                       | 1,300,408                      |
| Non-Agency RMBS  | 134,743                                     | 71,368   | 233,257                        |
| Agency CMBS and Agency CMBS IOs and IIOs   |   | 5,620  |                                |
| Non-Agency CMBS  | 198,582                                     | 1,895  | 161,985                        |
| Other securities   | 856,136                                     | 5,983  | 851,714                        |
| <b>Total MBS and other securities</b>  | <b>\$ 1,414,558</b>                         | <b>397,600</b>                                   | <b>\$ 2,547,364</b>            |
| Residential Whole-Loans(1)   | 229,199                                     | 20,355   |                                |
| Commercial Whole-Loans   | 8,750                                       | 8,750  |                                |
| Securitized commercial loan  | 14,000                                      |  |                                |
| <b>Total MBS and other securities: Including Whole-Loans and securitized commercial loan</b> | <b>\$ 1,666,507</b>                         | <b>\$ 426,705</b>                                | <b>\$ 2,547,364</b>            |

(1) Purchases of Residential Whole-Loans include premiums of \$3.3 million paid at acquisition.

|   | <b>For the year ended December 31, 2014</b> |  |                                |
|---|---|--|--------------------------------|
|   | <b>Purchases</b>                            | <b>Principal Payments<br/>and Basis Recovery</b> | <b>Proceeds from<br/>Sales</b> |
| Agency RMBS and Agency RMBS IOs and IIOs  | \$ 2,461,316                                | \$ 263,947                                       | \$ 1,608,541                   |
| Non-Agency RMBS   | 718,519                                     | 63,225   | 414,130                        |
| Agency CMBS and Agency CMBS IOs and IIOs  | 30,009                                      | 2,781  | 3,673                          |
| Non-Agency CMBS   | 549,376                                     | 1,272  | 168,535                        |
| Other securities  | 254,022                                     | 1,060  | 180,385                        |
| <b>Total MBS and other securities: Excluding Linked Transactions and Residential Whole-Loans (GAAP)</b>     | <b>\$ 4,013,242</b>                         | <b>\$ 332,285</b>                                | <b>\$ 2,375,264</b>            |
| Residential Whole-Loans(1)  | 7,161                                       | 9  |                                |
| Non-Agency RMBS Linked Transactions   |   | 4,801  | 6,215                          |
| Non-Agency CMBS Linked Transactions   | 41,656                                      |  |                                |
| Other securities Linked Transactions  | 13,083                                      |  |                                |
| <b>Total MBS and other securities: Including Linked Transactions and Residential Whole-Loans (Non-GAAP)</b> | <b>\$ 4,075,142</b>                         | <b>\$ 337,095</b>                                | <b>\$ 2,381,479</b>            |

(1)

Purchases of Residential Whole-Loans include premiums of \$131 thousand paid at acquisition.

|  | For the year ended December 31, 2013 |   |                        |
|--|--------------------------------------|---|------------------------|
|  | Purchases                            | Principal<br>Payments<br>and Basis Recovery | Proceeds from<br>Sales |
| Agency RMBS and Agency RMBS IOs and IIOs                   | \$ 1,581,736                         | \$ 288,257                                  | \$ 3,491,805           |
| Non-Agency RMBS  | 349,609                              | 17,132                                      | 108,086                |
| Agency CMBS and Agency CMBS IOs and IIOs                   | 20,559                               | 385   |                        |
| Non-Agency CMBS  | 8,325                                |   |                        |
| Other securities   | 44,367                               |   | 20,597                 |
| <b>Total MBS: Excluding Linked Transactions (GAAP)</b>     | <b>\$ 2,004,596</b>                  | <b>\$ 305,774</b>                           | <b>\$ 3,620,488</b>    |
| Agency RMBS Linked Transactions                            | 9,705                                | 58  |                        |
| Non-Agency RMBS Linked Transactions                        | 166,923                              | 1,950                                       | 21,735                 |
| <b>Total MBS: Including Linked Transactions (Non-GAAP)</b> | <b>\$ 2,181,224</b>                  | <b>\$ 307,782</b>                           | <b>\$ 3,642,223</b>    |



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For the years ended December 31, 2014 and December 31, 2013, we realized a net gain of approximately \$1.1 million and a net gain of approximately \$1.7 million, respectively from the unlinking of securities previously accounted for as derivatives through linked transactions. Through December 31, 2014, we reclassified, from mark-to-market adjustments on linked transactions to realized gain (loss) on linked transactions during the period the respective security became unlinked.

The following table presents the vintage of our investment portfolio at December 31, 2015:

|  | 2001        | 2003        | 2004        | 2005        | 2006        | 2007        | 2010        | 2011        | 2012         | 2013         | 2014         | 2015        | Total       |
|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|--------------|--------------|--------------|-------------|-------------|
| Agency RMBS  |             |             |             |             |             |             |             |             |              |              |              |             |             |
| 20-Year Mortgage   |             |             |             |             |             |             |             |             | 2.1%         | 12.4%        | 7.6%         | 0.1%        | 22.2%       |
| 30-Year Mortgage   |             |             |             |             |             |             |             | 0.1%        | 11.3%        | 8.3%         | 10.4%        |             | 30.1%       |
| Agency Interest Only- Strips   |             |             |             |             | 0.2%        |             |             |             | 1.2%         | 0.4%         | 0.4%         |             | 2.2%        |
| Agency and Non-Agency Interest-Only Strips, accounted for as derivatives |             |             |             | 0.2%        | 0.1%        |             | 0.1%        | 0.1%        | 0.9%         | 0.5%         | 0.1%         |             | 2.0%        |
| Non-Agency RMBS  |             | 0.1%        | 0.9%        | 4.2%        | 4.0%        | 4.9%        |             |             |              |              | 0.9%         | 1.9%        | 16.9%       |
| Agency and Non-Agency CMBS   |             |             |             |             | 5.1%        | 3.8%        |             | 1.1%        | 0.2%         | 0.1%         | 2.4%         | 2.7%        | 15.4%       |
| Other securities   | 0.4%        |             |             |             |             |             |             |             |              |              | 1.0%         | 1.9%        | 3.3%        |
| Residential Whole-Loans  |             |             |             |             |             |             |             | 0.3%        | 0.6%         | 3.9%         | 2.1%         | 0.2%        | 7.1%        |
| Securitized commercial loan  |             |             |             |             |             |             |             |             |              |              |              | 0.8%        | 0.8%        |
| <b>Total</b>   | <b>0.4%</b> | <b>0.1%</b> | <b>0.9%</b> | <b>4.4%</b> | <b>9.4%</b> | <b>8.7%</b> | <b>0.1%</b> | <b>1.6%</b> | <b>16.3%</b> | <b>25.6%</b> | <b>24.9%</b> | <b>7.6%</b> | <b>100%</b> |

As of December 31, 2015 the weighted average expected remaining term to the expected maturity of our investment portfolio was 6.7 years.

### *Financing and Other Liabilities*

We have entered into repurchase agreements to finance the vast majority of our investments. These agreements are secured by substantially all of our investments and bear interest at rates that have historically moved in close relationship to LIBOR. The following table summarizes our repurchase agreements and the fair value of the collateral pledged as of December 31, 2015 and December 31, 2014 (dollars in thousands):

| Collateral  | December 31, 2015                           |                                     | December 31, 2014                           |                                      |
|---|---|-------------------------------------|---|--------------------------------------|
|   | Repurchase Agreement Borrowings Outstanding | Fair Value of Collateral Pledged(1) | Repurchase Agreement Borrowings Outstanding | Fair Value of MBS Collateral Pledged |
| Agency RMBS   | \$ 1,601,713                                | \$ 1,658,865                        | \$ 2,994,351                                | \$ 3,158,544                         |
| Non-Agency RMBS   | 380,177                                     | 530,110                             | 473,942                                     | 670,526                              |
| Agency and Non-Agency CMBS                              | 356,369                                     | 487,643                             | 325,864                                     | 431,938                              |
| Whole-Loans and securitized commercial loan(1)          | 180,892                                     | 232,538                             | 4,930                                       | 7,220                                |
| Other securities  | 66,650                                      | 101,099                             | 76,634                                      | 101,523                              |
| Total: Excluding Linked Transactions                    | \$ 2,585,801                                | \$ 3,010,255                        | \$ 3,875,721                                | \$ 4,369,751                         |
| Non-Agency RMBS Linked Transactions                     |   |                                     | 6,559                                       | 8,156                                |
| Non-Agency CMBS Linked Transactions, including Non U.S. |   |                                     | 22,458                                      | 38,609                               |
| Other securities Linked Transactions                    |   |                                     | 2,840                                       | 5,719                                |
| Total: Including Linked Transactions (Non-GAAP)         | \$ 2,585,801                                | \$ 3,010,255                        | \$ 3,907,578                                | \$ 4,422,235                         |

(1)

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Repurchase borrowings and collateral pledged attributed to Whole-Loans and securitized commercial loan owned through trust certificates. The trust certificates are eliminated upon consolidation.

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The following table presents our repurchase agreement borrowing activity, by type of collateral pledged, for the years ended December 31, 2015 and December 31, 2014 (dollars in thousands):

| Collateral  | For the year ended<br>December 31,<br>2015 |                      | For the year ended<br>December 31,<br>2014 |                      |
|---|--|----------------------|--|----------------------|
|   | Proceeds                                   | Repayments           | Proceeds                                   | Repayments           |
| Agency RMBS   | \$ 11,993,568                              | \$ 13,386,205        | \$ 17,888,989                              | \$ 17,225,914        |
| Non-Agency RMBS   | 2,239,344                                  | 2,343,400            | 2,889,924                                  | 2,624,905            |
| Agency and Non-Agency CMBS                              | 2,199,492                                  | 2,189,523            | 1,425,232                                  | 1,116,912            |
| Whole-Loans and securitized commercial loan(1)          | 515,714                                    | 339,752              | 4,930                                      |                      |
| Other securities  | 595,942                                    | 605,033              | 610,911                                    | 555,601              |
| <b>Total: Excluding Linked Transactions</b>             | <b>\$ 17,544,060</b>                       | <b>\$ 18,863,913</b> | <b>\$ 22,819,986</b>                       | <b>\$ 21,523,332</b> |
| <b>Agency RMBS Linked Transactions</b>                  |  |                      |  |                      |
| Non-Agency RMBS Linked Transactions                     |  |                      | 126,769                                    | 181,396              |
| Non-Agency CMBS Linked Transactions, including Non U.S. |  |                      | 44,785                                     | 20,240               |
| Other securities Linked Transactions                    |  |                      | 9,381                                      | 6,541                |
| <b>Total</b>  | <b>\$ 17,544,060</b>                       | <b>\$ 18,863,913</b> | <b>\$ 23,000,921</b>                       | <b>\$ 21,731,509</b> |

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(1) Repurchase borrowings collateralized by Whole-Loans and securitized commercial loan owned through trust certificates. The trust certificates are eliminated upon consolidation.

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At December 31, 2015, we had outstanding repurchase agreement borrowings with the following 21 counterparties totaling approximately \$2.6 billion:

| (dollars in thousands)                      | Amount              | Percent of    | Fair Value of       | Counterparty |
|---|---------------------|---------------|---------------------|--------------|
| Repurchase Agreement Counterparties         | Outstanding         | Total Amount  | Company             | Rating(3)    |
|   |                     | Outstanding   | Investments         |              |
|   |                     |               | Held as             |              |
|   |                     |               | Collateral          |              |
| Merrill Lynch Pierce Fenner & Smith Inc.(1) | \$ 347,601          | 13.4%         | \$ 347,998          | A            |
| RBC (Barbados) Trading Bank Corporation(1)  | 322,154             | 12.5%         | 420,564             | P-1          |
| Credit Suisse Securities (USA) LLC(1)(2)    | 310,897             | 12.0%         | 429,833             | A            |
| JP Morgan Securities LLC(1)                 | 301,424             | 11.7%         | 324,133             | A+           |
| Barclays Capital Inc.(1)                    | 222,058             | 8.6%          | 262,381             | A            |
| UBS Securities LLC(1)                       | 143,318             | 5.5%          | 193,130             | A            |
| BNP Paribas Securities Corporation(1)       | 123,181             | 4.8%          | 129,483             | A+           |
| Goldman Sachs Bank USA(1)                   | 117,897             | 4.6%          | 120,848             | A            |
| Deutsche Bank Securities LLC(1)             | 110,610             | 4.3%          | 120,550             | BBB+         |
| TD Securities (USA) LLC(1)                  | 88,157              | 3.4%          | 92,686              | AA           |
| Mizuho Securities USA Inc.(1)               | 85,825              | 3.3%          | 96,008              | (P)A2        |
| KGS-Alpha Capital Markets, L.P.(1)          | 72,778              | 2.8%          | 76,261              | Unrated      |
| Morgan Stanley & Co. LLC(1)                 | 67,110              | 2.6%          | 72,693              | A            |
| Nomura Securities International, Inc.(1)    | 65,677              | 2.5%          | 79,196              | Unrated(4)   |
| Deutsche Bank AG(1)                         | 61,442              | 2.4%          | 90,260              | BBB+         |
| RBC Capital Markets LLC(1)                  | 59,695              | 2.3%          | 62,029              | AA           |
| The Bank of Nova Scotia(1)                  | 58,801              | 2.3%          | 59,922              | A+           |
| Citigroup Global Markets Inc.               | 10,981              | 0.4%          | 12,452              | A            |
| Wells Fargo Bank, N.A.                      | 10,375              | 0.4%          | 10,967              | AA           |
| Credit Suisse Securities (Europe) Limited   | 3,265               | 0.1%          | 5,323               | A            |
| Wells Fargo Securities LLC                  | 2,555               | 0.1%          | 3,538               | AA           |
| <b>Total</b>                                | <b>\$ 2,585,801</b> | <b>100.0%</b> | <b>\$ 3,010,255</b> |              |

(1) Counterparty holds collateral valued in excess of 5% of our stockholders' equity as security for our obligations under the applicable repurchase agreements as of December 31, 2015.

(2) Fair value of Company assets held as collateral includes Residential Whole-Loans and securitized commercial loan owned through trust certificates with a fair value of \$218.5 million and \$14.0 million, respectively.

(3) The counterparty ratings presented above are the long-term issuer credit ratings as rated at December 31, 2015 by S&P, except for Mizuho Securities USA Inc. which is the long-term issuer credit rating by Moody's at December 31, 2015 and for RBC (Barbados) Trading Bank Corporation which is the short-term issuer credit rating by Moody's at December 31, 2015.

(4) Nomura Holdings, Inc., the parent company of Nomura Securities International, Inc., is rated BBB+ by S&P at December 31, 2015.

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At December 31, 2014, we had outstanding repurchase agreement borrowings with the following 21 counterparties totaling approximately \$3.9 billion, which is a Non-GAAP measure due to our Linked Transactions, which is reconciled to GAAP below as follows:

| (dollars in thousands)   | Amount<br>Outstanding | Percent of<br>Total Amount<br>Outstanding | Fair Value of<br>Company<br>Investments<br>Held as<br>Collateral(2) | Counterparty<br>Rating(3) |
|--|-----------------------|---|---|---------------------------|
| <b>Repurchase Agreement Counterparties</b>                                     |                       |   |   |                           |
| Merrill Lynch Pierce Fenner & Smith Inc.(1)                                    | \$ 598,717            | 15.3%                                     | \$ 621,152  | A                         |
| Deutsche Bank Securities LLC(1)  | 442,131               | 11.3%                                     | 482,107   | A                         |
| Barclays Capital Inc.(1)   | 364,609               | 9.3%                                      | 413,245   | A                         |
| JP Morgan Securities LLC(1)  | 353,676               | 9.1%                                      | 382,364   | A+                        |
| BNP Paribas Securities Corporation(1)  | 336,531               | 8.6%                                      | 359,216   | A+                        |
| Royal Bank of Canada(1)  | 275,065               | 7.0%                                      | 371,280   | AA                        |
| UBS Securities LLC(1)  | 256,405               | 6.6%                                      | 307,947   | A                         |
| Credit Suisse Securities (USA) LLC(1)  | 241,541               | 6.2%                                      | 326,785   | A                         |
| Goldman Sachs Bank USA(1)  | 236,873               | 6.1%                                      | 246,796   | A                         |
| Mizuho Securities USA Inc.(1)  | 204,755               | 5.2%                                      | 231,506   | (P)A2                     |
| Morgan Stanley & Co. LLC(1)  | 157,926               | 4.0%                                      | 162,348   | A                         |
| Jefferies & Company Inc.(1)  | 77,098                | 2.0%                                      | 81,930  | BBB                       |
| RBC Capital Markets LLC(1)   | 75,003                | 1.9%                                      | 78,413  | AA                        |
| RBC (Barbados) Trading Bank Corporation(1)                                     | 54,561                | 1.4%                                      | 73,266  | P-1                       |
| The Royal Bank of Scotland plc(1)  | 51,252                | 1.3%                                      | 70,333  | A                         |
| Wells Fargo Bank NA(1)   | 50,984                | 1.3%                                      | 53,635  | AA                        |
| Nomura Securities International, Inc.(1)                                       | 41,226                | 1.1%                                      | 42,449  | Unrated(4)                |
| Citigroup Global Markets Inc.(1)   | 32,100                | 0.8%                                      | 42,399  | A                         |
| Deutsche Bank AG(1)  | 27,362                | 0.7%                                      | 41,866  | A                         |
| KGS-Alpha Capital Markets, L.P.  | 23,789                | 0.6%                                      | 25,229  | Unrated                   |
| Wells Fargo Securities LLC   | 5,974                 | 0.2%                                      | 7,968   | AA                        |
| <b>Total: Non-GAAP Basis Including Linked Transactions, including Non U.S.</b> | <b>\$ 3,907,578</b>   | <b>100.0%</b>                             | <b>\$ 4,422,234</b>   |                           |
| <b>Linked Transactions</b>   | <b>31,857</b>         |   | <b>52,483</b>   |                           |
| <b>Total: GAAP Basis Excluding Linked Transactions</b>                         | <b>\$ 3,875,721</b>   |   | <b>\$ 4,369,751</b>   |                           |

(1) Counterparty holds collateral valued in excess of 5% of our stockholders' equity as security for our obligations under the applicable repurchase agreements as of December 31, 2014.

(2) Fair value of Company assets held as collateral includes Residential Whole-Loans owned through trust certificates with a fair value of \$7.2 million.

(3) The counterparty ratings presented above are the long-term issuer credit ratings as rated at December 31, 2014 by S&P, except for Mizuho Securities USA Inc. which is the long-term issuer credit rating by Moody's at December 31, 2014 and for RBC (Barbados) Trading Bank Corporation which is the short-term issuer credit rating by Moody's at December 31, 2014.

(4) Nomura Holdings, Inc., the parent company of Nomura Securities International, Inc., is rated BBB+ by S&P at December 31, 2014.

We record the liability for MBS and other securities purchased, for which settlement has not taken place as an investment related payable. As of December 31, 2015, we had investment related payables of \$66.1 million of which no items were outstanding greater than 30 days.



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The following table presents our repurchase agreement borrowings by type of collateral pledged as of December 31, 2015 and December 31, 2014 and the respective Cost of Funds for the periods then ended (dollars in thousands):

| Collateral                                     | Balance<br>(GAAP)<br>December 31,<br>2015 | Weighted<br>Average<br>Cost of<br>Funds<br>for the<br>year ended<br>December 31,<br>2015 | Balance<br>(GAAP)<br>December 31,<br>2014 | Weighted<br>Average<br>Cost of Funds<br>for the<br>year ended<br>December 31,<br>2014 |
|--|---|--|---|---|
| Agency RMBS                                    | \$ 1,601,713                              | 0.46%  | \$ 2,994,351                              | 0.38%   |
| Non-Agency RMBS                                | 380,177                                   | 1.63   | 473,942                                   | 1.62  |
| Agency and Non-Agency CMBS                     | 356,369                                   | 1.61   | 325,864                                   | 1.51  |
| Whole-Loans and securitized commercial loan(1) | 180,892                                   | 2.63   | 4,930                                     | 1.36  |
| Other securities                               | 66,650                                    | 1.95   | 76,634                                    | 1.48  |
| <b>Total</b>                                   | <b>\$ 2,585,801</b>                       | <b>0.82%</b>   | <b>\$ 3,875,721</b>                       | <b>0.60%</b>  |

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- (1) Repurchase agreement borrowings collateralized by Whole-Loans and securitized commercial loan owned through trust certificates. The trust certificates are eliminated upon consolidation.

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The following table presents our repurchase agreement borrowings by type of collateral pledged as of December 31, 2015 and December 31, 2014, and the respective Effective Cost of Funds (Non-GAAP financial measure) for the periods then ended (dollars in thousands), see "Non-GAAP financial measures":

| <b>Collateral</b>  | <b>Balance<br/>(Non-GAAP)<br/>December 31,<br/>2015</b> | <b>Weighted<br/>Average<br/>Effective<br/>Cost of<br/>Funds<br/>for the<br/>year ended<br/>December 31,<br/>2015(1)</b> | <b>Balance<br/>(Non-GAAP)<br/>December 31,<br/>2014</b> | <b>Weighted<br/>Average<br/>Effective<br/>Cost of<br/>Funds<br/>for the<br/>year ended<br/>December 31,<br/>2014(1)</b> |
|--|---|---|---|---|
| Agency RMBS  | \$ 1,601,713  | 1.12%   | \$ 2,994,351  | 1.31%   |
| Non-Agency RMBS  | 380,177   | 1.97  | 473,942   | 1.83  |
| Agency and Non-Agency CMBS                                     | 356,369   | 2.08  | 325,864   | 2.08  |
| Whole-Loans and securitized commercial loan(2)                 | 180,892   | 2.63  | 4,930   | 1.36  |
| Other securities   | 66,650  | 1.95  | 76,634  | 1.48  |
| <b>Total: Excluding Linked Transactions</b>                    | <b>\$ 2,585,801</b>                                     | <b>1.39%</b>  | <b>\$ 3,875,721</b>                                     | <b>1.41%</b>  |
| <b>Non-Agency RMBS Linked Transactions</b>                     |   |   | <b>6,559</b>  | <b>1.65</b>   |
| <b>Non-Agency CMBS Linked Transactions, including Non U.S.</b> |   |   | <b>22,458</b>   | <b>1.94</b>   |
| <b>Other Securities Linked Transactions</b>                    |   |   | <b>2,840</b>  | <b>2.00</b>   |
| <b>Total</b>   | <b>\$ 2,585,801</b>                                     | <b>1.39%</b>  | <b>\$ 3,907,578</b>                                     | <b>1.41%</b>  |

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(1) The effective cost of funds for the years ended December 31, 2015 and December 31, 2014, are calculated on an annualized basis and include interest expense for the periods and net periodic interest payments on interest rate swaps, net of premium amortization on MAC swaps, of approximately \$19.1 million and \$29.9 million, respectively, interest payments on Non-Agency RMBS linked transactions of approximately \$0 and \$346 thousand, respectively, interest payments on Non-Agency CMBS linked transactions of approximately \$0 and \$167 thousand, respectively, and interest payments on other securities linked transactions of approximately \$0, and \$33 thousand, respectively. While swaps are not accounted for using hedge accounting, such instruments are viewed by us as an economic hedge against increases in interest rates on our liabilities and are classified as hedges for purposes of satisfying the REIT requirements. See "Non-GAAP Financial Measures."

(2) Repurchase agreement borrowings collateralized by Whole-Loans and securitized commercial loan owned through trust certificates. The trust certificates are eliminated upon consolidation.



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The following table presents our average repurchase agreement borrowings, by type of collateral pledged, on a GAAP and Non-GAAP basis for the years ended December 31, 2015 and December 31, 2014 (dollars in thousands):

| <b>Collateral</b>  | <b>For the<br/>year ended<br/>December 31,<br/>2015</b> | <b>For the<br/>year ended<br/>December 31,<br/>2014</b> |
|--|---|---|
| Agency RMBS  | \$ 2,403,723  | \$ 3,019,411  |
| Non-Agency RMBS  | 418,975   | 393,426   |
| Agency and Non-Agency CMBS   | 363,849   | 218,995   |
| Whole-Loans and securitized commercial loan(1)                     | 69,563  | 1,249   |
| Other securities   | 99,617  | 66,026  |
| <b>Total: Excluding Linked Transactions (GAAP)</b>                 | <b>\$ 3,355,727</b>                                     | <b>\$ 3,699,107</b>                                     |
| <b>Agency RMBS Linked Transactions (Non-GAAP)</b>                  |   |   |
| Non-Agency RMBS Linked Transactions (Non-GAAP)                     |   | 20,859  |
| Non-Agency CMBS Linked Transactions (Non-GAAP), including Non U.S. |   | 8,588   |
| Other securities Linked Transactions (Non-GAAP)                    |   | 1,652   |
| <b>Total (Non-GAAP)</b>  | <b>\$ 3,355,727</b>                                     | <b>\$ 3,730,206</b>                                     |
| <br>   |   |   |
| <u>Maximum borrowings during the period (Non-GAAP)(2)</u>          | 3,968,357   | 4,258,778   |

- (1) Repurchase agreement borrowings collateralized by Whole-Loans and securitized commercial loan owned through trust certificates. The trust certificates are eliminated upon consolidation.
- (2) Amount represents the maximum borrowings at month-end during each of the respective periods.

*Derivative Instruments.* As of December 31, 2015, we had entered into interest rate swaps designed to mitigate the effects of increases in interest rates under a portion of our repurchase agreements as such repurchase agreements are renewed and/or extended. The interest rate swaps generally provide for fixed interest rates that are indexed off of LIBOR and are viewed by us to effectively fix the floating interest rates, on our repurchase agreements. In managing our interest rate swap position in conjunction with our hedging strategy and potential tax implications, we may enter into variable-rate payment swaps which effectively act as an offset to fixed-rate payment swaps. We also enter into compression trades that enable us to terminate substantial amounts of swap contracts before they expire by their terms, when there has been substantial two-way (pay and receive) swap activity. For the year ended December 31, 2015, we entered into compression trades to terminate approximately \$11.1 billion of fixed-rate payment interest rate swaps and approximately \$11.1 billion of variable-rate payment interest rate swaps realizing a net gain on termination of approximately \$8.9 million. These "compression trades" reduce the number of interest rate swaps outstanding. In addition to simplifying, our balance sheet, by reducing the number of interest rate swaps outstanding, we are frequently able to reduce the amount of margin required to carry such positions. As of December 31, 2015, we have entered into approximately \$3.2 billion of interest rate swaps to effectively fix the interest rate of our borrowings under our repurchase agreements; net of variable-rate payment interest rate swaps of approximately \$2.3 billion, and excluding forward starting interest rate swaps of \$710.0 million.

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The following tables present information about our fixed pay rate interest rate swaps as of December 31, 2015, and December 31, 2014 (dollars in thousands):

| Remaining Interest Rate Swap Term          | Notional Amount     | December 31, 2015           |       | Average Fixed Pay Rate | Average Maturity (Years) | Forward Starting |
|--|---------------------|-----------------------------|-------|------------------------|--------------------------|------------------|
|  |                     | Fair Value (Liability), net | Asset |                        |                          |                  |
| 1 year or less                             | \$ 1,286,000        | \$ 163                      |       | 0.6%                   | 0.6                      | %                |
| Greater than 1 year and less than 3 years  | 1,131,800           | (1,450)                     |       | 1.1                    | 1.4                      |                  |
| Greater than 3 years and less than 5 years | 1,345,200           | (22,705)                    |       | 2.1                    | 4.6                      |                  |
| Greater than 5 years                       | 2,404,600           | (131,744)                   |       | 2.8                    | 10.2                     | 29.5             |
| <b>Total</b>                               | <b>\$ 6,167,600</b> | <b>\$ (155,736)</b>         |       | <b>1.9%</b>            | <b>5.4</b>               | <b>11.5%</b>     |

| Remaining Interest Rate Swap Term          | Notional Amount     | December 31, 2014           |       | Average Fixed Pay Rate | Average Maturity (Years) | Forward Starting |
|--|---------------------|-----------------------------|-------|------------------------|--------------------------|------------------|
|  |                     | Fair Value (Liability), net | Asset |                        |                          |                  |
| 1 year or less                             | \$ 89,300           | \$ (111)                    |       | 0.5%                   | 0.9                      | %                |
| Greater than 1 year and less than 3 years  | 1,972,300           | (733)                       |       | 0.8                    | 1.8                      | 20.3             |
| Greater than 3 years and less than 5 years | 603,000             | (4,597)                     |       | 1.8                    | 4.2                      |                  |
| Greater than 5 years                       | 3,103,770           | (156,952)                   |       | 2.8                    | 9.4                      | 63.1             |
| <b>Total</b>                               | <b>\$ 5,768,370</b> | <b>\$ (162,393)</b>         |       | <b>2.0%</b>            | <b>6.2</b>               | <b>40.9%</b>     |

The following tables present information about our variable pay rate interest rate swaps as of December 31, 2015, and December 31, 2014 (dollars in thousands):

| Remaining Interest Rate swap Term          | Notional Amount     | December 31, 2015           |       | Average Variable Pay Rate | Average Maturity (Years) | Forward Starting |
|--|---------------------|-----------------------------|-------|---------------------------|--------------------------|------------------|
|  |                     | Fair Value (Liability), net | Asset |                           |                          |                  |
| Greater than 3 years and less than 5 years | \$ 1,170,700        | \$ (8,902)                  |       | 0.4%                      | 4.5                      | %                |
| Greater than 5 years                       | 1,102,200           | (4,032)                     |       | 0.4                       | 12.3                     |                  |
| <b>Total</b>                               | <b>\$ 2,272,900</b> | <b>\$ (12,934)</b>          |       | <b>0.4%</b>               | <b>8.2</b>               | <b>%</b>         |

| Remaining Interest Rate swap Term          | Notional Amount     | December 31, 2014           |       | Average Variable Pay Rate | Average Maturity (Years) | Forward Starting |
|--|---------------------|-----------------------------|-------|---------------------------|--------------------------|------------------|
|  |                     | Fair Value (Liability), net | Asset |                           |                          |                  |
| Greater than 1 years and less than 3 years | \$ 220,000          | \$ (164)                    |       | 0.2%                      | 2.0                      | %                |
| Greater than 3 years and less than 5 years | 634,000             | 2,210                       |       | 0.2                       | 4.5                      |                  |
| Greater than 5 years                       | 1,309,600           | 45,229                      |       | 0.2                       | 12.1                     | 8.4              |
| <b>Total</b>                               | <b>\$ 2,163,600</b> | <b>\$ 47,275</b>            |       | <b>0.2%</b>               | <b>8.8</b>               | <b>5.1%</b>      |



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The following tables present information about our interest rate swaptions as of December 31, 2015, and December 31, 2014 (dollars in thousands):

| December 31, 2015                  |            |   |                    |                                       |  |
|------------------------------------|------------|---|--------------------|---------------------------------------|--|
| Fixed-Pay Rate for Underlying Swap | Fair Value | Option<br>Weighted Average<br>Months Until<br>Option Expiration | Notional<br>Amount | Underlying Swap<br>Notional<br>Amount | Weighted<br>Average Swap<br>Term (Years) |
| 1.76 - 2.00%                       | \$ 890     | 2.1   | \$ 400,000         |                                       | 5.0                                      |
| 2.01 - 2.25%                       | 129        | 2.1   | 100,000            |                                       | 5.0                                      |
| 2.26 - 2.50%                       | 1          | 5.8   | 105,000            |                                       | 1.0                                      |
|                                    | \$ 1,020   | 2.7   | \$ 605,000         |                                       | 4.3                                      |

| December 31, 2015                     |            |   |                    |                                       |  |
|---------------------------------------|------------|---|--------------------|---------------------------------------|--|
| Variable-Pay Rate for Underlying Swap | Fair Value | Option<br>Weighted Average<br>Months Until<br>Option Expiration | Notional<br>Amount | Underlying Swap<br>Notional<br>Amount | Weighted<br>Average Swap<br>Term (Years) |
| 1.26 - 1.50%                          | \$ 459     | 2.1   | \$ 500,000         |                                       | 5.0                                      |
|                                       | \$ 459     | 2.1   | \$ 500,000         |                                       | 5.0                                      |

| December 31, 2014                  |            |   |                    |                                       |  |
|------------------------------------|------------|---|--------------------|---------------------------------------|--|
| Fixed-Pay Rate for Underlying Swap | Fair Value | Option<br>Weighted Average<br>Months Until<br>Option Expiration | Notional<br>Amount | Underlying Swap<br>Notional<br>Amount | Weighted<br>Average Swap<br>Term (Years) |
| 2.26 - 2.50%                       | \$ 178     | 17.8  | \$ 105,000         |                                       | 1.0                                      |
|                                    | \$ 178     | 17.8  | \$ 105,000         |                                       | 1.0                                      |

We also purchased or shorted TBAs. As of December 31, 2015 and December 31, 2014, we had contracts to purchase ("long position") and sell ("short position") TBAs on a forward basis. Following is a summary of our long and short TBA positions reported in Derivative assets, at fair value and Derivative liability, at fair value on the Consolidated Balance Sheets as of December 31, 2015 and December 31, 2014 (dollars in thousands):

|                               | December 31, 2015  |               | December 31, 2014  |               |
|-------------------------------|--------------------|---------------|--------------------|---------------|
|                               | Notional<br>Amount | Fair<br>Value | Notional<br>Amount | Fair<br>Value |
| Purchase contracts, asset     | \$ 1,650,000       | \$ 3,268      | \$ 2,915,000       | \$ 17,457     |
| TBA securities, asset         | 1,650,000          | 3,268         | 2,915,000          | 17,457        |
| Purchase contracts, liability |                    |               |                    |               |

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|                           |            |          |             |          |
|---------------------------|------------|----------|-------------|----------|
| Sale contracts, liability | (825,000)  | (893)    | (2,590,000) | (12,355) |
| TBA securities, liability | (825,000)  | (893)    | (2,590,000) | (12,355) |
| TBA securities, net       | \$ 825,000 | \$ 2,375 | \$ 325,000  | \$ 5,102 |

The following table presents additional information about our contracts to purchase and sell TBAs for the years ended December 31, 2015 and December 31, 2014 (dollars in thousands):

|                     | Notional<br>Amount as<br>of<br>December 31,<br>2013 | Additions     | Settlement,<br>Termination,<br>Expiration or<br>Exercise | Notional<br>Amount as of<br>December 31,<br>2014 | Additions     | Settlement,<br>Termination,<br>Expiration or<br>Exercise | Notional<br>Amount as of<br>December 31,<br>2015 |
|---------------------|---|---------------|--|--|---------------|--|--|
| Purchase of<br>TBAs | \$ 190,000  | \$ 25,353,196 | \$ (22,628,196)  | \$ 2,915,000                                     | \$ 31,576,000 | \$ (32,841,000)  | \$ 1,650,000                                     |
| Sale of TBAs        | \$  | \$ 25,218,196 | \$ (22,628,196)  | \$ 2,590,000                                     | \$ 31,076,000 | \$ (32,841,000)  | \$ 825,000                                       |

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We also enter into Eurodollar, Volatility Index and U.S Treasury futures. As of December 31, 2015, we had entered into contracts to buy ("long position") U.S. Treasuries with a notional amount of \$480.8 million, a fair value in a liability position of \$635 thousand and an expiration date of March 2016. As of December 31, 2014, we had purchase contracts ("long position") for Eurodollar futures, representing a notional amount of \$592.0 million with a fair value of \$451 thousand and an expiration date of June 2016. In addition, as of December 31, 2014, we had sale contracts ("short position") for Eurodollar futures, representing a notional amount of \$592.0 million with a fair value in a liability position of \$1.2 million and an expiration date of June 2018. During the year ended December 31, 2015, we terminated both Eurodollar futures and realized a net loss of \$459 thousand.

We have invested in and, in the future, may invest in additional assets which are denominated in a currency or currencies other than U.S. dollars. Similarly, we have and may in the future, finance such assets in a currency or currencies other than U.S. dollars. In order to mitigate the impact to us, we may enter into derivative financial instruments, including foreign currency swaps and foreign currency forwards, to manage fluctuations in the valuation between U.S. dollars and such foreign currencies. Foreign currency swaps involve the payment of a foreign currency at fixed interest rate on a fixed notional amount and the receipt of U.S. dollars at a fixed interest rate on a fixed notional amount. Foreign currency forwards provide for the payment of a fixed amount of a foreign currency in exchange for a fixed amount of U.S. dollars at a date certain in the future. The carrying value of foreign currency swaps and forwards is included in Derivative assets (liabilities), at fair value on the Consolidated Balance Sheets with changes in valuation included in Gain (loss) on derivative instruments, net on the Consolidated Statement of Operations. The following is a summary of our foreign currency forwards at December 31, 2015 and December 31, 2014 (dollars and euros in thousands):

| Derivative Type                   | December 31, 2015 |                           |              |              |
|-----------------------------------|-------------------|---------------------------|--------------|--------------|
|                                   | Notional Amount   | Notional (USD Equivalent) | Maturity     | Fair Value   |
| Buy USD/Sell EUR currency forward | € 5,083           | \$ 5,825                  | January 2016 | \$ 302       |
| Currency forwards, assets         | € 5,083           | \$ 5,825                  | n/a          | \$ 302       |
| Buy EUR/Sell USD currency forward | € 6,800           | \$ 7,671                  | January 2016 | \$ (281)     |
| Currency forwards, liabilities    | € 6,800           | \$ 7,671                  | n/a          | \$ (281)     |
| <b>Total currency forwards</b>    | <b>€ 11,883</b>   | <b>\$ 13,496</b>          | <b>n/a</b>   | <b>\$ 21</b> |

| Derivative Type                   | December 31, 2014 |                           |               |                 |
|-----------------------------------|-------------------|---------------------------|---------------|-----------------|
|                                   | Notional Amount   | Notional (USD Equivalent) | Maturity      | Fair Value      |
| Buy USD/Sell EUR currency forward | € 3,331           | \$ 4,143                  | January 2015  | \$ 112          |
| Buy USD/Sell EUR currency forward | 7,766             | 9,417                     | January 2015  | 21              |
| Buy USD/Sell EUR currency forward | 3,471             | 4,211                     | February 2015 | 9               |
| Buy EUR/Sell USD currency forward | 5,000             | 6,051                     | January 2015  | 1               |
| Currency forwards, assets         | € 19,568          | \$ 23,822                 | n/a           | \$ 143          |
| Buy USD/Sell EUR currency forward | € 5,043           | \$ 6,104                  | February 2015 | \$ (1)          |
| Buy EUR/Sell USD currency forward | 11,156            | 13,542                    | April 2015    | (30)            |
| Buy EUR/Sell USD currency forward | 11,156            | 13,914                    | January 2015  | (415)           |
| Currency forwards, liabilities    | € 27,355          | \$ 33,560                 | n/a           | \$ (446)        |
| <b>Total currency forwards</b>    | <b>€ 46,923</b>   | <b>\$ 57,382</b>          | <b>n/a</b>    | <b>\$ (303)</b> |



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The following is a summary of our foreign currency swaps with a fair value of \$7.2 million and \$3.9 million at December 31, 2015 and December 31, 2014, respectively (dollars and euros in thousands):

|          | <b>Date entered</b> | <b>Maturity</b> | <b>Fixed Rate</b> | <b>Denomination</b> | <b>Notional Amount</b> |
|----------|---------------------|-----------------|-------------------|---------------------|------------------------|
| Payer    | June 2014           | July 2024       | 7.25%             | EUR                 | 18,500                 |
| Receiver | June 2014           | July 2024       | 9.005%            | USD                 | 25,160                 |

### **Results of Operations**

#### *General*

For the year ended December 31, 2015, we had net loss of \$9.5 million or \$0.25 per basic and diluted weighted average common share, compared to net income of \$100.7 million or \$2.67 per basic and diluted weighted average common share for the year ended December 31, 2014. Our results of operations, for the year ended December 31, 2015, were significantly impacted by declines in the fair value of our MBS portfolio, and the decline in fair value of our derivative instruments. This simultaneous movement was a result of mortgage spreads widening more than swap rates rallied in 2015, resulting in a combined mark-to-market loss of approximately of \$111.2 million in 2015 compared to a mark-to-market gain of \$8.9 million in 2014.



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### **Net Interest Income**

The following table sets forth certain information regarding our net investment income for the years ended December 31, 2015, December 31, 2014 and December 31, 2013 (dollars in thousands):

| Period Ended                   | Average<br>Amortized<br>Cost of<br>Assets | Total<br>Interest<br>Income(1) | Yield<br>on<br>Average<br>Assets | Average<br>Balance of<br>Borrowings | Total<br>Interest<br>Expense | Average<br>Cost of<br>Funds(2) | Net<br>Interest<br>Income | Net<br>Interest<br>Rate<br>Spread |
|--------------------------------|---|--------------------------------|----------------------------------|-------------------------------------|------------------------------|--------------------------------|---------------------------|-----------------------------------|
| <b>December 31, 2015</b>       |   |                                |                                  |                                     |                              |                                |                           |                                   |
| Agency RMBS                    | \$ 2,713,994                              | \$ 71,673                      | 2.64%                            | \$ 2,403,723                        | \$ 10,989                    | 0.46%                          | \$ 60,684                 | 2.18%                             |
| Non-Agency RMBS                | 566,416                                   | 36,464                         | 6.44%                            | 418,975                             | 6,829                        | 1.63%                          | 29,635                    | 4.81%                             |
| Agency and<br>Non-Agency CMBS  | 477,050                                   | 31,746                         | 6.65%                            | 363,849                             | 5,858                        | 1.61%                          | 25,888                    | 5.04%                             |
| Residential<br>Whole-Loans     | 82,936                                    | 3,031                          | 3.65%                            | 69,026                              | 1,816                        | 2.63%                          | 1,215                     | 1.02%                             |
| Commercial<br>Whole-Loans      | 4,699                                     | 424                            | 9.02%                            |                                     |                              | %                              | 424                       | 9.02%                             |
| Securitized<br>commercial loan | 3,904                                     | 356                            | 9.12%                            | 2,255                               | 170                          | 7.54%                          | 186                       | 1.58%                             |
| Other Securities               | 146,350                                   | 9,010                          | 6.16%                            | 99,617                              | 1,943                        | 1.95%                          | 7,067                     | 4.21%                             |
| <b>Total</b>                   | <b>\$ 3,995,349</b>                       | <b>\$ 152,704</b>              | <b>3.82%</b>                     | <b>\$ 3,357,445</b>                 | <b>\$ 27,605</b>             | <b>0.82%</b>                   | <b>\$ 125,099</b>         | <b>3.00%</b>                      |
| <b>December 31, 2014</b>       |   |                                |                                  |                                     |                              |                                |                           |                                   |
| Agency RMBS                    | \$ 3,199,803                              | \$ 95,847                      | 3.00%                            | \$ 3,019,411                        | \$ 11,589                    | 0.38%                          | \$ 84,258                 | 2.62%                             |
| Non-Agency RMBS                | 553,534                                   | 33,057                         | 5.97%                            | 393,426                             | 6,378                        | 1.62%                          | 26,679                    | 4.35%                             |
| Agency and<br>Non-Agency CMBS  | 276,394                                   | 15,459                         | 5.59%                            | 218,995                             | 3,300                        | 1.51%                          | 12,159                    | 4.08%                             |
| Residential<br>Whole-Loans     | 962                                       | 32                             | 3.33%                            | 1,249                               | 17                           | 1.36%                          | 15                        | 1.97%                             |
| Other Securities               | 82,125                                    | 4,715                          | 5.74%                            | 66,026                              | 979                          | 1.48%                          | 3,736                     | 4.26%                             |
| <b>Total</b>                   | <b>\$ 4,112,818</b>                       | <b>\$ 149,110</b>              | <b>3.63%</b>                     | <b>\$ 3,699,107</b>                 | <b>\$ 22,263</b>             | <b>0.60%</b>                   | <b>\$ 126,847</b>         | <b>3.03%</b>                      |
| <b>December 31, 2013</b>       |   |                                |                                  |                                     |                              |                                |                           |                                   |
| Agency RMBS                    | \$ 3,847,064                              | \$ 111,851                     | 2.91%                            | \$ 3,681,655                        | \$ 15,839                    | 0.43%                          | \$ 96,012                 | 2.48%                             |
| Non-Agency RMBS                | 190,692                                   | 12,299                         | 6.45%                            | 114,053                             | 2,012                        | 1.76%                          | 10,287                    | 4.69%                             |
| Agency and<br>Non-Agency CMBS  | 6,283                                     | 438                            | 6.97%                            | 4,525                               | 63                           | 1.39%                          | 375                       | 5.58%                             |
| Other Securities               | 9,071                                     | 740                            | 8.16%                            | 5,257                               | 105                          | 2.00%                          | 635                       | 6.16%                             |
| <b>Total</b>                   | <b>\$ 4,053,110</b>                       | <b>\$ 125,328</b>              | <b>3.09%</b>                     | <b>\$ 3,805,490</b>                 | <b>\$ 18,019</b>             | <b>0.47%</b>                   | <b>\$ 107,309</b>         | <b>2.62%</b>                      |

(1)

Amount includes net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately \$(48.1) million for Agency RMBS, approximately \$(8.0) million for Non-Agency RMBS, approximately \$1.6 million for Agency and Non-Agency CMBS, approximately \$(1.1) million for Residential Whole-Loans and \$2.6 million for other securities for the year ended December 31, 2015. For the year ended December 31, 2014, amount includes net (amortization of premiums), accretion of

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discounts and (amortization/recovery of basis) of approximately \$(57.1) million for Agency RMBS, approximately \$(3.3) million for Non-Agency RMBS, approximately \$(435) thousand for Agency and Non-Agency CMBS, approximately \$(26) thousand for Residential Whole-Loans and approximately \$858 thousand for other securities. For the year ended December 31, 2013, amount includes net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately \$(60.3) million for Agency RMBS, approximately \$8.1 million for Non-Agency RMBS, approximately \$(106) thousand for Agency and Non-Agency CMBS and approximately \$152 thousand for other securities. In accordance with GAAP, interest income does not include approximately \$2.9 million and \$1.4 million for linked transactions for the years ended December 31, 2014 and December 31, 2013, respectively; instead such amounts are included in gain (loss) on linked transactions.

(2)

For the years ended December 31, 2015, December 31, 2014 and December 31, 2013, cost of funds does not include accrual and settlement of interest, net of premium amortization on MAC swaps, of approximately \$19.1 million, \$29.9 million and \$22.9 million associated with derivative instruments and \$0, \$546 thousand and \$271 thousand associated with linked transactions, respectively. In accordance with GAAP, such costs are included in gain (loss) on derivative instruments, in the Consolidated Statement of Operations.

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For the years ended December 31, 2015, December 31, 2014 and December 31, 2013, we earned interest income on our investments of approximately \$152.7 million, \$149.1 million and \$125.3 million, respectively and incurred interest expense, which primarily related to our borrowings under repurchase of approximately \$27.6 million, \$22.3 million and \$18.0 million, respectively. The increase in interest income for the year ended December 31, 2015 as compared to the year ended December 31, 2014 was primarily the result of an increase in interest rates and our strategic shift to deploy capital to our Non-Agency RMBS, Agency CMBS, Non-Agency CMBS, ABS and Whole-Loans which generate higher yields and spreads, relative to our Agency RMBS. Our yield on average assets increased to 3.82% from 3.63%. Our higher borrowing costs reflects: (i) the increase in interest rates, (ii) increased interest costs associated with financing Non-Agency RMBS, Agency CMBS, Non-Agency CMBS, ABS and Whole-Loans which generally have higher interest rates than repurchase agreements on Agency RMBS, resulting from our continued reallocation of capital into these asset classes. The increase was partially offset by lower average repurchase agreement borrowings. With respect to our borrowings from repurchase agreements and securitized debt, for the year ended December 31, 2015, as compared to the year ended December 31, 2014, our average borrowings decreased slightly from \$3.7 billion to \$3.4 billion, while the average cost of funds for the same periods, increased from 0.60% to 0.82%. When we went public in 2012, our focus was on Agency RMBS and at December 31, 2013, our portfolio consisted almost entirely of Agency RMBS. In 2013, the percentage of Agency RMBS in our portfolio decreased from 99.9% to 94.9% with the difference being invested almost entirely in Non-Agency RMBS. This trend continued in 2014, with the percentage of Agency RMBS decreasing to 77.8% and the percentage of Non-Agency RMBS and CMBS increasing to 13.5% and 6.7% respectively. As we shifted to a more credit-oriented portfolio, our average yield increased to 3.82% and 3.63%, respectively for the years ended December 31, 2015 and 2014 from 3.09% for the year ended December 31, 2013. While our average cost of funds also increased to 0.82% and 0.60%, respectively for the years ended December 31, 2015 and 2014 from 0.47% for the year ended December 31, 2013 this was offset by the increase in average yield, resulting in a slight decrease in net interest spread to 3.00% from 3.03%, respectively for the years ended December 31, 2015 and 2014 from 2.62% for the year ended December 31, 2013. Other factors impacting interest income include assumptions pertaining prepayments, defaults and loss severity on our credit sensitive portfolio. The cost of repurchase financing for Agency RMBS remained relatively constant over the past three years. Our overall cost of repurchase financing has increased due to our gradual shift to credit sensitive investments.

***Other income (loss), net***

*Realized gain (loss) on investments*

The mortgage and structured securities markets remain dynamic and, at times, volatile markets. Our Manager regularly reviews the characteristics of our portfolio and may make changes to our portfolio in order to adjust such portfolio characteristics in response to and/or anticipation of changing market conditions in an effort to achieve the appropriate risk reward ratio. Accordingly, due to changes in market conditions or expected changes in market conditions, we sold these MBS and other assets in order to adjust the overall characteristics of our portfolio to include a higher proportion of credit sensitive investments.

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The following tables present the sales and realized gains (loss) of our investments for each of the years ended December 31, 2015, 2014 and 2013 (dollars in thousands):

#### For the year ended December 31, 2015

|                            | Proceeds            | Gross Gains      | Gross Losses       | Net Gain (Loss) |
|----------------------------|---------------------|------------------|--------------------|-----------------|
| Agency RMBS(1)             | \$ 1,293,120        | \$ 12,054        | \$ (12,449)        | \$ (395)        |
| Non-Agency RMBS            | 233,257             | 11,066           | (174)              | 10,892          |
| Agency and Non-Agency CMBS | 161,985             | 2,123            | (171)              | 1,952           |
| Other securities           | 851,714             | 1,188            | (5,358)            | (4,170)         |
| <b>Total</b>               | <b>\$ 2,540,076</b> | <b>\$ 26,431</b> | <b>\$ (18,152)</b> | <b>\$ 8,279</b> |

- (1) Excludes proceeds for Agency Interest-Only Strips, accounted for as derivatives, of approximately \$7.3 million, gross realized gains of \$626 thousand and gross realized losses of \$31 thousand.

#### For the year ended December 31, 2014

|                               | Proceeds            | Gross Gains      | Gross Losses       | Net Gain (Loss)   |
|-------------------------------|---------------------|------------------|--------------------|-------------------|
| Agency RMBS(1)                | \$ 1,574,301        | \$ 11,134        | \$ (39,353)        | \$ (28,219)       |
| Non-Agency RMBS               | 414,130             | 20,290           | (993)              | 19,297            |
| Agency and Non-Agency CMBS(2) | 168,535             | 2,007            | (22)               | 1,985             |
| Other securities              | 180,385             | 4,759            |                    | 4,759             |
| <b>Total</b>                  | <b>\$ 2,337,351</b> | <b>\$ 38,190</b> | <b>\$ (40,368)</b> | <b>\$ (2,178)</b> |

- (1) Excludes proceeds for Agency Interest-Only Strips, accounted for as derivatives, of approximately \$34.2 million, gross realized gains of \$439 thousand and gross realized losses of approximately \$1.6 million.
- (2) Excludes proceeds for Agency CMBS Interest-Only Strips, accounted for as derivatives, of approximately \$3.7 million, gross realized gains of \$389 thousand and gross realized losses of \$0.

#### For the year ended December 31, 2013

|                  | Proceeds            | Gross Gains      | Gross Losses        | Net Gain (Loss)     |
|------------------|---------------------|------------------|---------------------|---------------------|
| Agency RMBS(1)   | \$ 3,471,370        | \$ 8,646         | \$ (126,128)        | \$ (117,482)        |
| Non-Agency RMBS  | 108,086             | 5,449            | (376)               | 5,073               |
| Other securities | 20,597              | 1,697            |                     | 1,697               |
| <b>Total</b>     | <b>\$ 3,600,053</b> | <b>\$ 15,792</b> | <b>\$ (126,504)</b> | <b>\$ (110,712)</b> |

- (1) Excludes proceeds for Agency Interest-Only Strips, accounted for as derivatives, of approximately \$20.4 million and gross realized losses of approximately \$1.1 million.

### *Unrealized gain (loss) on investments*

With respect to our investments, we elected the fair value option and, as a result, we record the change in fair value related to these investments in earnings. The change in unrealized gain (loss) on investments is directly attributable to changes in market pricing on the underlying investments during the period. For the year ended December 31, 2015, the average price on our Agency RMBS, Non-Agency RMBS

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and CMBS decreased significantly as a result of mortgage spreads widening. The decrease was partially offset by unrealized gains on our Whole-Loan portfolio and other securities.

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The following table presents the net unrealized gains and losses we recorded on our investments (dollars in thousands):

|                            | <b>For the year ended<br/>December 31, 2015</b> | <b>For the year ended<br/>December 31, 2014</b> | <b>For the year ended<br/>December 31, 2013</b> |
|----------------------------|---|---|---|
| Agency RMBS                | \$ (17,428)                                     | \$ 177,089                                      | \$ (169,020)                                    |
| Non-Agency RMBS            | (3,024)   | 11,441  | 6,991   |
| Agency and Non-Agency CMBS | (17,598)  | 2,951   | 855   |
| Whole-Loans                | 3,548   | 94  |   |
| Other securities           | 491   | (2,564)   | 1,065   |
| <b>Total</b>               | <b>\$ (34,011)</b>                              | <b>\$ 189,011</b>                               | <b>\$ (160,109)</b>                             |

### *Other loss on securities*

With respect to our portfolio, OTTI is generally recorded when the credit quality of the underlying collateral deteriorates and or the schedule payments on our IO securities, which are not characterized as derivatives, are faster than previously projected. The credit deterioration could be as a result of, but not limited to increased projected realized losses, foreclosures, delinquencies and the likelihood of the borrower being able to make payments in the future. Generally, a prepayment occurs when the collateral securing a loan is sold or transferred and/or the loan has a higher interest rate relative to current interest rates and lenders are willing to extend credit at the lower current interest rate.

The following table presents the other-than-temporary impairments we recorded on our securities portfolio (dollars in thousands):

|                  | <b>For the year ended<br/>December 31, 2015</b> | <b>For the year ended<br/>December 31, 2014</b> | <b>For the year ended<br/>December 31, 2013</b> |
|------------------|---|---|---|
| Agency RMBS      | \$ 4,005  | \$ 4,703  | \$ 11,300                                       |
| Non-Agency RMBS  | 9,216   | 11,293  | 550   |
| Non-Agency CMBS  | 4,061   | 228   | 8   |
| Other securities | 2,509   | 790   |   |
| <b>Total</b>     | <b>\$ 19,791</b>                                | <b>\$ 17,014</b>                                | <b>\$ 11,858</b>                                |

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*Gain (loss) on linked transactions, net*

| Instrument                                     | For the year ended December 31, 2014   |  |                             |   |
|--|--|--|-----------------------------|---|
|  | Net Interest<br>Income(1)<br>(Expense) | Mark-to-market<br>adjustments<br>on linked<br>transactions | Net Realized<br>Gain (loss) | Gain (loss)<br>on linked<br>transactions, net |
| Non-Agency RMBS                                | \$ 1,569                               | \$ 393   | \$ 1,589                    | \$ 3,551                                      |
| Non-Agency CMBS, including Non U.S.            | 961                                    | (3,044)  |                             | (2,083)                                       |
| Other securities                               | 349                                    | 9  | (192)                       | 166   |
| Non-Agency Repurchase Agreement                | (346)                                  |  |                             | (346)   |
| CMBS Repurchase Agreement, including Non U.S.  | (167)                                  | 782  |                             | 615   |
| Other securities Repurchase Agreement          | (33)                                   |  |                             | (33)  |
| <b>Linked transactions, net, at fair value</b> | <b>\$ 2,333</b>                        | <b>\$ (1,860)</b>  | <b>\$ 1,397</b>             | <b>\$ 1,870</b>                               |

- (1) Net interest income includes amortization of premium of approximately \$3.3 million for Non-Agency RMBS and \$0 for Non-Agency CMBS and accretion of \$221 thousand for other securities.

| Instrument                                     | For the Year Ended December 31, 2013   |  |                             |   |
|--|--|--|-----------------------------|---|
|  | Net Interest<br>Income(1)<br>(Expense) | Mark-to-market<br>adjustments<br>on linked<br>transactions | Net Realized<br>Gain (loss) | Gain (loss)<br>on linked<br>transactions, net |
| Agency RMBS                                    | \$ 44                                  | \$ (254)   | \$ (210)                    |   |
| Non-Agency RMBS                                | 1,371                                  | (56)   | 3,303                       | 4,618   |
| Agency Repurchase Agreement                    | (6)                                    |  |                             | (6)   |
| Non-Agency Repurchase Agreement                | (265)                                  |  |                             | (265)   |
| <b>Linked transactions, net, at fair value</b> | <b>\$ 1,144</b>                        | <b>\$ (56)</b>   | <b>\$ 3,049</b>             | <b>\$ 4,137</b>                               |

- (1) Net interest income includes amortization of premium of \$9 thousand for Agency RMBS and accretion of discount of \$555 thousand for Non-Agency RMBS.

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*Gain (loss) on derivatives, net*

**For the year ended December 31, 2015:**

| Description   | Realized Gain (Loss), net | Contractual interest income (expense), net(1) | Return (Recovery) of Basis | Mark-to-market adjustments | Total              |
|---|---------------------------|---|----------------------------|----------------------------|--------------------|
| Interest rate swaps   | \$ 23,680                 | \$ (20,366)                                   | \$ 1,250                   | \$ (68,843)                | \$ (64,279)        |
| Interest rate swaptions   | (5,242)                   |   |                            | (1,486)                    | (6,728)            |
| Agency and Non-Agency Interest-Only Strips accounted for as derivatives | 595                       | 21,872  | (17,265)                   | (4,283)                    | 919                |
| Options   | (711)                     |   |                            |                            | (711)              |
| Futures contracts   | (527)                     |   |                            | 105                        | (422)              |
| Foreign currency forwards   | (901)                     |   |                            | 323                        | (578)              |
| Foreign currency swaps  |                           | 795   |                            | 3,311                      | 4,106              |
| TBAs  | 1,524                     |   |                            | (2,726)                    | (1,202)            |
| <b>Total</b>  | <b>\$ 18,418</b>          | <b>\$ 2,301</b>                               | <b>\$ (16,015)</b>         | <b>\$ (73,599)</b>         | <b>\$ (68,895)</b> |

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(1) Contractual interest income (expense), net on derivative instruments includes interest settlement paid or received.

**For the year ended December 31, 2014:**

| Description   | Realized Gain (Loss), net | Contractual interest income (expense), net(1) | Return (Recovery) of Basis | Mark-to-market adjustments | Total               |
|---|---------------------------|---|----------------------------|----------------------------|---------------------|
| Interest rate swaps   | \$ 5,440                  | \$ (31,764)                                   | \$ 1,818                   | \$ (183,379)               | \$ (207,885)        |
| Interest rate swaptions   | (3,606)                   |   |                            | (1,697)                    | (5,303)             |
| Agency and Non-Agency Interest-Only Strips accounted for as derivatives | (753)                     | 26,097  | (18,868)                   | (2,136)                    | 4,340               |
| Options   | (2,813)                   |   |                            |                            | (2,813)             |
| Futures contracts   | (16,495)                  |   |                            | (740)                      | (17,235)            |
| Foreign currency forwards   | (1,759)                   |   |                            | (303)                      | (2,062)             |
| Foreign currency swaps  |                           | 317   |                            | 3,857                      | 4,174               |
| TBAs  | 40,015                    |   |                            | 6,273                      | 46,288              |
| <b>Total</b>  | <b>\$ 20,029</b>          | <b>\$ (5,350)</b>                             | <b>\$ (17,050)</b>         | <b>\$ (178,125)</b>        | <b>\$ (180,496)</b> |

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(1) Contractual interest income (expense), net on derivative instruments includes interest settlement paid or received.



Table of Contents**For the Year ended December 31, 2013:**

| Description   | Realized<br>Gain<br>(Loss),<br>net | Contractual<br>interest<br>income<br>(expense),<br>net(1) | Basis<br>Recovery | Mark-to-<br>market<br>adjustments | Total      |
|---|------------------------------------|---|-------------------|-----------------------------------|------------|
| Interest rate swaps   | \$ 65,305                          | \$ (22,932)   | \$                | \$ 83,764                         | 126,137    |
| Interest rate swaptions   | 23,671                             |   |                   | 4,733                             | 28,404     |
| Agency and Non-Agency Interest-Only Strips accounted for as derivatives | (1,124)                            | 28,273  | (18,010)          | (700)                             | 8,439      |
| Options   | (925)                              |   |                   |                                   | (925)      |
| TBAs  | (1,499)                            |   |                   | (3,009)                           | (4,508)    |
| Total   | \$ 85,428                          | \$ 5,341  | \$ (18,010)       | \$ 84,788                         | \$ 157,547 |

(1) Contractual interest income (expense), net on derivative instruments includes interest settlement paid or received.

In order to mitigate interest rate risk resulting from our future repurchase agreement borrowings, we entered into interest rate swaps with an aggregate notional amount of approximately \$8.4 billion, of which \$710.0 million are forward starting. As of December 31, 2015, our effective swaps are comprised of approximately \$5.5 billion fixed pay rate swaps and \$2.3 billion are variable pay swaps, which effectively fix (for the life of the swap) the floating interest rate of approximately \$3.2 billion of borrowings. We also invested in interest rate swaptions with an aggregate notional amount of approximately \$105.0 million at December 31, 2015. Similarly, we have entered into currency swaps and currency forwards with an aggregate notional amount of approximately \$38.7 million (€ 30.4 million) in order to mitigate our foreign currency risk on our euro denominated assets and liabilities. The fair value of our interest rate swaps declined as a result of the swap spreads tightening. While not designated as a hedge for accounting purposes, our current and future interest rate swaps, interest rate swaptions, foreign currency swaps and foreign currency forwards are, collectively viewed as an economic hedge on a portion of our floating-rate borrowings and foreign currency rate exposure, respectively. Since we do not apply hedge accounting for these instruments, we record the change in fair value related to such agreements in earnings in Gain (loss) on derivative instruments, net. Included in Gain (loss) on derivative instruments, net in our Consolidated Statement of Operations are the net interest rate swap payments and currency payments (including accrued amounts) associated with these instruments.

*Other, net*

For the years ended December 31, 2015, December 31, 2014 and December 31, 2013 other income was approximately \$2.3 million, \$1.4 million and \$91 thousand of which approximately \$2.1 million, 1.7 million and \$0, respectively, was related to net foreign currency gain and the balance comprised of miscellaneous interest income/ expense on cash collateral for our derivatives and repurchase agreements. Generally, our foreign currency denominated investments are financed with repurchase agreements in the same currency. We recognize a gain or loss in foreign currency exchange, depending on the movement of the exchange rates during the period.

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**Expenses**

**General and Administrative Expenses**

We incurred general and administrative expenses of approximately \$11.6 million, \$9.1 million and \$6.4 million for the years ended December 31, 2015, December 31, 2014 and December 31, 2013, respectively, which represents professional fees, insurance, non-cash stock based compensation and overhead costs of the Company. The increase in general and administrative expenses from 2015 over 2014 is primarily due to an increase in equity based compensation, professional fees due to increased audit, tax, internal audit and outsourced accounting fees, compensation expense due to 2015 approved increases in compensation for our chief financial officer and controller, and clearinghouse fees related to our derivative instruments. The increase in general and administrative expenses from 2014 over 2013 is primarily due to an increase in equity based compensation, custodian fees, compensation expense for our chief financial officer and controller, and transaction costs related to the implementation of our Residential Whole-Loan program.

**Management Fee Expense**

We incurred management fee expense of approximately \$10.9 million, \$9.6 million and \$7.8 million for the years ended December 31, 2015, December 31, 2014 and December 31, 2013, respectively, of which approximately \$2.7 million was payable at December 31, 2015 to our Manager under the Management Agreement. Pursuant to the terms of the Management Agreement, our Manager is paid a management fee equal to 1.5% per annum of our stockholders' equity (as defined in the Management Agreement), calculated and payable (in cash) quarterly in arrears. Management fees primarily increased from 2015 over 2014 and 2014 over 2013 due to an increase in our stockholder's equity resulting from the successful completion of our follow-on offering in April 2014.

The management fees, expense reimbursements and the relationship between our Manager and us are discussed further in Note 10, "Related Party Transactions," to the financial statements contained in this Annual Report on Form 10-K.

**Book Value Per Share**

As of December 31, 2015 and December 31, 2014, our book value per common share was \$12.21 and \$14.94, respectively.

**Non-GAAP Financial Measures**

*Total Interest Income and Net Interest Income, including Interest Income on Agency and Non-Agency Interest-Only strips accounted for as derivatives and Effective Cost of Funds*

Total interest income including interest income on Agency and Non-Agency Interest-Only Strips classified as derivatives and Effective Cost of Funds (as defined below) for the years ended December 31, 2015, December 31, 2014 and December 31, 2013, constitute a Non-GAAP financial measures within the meaning of Regulation G promulgated by the SEC. We believe that the measures presented in this annual report on Form 10-K, when considered together with U.S. GAAP financial measures, provide information that is useful to investors in understanding our borrowing costs and net interest income, as viewed by us. An analysis of any Non-GAAP financial measure should be made in conjunction with results presented in accordance with GAAP.

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For purposes of evaluating operating results, we believe it useful to present investors with additional information pertaining to the net interest margin generated by our portfolio. Net interest margin is gross interest, adjusted for amortization/accretion of bond premium/discount, less interest expense or financing cost. GAAP requires that certain of our Agency and Non-Agency Interest Only Strips be treated as derivatives and, accordingly, the interest income associated with these securities be included with Gain (loss) on derivative instruments, net in our Consolidated Statement of Operations. Similarly, prior to January 1, 2015, GAAP required that interest income on linked transactions be included in Gain (loss) on linked transactions, net in our Consolidated Statement of Operations. Accordingly, in order to determine the gross interest income generated by our IO and IIO securities which are classified as derivatives and our MBS and other securities which are classified as linked transactions prior to January 1, 2015, we calculate the interest income on these securities as if they were not derivatives or linked transactions. Starting in January 2015, we report our securities and the corresponding repurchase agreements which had previously been classified as linked transactions on a gross basis on our Consolidated Balance Sheets and with the corresponding interest income and interest expense reported in our Consolidated Statements of Operations.

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The following table sets forth certain information regarding our net investment income for the years ended December 31, 2015, December 31, 2014 and December 31, 2013 (dollars in thousands):

#### Non-GAAP Financial Measures:

| Period Ended                | Average Amortized Cost of Assets(1) | Total Interest Income(2) | Yield on Average Assets(1) | Average Balance of Borrowings(3) | Total Interest Expense(4) | Average Effective Cost of Funds | Net Interest Income | Net Interest Rate Spread |
|-----------------------------|-------------------------------------|--------------------------|----------------------------|----------------------------------|---------------------------|---------------------------------|---------------------|--------------------------|
| <b>December 31, 2015</b>    |                                     |                          |                            |                                  |                           |                                 |                     |                          |
| Agency RMBS                 | \$ 2,778,106                        | \$ 75,205                | 2.71%                      | \$ 2,403,723                     | \$ 26,949                 | 1.12%                           | \$ 48,256           | 1.59%                    |
| Non-Agency RMBS             | 570,094                             | 36,947                   | 6.48%                      | 418,975                          | 8,272                     | 1.97%                           | 28,675              | 4.51%                    |
| Agency and Non-Agency CMBS  | 491,617                             | 33,133                   | 6.74%                      | 363,849                          | 7,571                     | 2.08%                           | 25,562              | 4.66%                    |
| Residential Whole-Loans     | 82,936                              | 3,031                    | 3.65%                      | 69,026                           | 1,816                     | 2.63%                           | 1,215               | 1.02%                    |
| Commercial Whole-Loans      | 4,699                               | 424                      | 9.02%                      |                                  |                           | %                               | 424                 | 9.02%                    |
| Securitized commercial loan | 3,904                               | 356                      | 9.12%                      | 2,255                            | 170                       | 7.54%                           | 186                 | 1.58%                    |
| Other Securities            | 146,350                             | 9,010                    | 6.16%                      | 99,617                           | 1,943                     | 1.95%                           | 7,067               | 4.21%                    |
| <b>Total</b>                | <b>\$ 4,077,706</b>                 | <b>\$ 158,106</b>        | <b>3.88%</b>               | <b>\$ 3,357,445</b>              | <b>\$ 46,721</b>          | <b>1.39%</b>                    | <b>\$ 111,385</b>   | <b>2.49%</b>             |
| <b>December 31, 2014</b>    |                                     |                          |                            |                                  |                           |                                 |                     |                          |
| Agency RMBS                 | \$ 3,275,878                        | \$ 101,839               | 3.11%                      | \$ 3,019,411                     | \$ 39,483                 | 1.31%                           | \$ 62,356           | 1.80%                    |
| Non-Agency RMBS             | 583,719                             | 34,936                   | 5.99%                      | 414,285                          | 7,527                     | 1.82%                           | 27,409              | 4.17%                    |
| Agency and Non-Agency CMBS  | 306,883                             | 17,664                   | 5.76%                      | 227,583                          | 4,716                     | 2.07%                           | 12,948              | 2.85%                    |
| Residential Whole-Loans     | 962                                 | 32                       | 3.33%                      | 1,249                            | 17                        | 1.36%                           | 15                  | 1.97%                    |
| Other Securities            | 85,451                              | 5,064                    | 5.93%                      | 67,678                           | 1,012                     | 1.50%                           | 4,052               | 4.43%                    |
| <b>Total</b>                | <b>\$ 4,252,893</b>                 | <b>\$ 159,535</b>        | <b>3.75%</b>               | <b>\$ 3,730,206</b>              | <b>\$ 52,755</b>          | <b>1.41%</b>                    | <b>\$ 106,780</b>   | <b>2.34%</b>             |
| <b>December 31, 2013</b>    |                                     |                          |                            |                                  |                           |                                 |                     |                          |
| Agency RMBS                 | \$ 3,949,104                        | \$ 122,095               | 3.09%                      | \$ 3,683,230                     | \$ 38,777                 | 1.05%                           | \$ 83,318           | 2.04%                    |
| Non-Agency RMBS             | 213,773                             | 13,670                   | 6.39%                      | 128,913                          | 2,277                     | 1.77%                           | 11,393              | 4.63%                    |
| Agency and Non-Agency CMBS  | 7,356                               | 501                      | 6.81%                      | 4,525                            | 63                        | 1.39%                           | 438                 | 5.42%                    |
| Other Securities            | 9,071                               | 740                      | 8.16%                      | 5,257                            | 105                       | 2.00%                           | 635                 | 6.16%                    |
| <b>Total</b>                | <b>\$ 4,179,304</b>                 | <b>\$ 137,006</b>        | <b>3.28%</b>               | <b>\$ 3,821,925</b>              | <b>\$ 41,222</b>          | <b>1.08%</b>                    | <b>\$ 95,784</b>    | <b>2.20%</b>             |

- (1) Includes Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions.

(2) Amounts for the year ended December 31, 2015 include net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately \$(70.2) million. This amount is composed of approximately \$(48.1) million for Agency RMBS included in interest income, approximately \$(8.0) million for Non-Agency RMBS included in interest income, approximately \$1.6 million for Agency and Non-Agency CMBS included in interest income, approximately \$(1.1) million for Residential Whole-Loans included in interest income, approximately \$2.6 million for Other securities included in interest income and approximately \$(17.2) million of amortization/recovery of basis on Agency and Non-Agency Interest-Only Strips accounted for as derivatives (Non-GAAP measure), not reported in interest income for GAAP (included in Loss on derivative

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instruments). For the year ended December 31, 2014 includes net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately \$(82.0) million. This amount is composed of approximately \$(57.1) million for Agency RMBS included in interest income, approximately \$(3.3) million for Non-Agency RMBS included in interest income, approximately \$(435) thousand for Agency and Non-Agency CMBS included in interest income, approximately \$(26) thousand for Residential Whole-Loans included in interest income, approximately \$858 thousand for Other securities included in interest income, approximately \$(3.3) million for Non-Agency linked transactions (Non-GAAP measure), approximately \$221 thousand for other securities linked transactions (Non-GAAP measure), and approximately \$(18.9) million of amortization/recovery of basis on Agency and Non-Agency Interest-Only Strips accounted for as derivatives (Non-GAAP measure), not reported in interest income for GAAP (included in Loss on derivative instruments). For the year ended December 31, 2013 includes net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately \$(69.6) million. This amount is composed of approximately \$(60.3) million for Agency RMBS included in interest income, approximately \$8.1 million for Non-Agency RMBS included in interest income, approximately \$(106) thousand for Agency and Non-Agency CMBS included in interest income, approximately \$152 thousand for other securities included in interest income, approximately \$(9) thousand for Agency linked transactions (Non-GAAP measure), approximately \$555 thousand for Non-Agency linked transactions (Non-GAAP measure) and approximately \$(18.0) million of amortization/recovery of basis on Agency and Non-Agency Interest-Only Strips accounted for as derivatives (Non-GAAP measure), not reported in interest income for GAAP (included in Loss on derivative instruments).

(3)

Includes repurchase agreement borrowings on linked transactions.

(4)

Includes the net amount paid, including accrued amounts and premium amortization for MAC interest rate swaps during the period included in loss on derivative instruments for GAAP and interest expense incurred on borrowings for linked transactions.

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We have supplemented our discussion of GAAP net interest income discussed above, with a discussion below of our net interest rate spread including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted as derivatives and net interest income (expenses), net incurred on swaps and linked-transactions, which only apply to the years ended December 31, 2014 and December 31, 2013, a Non-GAAP measure, defined below, which gives a more concise view of our hedged portfolio as a whole.

Our effective gross yield, a non-GAAP measure, for the years ended December 31, 2015, December 31, 2014 and December 31, 2013 was 3.88%, 3.75% and 3.28%, respectively. Our effective gross yield, a non-GAAP measure, increased for the year ended December 31, 2015 and 2014 due to the change in composition of our portfolio to more credit-oriented assets. Our effective cost of funds, a non-GAAP measure, for the years ended December 31, 2015, December 31, 2014 and December 31, 2013 was 1.39%, 1.41% and 1.08%, respectively. The decrease in our effective cost of funds for the year ended December 31, 2015 and 2014 primarily resulted from a decrease in the average effective notional of net pay-fixed interest rate swaps and a decrease in the lower average repurchase agreement borrowings. For the years ended December 31, 2015 and December 31, 2014, our hedging costs on interest rate swaps was 0.57% and 0.81%, respectively.

The following table reconciles total interest income to interest income including interest income on Agency and Non-Agency Interest-Only Strips classified as derivatives and interest income on linked transactions prior to January 1, 2015 (Non-GAAP financial measure) for the years ended December 31, 2015, December 31, 2014 and December 31, 2013:

| (dollars in thousands)  | For the year ended<br>December 31, 2015 | For the year ended<br>December 31, 2014 | For the year ended<br>December 31, 2013 |
|---|---|---|---|
| Coupon interest income  | \$ 205,672                              | \$ 209,146                              | \$ 177,472                              |
| Premium accretion, discount amortization and amortization of basis, net   | (52,968)                                | (60,036)                                | (52,144)                                |
| <b>Interest income</b>  | <b>\$ 152,704</b>                       | <b>\$ 149,110</b>                       | <b>\$ 125,328</b>                       |
| Contractual interest income, net of amortization of basis on Agency and Non-Agency Interest-Only Strips, classified as derivatives(1):  |   |   |   |
| Coupon interest income  | \$ 21,872                               | \$ 26,097                               | \$ 28,273                               |
| Amortization of basis (Non-GAAP Financial Measure)  | (17,265)                                | (18,868)                                | (18,010)                                |
| Contractual interest income, net on Foreign currency swaps(1)   | 795                                     | 317                                     |   |
| Contractual interest income, net of premium amortization, discount accretion and amortization of basis on Linked transactions(2):   |   |   |   |
| Coupon interest income  |   | 5,998                                   | 869                                     |
| Premium amortization, discount accretion and amortization of basis, net   |   | (3,119)                                 | 546                                     |
| <b>Subtotal</b>   | <b>5,402</b>                            | <b>10,425</b>                           | <b>11,678</b>                           |
| <b>Total interest income, including interest income on Agency and Non-Agency Interest-Only Strips, classified as derivatives and Linked transactions Non-GAAP Financial Measure</b> | <b>\$ 158,106</b>                       | <b>\$ 159,535</b>                       | <b>\$ 137,006</b>                       |

(1) Reported in gain (loss) on derivative instruments in the Consolidated Statement of Operations.

(2) Reported in gain (loss) on linked transactions in the Consolidated Statement of Operations.

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Effective Cost of Funds includes the net interest component related to our interest rate swaps and borrowings under linked transactions prior to January 1, 2015, as well as the impact of our foreign currency swaps and forwards. While we have not elected hedge accounting for these instruments, such derivative instruments are viewed by us as an economic hedge against increases in future market interest rates on our liabilities and changes in foreign currency exchange rates on our assets and liabilities and are characterized as hedges for purposes of satisfying the REIT requirements and therefore the Effective Cost of Funds reflects interest expense adjusted to include the realized loss (i.e., the interest expense component) for all of our interest rate swaps and the impact of our foreign currency swaps and forwards. In addition, prior to January 1, 2015, our linked transactions were comprised of real estate securities and other structured securities, associated with repurchase agreements. We view the cost of the associated repurchase agreements (interest expense) prior to January 1, 2015 as a component of our Effective Cost of Funds.

The following table reconciles the Effective Cost of Funds (Non-GAAP financial measure) with interest expense for the years ended December 31, 2015, December 31, 2014 and December 31, 2013:

| (dollars in thousands)                  | For the year ended<br>December 31, 2015 |  | For the year ended<br>December 31, 2014 |  | For year ended<br>December 31, 2013 |  |
|---|---|--|---|--|-------------------------------------|--|
|   | Reconciliation                          | Cost of<br>Funds/Effective<br>Borrowing<br>Costs | Reconciliation                          | Cost of<br>Funds/Effective<br>Borrowing<br>Costs | Reconciliation                      | Cost of<br>Funds/Effective<br>Borrowing<br>Costs |
| Interest expense                        | \$ 27,605                               | 0.82%  | \$ 22,263                               | 0.60%  | \$ 18,019                           | 0.47%  |
| Interest expense on linked transactions |   |  | 546                                     | 1.75%  | 271                                 | 1.65   |
| Net interest paid interest rate swaps   | 19,116                                  | 0.57%  | 29,946                                  | 0.81%  | 22,932                              | 0.61%  |
| Effective Borrowing Costs               | \$ 46,721                               | 1.39%  | \$ 52,755                               | 1.41%  | \$ 41,222                           | 1.08%  |
| Weighted average borrowings(1)          | \$ 3,357,445                            |  | \$ 3,730,206                            |  | \$ 3,821,925                        |  |

(1) Includes average repurchase borrowings under linked transactions for the years ended December 31, 2014 and December 31, 2013.

### *Core Earnings*

Our Core Earnings were approximately \$91.4 million, \$89.9 million and \$82.7 million for the years ended December 31, 2015, December 31, 2014 and December 31, 2013, respectively. Core Earnings is a Non-GAAP financial measure that is used by us to approximate cash yield or income associated with our portfolio and is defined as GAAP net income (loss) as adjusted, excluding: (i) net realized gain (loss) on investments and termination of derivative contracts; (ii) net unrealized gain (loss) on investments; (iii) net gain (loss) resulting from mark-to-market adjustments on derivative contracts; (iv) other loss on securities; (v) non-cash stock-based compensation expense; and (vi) one-time events pursuant to changes in GAAP and certain other non-cash charges after discussions between us, our Manager and our independent directors and after approval by a majority of the our independent directors.

In order to evaluate the effective yield of the portfolio, we use Core Earnings to reflect the net investment income of our portfolio as adjusted to reflect the net interest rate swap interest expense. Core Earnings allows us to isolate the interest expense associated with our interest rate swaps in order to monitor and project our borrowing costs and interest rate spread. In addition, we utilize Core Earnings as a key metric in conjunction with other portfolio and market factors to determine the appropriate leverage and hedge ratios, as well as the overall structure of the portfolio. We also believe that our investors use Core Earnings or a comparable supplemental performance measure to evaluate and compare our performance and our peers, and as such, we believe that the disclosure of Core Earnings is useful to our investors.

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Our presentation of Core Earnings may not be comparable to similarly-titled measures of other companies, who may use different calculations. As a result, Core Earnings should not be considered as a substitute for our GAAP net income as a measure of our financial performance or any measure of our liquidity under GAAP.

The table below reconciles Net Income (Loss) to Core Earnings for the years ended December 31, 2015, December 31, 2014 and December 31, 2013:

| <b>(dollars in thousands)</b>  | <b>For the year ended<br/>December 31, 2015</b> | <b>For the year ended<br/>December 31, 2014</b> | <b>For year ended<br/>December 31, 2013</b> |
|--|---|---|---|
| Net Income (loss) GAAP   | \$ (9,484)                                      | \$ 100,713                                      | \$ (27,855)                                 |
| Adjustments:   |   |   |   |
| <i>Investments:</i>  |   |   |   |
| Unrealized (gain) loss on investments  | 34,011  | (189,011)                                       | 160,109                                     |
| Other loss on securities   | 19,791  | 17,014  | 11,858                                      |
| Realized (gain) loss on sale of investments  | (8,279)   | 2,178   | 110,712                                     |
| <i>Derivative Instruments:</i>   |   |   |   |
| Realized gain on termination of interest rate swaps  | (23,680)  | (5,440)   | (65,305)                                    |
| Realized (gain) loss on settlement of TBAs   | (1,524)   | (40,015)  | 1,499                                       |
| Realized loss on currency forwards   | 901   | 1,759   |   |
| Realized loss on option derivatives  | 711   | 2,813   | 925   |
| Realized loss on termination of futures  | 527   | 16,495  |   |
| Realized (gain) loss on sale of swaptions  | 5,242   | 3,606   | (23,671)                                    |
| Realized gain on sale/unlinking of securities underlying linked transactions                                   |   | (1,397)   | (3,049)                                     |
| Realized (gain) loss on Agency Interest-Only Strips accounted for as derivatives                               | (595)   | 753   | 1,124                                       |
| Realized gain on foreign currency transactions   | (2,253)   | (1,725)   |   |
| Unrealized loss on foreign currency transactions   | 123   |   |   |
| Mark-to-market adjustments on interest rate swaps  | 68,843  | 183,379   | (83,764)                                    |
| Mark-to-market adjustments on interest rate swaptions  | 1,486   | 1,697   | (4,733)                                     |
| Mark-to-market adjustments on futures contracts  | (105)   | 740   |   |
| Mark-to-market adjustments on TBAs   | 2,726   | (6,273)   | 3,009                                       |
| Mark-to-market adjustments on linked transactions  |   | 1,860   | 56  |
| Mark-to-market adjustments on IOs  | 4,283   | 2,136   | 700   |
| Mark-to-market adjustments on foreign currency swaps   | (3,311)   | (3,857)   |   |
| Mark-to-market adjustments on foreign currency forwards  | (323)   | 303   |   |
| Non-cash stock-based compensation expense  | 2,301   | 2,203   | 1,087                                       |
| <b>Total adjustments</b>   | <b>100,875</b>                                  | <b>(10,782)</b>                                 | <b>110,557</b>                              |
| <b>Core Earnings Non-GAAP Financial Measure</b>  | <b>\$ 91,391</b>                                | <b>\$ 89,931</b>                                | <b>\$ 82,702</b>                            |
| <b>Basic Core Earnings per Share of Common Stock and Participating Securities Non-GAAP Financial Measure</b>   | <b>\$ 2.18</b>                                  | <b>\$ 2.39</b>                                  | <b>\$ 3.39</b>                              |
| <b>Diluted Core Earnings per Share of Common Stock and Participating Securities Non-GAAP Financial Measure</b> | <b>\$ 2.18</b>                                  | <b>\$ 2.39</b>                                  | <b>\$ 3.38</b>                              |
| <b>Basic weighted average common shares and participating securities</b>                                       | <b>41,909,835</b>                               | <b>37,677,685</b>                               | <b>24,374,025</b>                           |
| <b>Diluted weighted average common shares and participating securities</b>                                     | <b>41,909,835</b>                               | <b>37,677,685</b>                               | <b>24,454,716</b>                           |



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Alternatively, our Core Earnings can also be derived as presented in the table below by starting with Net interest income including interest income on Interest-Only Strips accounted for as derivatives and interest expense, net incurred on interest rate swaps and foreign currency swaps and forwards (a Non-GAAP financial measure) subtracting Operating Expenses, net of Non-cash stock based compensation, and adding Interest income on cash balances and other income (loss), net:

| (dollars in thousands)  | For the year ended<br>December 31, 2015 | For the year ended<br>December 31, 2014 | For the year ended<br>December 31, 2013 |
|---|---|---|---|
| Net interest income including interest income on Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and foreign currency swaps (a Non-GAAP financial measure) | \$ 111,385                              | \$ 106,780                              | \$ 95,784                               |
| Total Operating Expenses  | (22,483)                                | (18,760)                                | (14,260)                                |
| Non-cash stock based compensation   | 2,301                                   | 2,203                                   | 1,087                                   |
| Interest income on cash balances and other income (loss), net   | 188                                     | (292)                                   | 91                                      |
| <b>Core Earnings (a Non-GAAP financial measure)</b>   | <b>\$ 91,391</b>                        | <b>\$ 88,931</b>                        | <b>\$ 82,702</b>                        |

### **Liquidity and Capital Resources**

#### *General*

Our liquidity and capital resources are managed on a daily basis to ensure that we have sufficient liquidity to absorb market events that could negatively impact collateral valuations and result in margin calls as well as to ensure that we have the flexibility to manage our investment portfolio to take advantage of market opportunities.

Liquidity is a measure of our ability to meet potential cash requirements, including ongoing commitments to repay borrowings, fund and maintain our assets and operations, make distributions to our stockholders and other general business needs. We use cash to purchase our Target Assets, repay principal and interest on our borrowings, make distributions to our stockholders and fund our operations.

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Under our repurchase agreements and derivative contracts, counterparties retain the right to determine the fair value of the collateral pledged, or in the case of cleared swaps the required collateral may be determined by clearinghouse rules. A reduction in the value of the collateral pledged will require us to provide additional collateral or fund cash margin calls. Alternatively, since margins calls for our interest rate swaps and swaptions generally are inversely correlated to those of our repurchase agreements, our interest rate swap and swaptions counterparties would likely be required to post collateral with us during a period in which we were required to post collateral with our repurchase agreement counterparties. Similarly, we would likely be required to post collateral with swap and swaption counterparties during periods in which our repurchase agreement counterparties are required to post collateral with us. During 2014 and continuing into 2015, the market has experienced a sustained period of volatility. For the majority of 2015, such higher rate volatility has resulted in wider mortgage spreads and a higher cost of hedging. We were able to satisfy our additional collateral requirements with cash on hand, unlevered or underleveraged securities, cash from rehypothecation of securities received as incremental collateral and proceeds from our repurchase agreement borrowings and/or our swaps and swaptions, respectively. We were not forced to involuntarily sell any of our assets, nor did any of counterparties sell any of our assets held by them as collateral. During 2015 and 2014, we rehypothecated some of the U.S. Treasury securities we received as incremental collateral on our repurchase borrowings, swaps and swaptions, effectively entering into repurchase agreements with such securities, in order to increase our cash position. The maximum amount of repurchase borrowings for the rehypothecated U.S. Treasury securities was \$530 thousand and \$3.3 million during the years ended December 31, 2015 and December 31, 2014, respectively. At December 31, 2015, no U.S. Treasury securities were rehypothecated. In an instance of severe volatility, or where the additional stress on liquidity resulting from volatility is sustained over an extended period of time, we could be required to sell securities, possibly even at a loss to generate sufficient liquidity to satisfy collateral and margin requirements which could have a material adverse effect on our financial position, results of operations and cash flows.

As part of our risk management process, our Manager closely monitors our liquidity position. This includes the development and evaluation of various alternative processes and procedures, which continue to be updated with regard to scenario testing for purposes of assessing our liquidity in the face of different economic and market developments. We believe we have sufficient current liquidity and access to additional liquidity to meet financial obligations for at least the next 12 months.

Our primary sources of liquidity are as follows:

***Cash Generated Follow-On Public Offerings and Private Placements***

During the year ended December 31, 2015, we did not generate any proceeds from follow-on public offerings or private placements. However, at the beginning of the second quarter of 2014, we completed a follow-on public offering, including the exercise by the underwriters of a portion of an option to acquire additional shares resulting in net proceeds to us of approximately \$205.4 million. In addition, we sold shares to our Manager in a private placement for an aggregate offering price of approximately \$9.7 million.

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***Borrowing under Various Financing Arrangements***

As of December 31, 2015, we had master repurchase agreements with 26 counterparties. We had borrowings under repurchase agreements with 21 counterparties of approximately \$2.6 billion at December 31, 2015. The following tables present our repurchase agreement borrowings, by type of collateral pledged, as of December 31, 2015 and December 31, 2014, and the respective effective cost of funds (Non-GAAP financial measure) for the years ended December 31, 2015 and December 31, 2014, respectively. See "Non-GAAP Financial Measures" (dollars in thousands):

| Collateral                                     | Borrowings Outstanding December 31, 2015 | Fair Value of Collateral Pledged(1) | Weighted Average Interest Rate end of period | Weighted Average Cost of Funds for the year ended December 31, 2015 | Weighted Average Effective Cost of Funds (Non-GAAP) for the year ended December 31, 2015(2) | Weighted Average Haircut end of period |
|--|--|-------------------------------------|--|---|---|--|
| Agency RMBS                                    | \$ 1,601,713                             | \$ 1,658,865                        | 0.66%  | 0.46%   | 1.12%   | 5.13%                                  |
| Non-Agency RMBS                                | 380,177                                  | 530,110                             | 1.91   | 1.63  | 1.97  | 29.80                                  |
| Agency and Non-Agency CMBS(3)                  | 356,369                                  | 487,643                             | 1.84   | 1.61  | 2.08  | 26.97                                  |
| Whole-Loans and securitized commercial loan(4) | 180,892                                  | 232,538                             | 2.38   | 2.63  | 2.63  | 21.24                                  |
| Other securities                               | 66,650                                   | 101,099                             | 2.33   | 1.95  | 1.95  | 32.19                                  |
| Total  | \$ 2,585,801                             | \$ 3,010,255                        | 1.17%  | 0.82%   | 1.39%   | 13.59%                                 |

(1) Excludes approximately \$38.3 million of cash collateral posted.

(2) The effective cost of funds for the period presented is calculated on an annualized basis and includes interest expense for the period and net periodic interest payments on interest rate swaps, net of premium amortization on MAC swaps, of approximately \$19.1 million for the year ended December 31, 2015. While interest rate swaps are not accounted for using hedge accounting, such instruments are viewed by us as an economic hedge against increases in interest rates on our liabilities and are treated as hedges for purposes of satisfying the REIT requirements. See "Non-GAAP Financial Measures".

(3) Including Non U.S. CMBS pledged as collateral and Non U.S. repurchase agreement borrowings.

(4) Repurchase agreement borrowings collateralized by Whole-Loans and securitized commercial loan owned through trust certificates. The trust certificates are eliminated upon consolidation.

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| Collateral                             | Repurchase Agreement Borrowings Outstanding December 31, 2014 | Fair Value of Collateral Pledged(1) | Weighted Average Interest Rate end of period | Weighted Average Cost of Funds for the year ended December 31, 2014 | Weighted Average Effective Cost of Funds (Non-GAAP) for the year ended December 31, 2014(2) | Weighted Average Haircut end of period |
|--|---|-------------------------------------|--|---|---|--|
| Agency RMBS                            | \$ 2,994,351  | \$ 3,158,544                        | 0.40%  | 0.38%   | 1.31%   | 5.42%                                  |
| Non-Agency RMBS                        | 473,942   | 670,526                             | 1.54   | 1.62  | 1.83  | 30.21                                  |
| Agency and Non-Agency CMBS             | 325,864   | 431,938                             | 1.55   | 1.51  | 2.08  | 23.59                                  |
| Whole-Loans(3)                         | 4,930   | 7,220                               | 1.91   | 1.36  | 1.36  | 30.00                                  |
| Other securities                       | 76,634  | 101,523                             | 1.53   | 1.48  | 1.48  | 22.68                                  |
| Total: Excluding Linked Transactions   | \$ 3,875,721  | \$ 4,369,751                        | 0.66%  | 0.60%   | 1.41%   | 10.35%                                 |
| Non-Agency RMBS Linked Transactions    | 6,559   | 8,156                               | 1.66   | n/a   | 1.65  | 20.00                                  |
| Non-Agency CMBS Linked Transactions(4) | 22,458  | 38,609                              | 1.94   | n/a   | 1.94  | 41.34                                  |
| Other securities Linked Transactions   | 2,840   | 5,719                               | 1.93   | n/a   | 2.00  | 50.00                                  |
| Total (Non-GAAP)                       | \$ 3,907,578  | \$ 4,422,235                        | 0.67%  | 0.60%   | 1.41%   | 10.58%                                 |

(1) Excludes approximately \$25.7 million of cash collateral posted.

(2) The effective cost of funds for the period presented is calculated on an annualized basis and includes interest expense for the period and net periodic interest payments on interest rate swaps, net of premium amortization on MAC swaps, of approximately \$29.9 million and interest expense on linked transactions of approximately \$546 thousand for the year ended December 31, 2014. While interest rate swaps are not accounted for using hedge accounting, such instruments are viewed by us as an economic hedge against increases in interest rates on our liabilities and are treated as hedges for purposes of satisfying the REIT requirements. See "Non-GAAP Financial Measures".

(3) Repurchase borrowings collateralized by Residential Whole-Loans owned through trust certificates. The trust certificates are eliminated upon consolidation.

(4) Including Non U.S. CMBS pledged as collateral and Non U.S. repurchase agreement borrowings.

As of December 31, 2015, our repurchase agreements require collateral in excess of the loan amount, or haircuts, ranging from a low of 3.0% to a high of 5.0% for Agency RMBS, exclusive of IOs and IIOs for which the haircuts are as high as 25.0%. For Non-Agency RMBS and Agency and Non-Agency CMBS, haircuts range from a low of 13.0% to a high of 50.0%. Haircuts for other securities and Whole-Loans range from a low of 20.0% to a high of 50.0%. Declines in the value of our portfolio can trigger margin calls by our counterparties under our repurchase agreements. Margin calls could adversely affect our liquidity. Our inability to post adequate collateral for a margin call by the counterparty could result in a condition of default under our repurchase agreements. An event of default or termination event would give some of our counterparties the option to terminate all existing repurchase transactions with us and require any amount due to the counterparties by us to be payable immediately. If this were to occur, we may be forced to sell assets under adverse market conditions or through foreclosure which may have a material adverse consequence on our business, financial position, our results of operations and cash flows. During the year ended December 31, 2015, we were able to satisfy margin calls using cash on hand, unlevered or underleveraged securities, cash from rehypothecation

of securities received as incremental collateral and cash from our repurchase agreement borrowings.

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Under the repurchase agreements, the respective counterparties, subject to the terms of the individual agreements, retain the right to determine the fair value of the underlying collateral. A reduction in the value of pledged assets requires us to provide additional collateral or fund margin calls. In addition, certain of the repurchase agreements may be terminated by our counterparties if we do not maintain certain equity and leverage metrics, the most restrictive of which include a limit on leverage based on the composition of our portfolio. We were in compliance with the terms of such financial tests as of December 31, 2015. At December 31, 2015, approximately \$3.0 billion of our investments served as collateral for repurchase agreements. At December 31, 2014, approximately \$4.4 billion of our investments served as collateral for repurchase agreements.

We are also required to pledge cash or securities as collateral as part of a margin arrangement for our derivative contracts, calculated daily, subject either to the terms of individual agreements for bilateral agreements and the clearinghouse rules in the case of cleared swaps. The amount of margin that we are required to post will vary and generally reflects collateral posted with respect to swaps that are in an unrealized loss position to us and a percentage of the aggregate notional amount of swaps per counterparty as well as margin posted with our clearing broker, pursuant to clearinghouse rules and practices, for cleared swaps. Conversely, if our bilateral swaps and swaptions are in an unrealized gain position, our counterparties are required to post collateral with us, under the same terms that we post collateral with them. On occasion we may enter into a MAC interest rate swap in which we may receive or make a payment at the time of entering such interest rate swap to compensate for the out of the market nature of such interest rate swap. Similar to all other interest rate swaps, these interest rate swaps are also subject to margin requirements previously described.

Cash collateral held by counterparties at December 31, 2015 was approximately \$249.6 million, which is included in Due from counterparties on our Consolidated Balance Sheets, comprised of approximately \$38.3 million held in connection with repurchase agreement borrowings, approximately \$5.5 million held in connection with our futures contracts, \$0 held in connection with TBAs and approximately \$205.8 million held by our interest rate swap and swaption counterparties. Cash collateral held by counterparties at December 31, 2014 was approximately \$184.8 million, which is included in Due from counterparties on our Consolidated Balance Sheets, comprised of approximately \$25.7 million held in connection with repurchase agreement borrowings, approximately \$959 thousand held in connection with our futures contracts, approximately \$0 held in connection with TBAs and approximately \$158.1 million held by our interest rate swap counterparties. At December 31, 2015, Due to counterparties on our Consolidated Balance Sheets was comprised of approximately \$550 thousand posted with us by our repurchase agreement counterparties, approximately \$0 posted in connection with our TBAs and approximately \$9.4 million posted by our interest rate swap and swaption counterparties, approximately \$0 due as a result of the sale of U.S. Treasuries received as collateral under reverse repurchase agreements and \$0 due as a result of the rehypothecation of securities received as collateral under reverse repurchase agreements. At December 31, 2014, Due to counterparties on our Consolidated Balance Sheets was comprised of approximately \$2.1 million posted with us by our repurchase agreement counterparties, approximately \$6.6 million posted in connection with our TBAs and approximately \$3.5 million posted by our interest rate swap and swaption counterparties. In addition, at December 31, 2015, and December 31, 2014, we held securities of \$0 thousand and approximately \$530 thousand, respectively, received as collateral from our repurchase agreement counterparties to satisfy margin requirements.

We had approximately \$66.1 million and \$166.6 million, respectively of unsettled purchased securities as of December 31, 2015, and December 31, 2014, included in Investment related payables on our Consolidated Balance Sheets. In addition, we had \$0 and \$162.8 million, respectively of unsettled sold securities as of December 31, 2015, and December 31, 2014, included in Investment related receivables on our Consolidated Balance Sheets.

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***Cash Generated from Operations***

For the year ended December 31, 2015, operating activities increased our cash balance by approximately \$133.9 million. This was primarily attributable to the net interest income we earned on our investments for the year ended net of adjustments pertaining to the amortization/accretion of premiums and discounts, which are non-cash items. For the year ended December 31, 2014, operating activities increased our cash balance by approximately \$107.5 million. This was primarily attributable to the net interest income we earned on our investments for the year net of adjustments pertaining to the amortization/accretion of premiums and discounts, which are non-cash items. For the year ended December 31, 2013, operating activities increased our cash balance by approximately \$179.3 million. This was primarily attributable to the net interest income we earned on our investments for the year net of adjustments pertaining to the amortization/accretion of premiums and discounts, which are non-cash items, and cash received on termination of interest rate swaps.

***Cash Provided by and Used in Investing Activities***

For the year ended December 31, 2015, our investing activities increased our cash balance by approximately \$1.4 billion. This was primarily attributable to our proceeds from sales of MBS and other securities and by our receipt of principal payments on MBS and other securities, partially offset by cash expenditures to acquire MBS and other securities and payments made on reverse repurchase agreements. For the year ended December 31, 2014, our investing activities decreased our cash balance by approximately \$1.3 billion. This was primarily attributable to our cash expenditures to acquire MBS and other securities, partially offset by proceeds from sales of MBS and other securities and by our receipt of principal payments on MBS and other securities. For the year ended December 31, 2013, our investing activities increased our cash balance by approximately \$2.0 billion. This was primarily attributable to our receipt of principal payments on MBS and proceeds received from sales of MBS, reduced by our purchases of MBS.

***Cash Provided by and Used in Financing Activities***

For the year ended December 31, 2015, our financing activities decreased our cash balance by approximately \$1.5 billion. This was primarily attributable to a decrease in our net borrowings under repurchase agreements. For the year ended December 31, 2014, our financing activities increased our cash balance by approximately \$1.2 billion. This was primarily attributable to an increase in our net borrowings under repurchase agreements and the proceeds of a stock offering. For the year ended December 31, 2013, our financing activities decreased our cash balance by approximately \$2.2 billion. This was primarily attributable to the decrease in our net borrowings under repurchase agreements from approximately \$4.8 billion at December 31, 2012 to approximately \$2.6 billion at December 31, 2013.

***Other Potential Sources of Financing***

We held cash of approximately \$24.7 million, \$47.2 million and \$48.5 million at December 31, 2015, December 31, 2014 and December 31, 2013, respectively. Our primary sources of cash currently consist of repurchase facility borrowings, investment income, principal repayments and the proceeds of any future securities offering, to the extent available in the capital markets. In the future, we expect our primary sources of liquidity to consist of payments of principal and interest we receive on our portfolio of assets, unused borrowing capacity under our financing sources and future issuances of equity and debt securities.

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To maintain our qualification as a REIT, we must distribute annually at least 90% of our taxable income, exclusive of undistributed taxable income retained by our TRS. This distribution requirement limits our ability to retain earnings and thereby replenish or increase capital for operations. We believe that our significant capital resources and access to financing will provide us with financial flexibility at levels sufficient to meet current and anticipated capital requirements, including funding new investment opportunities, paying distributions to our stockholders and servicing our debt obligations.

### **Contractual Obligations and Commitments**

Our contractual obligations as of December 31, 2015 are as follows (dollars in thousands):

|  | Less than<br>1 year  | 1 to 3<br>years | 3 to 5<br>years | More than<br>5 years | Total                |
|--|----------------------|-----------------|-----------------|----------------------|----------------------|
| Borrowings under repurchase agreements                 | \$ 2,585,801         |                 |                 |                      | \$ 2,585,801         |
| Investment related payables                            | 66,146               |                 |                 |                      | 66,146               |
| TBA long positions                                     | 1,741,072            |                 |                 |                      | 1,741,072            |
| <br>Total: Non-GAAP Basis                              | <br>4,393,019        |                 |                 |                      | <br>4,393,019        |
| <br>TBA long positions                                 | <br>1,741,072        |                 |                 |                      | <br>1,741,072        |
| <br><br>Total: GAAP Basis Excluding TBA-long positions | <br><br>\$ 2,651,947 |                 |                 |                      | <br><br>\$ 2,651,947 |

- 
- (1) The table above does not include amounts due under the Management Agreement (as defined herein) with our Manager, as those obligations do not have fixed and determinable payments.

### *Repurchase Agreements*

As of December 31, 2015, we have an obligation for approximately \$6.5 million in contractual interest payments related to our repurchase agreements through the respective maturity date of each repurchase agreement. In addition, at December 31, 2015, we had entered into repurchase agreement borrowings of approximately \$2.3 million, which settled on January 4, 2016, with a weighted average interest rate of 2.01%, a weighted average contractual maturity of 91 days and secured by collateral of approximately \$3.2 million. These borrowings are recorded as a liability in our Consolidated Balance Sheets when settled.

### *Securitized Debt*

At December 31, 2015, we had securitized debt related to the consolidated VIEs, with a balance of \$11.0 million (and a fair value of \$11.0 million). The securitized debt of the VIEs can only be settled with the commercial loan that serve as collateral of the VIE and is non-recourse to us.



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*Management Agreement*

On May 9, 2012, we entered into a management agreement (the "Management Agreement") with our Manager which describes the services to be provided by our Manager and compensation for such services. Our Manager is responsible for managing our operations, including: (i) performing all of our day-to-day functions; (ii) determining investment criteria in conjunction with our Board of Directors; (iii) sourcing, analyzing and executing investments, asset sales and financings; (iv) performing asset management duties; and (v) performing financial and accounting management, subject to the direction and oversight of our Board of Directors. Pursuant to the terms of the Management Agreement, our Manager is paid a management fee equal to 1.50% per annum of our stockholders' equity, (as defined in the Management Agreement), calculated and payable (in cash) quarterly in arrears. For purposes of calculating the management fee, "stockholders' equity" means the sum of the net proceeds from any issuances of our equity securities since inception (allocated on a pro rata daily basis for such issuances during the fiscal quarter of any such issuance), plus retained earnings, calculated in accordance with GAAP, at the end of the most recently completed fiscal quarter (without taking into account any non-cash equity compensation expense incurred in current or prior periods), less any amount paid for repurchases of our shares of common stock, excluding any unrealized gains, losses or other non-cash items, including OTTI charges included in other loss on securities, unrealized gain (loss) on investments, net and the non-cash portion of gain (loss) on derivative instruments, that have impacted stockholders' equity as reported in our consolidated financial statements prepared in accordance with GAAP, regardless of whether such items are included in other comprehensive income or loss, or in net income, and excluding one-time events pursuant to changes in GAAP and certain other non-cash charges after discussions between our Manager and our independent directors and after approval by at least two-thirds ( $\frac{2}{3}$ ) of our independent directors. However, if our stockholders' equity for any given quarter is negative based on the calculation described above, our Manager will not be entitled to receive any management fee for that quarter.

In addition, under the Management Agreement, we are required to reimburse our Manager for the expenses described below. Expense reimbursements to the Manager are made in cash on a regular basis. Our reimbursement obligation is not subject to any dollar limitation. Because our Manager's personnel perform certain legal, accounting, due diligence tasks and other services that outside professionals or outside consultants otherwise would perform, our Manager may be paid or reimbursed for the documented cost of performing such tasks, provided that such costs and reimbursements are in amounts which are no greater than those which would be payable to outside professionals or consultants engaged to perform such services pursuant to agreements negotiated on an arm's-length basis. We also reimburse our Manager for certain direct costs, such as the travel expenses of our officers, incurred by our Manager on our behalf. As of January 1, 2014, our former chief financial officer became an employee of the Manager. Accordingly, we reimbursed our Manager for his compensation and benefits as well as the compensation and benefits provided to our controller. For the years ended December 31, 2015 and December 31, 2014, we recorded expenses, paid by the Manager on our behalf, totaling approximately \$1.2 million and \$624 thousand related to employee costs and benefits associated with our chief financial officer and controller, respectively, and approximately \$76 thousand for the year ended December 31, 2013.

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The Management Agreement may be amended, supplemented or modified by agreement between our Manager and us. The Management Agreement currently expires on May 16, 2017. It is automatically renewed for one-year terms on May 15th thereafter unless previously terminated as described below. Our independent directors will review the Manager's performance and any fees payable to the Manager annually and, following the initial term, the Management Agreement may be terminated annually upon the affirmative vote of at least two-thirds ( $\frac{2}{3}$ ) of our independent directors, based upon: (i) our Manager's unsatisfactory performance that is materially detrimental to us; or (ii) our determination that any fees payable to our Manager are not fair, subject to our Manager's right to prevent such termination due to unfair fees by accepting a reduction of management fees agreed to by at least two-thirds ( $\frac{2}{3}$ ) of our independent directors. We are required to provide our Manager 180 days prior notice of any such termination. Unless terminated for cause, we will be required to pay our Manager a termination fee equal to three times the average annual management fee earned by our Manager during the prior 24-month period immediately preceding the date of termination, calculated as of the end of the most recently completed fiscal quarter prior to the date of termination.

We may also terminate the Management Agreement at any time without the payment of any termination fee, with 30 days prior written notice from our Board of Directors for cause, which will be determined by at least two-thirds ( $\frac{2}{3}$ ) of our independent directors, which is defined as: (i) our Manager's continued material breach of any provision of the Management Agreement (including our Manager's failure to comply with our investment guidelines); (ii) our Manager's fraud, misappropriation of funds, or embezzlement against us; (iii) our Manager's gross negligence in the performance of its duties under the Management Agreement; (iv) the occurrence of certain events with respect to the bankruptcy or insolvency of our Manager, including an order for relief in an involuntary bankruptcy case or our Manager authorizing or filing a voluntary bankruptcy petition; (v) our Manager is convicted (including a plea of nolo contendere) of a felony; or (vi) the dissolution of our Manager.

### **Off-Balance Sheet Arrangements**

As of December 31, 2015, we held contracts to purchase ("long position") and sell ("short position") TBAs on a forward basis. If a counterparty to one of the TBAs that we enter into defaults on its obligations, we may not receive payments or securities due under the TBA agreement, and thus, we may lose any unrealized gain associated with that TBA transaction.

We do not have any relationships with any entities or financial partnerships, such as entities often referred to as structured investment vehicles, or special purpose or variable interest entities, established to facilitate off-balance sheet arrangements or other contractually narrow or limited purposes.

Further, other than guaranteeing certain obligations of our wholly-owned taxable REIT subsidiary or TRS, we have not guaranteed any obligations of any entities or entered into any commitment to provide additional funding to any such entities.

See "Warrants" above for a description of our outstanding warrants.

### **Dividends**

We intend to make regular quarterly dividend distributions to holders of our common stock. U.S. federal income tax law generally requires that a REIT distribute annually, in accordance with the REIT regulations, at least 90% of its REIT taxable income for the taxable year, without regard to the deduction for dividends paid and excluding net capital gains as well as undistributed taxable income retained by a TRS. To the extent that it we distribute less than 100% of our net taxable income, in accordance with the REIT regulations, for any given year, we will pay tax on such amount at the regular corporate rates. We intend to pay regular quarterly dividends to our stockholders based on our net taxable income, if and to the extent authorized by our Board of Directors. Before we pay any dividend, whether for U.S. federal income tax purposes or otherwise, we must first meet both our operating requirements and debt service on our repurchase agreements and other debts payable. If our cash available for distribution is less than our net taxable income, we could be required to sell assets or borrow funds to make cash distributions or we may make a portion of the required distribution in the form of a taxable stock distribution or distribution of debt securities.

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**ITEM 7A. Quantitative and Qualitative Disclosures about Market Risk.**

We seek to manage the risks related to the credit quality of our assets, interest rates, liquidity, prepayment speeds and market values while, at the same time, seeking to provide an opportunity to stockholders to realize attractive risk-adjusted returns from our assets through ownership of our common stock. While we do not seek to avoid risk completely, our Manager seeks to actively manage risk for us, to earn sufficient compensation to justify taking those risks and to maintain capital levels consistent with the risks we undertake.

***Credit Risk***

We are subject to varying degrees of credit risk in connection with our assets. Although we do not expect to encounter credit risk in our Agency MBS and U.S. Treasury securities, we do expect to encounter credit risk related to Non-Agency MBS and Non-Agency CMBS, Whole-Loans and other portfolio investments. Investment decisions are made following a bottom-up credit analysis and specific risk assumptions. As part of the risk management process, our Manager uses detailed proprietary models, applicable to evaluate, depending on the asset class, house price appreciation and depreciation by region, prepayment speeds and foreclosure/default frequency, cost and timing. If our Manager determines that the proposed investment can meet the appropriate risk and return criteria as well as complement our existing asset portfolio, the investment will undergo a more thorough analysis.

As of December 31, 2015, 17 of the counterparties that we had outstanding repurchase agreement borrowings held collateral which we posted as security for such borrowings in excess of 5% of our Stockholders' equity. Prior to entering into a repurchase agreement with any particular institution, our Manager does a thorough review of such potential counterparty. Such review, however, does not assure the creditworthiness of such counterparty nor that the financial wherewithal of the counterparty will not deteriorate in the future.

***Interest Rate Risk***

Interest rates are highly sensitive to many factors, including fiscal and monetary policies and domestic and international economic and political considerations, as well as other factors beyond our control. We are subject to interest rate risk in connection with our assets and our related financing obligations. In general, we expect to finance the acquisition of our assets through financings in the form of repurchase agreements, warehouse facilities, securitizations, resecuritizations, bank credit facilities (including term loans and revolving facilities) and public and private equity and debt issuances in addition to transaction or asset specific funding arrangements. Subject to maintaining our qualification as a REIT for U.S. federal income tax purposes, we utilize derivative financial instruments to hedge the interest rate risk associated with our borrowings. We also may engage in a variety of interest rate management techniques that seek to mitigate changes in interest rates or other potential influences on the values of our assets.

***Interest Rate Effect on Net Interest Income***

Our operating results will depend in large part on differences between the income earned on our assets and our borrowing costs. The cost of our borrowings is generally based on prevailing market interest rates. During a period of rising interest rates, our borrowing costs generally will increase and the yields earned on our leveraged fixed-rate mortgage assets will remain static. Further, the cost of such financing could increase at a faster pace than the yields earned on our leveraged ARM and hybrid ARM assets. This could result in a decline in our net interest spread and net interest margin. The severity of any such decline would depend on our asset/liability composition at the time as well as the magnitude and duration of the interest rate increase. Further, an increase in short-term interest rates could also have a negative impact on the market value of our assets. If any of these events happen, we could experience a decrease in net income or incur a net loss during these periods, which could adversely affect our liquidity and results of operations.

Table of Contents**Interest Rate Cap Risk**

To the extent we invest in adjustable-rate RMBS, such securities are generally subject to interest rate caps, which potentially could cause such RMBS to acquire many of the characteristics of fixed-rate securities if interest rates were to rise above the cap levels. This issue is magnified to the extent we acquire ARM and hybrid ARM assets that are not based on mortgages which are fully indexed. In addition, ARM and hybrid ARM assets may be subject to periodic payment caps that result in some portion of the interest being deferred and added to the principal outstanding or a portion of the incremental interest rate increase being deferred. To the extent we invest in such ARM and/or hybrid ARM assets, we could potentially receive less cash income on such assets than we would need to pay the interest cost on our related borrowings. To mitigate interest rate mismatches, we may utilize the hedging strategies discussed above under "Interest Rate Risk."

**Interest Rate Effects on Fair value**

Another component of interest rate risk is the effect that changes in interest rates will have on the market value of the assets that we acquire. We face the risk that the market value of our assets will increase or decrease at different rates than those of our liabilities, including our hedging instruments. See "Market Risk" below.

The impact of changing interest rates on fair value can change significantly when interest rates change materially. Therefore, the volatility in the fair value of our assets could increase significantly in the event interest rates change materially. In addition, other factors impact the fair value of our interest rate-sensitive investments and hedging instruments, such as the shape of the yield curve, market expectations as to future interest rate changes and other market conditions. Accordingly, changes in actual interest rates may have a material adverse effect on us.

**Market Risk**

*Market value risk.* Our MBS and other assets are reflected at their fair value with unrealized gains and losses included in earnings. The fair value of our investments fluctuates primarily due to changes in interest rates and other factors. Generally, in a rising interest rate environment, the fair value of these assets would be expected to decrease; conversely, in a decreasing interest rate environment, the fair value of these securities would be expected to increase.

The sensitivity analysis table presented below shows the estimated impact of an instantaneous parallel shift in the yield curve, up and down 50 and 100 basis points, on the market value of our interest rate-sensitive investments, including interest rate swaps, Interest-Only Strips, and net interest income at December 31, 2015, assuming a static portfolio of assets. When evaluating the impact of changes in interest rates, prepayment assumptions and principal reinvestment rates are adjusted based on our Manager's expectations. The analysis presented utilizes our Manager's assumptions, models and estimates, which are based on our Manager's judgment and experience.

| Change in Interest Rates |   | Percentage Change in Projected<br>Net Interest Income | Percentage Change in Projected<br>Portfolio Value |
|--------------------------|---|---|---|
| +1.00                    | % | 18.12%  | (1.27)%   |
| +0.50                    | % | 9.06%   | (0.52)%   |
| 0.50                     | % | (9.06)%   | 0.44%   |
| 1.00                     | % | NA(1)   | NA(1)   |

(1) Not applicable, borrowing rate is below zero.

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While the table above reflects the estimated immediate impact of interest rate increases and decreases on a static portfolio, we may rebalance our portfolio from time to time either to seek to take advantage of or reduce the impact of changes in interest rates. It is important to note that the impact of changing interest rates on market value and net interest income can change significantly when interest rates change beyond 100 basis points from current levels. Therefore, the volatility in the market value of our assets could increase significantly when interest rates change beyond amounts shown in the table above. In addition, other factors impact the market value of and net interest income from our interest rate-sensitive investments and derivative instruments, such as the shape of the yield curve, market expectations as to future interest rate changes and other market conditions. Accordingly, interest income would likely differ from that shown above and such difference might be material and adverse to our stockholders.

Certain assumptions have been made in connection with the calculation of the information set forth in the table above and, as such, there can be no assurance that assumed events will occur or that other events will not occur that would affect the outcomes. The base interest rate scenario assumes interest rates at December 31, 2015. The analysis presented utilizes assumptions and estimates based on our Manager's judgment and experience. Furthermore, while we generally expect to retain such assets and the associated interest rate risk, future purchases and sales of assets could materially change our interest rate risk profile.

***Prepayment Risk***

The value of our Agency and Non-Agency RMBS and our Residential Whole-Loans may be affected by prepayment rates on the underlying residential mortgage. We acquire RMBS and Residential Whole-Loans and anticipate that the underlying residential mortgages will prepay at a projected rate generating an expected yield. If we purchase assets at a premium to par value, when borrowers prepay their residential mortgage loans faster than expected, the corresponding prepayments may reduce the expected yield on our residential mortgage assets because we will have to amortize the related premium on an accelerated basis and, in the case of Agency RMBS, other than interest-only strips, and certain other investment grade rated securities, we are required to make a retrospective adjustment to historical amortization. Conversely, if we purchase assets at a discount to par value, when borrowers prepay their residential mortgage loans slower than expected, such decrease may reduce the expected yield on such assets because we will not be able to accrete the related discount as quickly as originally anticipated and, in the case of Agency RMBS, other than interest-only strips, and certain other investment grade rated securities, we will be required to make a retrospective adjustment to historical amortization.

The value of our Agency and Non-Agency CMBS, as well as, Commercial Whole-Loans will also be affected by prepayment rates, however, commercial mortgages frequently limit the ability of the borrower to prepay, thereby providing a certain level of prepayment protection. Common restrictions include yield maintenance and prepayment penalties, the proceeds of which are generally at least partially allocable to these securities, as well as defeasance.

Likewise, the value of our ABS and other structured securities will also be affected prepayment rates. The collateral underlying such securities may, similar to most residential mortgages, allow the borrower to prepay at any time or, similar to commercial mortgages, limit the ability of the borrower to prepay by imposing lock-out provisions, prepayment penalties and/or make whole provisions.

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***Extension Risk***

Most residential mortgage loans do not prohibit the partial or full prepayment of principal outstanding. Accordingly, while the stated maturity of a residential mortgage loan may be 30 years, or in some cases even longer, historically the vast majority of residential mortgage loans are satisfied prior to their maturity date. In periods of rising interest rates, borrowers have less incentive to refinance their existing mortgages and mortgage financing may not be as readily available. This generally results in a slower rate of prepayments and a corresponding longer weighted average life for RMBS. The increase, or extension, in weighted average life is commonly referred to as "Extension Risk" which can negatively impact our portfolio. To the extent we receive smaller pre-payments of principal; we will have less to capital to invest in new assets. This is extremely detrimental in periods of rising interest rates as we will be unable to invest in new higher coupon investments and a larger portion of our portfolio will remain invested in lower coupon investments. Further, our borrowing costs are generally short-term and, even if hedged, are likely to increase in a rising interest rate environment, thereby reducing our net interest margin. Finally, to the extent we acquired securities at a discount to par, a portion of the overall return on such investments is based on the recovery of this discount. Slower principal prepayments will result in a longer recovery period and a lower overall return on our investment.

Prepayment rates on Agency and Non-Agency CMBS, as well as, Commercial Whole-Loans are generally less volatile than residential mortgage assets as commercial mortgages usually limit the ability of the borrower to prepay the mortgage prior to maturity or a period shortly before maturity. Accordingly, extension risk for Agency and Non-Agency CMBS and Commercial Whole-Loans is generally less than RMBS and Residential Whole-Loans as it presumed that other than defaults (i.e. involuntary prepayments), most commercial mortgages will remain outstanding for the contractual term of the mortgage.

Prepayment rates on ABS and our other structured securities will be determined by the underlying collateral. The extension risk of such securities will generally be less than residential mortgages, but greater than commercial mortgages.

***Counterparty Risk***

The following discussion on counterparty risk reflects how these transactions are structured, rather than how they are presented for financial reporting purposes.

When we engage in repurchase transactions, we generally sell securities to lenders (i.e., repurchase agreement counterparties) and receive cash from the lenders. The lenders are obligated to resell the same securities back to us at the end of the term of the transaction. Because the cash we receive from the lender when we initially sell the securities to the lender is less than the value of those securities (this difference is the haircut), if the lender defaults on its obligation to resell the same securities back to us, we could incur a loss on the transaction up to the amount of the haircut (assuming there was no change in the value of the securities).

If a counterparty to a bi-lateral interest rate swap cannot perform under the terms of the interest rate swap, we may not receive payments due under that agreement, and thus, we may lose any unrealized gain associated with the interest rate swap. We may also risk the loss of any collateral we have pledged to secure our obligations under interest rate swap if the counterparty becomes insolvent or files for bankruptcy. In the case of a cleared swap, if our clearing broker were to default, become insolvent or file for bankruptcy, we may also risk the loss of any collateral we have posted to the clearing broker unless we were able to transfer or "port" our positions and held collateral to another clearing broker. In addition, the interest rate swap would no longer mitigate the impact of changes in interest rates as intended. As of September 2013, most of our interest swaps are cleared through a central clearing house which reduces but does not eliminate the aforementioned risks. Also see "Liquidity Risk" below.

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As of December 31, 2015, we have entered into five master securities forward trading agreements, or MSFTAs, which may govern the trading of some or all TBA transactions. Pursuant to the terms of these MSFTAs, we and our counterparties would be required to post margin to the other when the mark to market exposure of the TBA transactions executed under the agreement exceed certain thresholds. We expect to continue to negotiate and enter into MSFTAs with additional TBA counterparties. The margin provisions of the MSFTA help to mitigate, but do not eliminate, counterparty risk associated with TBA transactions. If a counterparty to a TBA transaction cannot perform under the terms of the trade, we may not receive securities we have agreed to purchase or payment for securities we have agreed to sell, and thus, we may lose any unrealized gain associated with such transaction.

Prior to entering into a trading agreement or transaction with any particular institution where we take on counterparty risk, our Manager does a thorough review of such potential counterparty. Such review, however, does not assure the creditworthiness of such counterparty nor that the financial wherewithal of the counterparty will not deteriorate in the future.

***Funding Risk***

We have financed a substantial majority of our assets with repurchase agreement financing. Over time, as market conditions change, in addition to these financings, we may use other forms of leverage. Changes in the regulatory environment, as well as, weakness in the financial markets, the residential mortgage markets, the commercial mortgage markets, the asset-backed securitization markets and the economy generally could adversely affect one or more of our potential lenders and could cause one or more of our potential lenders to be unwilling or unable to provide us with financing or to increase the costs of that financing.

***Liquidity Risk***

Our liquidity risk is principally associated with the financing of long-maturity assets with short-term borrowings in the form of repurchase agreements. Although the interest rate adjustments of these assets and liabilities fall within the guidelines established by our operating policies, maturities are not required to be, nor are they, matched.

Should the value of our assets pledged as collateral suddenly decrease, margin calls relating to our repurchase agreements could increase, causing an adverse change in our liquidity position. Our inability to post adequate collateral for a margin call by the counterparty could result in a condition of default under our repurchase agreements, thereby enabling the counterparty to liquidate the collateral pledged by us, which may have a material adverse consequence on our business and results of operations.

In an instance of severe volatility, or where the additional stress on liquidity resulting from volatility is sustained over an extended period of time, we could be required to sell securities, possibly even at a loss to generate sufficient liquidity to satisfy collateral and margin requirements which could have a material adverse effect on our financial position, results of operations and cash flows.

Additionally, if one or more of our repurchase agreement counterparties chose not to provide on-going funding, our ability to finance would decline or exist at possibly less advantageous terms. Further, if we are unable to renew, replace or expand repurchase financing with other sources of financing on substantially similar terms, it may have a material adverse effect on our business, financial position, results of operations and cash flows, due to the long term nature of our investments and relatively short-term maturities of our repurchase agreements. As such, there is no assurance that we will always be able to roll over our repurchase agreements.

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The costs associated with our borrowings are generally based on prevailing market interest rates. During a period of rising interest rates, our borrowing costs generally will increase while the yields earned on our existing portfolio of leveraged fixed-rate MBS and other fixed rate assets will remain static. Further, certain of our floating rate assets may contain annual or lifetime interest rate caps as well as limit the frequency or timing of changes to the underlying interest rate index. This could result in a decline in our net interest spread and net interest margin. The severity of any such decline would depend on our asset/liability composition at the time, as well as the magnitude and duration of the interest rate increase. Further, an increase in short-term interest rates could also have a negative impact on the market value of our assets. If any of these events happen, we could experience a decrease in net income or incur a net loss during these periods, which could have a material adverse effect on our liquidity and results of operations.

In addition, the assets that comprise our investment portfolio are not traded on a public exchange. A portion of these assets may be subject to legal and other restrictions on resale or will otherwise be less liquid than publicly-traded securities. The illiquidity of our assets may make it difficult for us to sell such assets if the need or desire arises, including in response to changes in economic and other conditions. Recent regulatory changes have imposed new capital requirements and other restrictions on banks and other market intermediaries' ability and desire to hold assets on their balance sheets and otherwise make markets in fixed income securities and other assets resulting in reduced liquidity in many sectors of the market. This regulatory trend is expected to continue. As a result of these developments it may become increasingly difficult for us to sell assets in the market, especially in credit oriented sectors such as Non-Agency RMBS and CMBS, ABS and Whole-Loans.

We enter into interest rate swaps to manage our interest rate risk. We are required to pledge cash or securities as collateral as part of a margin arrangement, calculated daily, in connection with the interest rate swaps. The amount of margin that we are required to post will vary and generally reflects collateral required to be posted with respect to interest rate swaps that are in an unrealized loss position to us and is generally based on a percentage of the aggregate notional amount of interest rate swaps per counterparty. Margin calls could adversely affect our liquidity. Our inability to post adequate collateral for a margin call could result in a condition of default under our interest rate swap agreements, thereby resulting in liquidation of the collateral pledged by us, which may have a material adverse consequence on our business, financial position, results of operations and cash flows. Conversely, if our interest rate swaps are in an unrealized gain position, our counterparties to bilateral swaps are required to post collateral with us, under the same terms that we post collateral with them. On occasion we may enter into a MAC interest rate swap in which we may receive or make a payment at the time of entering such interest rate swap to compensate for the out of the market nature of such interest rate swap. Similar to all other interest rate swaps, MAC interest rate swaps are also subject to the margin requirements previously described.

***Inflation***

Virtually all of our assets and liabilities are interest rate sensitive in nature. As a result, interest rates and other factors influence our performance far more so than does inflation. Changes in interest rates do not necessarily directly correlate with inflation rates or changes in inflation rates. Our consolidated financial statements are prepared in accordance with GAAP and our distributions will be determined by our Board of Directors consistent with our obligation to distribute to our stockholders at least 90% of our net taxable income on an annual basis, in accordance with the REIT regulations, in order to maintain our REIT qualification. In each case, our activities and consolidated balance sheets are measured with reference to historical cost and/or fair market value without considering inflation.



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***Foreign Investment risk***

We have invested in Non U.S. CMBS transactions and, in the future, we may make other investments in non U.S. issuers and transactions. These investments present certain unique risks, including those resulting from future political, legal, and economic developments, which could include favorable or unfavorable changes in currency exchange rates, exchange control regulations (including currency blockage), expropriation, nationalization, or confiscatory taxation of assets, adverse changes in investment capital or exchange control regulations (which may include suspension of the ability to transfer currency from a country), political changes, diplomatic developments, difficulty in obtaining and enforcing judgments against non U.S. entities, the possible imposition of the applicable country's governmental laws or restrictions, and the reduced availability of public information concerning issuers. In the event of a nationalization, expropriation, or other confiscation of assets, the Company could lose its entire investment in a security. Legal remedies available to investors in certain jurisdictions may be more limited than those available to investors in the United States. Issuers of non U.S. securities may not be subject to the same degree of regulation as U.S. issuers.

Furthermore, non U.S. issuers are not generally subject to uniform accounting, auditing, and financial reporting standards or other regulatory practices and requirements comparable to those applicable to U.S. issuers. There is generally less government supervision and regulation of non U.S. exchanges, brokers, and issuers than there is in the United States, and there is greater difficulty in taking appropriate legal action in Non U.S. courts. There are also special tax considerations that apply to securities of non U.S. issuers and securities principally traded overseas.

To the extent that our investments are denominated in U.S. dollars, the investment is not affected directly by changes in currency exchange rates relative to the dollar and exchange control regulations. We are, however, subject to currency risk with respect to such investments to the extent that a decline in a non U.S. issuer's or borrower's own currency relative to the dollar may impair such issuer's or borrower's ability to make timely payments of principal and/or interest on a loan or other debt security. To the extent that our investments are in non-dollar denominated securities, the value of the investment and the net investment income available for distribution may be affected favorably or unfavorably by changes in currency exchange rates relative to the dollar and exchange control regulations.

Currency exchange rates can be volatile and affected by, among other factors, the general economics of a country, the actions of governments or central banks and the imposition of currency controls and speculation. In addition, a security may be denominated in a currency that is different from the currency where the issuer is domiciled.

***Currency Risk***

We have and may continue in the future to invest in assets which are denominated in a currency other than U.S. dollars and may finance such investments with repurchase financing or other forms of financing which may also be denominated in a currency other than U.S. dollars. To the extent we make such investments and/or enter into such financing arrangements, we may utilize foreign currency swaps, forwards or other derivative instruments to hedge our exposure to foreign currency risk. Despite being economic hedges, we have elected not to treat such derivative instruments as hedges for accounting purposes and therefore the changes in the value of such instruments, including actual and accrued payments, will be included in our Consolidated Statement of Operations. While such transactions are entered into in an effort to minimize our foreign currency risk, there can be no assurance that they will perform as expected. If actual prepayments of the foreign denominated asset are faster, or slower, than expected, the hedge instrument is unlikely to fully protect us from changes in the valuation of such foreign currency. Further, as with interest rate swaps, there is counterparty risk associated with the future creditworthiness of such counterparty.

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**Item 8. Financial Statements and Supplementary Data.**

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Financial Statements Schedules other than the one listed above are omitted because the required information is not applicable or deemed not material, or the required information is presented in the financial statements and/or in the notes to financial statements.

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**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Shareholders  
of Western Asset Mortgage Capital Corporation:

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Western Asset Mortgage Capital Corporation and subsidiaries (the "Company") at December 31, 2015 and December 31, 2014, and the results of their operations and their cash flows for the three years ended December 31, 2015 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 2 to the financial statements, the Company changed its method of accounting for and presentation of linked transactions in 2015 due to the adoption of ASU 2014-11, Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures.

PricewaterhouseCoopers LLP  
Los Angeles, California  
March 11, 2016

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Consolidated Balance Sheets**

(in thousands except share and per share data)

|   | December 31,<br>2015 | December 31,<br>2014 |
|---|----------------------|----------------------|
| <b>Assets:</b>  |                      |                      |
| Cash and cash equivalents   | \$ 24,711            | \$ 47,222            |
| Mortgage-backed securities and other securities, at fair value (\$2,777,717 and \$4,362,532 pledged as collateral, at fair value, respectively) | 2,851,127            | 4,385,723            |
| Residential Whole-Loans, at fair value (\$218,538 and \$7,220 pledged as collateral, at fair value, respectively)                               | 218,538              | 7,220                |
| Securitized commercial loan, at fair value  | 25,000               |                      |
| Linked transactions, net, at fair value   |                      | 20,627               |
| Investment related receivable   | 572                  | 162,837              |
| Accrued interest receivable   | 22,621               | 27,309               |
| Due from counterparties   | 249,563              | 184,757              |
| Derivative assets, at fair value  | 21,915               | 73,256               |
| Other assets  | 516                  | 326                  |
| <b>Total Assets(1)</b>  | <b>\$ 3,414,563</b>  | <b>\$ 4,909,277</b>  |
| <b>Liabilities and Stockholders' Equity:</b>  |                      |                      |
| <b>Liabilities:</b>   |                      |                      |
| Borrowings under repurchase agreements  | \$ 2,585,801         | \$ 3,875,721         |
| Securitized debt, at fair value   | 11,000               |                      |
| Accrued interest payable  | 20,431               | 17,573               |
| Investment related payables   | 66,146               | 166,608              |
| Due to counterparties   | 9,950                | 12,180               |
| Derivative liability, at fair value   | 180,177              | 180,280              |
| Accounts payable and accrued expenses   | 2,078                | 1,794                |
| Payable to related party  | 3,019                | 2,705                |
| Dividend payable  | 24,313               | 29,204               |
| <b>Total Liabilities(2)</b>   | <b>2,902,915</b>     | <b>4,286,065</b>     |
| <b>Commitments and contingencies</b>  |                      |                      |
| <b>Stockholders' Equity:</b>  |                      |                      |
| Common stock, \$0.01 par value, 500,000,000 shares authorized, 41,919,801 and 41,719,801 shares issued and outstanding, respectively            | 419                  | 417                  |
| Preferred stock, \$0.01 par value, 100,000,000 shares authorized and no shares outstanding  |                      |                      |
| Additional paid-in capital  | 763,283              | 760,925              |
| Retained earnings (accumulated deficit)   | (252,054)            | (138,130)            |
| <b>Total Stockholders' Equity</b>   | <b>511,648</b>       | <b>623,212</b>       |
| <b>Total Liabilities and Stockholders' Equity</b>   | <b>\$ 3,414,563</b>  | <b>\$ 4,909,277</b>  |

(1)

Assets of consolidated VIEs included in the total assets above:

|   |    |         |    |       |
|---|----|---------|----|-------|
| Residential Whole-Loans, at fair value (\$218,538 and \$7,220 pledged as collateral, at fair value, respectively) | \$ | 218,538 | \$ | 7,220 |
| Securitized commercial loan, at fair value  |    | 25,000  |    |       |
| Accrued interest receivable   |    | 1,836   |    | 40    |
| Total assets of consolidated VIEs   | \$ | 245,374 | \$ | 7,260 |

(2)

Liabilities of consolidated VIEs included in the total liabilities above:

|  |    |        |    |     |
|--|----|--------|----|-----|
| Securitized debt, at fair value        | \$ | 11,000 | \$ |     |
| Accrued interest payable               |    | 85     |    |     |
| Accounts payable and accrued expenses  |    | 2      |    | 153 |
| Total liabilities of consolidated VIEs | \$ | 11,087 | \$ | 153 |

See notes to consolidated financial statements.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Consolidated Statements of Operations**

(in thousands except share and per share data)

|  | For the year ended December 31, |            |             |
|--|---------------------------------|------------|-------------|
|  | 2015                            | 2014       | 2013        |
| <b>Net Interest Income:</b>  |                                 |            |             |
| Interest income  | \$ 152,704                      | \$ 149,110 | \$ 125,328  |
| Interest expense   | 27,605                          | 22,263     | 18,019      |
| Net Interest Income  | 125,099                         | 126,847    | 107,309     |
| <b>Other Income (Loss):</b>  |                                 |            |             |
| Realized gain (loss) on sale of investments, net   | 8,279                           | (2,178)    | (110,712)   |
| Other loss on securities   | (19,791)                        | (17,014)   | (11,858)    |
| Unrealized gain (loss) on investments, net   | (34,011)                        | 189,011    | (160,109)   |
| Gain on linked transactions, net   |                                 | 1,870      | 4,137       |
| Gain (loss) on derivative instruments, net   | (68,895)                        | (180,496)  | 157,547     |
| Other, net   | 2,318                           | 1,433      | 91          |
| Other Income (Loss), net   | (112,100)                       | (7,374)    | (120,904)   |
| <b>Operating Expenses:</b>   |                                 |            |             |
| General and administrative (includes \$2,301, \$2,203 and \$1,087 non-cash stock based compensation, respectively) | 11,609                          | 9,127      | 6,446       |
| Management fee related party   | 10,874                          | 9,633      | 7,814       |
| Total Operating Expenses   | 22,483                          | 18,760     | 14,260      |
| Net income (loss) available to Common Stock and participating securities   | \$ (9,484)                      | \$ 100,713 | \$ (27,855) |
| Net income (loss) per Common Share Basic   | \$ (0.25)                       | \$ 2.67    | \$ (1.19)   |
| Net income (loss) per Common Share Diluted   | \$ (0.25)                       | \$ 2.67    | \$ (1.19)   |

See notes to consolidated financial statements.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Consolidated Statements of Changes in Stockholders' Equity**

(in thousands except shares and share data)

|   | Common Stock |        | Additional      | Retained                             |            |
|---|--------------|--------|-----------------|--------------------------------------|------------|
|   | Shares       | Par    | Paid-In Capital | Earnings<br>(Accumulated)<br>Deficit | Total      |
| Balance at December 31, 2012                        | 24,143,944   | \$ 241 | \$ 505,454      | \$ 17,513                            | \$ 523,208 |
| Grants of restricted stock                          | 160,559      | 2      | (2)             |                                      |            |
| Vesting of restricted stock                         |              |        | 1,024           |                                      | 1,024      |
| Net loss  |              |        |                 | (27,855)                             | (27,855)   |
| Dividends on common stock                           | 2,548,784    | 25     | 37,667          | (123,975)                            | (86,283)   |
| Balance at December 31, 2013                        | 26,853,287   | \$ 268 | \$ 544,143      | \$ (134,317)                         | \$ 410,094 |
| Proceeds from public offerings of common stock, net | 14,000,000   | 140    | 205,240         |                                      | 205,380    |
| Offering costs, public offerings of common stock    |              |        | (400)           |                                      | (400)      |
| Proceeds from private placement of common stock     | 650,000      | 7      | 9,646           |                                      | 9,653      |
| Grants of restricted stock                          | 216,514      | 2      | (2)             |                                      |            |
| Vesting of restricted stock                         |              |        | 2,266           |                                      | 2,266      |
| Net income  |              |        |                 | 100,713                              | 100,713    |
| Dividends on common stock                           |              |        | 32              | (104,526)                            | (104,494)  |
| Balance at December 31, 2014                        | 41,719,801   | \$ 417 | \$ 760,925      | \$ (138,130)                         | \$ 623,212 |
| Grants of restricted stock                          | 200,000      | 2      | (2)             |                                      |            |
| Vesting of restricted stock                         |              |        | 2,301           |                                      | 2,301      |
| Net income  |              |        |                 | (9,484)                              | (9,484)    |
| Dividends on common stock                           |              |        | 59              | (104,440)                            | (104,381)  |
| Balance at December 31, 2015                        | 41,919,801   | \$ 419 | \$ 763,283      | \$ (252,054)                         | \$ 511,648 |

See notes to consolidated financial statements.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Consolidated Statements of Cash Flows**

(in thousands)

|  | For the year ended December 31, |                |                |
|--|---------------------------------|----------------|----------------|
|  | 2015                            | 2014           | 2013           |
| Cash flows from operating activities:  |                                 |                |                |
| Net income (loss)  | \$ (9,484)                      | \$ 100,713     | \$ (27,855)    |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities:                         |                                 |                |                |
| Premium amortization and (discount accretion) on investments, net  | 5,086                           | 10,257         | 21,053         |
| Interest income earned added to principal of securities  | (207)                           |                |                |
| Amortization of deferred financing costs   | 486                             |                |                |
| Restricted stock amortization expense  | 2,301                           | 2,203          | 1,087          |
| Premium amortization for MAC interest rate swaps   | (1,250)                         | (1,818)        |                |
| Interest payments and basis recovered on MAC interest rate swaps   | 1,595                           | 7,164          |                |
| Premium on purchase of Residential Whole-Loans   | (3,329)                         | (131)          |                |
| Unrealized (gain) loss on investments, net   | 34,011                          | (189,011)      | 160,109        |
| Mark-to-market adjustments on linked transactions  |                                 | 1,762          | (856)          |
| Mark-to-market adjustments on derivative instruments   | 73,599                          | 178,125        | (84,788)       |
| Other loss on securities   | 19,791                          | 17,014         | 11,858         |
| Realized (gain) loss on sale of securities, net  | (8,279)                         | 2,178          | 110,712        |
| Realized (gain) loss on sale of Interest-Only Strips accounted for as derivatives, net                           | (595)                           | 753            | 1,124          |
| Realized loss on termination of MAC interest rate swaps containing an other-than-insignificant financing element | 8,658                           | 4,835          |                |
| Realized (gain) loss on sale of TBAs, net  | (1,524)                         | (40,015)       | 1,499          |
| Realized (gain) loss on sale of swaptions, net   | 5,242                           | 3,606          | (23,671)       |
| Realized loss on futures   | 527                             | 16,495         |                |
| Realized loss on forward contracts   | 901                             | 1,759          |                |
| Realized loss on option derivatives  | 711                             | 2,813          | 925            |
| Realized gain on linked transaction, net   |                                 | (1,397)        | (3,049)        |
| Gain on foreign currency transactions, net   | (2,130)                         | (1,306)        |                |
| Changes in operating assets and liabilities:   |                                 |                |                |
| Decrease (increase) in accrued interest receivable   | 4,688                           | (15,043)       | 5,095          |
| Decrease (increase) in other assets  | (56)                            | 13             | (95)           |
| Increase in accrued interest payable   | 2,858                           | 5,039          | 5,973          |
| Increase (decrease) in accounts payable and accrued expenses   | (16)                            | 503            | 302            |
| Increase (decrease) in payable to related party  | 314                             | 863            | (82)           |
| <b>Net cash provided by operating activities</b>   | <b>133,898</b>                  | <b>107,374</b> | <b>179,341</b> |

See notes to consolidated financial statements.



Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Consolidated Statements of Cash Flows (Continued)**

(in thousands)

|   | For the year ended December 31, |                    |                  |
|---|---------------------------------|--------------------|------------------|
|   | 2015                            | 2014               | 2013             |
| Cash flows from investing activities:   |                                 |                    |                  |
| Purchase of securities  | (1,354,274)                     | (4,007,240)        | (2,004,596)      |
| Purchase of securities underlying linked transactions   |                                 | (54,739)           | (176,628)        |
| Proceeds from sale of securities  | 2,547,364                       | 2,375,264          | 3,620,488        |
| Proceeds from sale of securities underlying linked transactions   |                                 | 6,215              | 21,735           |
| Principal payments and basis recovered on securities  | 397,073                         | 332,581            | 305,433          |
| Principal payments and basis recovered on securities underlying linked transactions                         |                                 | 4,801              | 2,008            |
| Purchase of Residential Whole-Loans   | (225,870)                       | (7,030)            |                  |
| Principal payments on Residential Whole-Loans   | 20,355                          | 9                  |                  |
| Purchase of Commercial Whole-Loans  | (8,750)                         |                    |                  |
| Principal payments on Commercial Whole-Loans  | 8,750                           |                    |                  |
| Purchase of securitized commercial loan   | (14,000)                        |                    |                  |
| Payment of premium for option derivatives   | (16,064)                        | (2,813)            | (4,675)          |
| Premium received from option derivatives  | 15,354                          |                    | 3,750            |
| Proceeds from gross settlement of TBAs  |                                 |                    | 208,313          |
| Net settlements of TBAs   | 3,710                           | 37,829             | (995)            |
| Payment on termination of futures   | (527)                           | (16,495)           |                  |
| Proceeds from sale of interest rate swaptions   | 32,186                          | 8,710              | 60,482           |
| Premium for MAC interest rate swaps, net  | (3,858)                         | 11,011             |                  |
| Payments on termination of MAC interest rate swaps  | (186)                           | 2,791              |                  |
| Interest payments and basis recovered on MAC interest rate swaps  | (1,193)                         | 706                |                  |
| Premium for interest rate swaptions, net  | (40,215)                        | (3,278)            | (32,904)         |
| <b>Net cash provided by (used in) investing activities</b>  | <b>1,359,855</b>                | <b>(1,311,678)</b> | <b>2,002,411</b> |
| Cash flows from financing activities:   |                                 |                    |                  |
| Proceeds from issuance of common stock  |                                 | 205,380            |                  |
| Proceeds from private placement of common stock (concurrent with initial public offering)                   |                                 | 9,653              |                  |
| Payment of offering costs   |                                 | (408)              | (67)             |
| Proceeds from repurchase agreement borrowings   | 17,544,060                      | 22,819,986         | 29,948,206       |
| Proceeds from repurchase agreement borrowings underlying linked transactions                                |                                 | 180,935            | 165,089          |
| Repayments of repurchase agreement borrowings   | (18,863,913)                    | (21,523,332)       | (32,163,869)     |
| Repayments of repurchase agreement borrowings underlying linked transactions                                |                                 | (208,177)          | (103,902)        |
| Proceeds from (Repayment of) cash overdraft   | 300                             |                    | (5,666)          |
| Proceeds from forward contracts   | 242,279                         | 44,897             |                  |
| Repayments of forward contracts   | (243,180)                       | (46,656)           |                  |
| Premium for MAC interest rate swaps containing an other-than-insignificant financing element                |                                 | 20,479             |                  |
| Payments on termination of MAC interest rate swaps containing an other-than-insignificant financing element | (18,655)                        | (14,147)           |                  |

See notes to consolidated financial statements.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Consolidated Statements of Cash Flows (Continued)**

(in thousands)

|   | For the year ended December 31, |             |             |
|---|---------------------------------|-------------|-------------|
|   | 2015                            | 2014        | 2013        |
| Interest payments and basis recovered on MAC interest rate swaps containing an other-than-insignificant financing element | (402)                           | (7,870)     |             |
| Payments made for deferred financing costs  | (620)                           |             |             |
| Due from counterparties, net  | (64,806)                        | (129,323)   | (1,292)     |
| Due to counterparties, net  | (2,230)                         | (53,681)    | 65,861      |
| Dividends on common stock   | (109,272)                       | (94,735)    | (93,879)    |
| Net cash provided by (used in) financing activities   | (1,516,439)                     | 1,203,001   | (2,189,519) |
| Effect of exchange rate changes on cash and cash equivalents  | 175                             |             |             |
| Net increase (decrease) in cash and cash equivalents  | (22,511)                        | (1,303)     | (7,767)     |
| Cash and cash equivalents beginning of period   | 47,222                          | 48,525      | 56,292      |
| Cash and cash equivalents end of period   | \$ 24,711                       | \$ 47,222   | \$ 48,525   |
| <b>Supplemental disclosure of operating cash flow information:</b>  |                                 |             |             |
| Interest paid   | \$ 27,515                       | \$ 20,553   | \$ 19,751   |
| <b>Supplemental disclosure of non-cash financing/investing activities:</b>  |                                 |             |             |
| Principal payments of securities, not settled   | \$ 572                          | \$ 45       | \$ 341      |
| Securities purchased, not settled   | \$ (66,146)                     | \$ (6,002)  | \$          |
| Securities used to settle TBAs  | \$                              | \$          | \$ 208,817  |
| Securities recorded upon unlinking of linked transactions   | \$                              | \$ (69,838) | \$ (77,046) |
| Assets of CSMC Trust  | \$ 11,000                       | \$          | \$          |
| Liabilities of CSMC Trust   | \$ (11,000)                     | \$          | \$          |

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|  |    |        |    |        |    |        |
|--|----|--------|----|--------|----|--------|
| Net unsettled TBAs                             | \$ |        | \$ | 2,186  | \$ |        |
| Stock dividends declared, not issued           | \$ |        | \$ |        |    | 37,671 |
| Dividends and distributions declared, not paid | \$ | 24,313 | \$ | 29,204 | \$ | 19,445 |

See notes to consolidated financial statements.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements**

**(in thousands except share and per share data)**

*The following defines certain of the commonly used terms in these Notes to Consolidated Financial Statements: "Agency" or "Agencies" refer to a federally chartered corporation, such as the Federal National Mortgage Association ("Fannie Mae" or "FNMA") or the Federal Home Loan Mortgage Corporation ("Freddie Mac" or "FHLMC"), or an agency of the U.S. Government, such as the Government National Mortgage Association ("Ginnie Mae" or "GNMA"); references to "MBS" refer to mortgage backed securities, including residential mortgage-backed securities or "RMBS", commercial mortgage-backed securities or "CMBS", and "Interest-Only Strips" (as defined herein); "Agency MBS" refer to RMBS, CMBS and Interest-Only Strips issued or guaranteed by the Agencies while "Non-Agency MBS" refer to RMBS, CMBS and Interest-Only Strips that are not issued or guaranteed by the Agencies; references to "ARMs" refers to adjustable rate mortgages; references to "Interest-Only Strips" refer to interest-only ("IO") and inverse interest-only ("IIO") securities issued as part of or collateralized with MBS; references to Residential Whole-Loans and Commercial Whole-Loans (collectively "Whole-Loans") refer to individual mortgage loans secured by single family and commercial properties, respectively.*

**Note 1 Organization**

Western Asset Mortgage Capital Corporation (the "Company") is a Delaware corporation commencing operations in May 2012 focusing on investing in, financing and managing a diversified portfolio of real estate related securities, whole-loans and other financial assets. The Company's portfolio is comprised of Agency RMBS (including TBAs as defined herein), Non-Agency RMBS, Agency and Non-Agency CMBS and Whole-Loans. In addition, and to a significantly lesser extent, the Company has invested in other securities including certain Agency obligations that are not technically MBS as well as certain Non U.S. CMBS and in asset-backed securities ("ABS") investments secured by a portfolio of private student loans. The Company's investment strategy is based on Western Asset Management Company's (the "Manager") perspective of which mix of portfolio assets it believes provides the Company with the best risk-reward opportunities at any given time. The Manager will vary the allocation among various asset classes subject to maintaining the Company's qualification as a REIT and maintaining its exemption from the Investment Company Act of 1940 (the "1940 Act"). These restrictions limit the Company's ability to invest in non-real estate assets and/or assets which are not secured by real estate. Accordingly, the Company's portfolio will continue to be principally invested in MBS and other real estate related assets.

The Company is externally managed by the Manager, an investment advisor registered with the Securities and Exchange Commission ("SEC"). The Manager is a wholly-owned subsidiary of Legg Mason, Inc. The Company operates and has elected to be taxed as a real estate investment trust or "REIT" commencing with its taxable year ended December 31, 2012.

**Note 2 Summary of Significant Accounting Policies**

***Basis of Presentation and Consolidation***

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 2 Summary of Significant Accounting Policies (Continued)**

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary. The Company also consolidated three variable interest entities ("VIE") where it was primary beneficiary. Refer to Note 5 "Variable Interest Entities" for additional information regarding the impact of consolidation of these VIE's. All intercompany amounts between the Company and its subsidiary and consolidated VIE's have been eliminated in consolidation.

*Variable Interest Entities*

VIEs are defined as entities that by design either lack sufficient equity for the entity to finance its activities without additional subordinated financial support or are unable to direct the entity's activities or are not exposed to the entity's losses or entitled to its residual returns. The Company evaluates all of its interests in VIEs for consolidation. When the interests are determined to be variable interests, the Company assesses whether it is deemed the primary beneficiary. The primary beneficiary of a VIE is determined to be the party that has both the power to direct the activities of a VIE that most significantly impact the VIE's economic performance and the obligation to absorb losses or the right to receive benefits of the VIE that could potentially be significant to the VIE.

To assess whether the Company has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, it considers all facts and circumstances, including its role in establishing the VIE and its ongoing rights and responsibilities. This assessment includes first, identifying the activities that most significantly impact the VIE's economic performance; and second, identifying which party, if any, has power over those activities. In general, the parties that make the most significant decisions affecting the VIE or have the right to unilaterally remove those decision makers is deemed to have the power to direct the activities of a VIE.

To assess whether the Company has the obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE, it considers all of its economic interests. This assessment requires that the Company applies judgment in determining whether these interests, in the aggregate, are considered potentially significant to the VIE. Factors considered in assessing significance include: the design of the VIE, including its capitalization structure; subordination of interests; payment priority; relative share of interests held across various classes within the VIE's capital structure; and the reasons why the interests are held by the Company.

In instances when a VIE is owned by both the Company and related parties, the Company considers whether there is a single party in the related party group that meets both the power and losses or benefits criteria on its own as though no related party relationship existed. If one party within the related party group meets both these criteria, such reporting entity is the primary beneficiary of the VIE and no further analysis is needed. If no party within the related party group on its own meets both the power and losses or benefits criteria, but the related party group does as a whole meets these two criteria, the determination of primary beneficiary within the related party group is based upon an analysis of the facts and circumstances with the objective of determining which party is most closely associated with the VIE. Determining the primary beneficiary within the related party group requires significant judgement.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 2 Summary of Significant Accounting Policies (Continued)**

In instances when the Company required to consolidate a VIE that is determined to be a qualifying collateralized financing entity, under GAAP, the Company will measure both the financial assets and financial liabilities of the VIE using the fair value of either the VIE's financial assets or financial liabilities, whichever is more observable.

Ongoing assessments of whether an enterprise is the primary beneficiary of a VIE is required.

The Company currently operates as one business segment.

***Cash and Cash Equivalents***

The Company considers all highly-liquid short term investments with original maturities of 90 days or less when purchased to be cash equivalents. Cash and cash equivalents are exposed to concentrations of credit risk. The Company places its cash and cash equivalents with what it believes to be high credit quality institutions. At times such investments may be in excess of the Federal Deposit Insurance Corporation insurance limit.

***Fair Value Election***

The Company has elected the fair value option for all of its investments and its securitized debt, which permits the Company to measure these financial instruments at fair value with the change in fair value included as a component of earnings. In the Manager's view, this election more appropriately reflects the results of the Company's operations for a particular reporting period, as financial asset fair value changes are presented in a manner consistent with the presentation and timing of the fair value changes of economic hedging instruments.

***Mortgage-Backed Securities and Other Securities***

The Company's purchases and sales of mortgage-backed securities and other securities are recorded on the trade date, which results in an investment related payable (receivable) for MBS and other securities purchased (sold) for which settlement has not taken place as of the balance sheet date. In addition, the Company's TBAs (as defined herein) which have matured but have not settled as of the balance sheet date result in an investment related payable (receivable). The Company's MBS and other securities are pledged as collateral against borrowings under repurchase agreements. Other than MBS and other securities which were accounted for as linked transactions through December 31, 2014, described below, the Company's MBS and other securities are included in Mortgage-backed securities and other securities at fair value and Investment related receivables on the Consolidated Balance Sheets, with the fair value of such MBS and other securities pledged disclosed parenthetically.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 2 Summary of Significant Accounting Policies (Continued)**

***Residential and Commercial Loans***

The Company records its purchases of residential and commercial loans on settlement date as the amount paid to the seller plus any fees paid or less any fees received. All other costs incurred in connection with acquiring residential and commercial loans or committing to purchase residential and commercial loans are charged to expense as incurred. The Company amortizes or accretes any premium or discount over the life of the related loan utilizing the effective interest method, based on the contractual payment terms of the loan. On at least a quarterly basis, the Company evaluates the collectability of both interest and principal of each loan, if circumstances warrant, to determine whether such loan is impaired. A loan is impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the existing contractual terms. When a loan is impaired, the Company does not record an allowance for loan loss as the Company has elected the fair value option. However, income recognition is suspended for loans at the earlier of the date at which payments become 90-days past due or when, in the opinion of management, a full recovery of income and principal becomes doubtful. When the ultimate collectability of the principal of an impaired loan is in doubt, all payments are applied to principal under the cost recovery method. When the ultimate collectability of the principal of an impaired loan is not in doubt, contractual interest is recorded as interest income when received, under the cash basis method until an accrual is resumed when the loan becomes contractually current and performance is demonstrated to be resumed. A loan is written off when it is no longer realizable and/or legally discharged.

***Valuation of financial instruments***

The Company discloses the fair value of its financial instruments according to a fair value hierarchy (Levels I, II, and III, as defined below). In accordance with GAAP, the Company is required to provide enhanced disclosures regarding instruments in the Level III category (which require significant management judgment), including a separate reconciliation of the beginning and ending balances for each major category of assets and liabilities. GAAP establishes a framework for measuring fair value and expands financial statement disclosure requirements for fair value measurements. GAAP further specifies a hierarchy of valuation techniques, which is based on whether the inputs into the valuation technique are observable or unobservable. The hierarchy is as follows:

Level I Quoted prices in active markets for identical assets or liabilities.

Level II Quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.

Level III Prices are determined using significant unobservable inputs. In situations where quoted prices or observable inputs are unavailable, for example, when there is little or no market activity for an investment at the end of the period, unobservable inputs may be used.

The level in the fair value hierarchy within which a fair value measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety. Transfers between levels are determined by the Company at the end of the reporting period.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 2 Summary of Significant Accounting Policies (Continued)**

When available, the Company uses quoted market prices to determine the fair value of an asset or liability. If quoted market prices are not available, the Company will use independent pricing services and if the independent pricing service cannot price a particular asset or liability, the Company will obtain third party broker quotes. The Manager's pricing group, which functions independently from its portfolio management personnel, corroborates the third party broker quote by comparing the broker price to alternate sources or using internal valuation techniques. If independent pricing service, or third party broker quotes are not available, the Company determines the fair value of the securities using valuation techniques that use, when possible, current market-based or independently-sourced market parameters, such as interest rates and when applicable, estimates of prepayment and credit losses.

Fair value under GAAP represents an exit price in the normal course of business, not a forced liquidation price. If the Company is forced to sell assets in a short period to meet liquidity needs, the prices it receives can be substantially less than their recorded fair values.

The Company performs quarterly reviews of the independent third party pricing data which may consist of a review of the daily change in the prices provided by the independent pricing vendor that exceed established tolerances or comparisons to executed transaction prices, utilizing its Manager's pricing group. The Manager's pricing group, which functions independently from its portfolio management personnel, corroborates the price differences or changes in price by comparing the vendor price to alternate sources including other independent pricing services or broker quotations. If the price change or difference cannot be corroborated, the Manager's pricing group consults with the portfolio management team for market color in reviewing such pricing data as warranted. To the extent that the Manager has information, typically in the form of broker quotations that would indicate that a price received from the independent pricing service is outside of a tolerance range, the Manager generally challenges the independent pricing service price.

***Interest income recognition and Impairment***

*Agency MBS, Non-Agency MBS and other securities, excluding Interest-Only Strips, rated AA and higher at the time of purchase*

Interest income on mortgage-backed and other securities is accrued based on the respective outstanding principal balances and corresponding contractual terms. Premiums and discounts associated with Agency MBS, Non-Agency MBS and other securities, excluding Interest-Only Strips, rated AA and higher at the time of purchase, are amortized into interest income over the estimated life of such securities using the effective yield method. Adjustments to premium and discount amortization are made for actual prepayment activity. The Company estimates prepayments at least quarterly for its securities and, as a result, if prepayments increase (or are expected to increase), the Company will accelerate the rate of amortization on premiums or discounts and make a retrospective adjustment to historical amortization. Alternatively, if prepayments decrease (or are expected to decrease), the Company will reduce the rate of amortization on the premiums or discounts and make a retrospective adjustment to historical amortization.



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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 2 Summary of Significant Accounting Policies (Continued)**

The Company assesses its Agency MBS, Non-Agency MBS and other securities, excluding Interest-Only Strips, rated AA and higher at the time of purchase, for other-than-temporary impairment ("OTTI") on at least a quarterly basis. The determination of whether a security is other-than-temporarily impaired involves judgement and assumptions based on subjective and objective factors. When the fair value of an investment is less than its amortized cost at the balance sheet date, during a reporting period, the security is considered impaired and the impairment is designated as either "temporary" or "other-than-temporary." In deciding on whether or not a security is other-than-temporarily impaired, the Company considers several factors, including the nature of the investment, communications (if any) from the trustee of securitization regarding the credit quality of the security, the severity and duration of the impairment and the cause of the impairment. When a security is impaired an OTTI is considered to have occurred if there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the security is less than its carrying amount and either the Company intends to sell the security or it is more likely than not the Company will be required to sell the security before recovery of its amortized cost. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a "market participant" would use and are discounted at a rate equal to the current yield used to accrete interest income. The OTTI is recorded in the Company's Consolidated Statement of Operations as Other loss on securities.

The determination as to whether OTTI exists is subjective given that such determination is based on information available at the time of assessment as well as the Company's estimates of the future performance and cash flow projections on the security. As a result, the timing and amount of an OTTI constitutes an accounting estimate that may change materially over time.

Finally, certain of the Company's MBS and other securities that are in an unrealized loss position at the end of the reporting period are not be considered other-than-temporarily impaired because the Company has the ability and intent to hold the securities to maturity or for a period of time sufficient for a price recovery up to or above the amortized cost of the investment and the Company is not required to sell the security for regulatory or other reasons.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 2 Summary of Significant Accounting Policies (Continued)**

*Non-Agency MBS and other securities that are rated below AA at the time of purchase and Interest-Only Strips that are not classified as derivatives*

Interest income on Non-Agency MBS and other securities that are rated below AA at the time of purchase and Interest-Only Strips that are not classified as derivatives are recognized based on the effective yield method. The effective yield on these securities is based on the projected cash flows from each security, which is estimated based on the Company's observation of the then current information and events, where applicable, and will include assumptions related to interest rates, prepayment rates and the timing and amount of credit losses. On at least a quarterly basis, the Company reviews and, if appropriate, makes adjustments to its cash flow projections based on input and analysis received from external sources, internal models, and its judgment about interest rates, prepayment rates, the timing and amount of credit losses, and other factors. Where appropriate, the Company may include in its cash flow projections the U.S Department of Justice's settlements with the major residential mortgage originators, regarding certain lending practices. Changes in cash flows from those originally projected, or from those estimated at the last evaluation, may result in a prospective change in the yield/interest income recognized on such securities. Actual maturities of the securities are affected by the contractual lives of the underlying collateral, periodic payments of scheduled principal, and prepayments of principal. Therefore, actual maturities of the securities will generally be shorter than stated contractual maturities.

Based on the projected cash flow of such securities purchased at a discount to par value, the Company may designate a portion of such purchase discount as credit protection against future credit losses and, therefore, not accrete such amount into interest income. The amount designated as credit discount may be adjusted over time, based on the actual performance of the security, its underlying collateral, actual and projected cash flow from such collateral, economic conditions and other factors. If the performance of a security with a credit discount is more favorable than forecasted, a portion of the amount designated as credit discount may be accreted into interest income prospectively.

In addition, an OTTI is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the security is less than its carrying amount. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a "market participant" would use and are discounted at a rate equal to the current yield used to accrete interest income. The OTTI is recorded in the Company's Consolidated Statements of Operations as Other loss on securities.

Securities denominated in a foreign currency contain additional risk in that the amortized cost basis for those securities may not be recovered due to declines in currency exchange rates. The Company considers the length of time that the security's fair value has declined due to the decline in foreign exchange rates, when assessing other-than temporary impairment.

The determination as to whether OTTI exists is subjective given that such determination is based on information available at the time of assessment as well as the Company's estimates of the future performance and cash flow projections on the security. As a result, the timing and amount of an OTTI constitutes an accounting estimate that may change materially over time

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 2 Summary of Significant Accounting Policies (Continued)**

Finally, certain of the Company's MBS and other securities that are in an unrealized loss position at the end of the reporting period are not be considered other-than-temporarily impaired because the Company has the ability and intent to hold the securities to maturity or for a period of time sufficient for a price recovery up to or above the amortized cost of the investment and the Company is not required to sell the security for regulatory or other reasons.

***Sales of Investments***

Sales of investments are driven by the Company's portfolio management process. The Company seeks to mitigate risks including those associated with prepayments and will opportunistically rotate the portfolio into securities and/or other assets the Company's Manager believes have more favorable attributes. Strategies may also be employed to manage net capital gains, which need to be distributed for tax purposes. Realized gains or losses on sales of investments, including Agency Interest-Only Strips not characterized as derivatives, are included in the net Realized gain (loss) on sale of investments, net line item on the Consolidated Statements of Operations, and are recorded at the time of disposition. Realized gains losses on Interest-Only Strips which are characterized as derivatives are included in Gain (loss) on derivative instruments, net line item in the Consolidated Statements of Operations. Prior to January 1, 2015, realized gains or losses on sales of securities which were part of a linked transaction were included in Gain (loss) on linked transactions, net. The cost of positions sold is calculated using the specific identification method.

Investments in an unrealized loss position at the end of each reporting period are evaluated by the Company's Manager to determine whether the Company has the intent to sell such investments. To the extent the Company has no intent as of the end of such reporting period to sell such investments and it is more likely than not that the Company will not be required to sell the investment before recovery of its amortized cost basis, such unrealized loss is included in Unrealized gain (loss) on investments, net in the Consolidated Statements of Operations. Otherwise, when the Company has determined its intent to sell such securities, the unrealized loss is characterized as a realized loss and included in Other loss on securities on the Consolidated Statements of Operations. The Company has no intent to sell any of its investments in an unrealized loss position at December 31, 2015.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 2 Summary of Significant Accounting Policies (Continued)**

***Foreign currency transactions***

The Company has and expects to continue to enter into transactions denominated in foreign currency from time to time. At the date the transaction is recognized, the asset and/or liability will be measured and recorded using the exchange rate in effect at the date of the transaction. At each balance sheet date, such foreign currency assets and liabilities are re-measured using the exchange rate in effect at the date of the balance sheet, resulting in unrealized foreign currency gains or losses. Unrealized foreign currency gains or losses on MBS and other assets are recorded in Unrealized gain (loss) on investments, net on the Consolidated Statement of Operations. In addition, the Company evaluates whether an other-than-temporary impairment is deemed to have occurred on MBS and other assets denominated in a foreign currency. Cash flows from MBS and other assets denominated in foreign currencies are received in a foreign currency, and as a result, the Company may incur a loss due to changes in foreign exchange rates even when all contractual cash flows are received. These adjustments are reflected in the Consolidated Statements of Operations as Other loss on securities. Unrealized and realized foreign currency gains or losses on borrowings under repurchase agreements are recorded in Other, net on the Consolidated Statement of Operations. Interest income from investments denominated in a foreign currency and interest expense on borrowings denominated in a foreign currency are recorded at the average rate of exchange during the period.

***Due from counterparties/Due to counterparties***

Due from counterparties represents cash posted by the Company with its counterparties as collateral for the Company's interest rate and/or currency derivative financial instruments, repurchase agreements, and TBAs. Due to counterparties represents cash posted with the Company by its counterparties as collateral under the Company's interest rate and/or currency derivative financial instruments, repurchase agreements, and TBAs. Included in the due from counterparties and/or due to counterparties are daily variation margin settlement amounts with counterparties which are based on the price movement of the Company's futures contracts. In addition, as provided below, Due to counterparties may include non-cash collateral in which the Company has the obligation to return and which the Company has either sold or pledged. To the extent the Company receives collateral other than cash from its counterparties such assets are not included in the Company's Consolidated Balance Sheets. Notwithstanding the foregoing, if the Company either rehypothecates such assets or pledges the assets as collateral pursuant to a repurchase agreement, the cash received and the corresponding liability are reflected on the Consolidated Balance Sheets.

***Derivatives and hedging activities***

Subject to maintaining its qualification as a REIT for U.S. federal income tax purposes, the Company utilizes derivative financial instruments, including interest rate swaps, interest rate swaptions, mortgage put options, currency forwards, futures contracts, TBAs and Agency and Non-Agency Interest-Only Strips to hedge the interest rate and currency risk associated with its portfolio and related borrowings. Derivatives, subject to REIT requirements, are used for hedging purposes rather than speculation. The Company determines the fair value of its derivative positions and obtains quotations from third parties, including the Chicago Mercantile Exchange or CME, to facilitate the process of determining such fair values. If the Company's hedging activities do not achieve the desired results, reported earnings may be adversely affected.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 2 Summary of Significant Accounting Policies (Continued)**

GAAP requires an entity to recognize all derivatives as either assets or liabilities on the balance sheet and to measure those instruments at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative. The fair value adjustment will affect either other comprehensive income in stockholders' equity until the hedged item is recognized in earnings or net income depending on whether the derivative instrument is designated and qualifies as a hedge for accounting purposes and if so, the nature of the hedging activity. The Company elected not to apply hedge accounting for its derivative instruments. Accordingly, the Company records the change in fair value, of its derivative instruments, which includes net interest rate swap payments (including accrued amounts) and net currency payments (including accrued amounts) related to interest rate swaps and currency swaps, respectively in Gain (loss) on derivative instruments, net in its Consolidated Statements of Operations.

In the Company's Consolidated Statements of Cash Flows, premiums received or paid on termination of its interest rate swaps, excluding interest rate swaps containing an other-than-insignificant financing element and the unamortized premium of market agreed coupon ("MAC") interest rate swaps, are included in cash flows from operating activities. Notwithstanding the foregoing, proceeds and payments on settlement of swaptions, mortgage put options, futures contracts and TBAs are included in cash flows from investing activities. Proceeds and payments on settlement of forward contracts are reflected in cash flows from financing activities in the Company's Consolidated Statement of Cash Flows. While payments made at the time of entering MAC interest rate swaps are included in cash flows from investing activities, payments received by the Company upon entering MAC interest rate swaps are included in either cash flows from investing activities or cash flows financing activities, depending on whether or not the derivative instrument includes an other-than-insignificant financing element. For MAC interest rate swaps containing an other-than-insignificant financing element, all cash flows over the life of the derivative are treated as cash flows from financing activities. Return and recovery of basis activity for MAC interest rate swaps is included in cash flows from investing activities for swaps not containing an other-than-insignificant financing element in the Company's Consolidated Statement of Cash Flows. For Agency and Non-Agency Interest-Only Strips accounted for as derivatives, the purchase, sale and recovery of basis activity is included with MBS and other securities under cash flows from investing activities in the Company's Consolidated Statement of Cash Flows.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 2 Summary of Significant Accounting Policies (Continued)**

The Company evaluates the terms and conditions of its holdings of Agency and Non-Agency Interest-Only Strips, interest rate swaptions, currency forwards, futures contracts and TBAs to determine if these instruments have the characteristics of an investment or should be considered a derivative under GAAP. In determining the classification of its holdings of Interest-Only Strips, the Company evaluates the securities to determine if the nature of the cash flows has been altered from that of the underlying mortgage collateral. Generally, Interest-Only Strips for which the security represents a strip off of a mortgage pass through security will be considered a hybrid instrument classified as a MBS investment on the Consolidated Balance Sheets utilizing the fair value option. Alternatively, those Interest-Only Strips, for which the underlying mortgage collateral has been included into a structured security that alters the cash flows from the underlying mortgage collateral, are accounted for as derivatives at fair value. Accordingly, Agency and Non-Agency Interest-Only Strips, interest rate swaptions, currency forwards, futures contracts and TBAs having the characteristics of derivatives are accounted for at fair value with such changes recognized in Gain (loss) on derivative instruments, net in its Consolidated Statements of Operations, along with any interest earned or paid (including accrued amounts). The carrying value of the Agency and Non-Agency Interest-Only Strips, accounted for as derivatives, is included in Mortgage-backed securities on the Consolidated Balance Sheets. The carrying value of interest rate swaptions, currency forwards, futures contracts and TBAs is included in Derivative assets or Derivative liabilities on the Consolidated Balance Sheets.

The Company evaluates all of its financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. An embedded derivative is separated from the host contract and accounted for separately when all of the guidance criteria are met. Hybrid instruments that are remeasured at fair value through earnings, including the fair value option are not bifurcated. Derivative instruments, including derivative instruments accounted for as liabilities, are recorded at fair value and are re-valued at each reporting date, with changes in the fair value together with interest earned or paid (including accrued amounts) reported in the Gain (loss) on derivative instruments, net in the Consolidated Statements of Operations. While accounted for as derivative instruments through December 31, 2014, linked transactions, including changes in fair value and interest earned or paid (including accrued amounts) were reported separately in our Consolidated Balance Sheets, Consolidated Statements of Operations and Consolidated Statements of Cash Flows. See "Warrants" below.

***Repurchase agreements and Reverse Repurchase agreements***

Mortgage-backed securities and other securities sold under repurchase agreements are treated as collateralized financing transactions, unless they meet sales treatment. Securities financed through a repurchase agreement remain on the Company's Consolidated Balance Sheets as assets and cash received from the lender is recorded in the Company's Consolidated Balance Sheets as a liability, unless such transaction was accounted for as a linked transaction prior to January 1, 2015, as described below. Interest payable in accordance with repurchase agreements is recorded as accrued interest payable on the Consolidated Balance Sheets. Interest paid (including accrued amounts) in accordance with repurchase agreements was recorded as interest expense, unless the repurchase agreement is accounted for as a linked transaction, prior to January 1, 2015, as described below. The Company reflects all proceeds from repurchase agreement borrowings and repayment of repurchase agreement borrowings which are not linked transactions, including transactions pertaining to collateral received with respect to certain swap transactions, on a gross basis on the Consolidated Statements of Cash Flows.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 2 Summary of Significant Accounting Policies (Continued)**

The Company may borrow securities under reverse repurchase agreements to deliver a security owned and sold by the Company but pledged to a different counterparty under a separate repurchase agreement when in the Manager's view terminating the outstanding repurchase agreement is not in the Company's interest. Cash paid to the borrower is recorded in the Company's Consolidated Balance Sheets as an asset. Interest receivable in accordance with reverse repurchase agreements is recorded as accrued interest receivable on the Consolidated Balance Sheets. The Company reflects all proceeds on reverse repurchase agreement and repayment of reverse repurchase agreement, on a net basis on the Consolidated Statements of Cash Flows. Upon sale of a pledged security, the Company recognizes an obligation to return the borrowed security on the Consolidated Balance Sheet in Due to Counterparty. The Company establishes haircuts to ensure the market value of the underlying asset remains sufficient to protect the Company in the event of default by the counterparty. Realized gains and losses associated with the sale of the security are recognized in Realized gain (loss) on sale of investments, net on the Consolidated Statement of Cash Flows.

***Securitized debt***

Securitized debt was issued at par by consolidated securitization trust. The Company elected the fair value option for the debt and as a result all changes in fair value are reflected in the results of operations.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 2 Summary of Significant Accounting Policies (Continued)**

***Linked transactions***

Prior to January 1, 2015, in instances where the Company acquired a security through a repurchase agreement with the same counterparty from which the security was purchased, the Company evaluated such transaction in accordance with GAAP. This guidance in effect prior to January 1, 2015 required that if the initial transfer of a financial asset and repurchase financing were entered into contemporaneously with, or in contemplation of, one another, such purchase and financing would be considered linked unless all of the criteria found in the guidance were met at the inception of the transaction. If the transaction met all of the conditions, the initial transfer would be accounted for separately from the repurchase financing, and the Company would record the security and the related financing on a gross basis on its Consolidated Balance Sheets with the corresponding interest income and interest expense being reported in the Consolidated Statements of Operations. If the transaction was determined to be linked, the Company would record the initial transfer and repurchase financing on a net basis and record a forward commitment to purchase the security as a derivative instrument. Through December 31, 2014, such forward commitment was recorded at fair value in Linked transactions, net, at fair value on the Consolidated Balance Sheets with subsequent changes through December 31, 2014 in fair value recognized in Gain (loss) on linked transactions, net on its Consolidated Statements of Operations. The Company refers to these transactions as Linked Transactions. Prior to January 1, 2015, when or if a transaction was no longer considered to be linked, the security and related repurchase financing were reported on a gross basis. The unlinking of a transaction caused a realized event in which the fair value of the security as of the date of unlinking, became the cost basis of the security. The difference between the fair value on the unlinking date and the existing cost basis of the security was the realized gain or loss. Recognition of effective yield for such security was calculated prospectively using the new cost basis. For linked transactions, the Company reflected purchases and sales of securities within the investing section of the Consolidated Statements of Cash Flows. Proceeds from repurchase agreements borrowings and repayments of repurchase agreement borrowings were reflected in the financing section of the Consolidated Statements of Cash Flows. Starting in 2015, GAAP no longer requires the segregation and treatment of linked transactions as derivatives. Accordingly, starting in January 2015, the Company reports such securities and the corresponding repurchase agreement on a gross basis on its Consolidated Balance Sheets and with the corresponding interest income and interest expense reported in its Consolidated Statements of Operations. See "Recent accounting pronouncements" for details.

***Share-based compensation***

The Company accounts for share-based compensation to its independent directors, to any employee, to its Manager and to employees of its Manager and its affiliates using the fair value based methodology prescribed by GAAP. Compensation cost related to restricted common stock issued to the Company's independent directors including any such restricted stock which is subject to a deferred compensation program, and any employee of the Company is measured at its fair value at the grant date, and amortized into expense over the service period on a straight-line basis. Compensation cost related to restricted common stock issued to the Manager and to employees of the Manager, including officers of the Company who are employees of the Manager and its affiliates is initially measured at fair value at the grant date, and amortized into expense over the vesting period on a straight-line basis and re-measured on subsequent dates to the extent the awards are unvested.



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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 2 Summary of Significant Accounting Policies (Continued)**

***Warrants***

For the Company's warrants, the Company uses a variation of the adjusted Black-Scholes option valuation model to record the financial instruments at their relative fair values at issuance. The warrants issued with the Company's common stock in the private placement to certain accredited institutional investors on May 15, 2012, were evaluated by the Company and were recorded at their relative fair value as a component of equity at the date of issuance. See "Derivatives and hedging activities" above.

***Income taxes***

The Company operates and has elected to be taxed as a REIT commencing with its taxable year ended December 31, 2012. Accordingly, the Company will generally not be subject to corporate U.S. federal or state income tax to the extent that the Company makes qualifying distributions to stockholders, and provided that 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, the Company 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 failure to qualify as a REIT could have a material adverse impact on the Company's results of operations and amounts available for distribution to stockholders.

The dividends paid deduction for qualifying dividends paid to stockholders is computed using the Company's taxable income as opposed to net income reported on the consolidated financial statements. Taxable income, generally, will differ from net income reported on the consolidated financial statements because the determination of taxable income is based on tax regulations and not GAAP.

The Company may create and elect to treat certain 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 domestic TRS is subject to U.S. federal, state and local corporate income taxes, and its value may not exceed 25% of the value of the Company. While a TRS may generate net income, a TRS can declare dividends to the Company, which will be included in the Company's taxable income and necessitate a distribution to its stockholders. Conversely, if the Company retains earnings at the TRS level, no distribution is required and it can increase book equity of the consolidated entity. As of December 31, 2015, the Company has a single wholly-owned subsidiary which it has elected to treat as a domestic TRS.

The Company evaluates uncertain tax positions, if any, and classifies interest and penalties, if any, related to unrecognized tax benefits, if any, as a component of the provision for income taxes. In addition, the Company evaluates the performance of the TRS each period to determine the need for a provision for income taxes.

***Offering costs***

Offering costs borne by the Company in connection with common stock offerings and private placements are reflected as a reduction of additional paid-in-capital.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 2 Summary of Significant Accounting Policies (Continued)**

***Earnings per share***

GAAP requires use of the two-class method of computing earnings per share for all periods presented for each class of common stock and participating securities as if all earnings for the period had been distributed. Under the two-class method, during periods of net income, the net income is first reduced for dividends declared on all classes of securities to arrive at undistributed earnings. During periods of net losses, the net loss is reduced for dividends declared on participating securities only if the security has the right to participate in the earnings of the entity and an objectively determinable contractual obligation to share in net losses of the entity. The Company's participating securities are not allocated a share of the net loss, as the participating securities do not have a contractual obligation to share in the net losses of the Company.

The remaining earnings are allocated to common stockholders and participating securities, to the extent that each security shares in earnings, as if all of the earnings for the period had been distributed. Each total is then divided by the applicable number of shares to arrive at basic earnings per share. For the diluted earnings, the denominator includes all outstanding common shares and all potential common shares assumed issued if they are dilutive. The numerator is adjusted for any changes in income or loss that would result from the assumed conversion of these potential common shares.

***Comprehensive Income (Loss)***

The Company has none of the components of comprehensive income (loss) and therefore comprehensive income (loss) is not presented.

***Accounting standards applicable to emerging growth companies***

The JOBS Act contains provisions that relax certain requirements for "emerging growth companies", which includes the Company. For as long as the Company is an emerging growth company, which may be up to five full fiscal years, unlike other public companies, the Company will not be required to: (i) comply with any new or revised financial accounting standards applicable to public companies until such standards are also applicable to private companies under Section 102(b)(1) of the JOBS Act; (ii) provide an auditor's attestation report on management's assessment of the effectiveness of the Company's system of internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act; (iii) comply with any new requirements adopted by the PCAOB requiring mandatory audit firm rotation or a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer; or (iv) comply with any new audit rules adopted by the PCAOB after April 5, 2012, unless the SEC determines otherwise. The Company currently takes advantage of some of these exemptions. The Company's qualification for remaining an emerging growth company under the five full fiscal years expires on December 31, 2017. However, the Company will no longer qualify for such exemption if its gross revenues for any year equals or exceeds \$1.0 billion, the Company issues more than \$1.0 billion in non-convertible debt during the three previous years, or if the Company is deemed to be a large accelerated filer.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 2 Summary of Significant Accounting Policies (Continued)**

As noted above, under the JOBS Act, emerging growth companies can delay adopting new or revised accounting standards that have different effective dates for public and private companies until such time as those standards apply to private companies. The Company intends to take advantage of such extended transition period. Since the Company will not be required to comply with new or revised accounting standards on the relevant dates on which adoption of such standards is required for other public companies, its financial statements may not be comparable to the financial statements of companies that comply with public company effective dates. If the Company were to elect to comply with these public company effective dates, such election would be irrevocable pursuant to Section 107 of the JOBS Act.

***Recent accounting pronouncements***

Accounting Standards Adopted in 2015

In April 2014, the Financial Accounting Standards Board issued updated guidance that changes the requirements for reporting discontinued operations. Under the new guidance, a discontinued operation is defined as a disposal of a component of an entity or group of components of an entity that is disposed of or is classified as held for sale and represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results. The guidance is effective prospectively as of the first quarter of 2015 for a public company and for certain non-for-profit entities, with early adoption permitted for new disposals or new classifications as held-for-sale. The guidance is effective for other entities for annual periods beginning on or after December 15, 2014 and interim periods within annual periods beginning on or after December 15, 2015. The new guidance did not have a material impact on the Company's consolidated financial statements.

In June 2014, the Financial Accounting Standards Board issued guidance that changes the accounting for repurchase-to-maturity transactions and repurchase financing arrangements. The new guidance aligns the accounting for repurchase-to-maturity transactions and repurchase agreements executed as a repurchase financing with the accounting for other typical repurchase agreements. These transactions would all be accounted for as secured borrowings. The guidance eliminates sale accounting for repurchase-to-maturity transactions and supersedes the guidance under which a transfer of a financial asset and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward agreement, which has resulted in outcomes referred to as off-balance-sheet accounting. In addition, the guidance requires additional disclosures. The guidance for a public company is effective for the first interim or annual period beginning after December 15, 2014. Other entities may elect to apply the requirements for interim periods beginning after December 31, 2014. Certain disclosures under this guidance do not take effect for a public company until the first period beginning after March 15, 2015 and do not take effect for other companies beginning for annual periods commencing after December 31, 2014 and for interim periods beginning after December 15, 2015. Through December 31, 2014, the Company accounted for certain transfers as forward agreements under the previous guidance, which were classified as linked transactions. The new guidance requires the Company to record these transfers as secured borrowings. The implementation of the new guidance resulted in an increase to Mortgage-backed securities and other securities, at fair value of approximately \$52.5 million, an increase in Borrowings under repurchase agreements of approximately \$31.9 million and a decrease in Linked transactions, net, at fair value of approximately \$20.6 million in the Company's Consolidated Balance Sheets as of January 1, 2015. Further, the implementation of the new guidance resulted in a cumulative-effect adjustment of zero to retained earnings as of January 1, 2015.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 2 Summary of Significant Accounting Policies (Continued)**

In August 2014, the FASB issued guidance on measuring the financial assets and financial liabilities of consolidated collateralized financing entities, or CFEs. The update allows an entity to measure both the financial assets and financial liabilities of a qualifying CFE it consolidates using the fair value of either the CFE's financial assets or financial liabilities, whichever is more observable. The guidance requires certain recurring disclosures and is effective for annual periods beginning on or after December 15, 2015, with early adoption permitted as of the beginning of an annual period. Early adoption was applied, which did not have a material impact on the Company's financial condition or results of operations.

Accounting Standards to be Adopted in Future Periods

In May 2014, the Financial Accounting Standards Board issued guidance that changes an entity's recognition of revenue from contracts with customers. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In addition, the new guidance requires improved disclosures to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. In applying the new guidance, an entity may use either a retrospective approach to each prior reporting period or a retrospective approach with the cumulative effect recognized at the date of initial application. For a public company, the standard is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early adoption is not permitted for a public entity. For all other entities, the standard is effective for annual reporting periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2015. With certain restrictions, a nonpublic entity may elect to apply the guidance earlier. The new guidance is not expected to have a material impact on the Company's consolidated financial statements.

In August 2014, the Financial Accounting Standards Board issued guidance that will require an entity's management to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. According to the new guidance, substantial doubt exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date the financial statements are issued. The term "probable" is used consistently with its current use in U.S. GAAP for loss contingencies. Disclosures will be required if conditions give rise to substantial doubt about the entity's ability to continue as a going concern, including whether management's plans that are intended to mitigate those conditions will alleviate the substantial doubt when implemented. The guidance is effective for annual periods ending after December 15, 2016. The effective date is the same for both public companies and all other entities. Early application is permitted. The Company's first assessment under the new guidance will be completed for the year ending December 31, 2016.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 2 Summary of Significant Accounting Policies (Continued)**

In January 2015, the FASB issued guidance to simplify income statement presentation by eliminating the concept of extraordinary items. U.S. GAAP currently requires that a company separately classify, disclose and present extraordinary events and transactions. The guidance eliminates the concept of extraordinary items from U.S. GAAP. Under the existing guidance, an entity is required to separately disclose extraordinary items, net of tax, in the income statement after income from continuing operations if an event or transaction is of an unusual nature and occurs infrequently. This separate, net-of-tax presentation (and corresponding earnings per share impact) will no longer be allowed. The existing requirement to separately present items that are of an unusual nature or occur infrequently on a pre-tax basis within income from continuing operations has been retained. The new guidance also requires similar separate presentation of items that are both unusual and infrequent. The standard is effective for periods beginning after December 15, 2015. The effective date is the same for both public companies and all other entities. Early adoption is permitted, but only as of the beginning of the fiscal year of adoption. Upon adoption, a reporting entity may elect prospective or retrospective application. If adopted prospectively, both the nature and amount of any subsequent adjustments to previously reported extraordinary items must be disclosed. The Company has not elected to early adopt this guidance. The new guidance is not expected to have a material impact on the Company's consolidated financial statements.

In February 2015, the FASB issued guidance to simplify and reduce the number of consolidation models through the elimination of an indefinite deferral for certain entities and by placing more emphasis on risk of loss when determining a controlling financial interest. The guidance affects reporting entities that are required to evaluate whether they should consolidate certain legal entities. All legal entities are subject to reevaluation under the revised consolidation model. The standard is effective for a public company for fiscal years, and for interim periods within fiscal years beginning after December 15, 2015. The standard is effective for other entities for fiscal years beginning after December 31, 2016, and for interim periods beginning after December 15, 2017. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. The Company has not elected to early adopt this guidance. The new guidance is not expected to have a material impact on the Company's consolidated financial statements.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 2 Summary of Significant Accounting Policies (Continued)**

In April 2015, the FASB issued guidance to amend the presentation of debt issuance cost related to a recognized debt liability. Under the new guidance, the debt issuance costs will be presented in the balance sheet as a direct deduction from the carrying amount of the recognized debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected under the new guidance. The standard is effective for a public company for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. The standard is effective for other entities for the fiscal years beginning after December 15, 2015, and interim periods within fiscal years beginning after December 15, 2016. Early adoption is permitted. The guidance should be applied on a retrospective basis. The balance sheet of each individual period presented should be adjusted to reflect the period-specific effects of applying the new guidance. Upon adoption, an entity is required to comply with the applicable disclosures for a change in an accounting principle. These disclosures include the nature of and reason for the change in accounting principle, the transition method, a description of the prior-period information that has been retrospectively adjusted, and the effect of the change on the financial statement line items (i.e., debt issuance cost asset and the debt liability). The Company has not elected to early adopt this guidance. The new guidance is not expected to have a material impact on the Company's consolidated financial statements.

In January 2016, the FASB issued guidance to improve certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. The standard is effective for a public company for fiscal years beginning after December 15, 2017, and for interim periods within those fiscal years. The standard is effective for other entities for fiscal years beginning after December 15, 2018, and for interim periods beginning after December 15, 2019. Early adoption by public companies for fiscal years or interim periods that have not yet been issued or, by all other entities, that have not yet been made available for issuance of this guidance are permitted as of the beginning of the fiscal year of adoption, under certain restrictions. The Company should apply the guidance by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The guidance related to equity securities without readily determinable fair values should be applied prospectively to equity investments that exist at the date of adoption. The Company is currently assessing the impact that this guidance will have on its consolidated financial statements when adopted.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 3 Fair Value of Financial Instruments**

The following tables present the Company's financial instruments carried at fair value as of December 31, 2015 and December 31, 2014, based upon the valuation hierarchy (dollars in thousands):

|  | December 31, 2015 |              |            | Total        |
|--|-------------------|--------------|------------|--------------|
|  | Fair Value        |              |            |              |
|  | Level I           | Level II     | Level III  |              |
| <b>Assets</b>  |                   |              |            |              |
| Agency RMBS:   |                   |              |            |              |
| 20-Year mortgage   | \$                | \$ 687,272   | \$         | \$ 687,272   |
| 30-Year mortgage   |                   | 926,459      |            | 926,459      |
| Agency RMBS Interest-Only Strips   |                   | 71,954       |            | 71,954       |
| Agency and Non-Agency Interest-Only Strips accounted for as derivatives, included in MBS |                   | 56,431       | 3,556      | 59,987       |
| Non-Agency RMBS  |                   | 278,885      | 247,753    | 526,638      |
| Agency and Non-Agency CMBS   |                   | 334,687      | 143,031    | 477,718      |
| Other securities   |                   | 29,103       | 71,996     | 101,099      |
| Subtotal   |                   | 2,384,791    | 466,336    | 2,851,127    |
| Residential Whole-Loans  |                   |              | 218,538    | 218,538      |
| Securitized commercial loan  |                   |              | 25,000     | 25,000       |
| Subtotal   |                   |              | 243,538    | 243,538      |
| Derivative assets  | 63                | 21,852       |            | 21,915       |
| <b>Total</b>   | \$ 63             | \$ 2,406,643 | \$ 709,874 | \$ 3,116,580 |
| <b>Liabilities</b>   |                   |              |            |              |
| Derivative liabilities   | \$ 698            | \$ 179,479   | \$         | \$ 180,177   |
| Securitized debt   |                   |              | 11,000     | 11,000       |
| <b>Total</b>   | \$ 698            | \$ 179,479   | \$ 11,000  | \$ 191,177   |

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 3 Fair Value of Financial Instruments (Continued)**

|  | December 31, 2014 |              |            | Total        |
|--|-------------------|--------------|------------|--------------|
|  | Level I           | Level II     | Level III  |              |
| <b>Assets</b>  |                   |              |            |              |
| Agency RMBS:   |                   |              |            |              |
| 20-Year mortgage   | \$                | \$ 1,120,031 | \$         | \$ 1,120,031 |
| 30-Year mortgage   |                   | 1,790,219    |            | 1,790,219    |
| Agency RMBS Interest-Only Strips   |                   | 188,506      |            | 188,506      |
| Agency and Non-Agency Interest-Only Strips accounted for as derivatives, included in MBS |                   | 83,773       | 4,456      | 88,229       |
| Non-Agency RMBS  |                   | 490,093      | 176,479    | 666,572      |
| Agency and Non-Agency CMBS   |                   | 320,171      | 103,069    | 423,240      |
| Other securities   |                   | 101,523      | 7,403      | 108,926      |
| Subtotal   |                   | 4,094,316    | 291,407    | 4,385,723    |
| Residential Whole-Loans  |                   |              | 7,220      | 7,220        |
| Derivative assets  | 451               | 72,805       |            | 73,256       |
| Non-Agency RMBS linked transactions  |                   |              | 1,596      | 1,596        |
| Non-Agency CMBS linked transactions, including Non U.S.                                  |                   |              | 16,152     | 16,152       |
| Other securities linked transactions   |                   |              | 2,879      | 2,879        |
| Total  | \$ 451            | \$ 4,167,121 | \$ 319,254 | \$ 4,486,826 |
| <b>Liabilities</b>   |                   |              |            |              |
| Derivative liabilities   | \$ 1,191          | \$ 179,089   | \$         | \$ 180,280   |
| Total  | \$ 1,191          | \$ 179,089   | \$         | \$ 180,280   |

When available, the Company uses quoted market prices to determine the fair value of an asset or liability. If quoted market prices are not available, the Company will use independent pricing services and if the independent pricing service cannot price a particular asset or liability, the Company will obtain third party broker quotes. The Manager's pricing group, which functions independently from its portfolio management personnel, corroborates the third party broker quote by comparing the broker price to alternate sources or using internal valuation techniques. If independent pricing service, or third party broker quotes are not available, the Company determines the fair value of the securities using valuation techniques that use, when possible, current market-based or independently-sourced market parameters, such as interest rates and when applicable, estimates of prepayments and credit losses.



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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 3 Fair Value of Financial Instruments (Continued)**

*Mortgage-backed securities and other securities*

In determining the proper fair value hierarchy or level, all securities are initially classified in Level III. The Company further determined, given the amount of available observable market data to fair value its Agency RMBS, that these securities should be classified in Level II. For Non-Agency RMBS, CMBS and other securities, to determine whether a security should be a Level II, the securities are grouped by security type and the Manager reviews the internal trade history, for the quarter, for each security type. If there is sufficient trade data above a predetermined threshold of a security type, the Manager determines it has sufficient observable market data and the security will be categorized as a Level II.

Values for the Company's securities are based upon prices obtained from independent third party pricing services. The valuation methodology of the third party pricing services incorporates a commonly used market pricing method. Depending on the type of asset and the underlying collateral, the primary inputs to the model include yields for TBAs, Agency RMBS, the U.S. Treasury market and floating rate indices such as LIBOR, the Constant Maturity Treasury rate and the prime rate as a benchmark yield. In addition, the model may incorporate the current weighted average maturity and additional pool level information such as prepayment speeds, default frequencies and default severities, if applicable. When the third party pricing service cannot adequately price a particular security, the Company utilizes a broker's quote which is validated by the Manager's pricing group.

*Residential and Commercial Loans*

Values for the Company's residential and commercial loans are based upon prices obtained from an independent third party pricing service that specializes in residential and commercial loans, utilizing a trade based valuation model. Their valuation methodology incorporates commonly used market pricing methods, including LTV, debt to income, maturity, interest rates, collateral location, and unpaid principal balance, prepayment penalties, FICO, lien position and times late. Due to the inherent uncertainty of such valuation, the fair values established for residential and commercial loans held by the Company may differ from the fair values that would have been established if a ready market existed for these loans. Accordingly, the Company's loans are classified as Level III in the fair value hierarchy.

*Securitized commercial loan and securitized debt*

Values for the Company's securitized commercial loan and securitized debt is based on the fair value that is more observable. Since there is an extremely limited market for the securitized commercial loan, the Company determined the fair value of the securitized debt was more observable. The fair value of the securitized debt was based upon a third party broker quote, which is validated by the Manager's pricing group. Due to the inherent uncertainty of such valuation the Company classifies its securitized commercial loan and securitized debt as Level III.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 3 Fair Value of Financial Instruments (Continued)**

*Linked transactions*

While linked transactions were treated as derivatives for GAAP through December 31, 2014, the securities underlying the Company's linked transactions were valued using similar techniques to those used for our securities portfolio. The value of the underlying security was then netted against the carrying amount (which approximates fair value) of the repurchase agreement at the valuation date. Additionally, TBA instruments are similar in substance to our Agency RMBS portfolio, and the Company therefore estimates fair value based on similar methods.

*Derivatives*

Values for the Company derivatives are based upon prices from third party pricing services, whose pricing is subject to review by the Manager's pricing committee. In valuing its over-the-counter interest rate derivatives, such as swaps and swaptions, and its currency derivatives, such as swaps and forwards, the Company considers the creditworthiness of both the Company and its counterparties, along with collateral provisions contained in each derivative agreement, from the perspective of both the Company and its counterparties. The majority of the Company's interest rate swaps are cleared through a central clearing house and subject to the clearing house margin requirements. The Company's agreements with its derivative counterparties also contain netting provisions; however the Company has elected to report its interest rate swaps and swaptions and currency swaps and forwards on a gross basis. No credit valuation adjustment was made in determining the fair value of interest rate and/or currency derivatives for the years ended December 31, 2015 and 2014.

The Company performs quarterly reviews of the independent third party pricing data may consist of a review of the daily change in the prices provided by the independent pricing vendor which exceed established tolerances or comparisons to executed transaction prices, utilizing the Manager's pricing group. The Manager's pricing group, which functions independently from its portfolio management personnel, corroborates the price differences or changes in price by comparing the vendor price to alternate sources including other independent pricing services or broker quotations. If the price change or difference cannot be corroborated, the Manager's pricing group consults with the portfolio management team for market color in reviewing such pricing data as warranted. To the extent that the Manager has information, typically in the form of broker quotations that would indicate that a price received from the independent pricing service is outside of a tolerance range, the Manager generally challenges the independent pricing service price.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 3 Fair Value of Financial Instruments (Continued)**

The following table presents additional information about the Company's financial instruments which are measured at fair value on a recurring basis for which the Company has utilized Level III inputs to determine fair value:

| \$ in thousands  | Year ended December 31, 2015                    |                         |                             |                     |                  |
|--|---|-------------------------|-----------------------------|---------------------|------------------|
|  | Mortgage-backed securities and other securities | Residential Whole-Loans | Securitized commercial loan | Linked Transactions | Securitized debt |
| Beginning balance  | \$ 291,407                                      | \$ 7,220                | \$                          | \$ 20,627           | \$               |
| Fair value of securities previously accounted for as linked transactions(1)            | 52,484  |                         |                             |                     |                  |
| Fair value of financial instruments previously accounted for as linked transactions(1) |   |                         |                             | (20,627)            |                  |
| Transfers into Level III from Level II   | 104,748   |                         |                             |                     |                  |
| Transfers from Level III into Level II   | (42,952)  |                         |                             |                     |                  |
| Purchases  | 179,546   | 217,325                 | 25,000                      |                     | 11,000           |
| Sales and settlements  | (88,574)  |                         |                             |                     |                  |
| Principal repayments   | (11,880)  | (8,674)                 |                             |                     |                  |
| Total net gains / (losses) included in net income                                      |   |                         |                             |                     |                  |
| Realized gains/(losses), net   | 4,314   |                         |                             |                     |                  |
| Other loss on Mortgage-backed securities   | (7,552)   |                         |                             |                     |                  |
| Unrealized gains/(losses), net(2)  | (7,386)   | 3,548                   |                             |                     |                  |
| Premium and discount amortization, net   | (7,819)   | (881)                   |                             |                     |                  |
| Ending balance   | \$ 466,336                                      | \$ 218,538              | \$ 25,000                   | \$                  | \$ 11,000        |

(1) Resulting from the implementation of guidance issued by the Financial Accounting Standards Board which eliminated the requirement to account for certain financial instruments as linked transactions. See "Recent accounting pronouncements" for details.

(2) For Mortgage-backed securities and other securities and Residential Whole-Loans classified as Level III at December 31, 2015, the Company recorded gross unrealized gains of approximately \$7.3 million and \$3.6 million and gross unrealized losses of approximately \$13.4 million and \$8 thousand, respectively. These gains and losses are included in Unrealized gain (loss) on investments, net on the Consolidated Statements of Operations.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 3 Fair Value of Financial Instruments (Continued)**

| \$ in thousands                                   | Year ended December 31, 2014                    |                         |                             |                     |                  |
|---|---|-------------------------|-----------------------------|---------------------|------------------|
|   | Mortgage-backed securities and other securities | Residential Whole-Loans | Securitized commercial loan | Linked Transactions | Securitized debt |
| Beginning balance                                 | \$ 15,681                                       | \$                      | \$                          | \$                  | \$               |
| Transfers into Level III from Level II            | 118,174   |                         |                             | 10,944              |                  |
| Transfers from Level III into Level II            | (10,732)  |                         |                             |                     |                  |
| Purchases   | 185,137   | 7,161                   |                             | 10,008              |                  |
| Sales and settlements                             | (14,649)  |                         |                             |                     |                  |
| Principal repayments                              | (2,283)   | (9)                     |                             |                     |                  |
| Total net gains / (losses) included in net income |   |                         |                             |                     |                  |
| Realized gains/(losses), net                      | 184   |                         |                             | 130                 |                  |
| Other loss on Mortgage-backed securities          | (996)   |                         |                             | (2)                 |                  |
| Unrealized gains/(losses), net(1)                 | 9,051   | 94                      |                             | (483)               |                  |
| Premium and discount amortization, net            | (8,160)   | (26)                    |                             | 30                  |                  |
| Ending balance                                    | \$ 291,407                                      | \$ 7,220                | \$                          | \$ 20,627           | \$               |

(1)

For Mortgage-backed securities and other securities and Residential Whole-Loans classified as Level III at December 31, 2014, the Company recorded gross unrealized gains of approximately \$9.0 million and \$95 thousand and gross unrealized losses of approximately \$930 thousand and \$1 thousand, respectively. These gains and losses are included in Unrealized gain (loss) on investments, net on the Consolidated Statements of Operations.

Transfers between hierarchy levels during operations for the years ended December 31, 2015 and December 31, 2014 were based on the lack of availability of sufficient observable inputs to meet Level II versus Level III criteria. The leveling of these assets was based on information received from a third party pricing service which utilized unobservable inputs, along with the back-testing of historical sales transactions performed by the Manager. The Company did not have transfers between Level I and Level II for the years ended December 31, 2015 and December 31, 2014.

**Other Fair Value Disclosures**

Due from counterparties and Due to counterparties on the Company's Consolidated Balance Sheets are reflected at cost which approximates fair value.

The fair value of the repurchase agreements is based on an expected present value technique. This method discounts future estimated cash flows using rates the Company determined best estimate current market interest rates that would be offered for loans with similar characteristics and credit quality. The use of different market assumptions or estimation methodologies could have a material effect on the fair value amounts. At December 31, 2015, the Company's borrowings under repurchase agreements had a fair value of approximately \$2.589 billion and a carrying value of approximately \$2.586 billion. Inputs used to arrive at the fair value of the repurchase agreement borrowings and receivables under reverse repurchase agreements are generally observable, and therefore, they would be considered a Level II fair value measurement.



Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 4 Mortgage-Backed Securities and other securities**

The following tables present certain information about the Company's investment portfolio at December 31, 2015 and December 31, 2014 (dollars in thousands). Real estate securities and other securities that are accounted for as a component of linked transactions as of December 31, 2014 are not reflected in the tables set forth in this note. See Note 8 for further details.

|  | December 31, 2015   |                                     |  |                     |                             |                      |                                |
|--|---------------------|-------------------------------------|--|---------------------|-----------------------------|----------------------|--------------------------------|
|  | Principal Balance   | Unamortized Premium (Discount), net | Discount Designated as Credit Reserve and OTTI | Amortized Cost      | Unrealized Gain (Loss), net | Estimated Fair Value | Net Weighted Average Coupon(1) |
| Agency RMBS:   |                     |                                     |  |                     |                             |                      |                                |
| 20-Year mortgage   | \$ 645,313          | \$ 35,216                           | \$   | \$ 680,529          | \$ 6,743                    | \$ 687,272           | 3.9%                           |
| 30-Year mortgage   | 856,014             | 71,342                              |  | 927,356             | (897)                       | 926,459              | 4.2%                           |
| Agency RMBS Interest-Only Strips(2)  | N/A                 | N/A                                 | N/A  | 71,632              | 322                         | 71,954               | 3.1%(2)                        |
| Agency and Non-Agency Interest-Only Strips, accounted for as derivatives(2)(3) | N/A                 | N/A                                 | N/A  | N/A                 | N/A                         | 59,987               | 2.5%(2)                        |
| Non-Agency RMBS  | 601,233             | (16,669)                            | (141,014)                                      | 443,550             | 1,899                       | 445,449              | 3.7%                           |
| Non-Agency RMBS Interest- Only Strips(2)                                       | N/A                 | N/A                                 | N/A  | 66,600              | 14,589                      | 81,189               | 5.9%(2)                        |
| Agency and Non-Agency CMBS   | 575,351             | (73,835)                            | (9,017)  | 492,499             | (16,894)                    | 475,605              | 5.0%                           |
| Agency CMBS Interest-Only Strips(2)  | N/A                 | N/A                                 | N/A  | 1,915               | 198                         | 2,113                | 4.7%(2)                        |
| Other securities(4)  | 81,518              | 1,135                               | (2,719)  | 102,778             | (1,679)                     | 101,099              | 4.8%                           |
| <b>Total</b>   | <b>\$ 2,759,429</b> | <b>\$ 17,189</b>                    | <b>\$ (152,750)</b>                            | <b>\$ 2,786,859</b> | <b>\$ 4,281</b>             | <b>\$ 2,851,127</b>  | <b>3.9%</b>                    |

|  | December 31, 2014   |                                     |  |                     |                             |                      |                                |
|--|---------------------|-------------------------------------|--|---------------------|-----------------------------|----------------------|--------------------------------|
|  | Principal Balance   | Unamortized Premium (Discount), net | Discount Designated as Credit Reserve and OTTI | Amortized Cost      | Unrealized Gain (Loss), net | Estimated Fair Value | Net Weighted Average Coupon(1) |
| Agency RMBS:   |                     |                                     |  |                     |                             |                      |                                |
| 20-Year mortgage   | \$ 1,054,864        | \$ 56,616                           | \$   | \$ 1,111,480        | \$ 8,551                    | \$ 1,120,031         | 3.6%                           |
| 30-Year mortgage   | 1,657,640           | 127,876                             |  | 1,785,516           | 4,703                       | 1,790,219            | 4.1%                           |
| Agency RMBS Interest-Only Strips(2)  | N/A                 | N/A                                 | N/A  | 178,162             | 10,344                      | 188,506              | 4.0%(2)                        |
| Agency and Non-Agency Interest-Only Strips, accounted for as derivatives(2)(3) | N/A                 | N/A                                 | N/A  | N/A                 | N/A                         | 88,229               | 2.9%(2)                        |
| Non-Agency RMBS  | 759,068             | 6,941                               | (178,883)                                      | 587,126             | 9,791                       | 596,917              | 3.6%                           |
| Non-Agency RMBS Interest- Only Strips(2)                                       | N/A                 | N/A                                 | N/A  | 61,144              | 8,511                       | 69,655               | 6.1%                           |
| Agency and Non-Agency CMBS   | 449,617             | (31,216)                            | (3,124)  | 415,277             | 3,848                       | 419,125              | 5.3%                           |
| Agency CMBS Interest-Only Strips(2)  | N/A                 | N/A                                 | N/A  | 4,017               | 98                          | 4,115                | 4.8%                           |
| Other securities(4)  | 102,323             | 699                                 |  | 110,425             | (1,499)                     | 108,926              | 4.6%                           |
| <b>Total</b>   | <b>\$ 4,023,512</b> | <b>\$ 160,916</b>                   | <b>\$ (182,007)</b>                            | <b>\$ 4,253,147</b> | <b>\$ 44,347</b>            | <b>\$ 4,385,723</b>  | <b>4.0%</b>                    |

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- (1) Net weighted average coupon as of December 31, 2015 and December 31, 2014 is presented, net of servicing and other fees.
- (2) Agency RMBS IOs and IIOs, Non-Agency RMBS IOs and IIOs, Agency and Non-Agency IOs and IIOs, accounted for as derivatives, and Agency and Non-Agency CMBS IOs and IIOs have no principal balances and bear interest based on a notional balance. The notional balance is used solely to determine interest distributions on interest-only class of securities. At December 31, 2015, the notional balance for Agency RMBS IOs and IIOs, Non-Agency IOs and IIOs, Agency and Non-Agency IOs and IIOs, accounted for as derivatives, and CMBS IOs and IIOs was \$593.4 million, \$321.0 million, \$655.6 million and \$43.2 million, respectively. At December 31, 2014, the notional balance for Agency RMBS IOs and IIOs, Non-Agency IOs and IIOs, Agency and Non-Agency IOs and IIOs, accounted for as derivatives, and CMBS IOs and IIOs was \$1.2 billion, \$329.7 million, \$818.7 million and \$46.6 million, respectively.
- (3) Interest on these securities is reported as a component of Gain (loss) on derivative instruments, net on the Consolidated Statements of Operations.
- (4) Other securities include residual interests in asset-backed securities which have no principal balance and an amortized cost of approximately \$22.8 million and \$7.4 million, as of December 31, 2015 and December 31, 2014, respectively.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 4 Mortgage-Backed Securities and other securities (Continued)**

As of December 31, 2015 and December 31, 2014 the weighted average expected remaining term to the expected maturity of the MBS and other securities investment portfolio, excluding linked transactions was 7.1 years and 6.7 years, respectively.

The following table presents the components of the carrying value of the Company's real estate securities and other securities (dollars in thousands):

|   | December 31,<br>2015 | December 31,<br>2014 |
|---|----------------------|----------------------|
| Principal balance   | \$ 2,759,429         | \$ 4,023,512         |
| Amortized cost of Interest-Only Strips and residual interests                             | 162,991              | 250,726              |
| Carrying value of Agency and Non-Agency Interest-Only Strips accounted for as derivatives | 59,987               | 88,229               |
| Unamortized premium   | 124,870              | 218,561              |
| Unamortized discount  | (107,681)            | (57,645)             |
| Discount designated as Credit Reserve and OTTI  | (152,750)            | (182,007)            |
| Gross unrealized gains  | 51,542               | 75,444               |
| Gross unrealized losses   | (47,261)             | (31,097)             |
| <b>Fair value</b>   | <b>\$ 2,851,127</b>  | <b>\$ 4,385,723</b>  |

The following tables present the changes in the components of the Company's purchase discount and amortizable premium on its Non-Agency RMBS, Non-Agency CMBS and other securities for the years ended December 31, 2015, December 31, 2014 and December 31, 2013 (dollars in thousands):

|   | Year ended December 31, 2015                         |                           |                           |
|---|--|---------------------------|---------------------------|
|   | Discount Designated as<br>Credit Reserve and<br>OTTI | Accretable<br>Discount(1) | Amortizable<br>Premium(1) |
| Balance at beginning of period(3)                             | \$ (182,007)   | \$ (105,804)              | \$ 82,228                 |
| Securities previously accounted for as linked transactions(2) | (2,320)  | (1,393)                   | 4,587                     |
| Accretion of discount   |  | 18,465                    |                           |
| Amortization of premium                                       |  |                           | (9,025)                   |
| Realized credit losses  | 9,534  |                           |                           |
| Purchases   | (38,634)   | (96,380)                  | 18,544                    |
| Sales   | 60,747   | 44,232                    | (30,054)                  |
| Net impairment losses recognized in earnings                  | (14,839)   |                           |                           |
| Transfers/release of credit reserve(3)                        | 14,769   | (4,652)                   | (10,117)                  |
| <b>Balance at end of period</b>                               | <b>\$ (152,750)</b>                                  | <b>\$ (145,532)</b>       | <b>\$ 56,163</b>          |

(1)



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Together with coupon interest, accretable purchase discount and amortizable premium is recognized as interest income over the life of the security.

(2)

Resulting from the implementation of guidance issued by the Financial Accounting Standards Board which eliminated the requirement to account for certain financial instruments as linked transactions. See "Recent accounting pronouncements" for details.

(3)

Subsequent reductions of a security's non-accretable discount results in a corresponding reduction in its amortizable premium.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 4 Mortgage-Backed Securities and other securities (Continued)**

|  | Year ended December 31, 2014                            |                           |                           |
|--|---|---------------------------|---------------------------|
|  | Discount Designated<br>as<br>Credit Reserve and<br>OTTI | Accretable<br>Discount(1) | Amortizable<br>Premium(1) |
| Balance at beginning of period(2)            | \$ (79,898)   | \$ (71,295)               | \$ 20,625                 |
| Accretion of discount                        |   | 17,174                    |                           |
| Amortization of premium                      |   |                           | (9,135)                   |
| Realized credit losses                       | 5,175   |                           |                           |
| Purchases                                    | (163,082)   | (117,396)                 | 92,667                    |
| Sales  | 46,848  | 73,345                    | (26,598)                  |
| Net impairment losses recognized in earnings | (11,959)  |                           |                           |
| Unlinking of Linked Transactions             | (13,889)  | (297)                     | 32,132                    |
| Transfers/release of credit reserve(3)       | 34,798  | (7,335)                   | (27,463)                  |
| Balance at end of period                     | \$ (182,007)  | \$ (105,804)              | \$ 82,228                 |

- 
- (1) Together with coupon interest, accretable purchase discount and amortizable premium is recognized as interest income over the life of the security.
- (2) The beginning of period balance for accretable discount does not agree to the end of period balance in the December 31, 2013 table since Non-Agency CMBS did not have a discount designated as credit reserve and OTTI for the year ended December 31, 2013; and therefore, the Non-Agency CMBS securities were not included in the table. Non-Agency CMBS is included in the table for December 31, 2014.
- (3) Subsequent reductions of a security's non-accretable discount results in a corresponding reduction in its amortizable premium.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 4 Mortgage-Backed Securities and other securities (Continued)**

|  | Year ended December 31, 2013                            |                           |                           |
|--|---|---------------------------|---------------------------|
|  | Discount Designated<br>as<br>Credit Reserve and<br>OTTI | Accretable<br>Discount(1) | Amortizable<br>Premium(1) |
| Balance at beginning of period               | \$ (12,659)   | \$ (5,523)                | \$ 12                     |
| Accretion of discount                        |   | 10,722                    |                           |
| Amortization of premium                      |   |                           | (2,001)                   |
| Realized credit losses                       | 541   |                           |                           |
| Purchases                                    | (133,242)   | (89,697)                  | 35,416                    |
| Sales  | 81,144  | 34,894                    | (20,709)                  |
| Net impairment losses recognized in earnings | (550)   |                           |                           |
| Unlinking of Linked Transactions             | (21,986)  | (6,922)                   | 3,438                     |
| Transfers/release of credit reserve(2)       | 6,854   | (11,323)                  | 4,469                     |
| Balance of end of period                     | \$ (79,898)   | \$ (67,849)               | \$ 20,625                 |

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(1) Together with coupon interest, accretable purchase discount and amortizable premium is recognized as interest income over the life of the security.

(2) Subsequent reductions of a security's non-accretable discount results in a corresponding reduction in its amortizable premium.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 4 Mortgage-Backed Securities and other securities (Continued)**

The following tables present the fair value and contractual maturities of the Company's investment securities at December 31, 2015 and December 31, 2014 (dollars in thousands):

|   | December 31, 2015            |   |   |                   | Total               |
|---|------------------------------|---|---|-------------------|---------------------|
|   | < or equal to<br>10<br>years | > 10 years and <<br>or<br>equal to 20 years | > 20 years and <<br>or<br>equal to 30 years | > 30 years        |                     |
| Agency RMBS:  |                              |   |   |                   |                     |
| 20-Year mortgage  | \$                           | \$ 687,272                                  | \$  | \$                | \$ 687,272          |
| 30-Year mortgage  |                              |   | 926,459                                     |                   | 926,459             |
| Agency RMBS Interest-Only Strips  |                              | 40,900                                      | 31,054                                      |                   | 71,954              |
| Agency and Non-Agency Interest-Only Strips,<br>accounted for as derivatives | 1,310                        | 10,081                                      | 35,219                                      | 13,377            | 59,987              |
| Non-Agency RMBS   | 15                           | 86,172                                      | 59,502                                      | 299,760           | 445,449             |
| Non-Agency RMBS Interest-Only Strips  |                              |   | 20,639                                      | 60,550            | 81,189              |
| Agency and Non-Agency CMBS  | 65,213                       | 27,849                                      | 167,355                                     | 215,188           | 475,605             |
| Agency CMBS Interest-Only Strips  | 2,113                        |   |   |                   | 2,113               |
| Other securities  | 29,102                       | 11,088                                      | 39,256                                      | 21,653            | 101,099             |
| <b>Total</b>  | <b>\$ 97,753</b>             | <b>\$ 863,362</b>                           | <b>\$ 1,279,484</b>                         | <b>\$ 610,528</b> | <b>\$ 2,851,127</b> |

|   | December 31, 2014            |   |   |                   | Total               |
|---|------------------------------|---|---|-------------------|---------------------|
|   | < or equal to<br>10<br>years | > 10 years and <<br>or<br>equal to 20 years | > 20 years and <<br>or<br>equal to 30 years | > 30 years        |                     |
| Agency RMBS:  |                              |   |   |                   |                     |
| 20-Year mortgage  | \$                           | \$ 1,120,031                                | \$  | \$                | \$ 1,120,031        |
| 30-Year mortgage  |                              |   | 1,790,219                                   |                   | 1,790,219           |
| Agency RMBS Interest-Only Strips  |                              | 52,975                                      | 135,531                                     |                   | 188,506             |
| Agency and Non-Agency Interest-Only Strips,<br>accounted for as derivatives |                              | 17,123                                      | 53,452                                      | 17,654            | 88,229              |
| Non-Agency RMBS   | 22                           | 26,632                                      | 193,852                                     | 376,411           | 596,917             |
| Non-Agency RMBS Interest-Only Strips  |                              |   | 30,217                                      | 39,438            | 69,655              |
| Agency and Non-Agency CMBS  | 43,286                       | 52,135                                      | 82,055                                      | 241,649           | 419,125             |
| Agency CMBS Interest-Only Strips  | 4,115                        |   |   |                   | 4,115               |
| Other securities  | 65,128                       |   | 36,395                                      | 7,403             | 108,926             |
| <b>Total</b>  | <b>\$ 112,551</b>            | <b>\$ 1,268,896</b>                         | <b>\$ 2,321,721</b>                         | <b>\$ 682,555</b> | <b>\$ 4,385,723</b> |

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 4 Mortgage-Backed Securities and other securities (Continued)**

The following tables present the gross unrealized losses and estimated fair value of the Company's MBS and other securities by length of time that such securities have been in a continuous unrealized loss position at December 31, 2015 and December 31, 2014 (dollars in thousands):

|                      | December 31, 2015   |                   |                      |                   |                   |                      |              |                   |                      |
|----------------------|---------------------|-------------------|----------------------|-------------------|-------------------|----------------------|--------------|-------------------|----------------------|
|                      | Less than 12 Months |                   |                      | 12 Months or More |                   |                      | Total        |                   |                      |
|                      | Fair Value          | Unrealized Losses | Number of Securities | Fair Value        | Unrealized Losses | Number of Securities | Fair Value   | Unrealized Losses | Number of Securities |
| Agency RMBS:         |                     |                   |                      |                   |                   |                      |              |                   |                      |
| 20-Year mortgage     | \$ 113,919          | \$ (1,229)        | 35                   | \$ 44,470         | \$ (590)          | 10                   | \$ 158,389   | \$ (1,819)        | 45                   |
| 30-Year mortgage     | 68,890              | (1,325)           | 17                   | 329,716           | (10,399)          | 55                   | 398,606      | (11,724)          | 72                   |
| Agency RMBS          |                     |                   |                      |                   |                   |                      |              |                   |                      |
| Interest-Only Strips | 39,091              | (2,177)           | 18                   |                   |                   |                      | 39,091       | (2,177)           | 18                   |
| Non-Agency RMBS      | 234,897             | (6,928)           | 36                   | 19,656            | (519)             | 5                    | 254,553      | (7,447)           | 41                   |
| Agency and           |                     |                   |                      |                   |                   |                      |              |                   |                      |
| Non-Agency CMBS      | 298,369             | (19,888)          | 55                   | 27,755            | (1,294)           | 7                    | 326,124      | (21,182)          | 62                   |
| Other securities     | 59,610              | (1,746)           | 5                    | 11,334            | (1,166)           | 1                    | 70,944       | (2,912)           | 6                    |
| Total                | \$ 814,776          | \$ (33,293)       | 166                  | \$ 432,931        | \$ (13,968)       | 78                   | \$ 1,247,707 | \$ (47,261)       | 244                  |

|                       | December 31, 2014   |                   |                      |                   |                   |                      |              |                   |                      |
|-----------------------|---------------------|-------------------|----------------------|-------------------|-------------------|----------------------|--------------|-------------------|----------------------|
|                       | Less than 12 Months |                   |                      | 12 Months or More |                   |                      | Total        |                   |                      |
|                       | Fair Value          | Unrealized Losses | Number of Securities | Fair Value        | Unrealized Losses | Number of Securities | Fair Value   | Unrealized Losses | Number of Securities |
| Agency RMBS:          |                     |                   |                      |                   |                   |                      |              |                   |                      |
| 20-Year mortgage      | \$ 1,475            | \$ (10)           | 1                    | \$ 422,287        | \$ (5,426)        | 54                   | \$ 423,762   | \$ (5,436)        | 55                   |
| 30-Year mortgage      | 2,893               | (93)              | 5                    | 882,482           | (18,358)          | 126                  | 885,375      | (18,451)          | 131                  |
| Agency RMBS           |                     |                   |                      |                   |                   |                      |              |                   |                      |
| Interest-Only Strips  | 20,756              | (587)             | 11                   |                   |                   |                      | 20,756       | (587)             | 11                   |
| Non-Agency RMBS       | 112,505             | (1,090)           | 20                   | 11,564            | (149)             | 2                    | 124,069      | (1,239)           | 22                   |
| Non-Agency RMBS       |                     |                   |                      |                   |                   |                      |              |                   |                      |
| Interest-Only Strips  | 5,081               | (411)             | 1                    |                   |                   |                      | 5,081        | (411)             | 1                    |
| Agency and Non-Agency |                     |                   |                      |                   |                   |                      |              |                   |                      |
| CMBS                  | 173,139             | (1,716)           | 34                   |                   |                   |                      | 173,139      | (1,716)           | 34                   |
| Other securities      | 62,345              | (3,257)           | 6                    |                   |                   |                      | 62,345       | (3,257)           | 6                    |
| Total                 | \$ 378,194          | \$ (7,164)        | 78                   | \$ 1,316,333      | \$ (23,933)       | 182                  | \$ 1,694,527 | \$ (31,097)       | 260                  |

At December 31, 2015, the Company did not intend to sell any of its MBS and other securities that were in an unrealized loss position, and it is "more likely than not" that the Company will not be required to sell these MBS and other securities before recovery of their amortized cost basis, which may be at their maturity.



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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 4 Mortgage-Backed Securities and other securities (Continued)**

The Company assesses its Agency MBS, Non-Agency MBS and other securities, excluding Interest-Only Strips, rated AA and higher at the time of purchase for other-than-temporary impairment on at least a quarterly basis. 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." In deciding on whether or not a security is other-than-temporarily impaired, the Company considers several factors, including the nature of the investment, communications (if any) from the securitization trustee regarding the credit quality of the security, the severity and duration of the impairment, the cause of the impairment, and the Company's intent not to sell the security and that it is more likely than not that the Company will not be required to sell the security until recovery of its amortized cost. In addition, an other-than-temporary impairment is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the security is less than its carrying amount. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a "market participant" would use and are discounted at a rate equal to the current yield used to accrete interest income. These adjustments are reflected in the Company's Consolidated Statement of Operations as Other loss on securities.

For Non-Agency MBS and other securities rated below AA at the time of purchase and Agency and Non-Agency Interest-Only Strips, excluding Interest-Only Strips classified as derivatives, an other-than-temporary impairment is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the beneficial interest is less than its carrying amount. Other than for "plain-vanilla" variable rate Non-Agency MBS, the Company does not bifurcate the loss between credit loss and loss attributed to change in interest rates, therefore, the entire loss is recorded as other-than-temporary. These adjustments are reflected in the Company's Consolidated Statement of Operations as Other loss on securities. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a "market participant" would use and are discounted at a rate equal to the current yield used to accrete interest income. If an other-than-temporary impairment is recognized as a result of this analysis, the yield is maintained at the current accretion rate. The last revised estimated cash flows are then used for future impairment analysis purposes. The Company's prepayment speed estimate was the primary assumption used to determine other-than-temporary-impairments for Interest-Only Strips, excluding Agency and Non-Agency Interest-Only Strips accounted for as derivatives, for the years ended December 31, 2015, December 31, 2014 and December 31, 2013.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 4 Mortgage-Backed Securities and other securities (Continued)**

With respect to the Company's security portfolio, OTTI is generally recorded when the credit quality of the underlying collateral deteriorates and or the schedule payments are faster than previously projected. The credit deterioration could be as a result of, but not limited to, increased projected realized losses, foreclosures, delinquencies and the likelihood of the borrower being able to make payments in the future. Generally, a prepayment occurs when a loan has a higher interest rate relative to current interest rates and lenders are willing to extend credit at the lower current interest rate of the underlying collateral for the loan is sold or transferred. Other-than-temporary-impairments are reported as Other loss on securities in the Company's Consolidated Statement of Operations.

The following table presents the other-than-temporary impairments the Company recorded on its securities portfolio (dollars in thousands):

|                  | For the year ended<br>December 31, 2015 | For the year ended<br>December 31, 2014 | For the year ended<br>December 31, 2013 |
|------------------|---|---|---|
| Agency RMBS      | \$ 4,005                                | \$ 4,703                                | \$ 11,300                               |
| Non-Agency RMBS  | 9,216                                   | 11,293                                  | 550                                     |
| Non-Agency CMBS  | 4,061                                   | 228                                     | 8                                       |
| Other securities | 2,509                                   | 790                                     |   |
| <b>Total</b>     | <b>\$ 19,791</b>                        | <b>\$ 17,014</b>                        | <b>\$ 11,858</b>                        |

The Company has made investments in certain Non-Agency RMBS inverse floaters. These securities' coupon rates have an inverse relationship to a benchmark rate. When the benchmark interest rate increases the coupon payment rate will decrease because the benchmark interest rate is deducted from the coupon payment. The Company has generally purchased these securities at a premium. Accelerated prepayments on these securities could result in an economic loss, as the Company would not recover the upfront premium. The premiums are amortized into income using the effective interest rate method. As of December 31, 2015 and December 31, 2014, the Company held \$79.1 million and \$93.9 million, respectively, in Non-Agency RMBS inverse floaters.



Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 4 Mortgage-Backed Securities and other securities (Continued)**

The following tables present components of interest income on the Company's MBS and other securities (dollars in thousands):

|                            | <b>For the year ended December 31, 2015</b> |   |                            |
|----------------------------|---|---|----------------------------|
|                            | <b>Coupon<br/>Interest</b>                  | <b>Net (Premium<br/>Amortization/<br/>Amortization<br/>Basis)<br/>Discount<br/>Amortization</b> | <b>Interest<br/>Income</b> |
| Agency RMBS                | \$ 119,789                                  | \$ (48,119)   | \$ 71,670                  |
| Non-Agency RMBS            | 44,473                                      | (8,008)   | 36,465                     |
| Agency and Non-Agency CMBS | 30,162                                      | 1,585   | 31,747                     |
| Other securities           | 6,363                                       | 2,648   | 9,011                      |
| <b>Total(1)</b>            | <b>\$ 200,787</b>                           | <b>\$ (51,894)</b>  | <b>\$ 148,893</b>          |

(1) Interest income on the Consolidated Statements of Operations includes coupon interest, net premium/discount amortization and interest income of approximately \$4.1 million, \$(1.1) million and \$3.0 million on Residential Whole-Loans, respectively, coupon interest, net premium amortization and interest income of \$424 thousand, \$0 and \$424 thousand on Commercial Whole-Loans, respectively, and coupon interest, net premium amortization and interest income of \$356 thousand, \$0 and \$356 thousand on a securitized commercial loan, respectively.

|                            | <b>For the year ended December 31, 2014</b> |   |                            |
|----------------------------|---|---|----------------------------|
|                            | <b>Coupon<br/>Interest</b>                  | <b>Net (Premium<br/>Amortization/<br/>Amortization<br/>Basis)<br/>Discount<br/>Amortization</b> | <b>Interest<br/>Income</b> |
| Agency RMBS                | \$ 152,967                                  | \$ (57,120)   | \$ 95,847                  |
| Non-Agency RMBS            | 36,370                                      | (3,313)   | 33,057                     |
| Agency and Non-Agency CMBS | 15,894                                      | (435)   | 15,459                     |
| Other securities           | 3,858                                       | 857   | 4,715                      |
| <b>Total(1)</b>            | <b>\$ 209,089</b>                           | <b>\$ (60,011)</b>  | <b>\$ 149,078</b>          |

(1) Interest income on the Consolidated Statements of Operations includes coupon interest, net premium amortization and interest income of \$57 thousand, \$(25) thousand and \$32 thousand on Residential Whole-Loans, respectively.

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For the year ended December 31, 2013

|                            | Net (Premium<br>Amortization/<br>Amortization<br>Basis) |                          |                    |
|----------------------------|---|--------------------------|--------------------|
|                            | Coupon<br>Interest                                      | Discount<br>Amortization | Interest<br>Income |
| Agency RMBS                | \$ 172,171  | \$ (60,320)              | \$ 111,851         |
| Non-Agency RMBS            | 4,170   | 8,130                    | 12,300             |
| Agency and Non-Agency CMBS | 544   | (106)                    | 438                |
| Other securities           | 587   | 152                      | 739                |
| Total                      | \$ 177,472  | \$ (52,144)              | \$ 125,328         |

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Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 4 Mortgage-Backed Securities and other securities (Continued)**

The following tables present the sales and realized gains (loss) of the Company's MBS and other securities (dollars in thousands):

|                            | For the year ended December 31, 2015 |                  |                    |                 |
|----------------------------|--------------------------------------|------------------|--------------------|-----------------|
|                            | Proceeds                             | Gross Gains      | Gross Losses       | Net Gain (Loss) |
| Agency RMBS(1)             | \$ 1,293,120                         | \$ 12,054        | \$ (12,449)        | \$ (395)        |
| Non-Agency RMBS            | 233,257                              | 11,066           | (174)              | 10,892          |
| Agency and Non-Agency CMBS | 161,985                              | 2,123            | (171)              | 1,952           |
| Other securities           | 851,714                              | 1,188            | (5,358)            | (4,170)         |
| <b>Total</b>               | <b>\$ 2,540,076</b>                  | <b>\$ 26,431</b> | <b>\$ (18,152)</b> | <b>\$ 8,279</b> |

- (1) Excludes proceeds for Agency Interest-Only Strips, accounted for as derivatives, of approximately \$7.3 million, gross realized gains of \$626 thousand and gross realized losses of \$31 thousand.

|                               | For the year ended December 31, 2014 |                  |                    |                   |
|-------------------------------|--------------------------------------|------------------|--------------------|-------------------|
|                               | Proceeds                             | Gross Gains      | Gross Losses       | Net Gain (Loss)   |
| Agency RMBS(1)                | \$ 1,574,301                         | \$ 11,134        | \$ (39,353)        | \$ (28,219)       |
| Non-Agency RMBS               | 414,130                              | 20,290           | (993)              | 19,297            |
| Agency and Non-Agency CMBS(2) | 168,535                              | 2,007            | (22)               | 1,985             |
| Other securities              | 180,385                              | 4,759            |                    | 4,759             |
| <b>Total</b>                  | <b>\$ 2,337,351</b>                  | <b>\$ 38,190</b> | <b>\$ (40,368)</b> | <b>\$ (2,178)</b> |

- (1) Excludes proceeds for Agency Interest-Only Strips, accounted for as derivatives, of approximately \$34.2 million, gross realized gains of \$439 thousand and gross realized losses of approximately \$1.6 million.
- (2) Excludes proceeds for Agency CMBS Interest-Only Strips, accounted for as derivatives, of approximately \$3.7 million, gross realized gains of \$389 thousand and gross realized losses of \$0.

|                  | For the year ended December 31, 2013 |             |              |                 |
|------------------|--------------------------------------|-------------|--------------|-----------------|
|                  | Proceeds                             | Gross Gains | Gross Losses | Net Gain (Loss) |
| Agency RMBS(1)   | \$ 3,471,370                         | \$ 8,646    | \$ (126,128) | \$ (117,482)    |
| Non-Agency RMBS  | 114,322                              | 5,883       | (376)        | 5,507           |
| Other securities | 14,361                               | 1,263       |              | 1,263           |

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Total                   \$   3,600,053   \$   15,792   \$   (126,504)   \$   (110,712)

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(1) Excludes proceeds for Agency Interest-Only Strips, accounted for as derivatives, of approximately \$20.4 million and gross realized losses of \$1.1 million.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 5 Variable Interest Entities**

*Residential Whole-Loan Trusts*

The consolidated financial statements also include the consolidation of certain trusts that each meet the definition of a VIE related to the acquisition of Residential Whole-Loans in which the Company has been determined itself to be the primary beneficiary of each such trust. The Company determined that it was the primary beneficiary of the two residential Whole-Loan trusts because it was involved in certain aspects of the design of each trust, has certain oversight rights on defaulted assets and has other significant decision making powers. In addition, the Company has the obligation to absorb losses and the right to receive benefits from the trusts that could potentially be significant to the trusts. Each trust has issued a trust certificate to the Company which is collateralized by pools of Residential Whole-Loans held by such trust. As of December 31, 2015, the Company financed the trust certificates with \$173.9 million of repurchase borrowings, which is a liability held outside the trusts. The Company classifies the underlying Residential Whole-Loans owned by the trusts in Residential Whole-Loans at fair value in the Consolidated Balance Sheets and has eliminated the intercompany trust certificates in consolidation.

*Commercial Loan Trust*

In November 2015, the Company acquired \$14.0 million interest in the trust certificate issued by CMSC Trust 2015 Longhouse MZ ("CMSC Trust"), which was financed with \$7.0 million of repurchase borrowings. The Company determined that CMSC Trust was a VIE and itself the primary beneficiary because it was involved in certain aspects of the design of the trust, has certain oversight rights on defaulted assets and has other significant decision making powers. In addition, the Company has the obligation to absorb losses and the right to receive benefits from the trust that could potentially be significant to the trust. The CMSC Trust holds a \$25.0 million mezzanine loan collateralized by interests in commercial real estate. The mezzanine loan serves as collateral for the \$25.0 million of trust certificates issued. As of December 31, 2015, the Company classified the mezzanine loan at fair value in Securitized commercial loan in the Consolidated Balance Sheets. The \$25.0 million of trust certificates, of which \$14.0 million was eliminated in consolidation and the remaining \$11.0 million held by an affiliate was carried at fair value and classified as Securitized debt in the Consolidated Balance Sheets.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)****(in thousands except share and per share data)****Note 5 Variable Interest Entities (Continued)**

The Company assesses modifications to VIEs on an ongoing basis to determine if a significant reconsideration event has occurred that would change the Company's initial consolidation assessment. The consolidated three trusts hold 524 performing Residential Whole-Loans and 1 performing commercial loan. The following table presents a summary of the assets and liabilities of the residential and commercial loan trusts included in the Consolidated Balance Sheets as of December 31, 2015 and December 31, 2014 (dollars in thousands).

|  | December 31, 2015 |         | December 31, 2014 |       |
|--|-------------------|---------|-------------------|-------|
| Residential Whole-Loans, at fair value     | \$                | 218,538 | \$                | 7,220 |
| Securitized commercial loan, at fair value |                   | 25,000  |                   |       |
| Accrued interest receivable                |                   | 1,836   |                   | 40    |
| Total assets                               | \$                | 245,374 | \$                | 7,260 |
| Securitized debt                           | \$                | 11,000  | \$                |       |
| Accrued interest payable                   |                   | 85      |                   |       |
| Accounts payable and accrued expenses      |                   | 2       |                   | 153   |
| Total liabilities                          | \$                | 11,087  | \$                | 153   |

The Company's risk with respect to its investment in each trust is limited to its direct ownership in the trust. The Residential Whole-Loans and securitized commercial loan held by the consolidated trusts are held solely to satisfy the liabilities of the trust, and creditors of the trust have no recourse to the general credit of the Company for the trust certificates issued by the trusts. The assets of a consolidated trust can only be used to satisfy the obligations of that trust. The Company is not contractually required and has not provided any additional financial support to the trusts for the years ended December 31, 2015 and December 31, 2014. The Company did not deconsolidate any trusts during the year ended December 31, 2015.

The following table presents the components of the carrying value of Residential Whole-Loans and securitized commercial loan as of December 31, 2015 and December 31, 2014 (dollars in thousands):

|                         | Residential Whole-Loans |                   | Securitized Commercial Loan |                   |
|-------------------------|-------------------------|-------------------|-----------------------------|-------------------|
|                         | December 31, 2015       | December 31, 2014 | December 31, 2015           | December 31, 2014 |
| Principal balance       | \$ 212,647              | \$ 7,034          | \$ 25,000                   | \$                |
| Unamortized premium     | 2,410                   | 111               |                             |                   |
| Unamortized discount    | (161)                   | (18)              |                             |                   |
| Gross unrealized gains  | 3,642                   | 94                |                             |                   |
| Gross unrealized losses |                         | (1)               |                             |                   |
| Fair value              | \$ 218,538              | \$ 7,220          | \$ 25,000                   | \$                |



Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 5 Variable Interest Entities (Continued)**

The Residential Whole-Loans are comprised of non-qualifying, mostly adjustable rate mortgages with low LTVs. The following tables present certain information about the Company's Residential Whole-Loans investment portfolio at December 31, 2015 and December 31, 2014 (dollars in thousands):

| Current Coupon Rate | Number of Loans | Principal Balance | Original LTV | Weighted Average       |                       |                              | Coupon Rate |
|---------------------|-----------------|-------------------|--------------|------------------------|-----------------------|------------------------------|-------------|
|                     |                 |                   |              | Original FICO Score(1) | Expected Life (years) | Contractual Maturity (years) |             |
| 3.01 - 4.00%        | 2               | \$ 698            | 35.7%        | 766                    | 1.9                   | 29.4                         | 3.9%        |
| 4.01 - 5.00%        | 211             | 79,696            | 56.6%        | 728                    | 1.4                   | 27.5                         | 4.5%        |
| 5.01 - 6.00%        | 302             | 128,204           | 55.1%        | 723                    | 1.6                   | 27.9                         | 5.1%        |
| 6.01 - 7.00%        | 9               | 4,049             | 71.0%        | 723                    | 1.4                   | 23.4                         | 6.4%        |
| <b>Total</b>        | <b>524</b>      | <b>\$ 212,647</b> | <b>55.9%</b> | <b>725</b>             | <b>1.5</b>            | <b>27.6</b>                  | <b>4.9%</b> |

(1)

The original FICO score is not available for 139 loans with a principal balance of approximately \$58.7 million at December 31, 2015. The Company has excluded those loans from the weighted average computation.

| Current Coupon Rate | Number of Loans | Principal Balance | Original LTV | Weighted Average    |                       |                              | Coupon Rate |
|---------------------|-----------------|-------------------|--------------|---------------------|-----------------------|------------------------------|-------------|
|                     |                 |                   |              | Original FICO Score | Expected Life (years) | Contractual Maturity (years) |             |
| 4.01 - 5.00%        | 5               | \$ 3,387          | 63.8%        | 744                 | 4.2                   | 29.8                         | 4.8%        |
| 5.01 - 6.00%        | 3               | 1,001             | 74.0%        | 742                 | 3.0                   | 29.8                         | 5.8%        |
| 6.01 - 7.00%        | 7               | 2,044             | 70.6%        | 713                 | 4.1                   | 29.8                         | 6.6%        |
| 7.01 - 8.00%        | 3               | 381               | 66.6%        | 669                 | 4.4                   | 29.8                         | 7.3%        |
| 8.01 - 9.00%        | 1               | 221               | 75.0%        | 665                 | 2.1                   | 29.7                         | 8.5%        |
| <b>Total</b>        | <b>19</b>       | <b>\$ 7,034</b>   | <b>67.7%</b> | <b>728</b>          | <b>3.9</b>            | <b>29.8</b>                  | <b>5.7%</b> |



Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 5 Variable Interest Entities (Continued)**

The following tables present the U.S. states in which the collateral securing the Company's Residential Whole-Loans at December 31, 2015 and December 31, 2014, based on principal balance, is located (dollars in thousands):

|               | <b>December 31, 2015</b>       |                              |
|---------------|--------------------------------|------------------------------|
|               | <b>State<br/>Concentration</b> | <b>Principal<br/>Balance</b> |
| California    | 83.1%                          | \$ 176,611                   |
| Washington    | 6.8                            | 14,442                       |
| Massachusetts | 5.6                            | 12,000                       |
| New York      | 2.5                            | 5,399                        |
| Georgia       | 0.9                            | 1,813                        |
| Other         | 1.1                            | 2,382                        |
| <b>Total</b>  | <b>100.0%</b>                  | <b>\$ 212,647</b>            |

|               | <b>State<br/>Concentration</b> | <b>Principal<br/>Balance</b> |
|---------------|--------------------------------|------------------------------|
| California    | 58.1%                          | \$ 4,085                     |
| Florida       | 23.8                           | 1,675                        |
| West Virginia | 9.2                            | 649                          |
| New Jersey    | 4.7                            | 327                          |
| Virginia      | 2.1                            | 149                          |
| Pennsylvania  | 2.1                            | 149                          |
| <b>Total</b>  | <b>100.0%</b>                  | <b>\$ 7,034</b>              |

As of December 31, 2015, the aggregate fair value of the securitized debt issued by the consolidated VIE was \$11.0 million which is classified as Securitized debt, at fair value on the Company's Consolidated Balance sheets. The cost of financing the securitized debt is approximately 8.9%.

*Unconsolidated VIEs*

As of December 31, 2015 and December 31, 2014, the Company had three investments in VIEs where it was not the primary beneficiary, and accordingly, the VIEs were not consolidated in the Company's consolidated financial statements. As of December 31, 2015 and December 31, 2014, the Company's maximum exposure to loss from these investments did not exceed the sum of the \$58.2 million and \$32.9 million carrying value of the investments, respectively, which are classified in Mortgage-backed securities and other securities, at fair value on the Company's Consolidated Balance sheets.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 6 Borrowings under Repurchase Agreements**

As of December 31, 2015, the Company had master repurchase agreements with 26 counterparties. As of December 31, 2015, the Company had borrowings under repurchase agreements with 21 counterparties. The following tables summarize certain characteristics of the Company's repurchase agreements at December 31, 2015 and December 31, 2014 (dollars in thousands):

| Securities Pledged                             | Repurchase Agreement Borrowings | December 31, 2015   |  |
|--|---------------------------------|---|--|
|  |                                 | Weighted Average Interest Rate on Borrowings Outstanding at end of period | Weighted Average Remaining Maturity (days) |
| Agency RMBS                                    | \$ 1,601,713                    | 0.66%   | 41   |
| Non-Agency RMBS                                | 380,177                         | 1.91%   | 44   |
| Agency and Non-Agency CMBS                     | 356,369                         | 1.84%   | 35   |
| Whole-Loans and securitized commercial loan(1) | 180,892                         | 2.38%   | 26   |
| Other securities                               | 66,650                          | 2.33%   | 60   |
| Total  | \$ 2,585,801                    | 1.17%   | 38   |

(1) Repurchase agreement borrowings on Whole-Loans and securitized commercial loan owned through trust certificates. The trust certificates are eliminated upon consolidation.

| Securities Pledged         | Repurchase Agreement Borrowings | December 31, 2014   |  |
|----------------------------|---------------------------------|---|--|
|                            |                                 | Weighted Average Interest Rate on Borrowings Outstanding at end of period | Weighted Average Remaining Maturity (days) |
| Agency RMBS                | \$ 2,994,351                    | 0.40%   | 32   |
| Non-Agency RMBS            | 473,942                         | 1.54%   | 49   |
| Agency and Non-Agency CMBS | 325,864                         | 1.55%   | 29   |
| Whole-Loans(1)             | 4,930                           | 1.91%   | 286  |
| Other securities           | 76,634                          | 1.53%   | 18   |
| Total                      | \$ 3,875,721                    | 0.66%   | 34   |

(1) Repurchase agreement borrowings on Residential Whole-Loans owned through trust certificates. The trust certificates are eliminated upon consolidation.



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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 6 Borrowings under Repurchase Agreements (Continued)**

For the years ended December 31, 2015 and December 31, 2014, the Company had average borrowings under its repurchase agreements of approximately \$3.4 billion and \$3.7 billion, respectively, had a maximum month-end balance during the period of approximately \$4.0 billion and \$4.2 billion, respectively. The Company had accrued interest payable at December 31, 2015 and December 31, 2014 of approximately \$3.0 million and \$3.4 million, respectively. In addition, at December 31, 2015, the Company had entered into repurchase agreement borrowings of approximately \$2.3 million, which settled on January 4, 2016, with a weighted average interest rate of 2.01%, a weighted average contractual maturity of 91 days and secured by collateral of approximately \$3.2 million. These borrowings are recorded as a liability in the Company's Consolidated Balance Sheets when settled.

The repurchase agreements bear interest at a contractually agreed-upon rate and typically have terms ranging from one month to three months. The Company's repurchase agreement borrowings are accounted for as secured borrowings when the Company maintains effective control of the financed assets. Under the repurchase agreements, the respective counterparties retain the right to determine the fair value of the underlying collateral. A reduction in the value of pledged assets requires the Company to post additional securities as collateral, pay down borrowings or establish cash margin accounts with the counterparties in order to re-establish the agreed-upon collateral requirements, and is referred to as a margin call. The inability of the Company to post adequate collateral for a margin call by a counterparty, in a timeframe as short as the close of the same business day, could result in a condition of default under the Company's repurchase agreements, thereby enabling the counterparty to liquidate the collateral pledged by the Company, which may have a material adverse effect on the Company's financial position, results of operations and cash flows. During 2015 and 2014, the Company also rehypothecated pledged U.S. Treasury securities it received from its repurchase agreement and interest rate swap counterparties as incremental collateral in order to increase the Company's cash position. The maximum amount of repurchase borrowings for the rehypothecated U.S. Treasury securities was \$530 thousand and \$3.3 million during the years ended December 31, 2015 and December 31, 2014, respectively. At December 31, 2015 and December 31, 2014, the Company did not have any rehypothecated U.S. Treasury securities.

Volatility in the mortgage markets may create additional stress on the overall liquidity of the Company due to the long-term nature of its assets and the short-term nature of its liabilities. In an instance of severe volatility, or where the additional stress on liquidity resulting from volatility is sustained over an extended period of time, the Company could be required to sell assets, possibly even at a loss, to generate sufficient liquidity to satisfy collateral and margin requirements which could have a material adverse effect on the Company's financial position, results of operations and cash flows. All of the Company's repurchase agreement counterparties are either U.S. financial institutions or the U.S. broker-dealer subsidiaries of foreign financial institutions.

Further, if the Company is unable to renew, replace or expand repurchase financing with other sources of financing on substantially similar terms it may have a material adverse effect on the Company's financial position, results of operations and cash flow, due to the long term nature of the Company's investments and relatively short-term maturities of the Company's repurchase agreements. Certain of the repurchase agreements provide the counterparty with the right to terminate the agreement if the Company does not maintain certain equity and leverage metrics, the most restrictive of which include a limit on leverage based on the composition of the Company's portfolio. The Company was in compliance with the terms of such financial tests as of December 31, 2015.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 6 Borrowings under Repurchase Agreements (Continued)**

At December 31, 2015 and December 31, 2014, repurchase agreements collateralized by investments had the following remaining maturities:

| (dollars in thousands)            | December 31, 2015   | December 31, 2014   |
|-----------------------------------|---------------------|---------------------|
| Overnight                         | \$                  | \$                  |
| 1 to 29 days                      | 1,335,119           | 2,034,282           |
| 30 to 59 days                     | 362,940             | 1,302,439           |
| 60 to 89 days                     | 847,781             | 484,109             |
| 90 to 119 days                    |                     | 40,127              |
| Greater than or equal to 120 days | 39,961              | 14,764              |
| <b>Total</b>                      | <b>\$ 2,585,801</b> | <b>\$ 3,875,721</b> |

As discussed in Note 2, for any transactions determined to be linked through December 31, 2014, the initial transfer and repurchase financing will be recorded as a forward commitment to purchase assets. Linked repurchase agreements are not included in the tables above. See Note 8 for details.

At December 31, 2015, the following table reflects amounts of collateral at risk under its repurchase agreements greater than 10% of the Company's equity with any counterparty (dollars in thousands):

| Counterparty                            | December 31, 2015                                 |  |  |
|---|---|--|--|
|   | Amount of Collateral<br>at Risk, at fair<br>value | Weighted Average<br>Remaining<br>Maturity (days) | Percentage of<br>Stockholders'<br>Equity |
| Credit Suisse Securities (USA) LLC      | \$ 121,184  | 31   | 23.7%                                    |
| RBC (Barbados) Trading Bank Corporation | 108,015   | 47   | 21.1                                     |
| UBS Securities LLC                      | 53,525  | 31   | 10.5                                     |

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)****(in thousands except share and per share data)****Note 7 Collateral Positions**

The following tables summarize the Company's collateral positions, with respect to its borrowings under repurchase agreements, securitized debt, derivatives and clearing margin account at December 31, 2015 and December 31, 2014 (dollars in thousands):

|   | <b>December 31, 2015</b>                 |                             |  |
|---|--|-----------------------------|--|
|   | <b>Assets<br/>Pledged-Fair<br/>Value</b> | <b>Accrued<br/>Interest</b> | <b>Fair Value of<br/>Assets Pledged<br/>and Accrued<br/>Interest</b> |
| <b>Assets pledged for borrowings under repurchase agreements:</b> |  |                             |  |
| Agency RMBS   | \$ 1,658,865                             | \$ 7,366                    | \$ 1,666,231   |
| Non-Agency RMBS   | 530,110                                  | 1,053                       | 531,163  |
| Agency and Non-Agency CMBS  | 487,643                                  | 3,291                       | 490,934  |
| Whole-Loans and securitized commercial loan(1)                    | 232,538                                  | 1,750                       | 234,288  |
| Other securities  | 101,099                                  | 270                         | 101,369  |
| Cash(2)   | 38,300                                   |                             | 38,300   |
| Securitized commercial loan pledged for securitized debt          | 11,000                                   | 85                          | 11,085   |
| Cash collateral for derivatives(2):                               | 211,263                                  |                             | 211,263  |
| <b>Total</b>  | <b>\$ 3,270,818</b>                      | <b>\$ 13,815</b>            | <b>\$ 3,284,633</b>  |

(1) Whole-Loans and securitized commercial loan owned through trust certificates are pledged as collateral. The trust certificates are eliminated upon consolidation.

(2) Cash posted as collateral is included in Due from counterparties on the Company's Consolidated Balance Sheets.

|   | <b>December 31, 2014</b>                 |                             |  |
|---|--|-----------------------------|--|
|   | <b>Assets<br/>Pledged-Fair<br/>Value</b> | <b>Accrued<br/>Interest</b> | <b>Fair Value of<br/>Assets Pledged<br/>and Accrued<br/>Interest</b> |
| <b>Assets pledged for borrowings under repurchase agreements:</b> |  |                             |  |
| Agency RMBS   | \$ 3,158,544                             | \$ 12,685                   | \$ 3,171,229   |
| Non-Agency RMBS   | 670,526                                  | 1,511                       | 672,037  |
| Agency and Non-Agency CMBS  | 431,938                                  | 2,077                       | 434,015  |
| Whole-Loans(1)  | 7,220                                    | 40                          | 7,260  |
| Other securities  | 101,523                                  | 104                         | 101,627  |
| Cash(2)   | 25,727                                   |                             | 25,727   |
| Cash collateral for derivatives(2):                               | 159,030                                  |                             | 159,030  |
| <b>Total</b>  | <b>\$ 4,554,508</b>                      | <b>\$ 16,417</b>            | <b>\$ 4,570,925</b>  |

- (1) Residential Whole-Loans owned through trust certificates are pledged as collateral. The trust certificates are eliminated upon consolidation.
- (2) Cash posted as collateral is included in Due from counterparties on the Company's Consolidated Balance Sheets.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 7 Collateral Positions (Continued)**

A reduction in the value of pledged assets typically results in the repurchase agreement counterparties, derivative counterparties and clearing margin counterparty initiating a daily margin call. At December 31, 2015 and December 31, 2014, investments held by counterparties as security for repurchase agreements totaled approximately \$3.0 billion and approximately \$4.4 billion, respectively. Cash collateral held by counterparties at December 31, 2015 and December 31, 2014 was approximately \$249.6 million and \$184.8 million, respectively. Cash posted by counterparties at December 31, 2015 and December 31, 2014, was approximately \$10.0 million and \$12.2 million, respectively. In addition, at December 31, 2015 and December 31, 2014, the Company held securities with a fair value of \$0 and \$530 thousand, respectively, received as collateral from its repurchase agreement counterparties to satisfy margin requirements. The Company has the ability to repledge collateral received from its repurchase counterparties.

**Note 8 Derivative Instruments**

The Company's derivatives currently include interest rate swaps, interest rate swaptions, futures contracts, TBAs, currency swaps and forwards, linked transactions (prior to January 1, 2015), Agency and Non-Agency Interest-Only Strips that are classified as derivatives, and options.

***Interest rate swaps and interest rate swaptions***

The Company is exposed to certain risks arising from both its business operations and economic conditions. Specifically, the Company's primary source of debt funding is repurchase agreements and the Company enters into derivative financial instruments to manage exposure to variable cash flows on portions of its borrowings under those repurchase agreements. Since the interest rates on repurchase agreements typically change with market interest rates such as LIBOR, the Company is exposed to constantly changing interest rates, which accordingly affects cash flows associated with these rates on its borrowings. To mitigate the effect of changes in these interest rates, the Company enters into interest rate swap agreements, which help to mitigate the volatility in the interest rate exposures and their related cash flows. Interest rate swaps generally involve the receipt of variable-rate amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the interest rate swap without exchange of the underlying notional amount. Notwithstanding the foregoing, in order to manage its hedge position with regard to its liabilities, the Company on occasion will enter into interest rate swaps which involve the receipt of fixed-rate amounts from a counterparty in exchange for the Company making variable-rate payments over the life of the interest rate swap without exchange of the underlying notional amount. The Company also enters into forward starting swaps and interest rate swaptions to help mitigate the effects of changes in interest rates on a portion of its borrowings under repurchase agreements. Interest rate swaptions provide the Company the option to enter into an interest rate swap agreement for a predetermined notional amount, stated term and pay and receive interest rates in the future. On occasion the Company may enter into a MAC interest rate swap in which it may receive or make a payment at the time of entering such interest rate swap to compensate for the out of the market nature of such interest rate swap. Similar to all other interest rate swaps, these interest rate swaps are also subject to margin requirements as previously described.



Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 8 Derivative Instruments (Continued)**

While the Company has not elected to account for its interest rate swap derivative instruments as "hedges" under GAAP, it does not use interest rate swaps and swaptions for speculative purposes, but rather uses such instruments to manage interest rate risk and views them as economic hedges. Changes in the fair value of derivatives not designated in hedging relationships are recorded directly in earnings together with periodic net interest settlement amounts.

The Company's interest rate swaps, interest rate swaptions, currency swaps and forwards, futures contracts, TBA derivative instruments, options and linked transactions consisted of the following at December 31, 2015 and December 31, 2014 (dollars in thousands):

| Derivative Instrument                         | Accounting Designation | Consolidated Balance Sheets Location | Notional Amount | December 31, 2015                      |                                       |
|---|------------------------|--------------------------------------|-----------------|--|---------------------------------------|
|   |                        |                                      |                 | Fair Value, excluding accrued interest | Accrued Interest Payable (receivable) |
| Interest rate swaps, assets                   | Non-Hedge              | Derivative assets, at fair value     | \$ 2,808,700    | \$ 9,635                               | \$ 1,287                              |
| Interest rate swaptions, assets               | Non-Hedge              | Derivative assets, at fair value     | 1,105,000       | 1,479                                  |                                       |
| Futures contract, asset                       | Non-Hedge              | Derivative assets, at fair value     | 201,600         | 63                                     |                                       |
| Foreign currency swaps, asset                 | Non-Hedge              | Derivative assets, at fair value     | 25,160          | 7,168                                  | (398)                                 |
| Foreign currency forward contracts, asset     | Non-Hedge              | Derivative assets, at fair value     | 5,825           | 302                                    |                                       |
| TBA securities, assets                        | Non-Hedge              | Derivative assets, at fair value     | 1,650,000       | 3,268                                  |                                       |
| Total derivative instruments, assets          |                        |                                      |                 | 21,915                                 | 889                                   |
| Interest rate swaps, liability                | Non-Hedge              | Derivative liability, at fair value  | 5,631,800       | (178,305)                              | 7,875                                 |
| Futures contract, liability                   | Non-Hedge              | Derivative liability, at fair value  | 279,200         | (698)                                  |                                       |
| Foreign currency forward contracts, liability | Non-Hedge              | Derivative liability, at fair value  | 7,671           | (281)                                  |                                       |
| TBA securities, liabilities                   | Non-Hedge              | Derivative liability, at fair value  | 825,000         | (893)                                  |                                       |
| Total derivative instruments, liabilities     |                        |                                      |                 | (180,177)                              | 7,875                                 |
| Total derivative instruments                  |                        |                                      |                 | \$ (158,262)                           | \$ 8,764                              |

| Derivative Instrument | Accounting Designation | Consolidated Balance Sheets Location | Notional Amount | December 31, 2014                      |                                       |
|-----------------------|------------------------|--------------------------------------|-----------------|--|---------------------------------------|
|                       |                        |                                      |                 | Fair Value, excluding accrued interest | Accrued Interest Payable (receivable) |

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|   |           |   |              |             |            |
|---|-----------|---|--------------|-------------|------------|
| Interest rate swaps, assets                   | Non-Hedge | Derivative assets, at fair value        | \$ 3,283,100 | \$ 51,170   | \$ (6,718) |
| Interest rate swaptions, assets               | Non-Hedge | Derivative assets, at fair value        | 105,000      | 178         |            |
| Futures contracts, assets                     | Non-Hedge | Derivative assets, at fair value        | 592,000      | 451         |            |
| Foreign currency swaps, asset                 | Non-Hedge | Derivative assets, at fair value        | 25,160       | 3,857       |            |
| Foreign currency forward contracts, asset     | Non-Hedge | Derivative assets, at fair value        | 23,822       | 143         |            |
| TBA securities, assets                        | Non-Hedge | Derivative assets, at fair value        | 2,915,000    | 17,457      |            |
| Total derivative instruments, assets          |           |   |              | 73,256      | (6,718)    |
| Interest rate swaps, liability                | Non-Hedge | Derivative liability, at fair value     | 4,648,870    | (166,288)   | 11,490     |
| Futures contract, liability                   | Non-Hedge | Derivative liability, at fair value     | 592,000      | (1,191)     |            |
| Foreign currency forward contracts, liability | Non-Hedge | Derivative liability, at fair value     | 33,560       | (446)       |            |
| TBA securities, liabilities                   | Non-Hedge | Derivative liability, at fair value     | 2,590,000    | (12,355)    |            |
| Total derivative instruments, liabilities     |           |   |              | (180,280)   | 11,490     |
| Linked transactions(1)                        | Non-Hedge | Linked transactions, net, at fair value | 54,117       | 20,627      | (400)      |
| Total derivative instruments                  |           |   |              | \$ (86,397) | \$ 4,372   |

(1)

Notional amount represents the current face of the securities comprising the linked transactions.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 8 Derivative Instruments (Continued)**

The following tables summarize the average fixed pay rate and average maturity for the Company's interest rate swaps as of December 31, 2015 and December 31, 2014 (excludes interest rate swaptions) (dollars in thousands):

| Remaining Interest Rate Swap Term          | December 31, 2015   |                                   |       |                        |                          |                  |
|--|---------------------|-----------------------------------|-------|------------------------|--------------------------|------------------|
|  | Notional Amount     | Fair Value Asset (Liability), net | Asset | Average Fixed Pay Rate | Average Maturity (Years) | Forward Starting |
| 1 year or less                             | \$ 1,286,000        | \$ 163                            |       | 0.6%                   | 0.6                      | %                |
| Greater than 1 year and less than 3 years  | 1,131,800           | (1,450)                           |       | 1.1                    | 1.4                      |                  |
| Greater than 3 years and less than 5 years | 1,345,200           | (22,705)                          |       | 2.1                    | 4.6                      |                  |
| Greater than 5 years                       | 2,404,600           | (131,744)                         |       | 2.8                    | 10.2                     | 29.5             |
| <b>Total</b>                               | <b>\$ 6,167,600</b> | <b>\$ (155,736)</b>               |       | <b>1.9%</b>            | <b>5.4</b>               | <b>11.5%</b>     |

| Remaining Interest Rate Swap Term          | December 31, 2014   |                                   |       |                        |                          |                  |
|--|---------------------|-----------------------------------|-------|------------------------|--------------------------|------------------|
|  | Notional Amount     | Fair Value Asset (Liability), net | Asset | Average Fixed Pay Rate | Average Maturity (Years) | Forward Starting |
| 1 year or less                             | \$ 89,300           | \$ (111)                          |       | 0.5%                   | 0.9                      | %                |
| Greater than 1 year and less than 3 years  | 1,972,300           | (733)                             |       | 0.8                    | 1.8                      | 20.3             |
| Greater than 3 years and less than 5 years | 603,000             | (4,597)                           |       | 1.8                    | 4.2                      |                  |
| Greater than 5 years                       | 3,103,770           | (156,952)                         |       | 2.8                    | 9.4                      | 63.1             |
| <b>Total</b>                               | <b>\$ 5,768,370</b> | <b>\$ (162,393)</b>               |       | <b>2.0%</b>            | <b>6.2</b>               | <b>40.9%</b>     |

The Company has entered into swaps to effectively fix the interest rate (for the life of the swap); net of variable-rate payment swaps, of approximately \$3.2 billion of borrowings under its repurchase agreements, excluding forward starting swaps of \$710.0 million.

The following tables summarize the average variable pay-rate and average maturity for the Company's interest rate swaps as of December 31, 2015 and December 31, 2014 (excludes interest rate swaptions) (dollars in thousands):

| Remaining Interest Rate interest rate swap Term | December 31, 2015   |                                   |       |                           |                          |                  |
|---|---------------------|-----------------------------------|-------|---------------------------|--------------------------|------------------|
|   | Notional Amount     | Fair Value Asset (Liability), net | Asset | Average Variable Pay Rate | Average Maturity (Years) | Forward Starting |
| Greater than 3 years and less than 5 years      | \$ 1,170,700        | \$ (8,902)                        |       | 0.4%                      | 4.5                      | %                |
| Greater than 5 years                            | 1,102,200           | (4,032)                           |       | 0.4                       | 12.3                     |                  |
| <b>Total</b>                                    | <b>\$ 2,272,900</b> | <b>\$ (12,934)</b>                |       | <b>0.4%</b>               | <b>8.2</b>               | <b>%</b>         |



Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 8 Derivative Instruments (Continued)**

| Remaining Interest Rate<br>interest rate swap Term | December 31, 2014  |   |                                 |                                |                     |   |
|--|--------------------|---|---------------------------------|--------------------------------|---------------------|---|
|  | Notional<br>Amount | Fair<br>Value Asset<br>(Liability), net | Average<br>Variable Pay<br>Rate | Average<br>Maturity<br>(Years) | Forward<br>Starting | % |
| Greater than 1 years and less than 3 years         | \$ 220,000         | \$ (164)                                | 0.2%                            | 2.0                            |                     |   |
| Greater than 3 years and less than 5 years         | 634,000            | 2,210                                   | 0.2                             | 4.5                            |                     |   |
| Greater than 5 years                               | 1,309,600          | 45,229                                  | 0.2                             | 12.1                           | 8.4                 |   |
| Total  | \$ 2,163,600       | \$ 47,275                               | 0.2%                            | 8.8                            | 5.1%                |   |

The Company's agreements with certain of its bilateral interest rate swap counterparties may be terminated at the option of the counterparty, and settled at fair value, if the Company does not maintain certain equity and leverage metrics. The most restrictive of which contain provisions which become more restrictive based upon portfolio composition. Through December 31, 2015, the Company was in compliance with the terms of such financial tests.

The following tables present information about the Company's interest rate swaptions as of December 31, 2015 and December 31, 2014 (dollars in thousands):

| December 31, 2015                  |            |   |                    |  |  |
|------------------------------------|------------|---|--------------------|--|--|
| Fixed-Pay Rate for Underlying Swap | Fair Value | Option  | Underlying Swap    |  |  |
|                                    |            | Weighted<br>Average<br>Months Until<br>Option<br>Expiration | Notional<br>Amount | Weighted<br>Average Swap<br>Term (Years) |  |
| 1.76 - 2.00%                       | \$ 890     | 2.1   | \$ 400,000         | 5.0                                      |  |
| 2.01 - 2.25%                       | 129        | 2.1   | 100,000            | 5.0                                      |  |
| 2.26 - 2.50%                       | 1          | 5.8   | 105,000            | 1.0                                      |  |
|                                    | \$ 1,020   | 2.7   | \$ 605,000         | 4.3                                      |  |

| December 31, 2015                     |            |   |                    |  |  |
|---------------------------------------|------------|---|--------------------|--|--|
| Variable-Pay Rate for Underlying Swap | Fair Value | Option  | Underlying Swap    |  |  |
|                                       |            | Weighted<br>Average<br>Months Until<br>Option<br>Expiration | Notional<br>Amount | Weighted<br>Average Swap<br>Term (Years) |  |
| 1.26 - 1.50%                          | \$ 459     | 2.1   | \$ 500,000         | 5.0                                      |  |

\$ 459 2.1 \$ 500,000 5.0

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 8 Derivative Instruments (Continued)**

| December 31, 2014                  |            |   |                    |  |  |
|------------------------------------|------------|---|--------------------|--|--|
|                                    | Fair Value | Option  | Underlying Swap    |  |  |
|                                    |            | Weighted<br>Average<br>Months Until<br>Option<br>Expiration | Notional<br>Amount | Weighted<br>Average Swap<br>Term (Years) |  |
| Fixed-Pay Rate for Underlying Swap |            |   |                    |  |  |
| 2.26 - 2.50%                       | \$ 178     | 17.8  | \$ 105,000         | 1.0                                      |  |
|                                    | \$ 178     | 17.8  | \$ 105,000         | 1.0                                      |  |

The Company has minimum collateral posting thresholds with certain of its derivative counterparties, including with its clearing broker for cleared swaps, for which it typically pledges cash. The fixed income markets experienced continued market volatility during the three month-ended December 31, 2015 primarily as a result of global economic concerns and the corresponding timing of if and when the Federal Reserve will increase short term interest rates. Overall long term interest rates decreased during the three months-ended December 31, 2015. During 2015 and 2014, the Company rehypothecated some of the U.S. Treasury securities it received as incremental collateral on its repurchase borrowings, swaps and swaptions, effectively entering into repurchase agreements with such securities, in order to increase its cash position. The maximum amount of repurchase borrowings for the rehypothecated U.S. Treasury securities was \$530 thousand and \$3.3 million during the years ended December 31, 2015 and December 31, 2014, respectively. At December 31, 2015, no U.S. Treasury securities were rehypothecated. As of December 31, 2015 and December 31, 2014, the Company had cash pledged as collateral for derivatives of approximately \$211.3 million and approximately \$159.0 million, respectively, which is reported on the Consolidated Balance Sheets as Due from counterparties. The Company held cash of approximately \$9.4 million and approximately \$10.1 million as collateral against derivatives at December 31, 2015 and December 31, 2014, respectively, which is reported on the Consolidated Balance Sheets as Due to counterparties. As of December 31, 2015, the Company has swaps with two counterparties that are based in England and Switzerland, with fair values in an asset position of approximately \$7.6 million and with fair values in a liability position of approximately \$183 thousand and notional balances of \$25.2 million and \$123.9 million, respectively. As of December 31, 2014, the Company has swaps with two counterparties that are based in England and Switzerland, with fair values in a liability position of approximately \$86 thousand and fair values in an asset position of \$645 thousand and notional balances of \$49.3 million and \$163.9 million, respectively. Included in the \$211.3 million and \$159.0 million pledged by the Company is cash pledged to the counterparty based in Switzerland of \$1.4 million and \$500 thousand at December 31, 2015 and December 31, 2014, respectively. Included in the \$9.4 million and \$10.1 million received by the Company is cash posted as collateral by the counterparty based in England of approximately \$7.4 million and \$3.4 million at December 31, 2015 December 31, 2014, respectively.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 8 Derivative Instruments (Continued)*****Currency Swaps and Forwards***

The Company has invested in and, in the future, may invest in additional securities which are denominated in a currency or currencies other than U.S. dollars. Similarly, it has and may in the future, finance such assets in a currency or currencies other than U.S. dollars. In order to mitigate the impact to the Company, the Company may enter into derivative financial instruments, including foreign currency swaps and foreign currency forwards, to manage fluctuations in the valuation between U.S. dollars and such foreign currencies. Foreign currency swaps involve the payment of a foreign currency at fixed interest rate on a fixed notional amount and the receipt of U.S. dollars at a fixed interest rate on a fixed notional amount. Foreign currency forwards provide for the payment of a fixed amount of a foreign currency in exchange for a fixed amount of U.S. dollars at a date certain in the future. The carrying value of foreign currency swaps and forwards is included in Derivative assets (liabilities), at fair value on the Consolidated Balance Sheets with changes in valuation included in Gain (loss) on derivative instruments, net on the Consolidated Statement of Operations. The following is a summary of the Company's foreign currency forwards at December 31, 2015 and December 31, 2014 (dollars and euros in thousands):

| Derivative Type                   | Notional Amount | December 31, 2015         |  | Maturity     | Fair Value |
|-----------------------------------|-----------------|---------------------------|--|--------------|------------|
|                                   |                 | Notional (USD Equivalent) |  |              |            |
| Buy USD/Sell EUR currency forward | € 5,083         | \$ 5,825                  |  | January 2016 | \$ 302     |
| Currency forwards, assets         | € 5,083         | \$ 5,825                  |  | n/a          | \$ 302     |
| Buy EUR/Sell USD currency forward | € 6,800         | \$ 7,671                  |  | January 2016 | \$ (281)   |
| Currency forwards, liabilities    | € 6,800         | \$ 7,671                  |  | n/a          | \$ (281)   |
| Total currency forwards           | € 11,883        | \$ 13,496                 |  | n/a          | \$ 21      |

| Derivative Type                   | Notional Amount | December 31, 2014         |  | Maturity      | Fair Value |
|-----------------------------------|-----------------|---------------------------|--|---------------|------------|
|                                   |                 | Notional (USD Equivalent) |  |               |            |
| Buy USD/Sell EUR currency forward | € 3,331         | \$ 4,143                  |  | January 2015  | \$ 112     |
| Buy USD/Sell EUR currency forward | 7,766           | 9,417                     |  | January 2015  | 21         |
| Buy USD/Sell EUR currency forward | 3,471           | 4,211                     |  | February 2015 | 9          |
| Buy EUR/Sell USD currency forward | 5,000           | 6,051                     |  | January 2015  | 1          |
| Currency forwards, assets         | € 19,568        | \$ 23,822                 |  | n/a           | \$ 143     |



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|                                   |   |        |    |        |               |    |       |
|-----------------------------------|---|--------|----|--------|---------------|----|-------|
| Buy USD/Sell EUR currency forward | € | 5,043  | \$ | 6,104  | February 2015 | \$ | (1)   |
| Buy EUR/Sell USD currency forward |   | 11,156 |    | 13,542 | April 2015    |    | (30)  |
| Buy EUR/Sell USD currency forward |   | 11,156 |    | 13,914 | January 2015  |    | (415) |
| Currency forwards, liabilities    | € | 27,355 | \$ | 33,560 | n/a           | \$ | (446) |
| Total currency forwards           | € | 46,923 | \$ | 57,382 | n/a           | \$ | (303) |

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 8 Derivative Instruments (Continued)**

The following is a summary of the Company's foreign currency swaps with a fair value of \$7.2 million and \$3.9 million at December 31, 2015 and December 31, 2014, respectively (dollars and euros in thousands):

|          | Date entered | Maturity  | Fixed Rate | Denomination | Notional Amount |
|----------|--------------|-----------|------------|--------------|-----------------|
| Payer    | June 2014    | July 2024 | 7.25%      | EUR          | 18,500          |
| Receiver | June 2014    | July 2024 | 9.005%     | USD          | 25,160          |

***Interest-Only Strips***

The Company also invests in Interest-Only Strips. In determining the classification of its holdings of Interest-Only Strips, the Company evaluates the securities to determine if the nature of the cash flows has been altered from that of the underlying mortgage collateral. Generally, Interest-Only Strips for which the security represents a strip off of a mortgage pass through security will be considered a hybrid instrument classified as a MBS investment on the Consolidated Balance Sheets utilizing the fair value option. Alternatively, those Interest-Only Strips, for which the underlying mortgage collateral has been included into a structured security that alters the cash flows from the underlying mortgage collateral, are accounted for as derivatives at fair value with changes recognized in Gain (loss) on derivative instruments, net in the Consolidated Statements of Operations, along with any interest received. The carrying value of these Interest-Only Strips is included in Mortgage-backed securities and other securities, at fair value on the Consolidated Balance Sheets.

***To-be-announced securities***

The Company has also purchased or sold TBAs. As of December 31, 2015 and December 31, 2014, the Company had contracts to purchase ("long position") and sell ("short position") TBAs on a forward basis. Following is a summary of the Company's long and short TBA positions reported in Derivative assets, at fair value on the Consolidated Balance Sheets as of December 31, 2015 and December 31, 2014 (dollars in thousands):

|                               | December 31, 2015 |            | December 31, 2014 |            |
|-------------------------------|-------------------|------------|-------------------|------------|
|                               | Notional Amount   | Fair Value | Notional Amount   | Fair Value |
| Purchase contracts, asset     | \$ 1,650,000      | \$ 3,268   | \$ 2,915,000      | \$ 17,457  |
| TBA securities, asset         | 1,650,000         | 3,268      | 2,915,000         | 17,457     |
| Purchase contracts, liability |                   |            |                   |            |
| Sale contracts, liability     | (825,000)         | (893)      | (2,590,000)       | (12,355)   |
| TBA securities, liability     | (825,000)         | (893)      | (2,590,000)       | (12,355)   |
| TBA securities, net           | \$ 825,000        | \$ 2,375   | \$ 325,000        | \$ 5,102   |

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 8 Derivative Instruments (Continued)**

The following table presents additional information about the Company's contracts to purchase and sell TBAs for the year ended December 31, 2015 (dollars in thousands):

|                  | Notional Amount<br>as of<br>December 31,<br>2014 |           | Additions     | Settlement,<br>Termination,<br>Expiration<br>or Exercise | Notional<br>Amount as of<br>December 31,<br>2015 |
|------------------|--|-----------|---------------|--|--|
| Purchase of TBAs | \$   | 2,915,000 | \$ 31,576,000 | \$ (32,841,000)  | \$ 1,650,000                                     |
| Sale of TBAs     | \$   | 2,590,000 | \$ 31,076,000 | \$ (32,841,000)  | \$ 825,000                                       |

***Futures Contracts***

The Company also enters into Eurodollar, Volatility Index and U.S. Treasury futures. As of December 31, 2015, the Company had entered into contracts to buy ("long position") U.S. Treasuries with a notional amount of \$480.8 million, a fair value in a liability position of \$635 thousand and an expiration date of March 31, 2016. As of December 31, 2014, the Company had purchase contracts ("long position") for Eurodollar futures, representing a notional amount of \$592.0 million with a fair value of \$451 thousand and an expiration date of June 2016. In addition, as of December 31, 2014, the Company had sale contracts ("short position") for Eurodollar futures, representing a notional amount of \$592.0 million with a fair value in a liability position of \$1.2 million and an expiration date of June 2018. During the year ended December 31, 2015, the Company terminated both Eurodollar futures and realized a net loss of \$459 thousand.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 8 Derivative Instruments (Continued)***Gain (loss) on derivative instruments*

The below tables summarize the effect of interest rate swaps, interest rate swaptions, foreign currency swaps, foreign currency forwards, options, futures contracts, Agency and Non-Agency Interest-Only Strips characterized as derivatives and TBAs reported in Gain (loss) on derivative instruments, net on our Consolidated Statements of Operations for the years ended December 31, 2015, December 31, 2014 and December 31, 2013 (dollars in thousands):

| Description   | Year ended December 31, 2015 |   |                            |                            |                    |
|---|------------------------------|---|----------------------------|----------------------------|--------------------|
|   | Realized Gain (Loss), net    | Contractual interest income (expense), net(1) | Return (Recovery) of Basis | Mark-to-market adjustments | Total              |
| Interest rate swaps   | \$ 23,680                    | \$ (20,366)                                   | \$ 1,250                   | \$ (68,843)                | \$ (64,279)        |
| Interest rate swaptions   | (5,242)                      |   |                            | (1,486)                    | (6,728)            |
| Agency and Non-Agency Interest-Only Strips accounted for as derivatives | 595                          | 21,872  | (17,265)                   | (4,283)                    | 919                |
| Options   | (711)                        |   |                            |                            | (711)              |
| Futures contracts   | (527)                        |   |                            | 105                        | (422)              |
| Foreign currency forwards   | (901)                        |   |                            | 323                        | (578)              |
| Foreign currency swaps  |                              | 795   |                            | 3,311                      | 4,106              |
| TBAs  | 1,524                        |   |                            | (2,726)                    | (1,202)            |
| <b>Total</b>  | <b>\$ 18,418</b>             | <b>\$ 2,301</b>                               | <b>\$ (16,015)</b>         | <b>\$ (73,599)</b>         | <b>\$ (68,895)</b> |

| Description   | Year ended December 31, 2014 |   |                            |                            |                     |
|---|------------------------------|---|----------------------------|----------------------------|---------------------|
|   | Realized Gain (Loss), net    | Contractual interest income (expense), net(1) | Return (Recovery) of Basis | Mark-to-market adjustments | Total               |
| Interest rate swaps   | \$ 5,440                     | \$ (31,764)                                   | \$ 1,818                   | \$ (183,379)               | \$ (207,885)        |
| Interest rate swaptions   | (3,606)                      |   |                            | (1,697)                    | (5,303)             |
| Agency and Non-Agency Interest-Only Strips accounted for as derivatives | (753)                        | 26,097  | (18,868)                   | (2,136)                    | 4,340               |
| Options   | (2,813)                      |   |                            |                            | (2,813)             |
| Futures contracts   | (16,495)                     |   |                            | (740)                      | (17,235)            |
| Foreign currency forwards   | (1,759)                      |   |                            | (303)                      | (2,062)             |
| Foreign currency swaps  |                              | 317   |                            | 3,857                      | 4,174               |
| TBAs  | 40,015                       |   |                            | 6,273                      | 46,288              |
| <b>Total</b>  | <b>\$ 20,029</b>             | <b>\$ (5,350)</b>                             | <b>\$ (17,050)</b>         | <b>\$ (178,125)</b>        | <b>\$ (180,496)</b> |



Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 8 Derivative Instruments (Continued)**

| Description   | Year ended December 31, 2013    |   |                   |                               |    | Total   |
|---|---------------------------------|---|-------------------|-------------------------------|----|---------|
|   | Realized<br>Gain<br>(Loss), net | Contractual<br>interest<br>income<br>(expense),<br>net(1) | Basis<br>Recovery | Mark-to-market<br>adjustments |    |         |
| Interest rate swaps   | \$ 65,305                       | \$ (22,932)   | \$                | \$ 83,764                     | \$ | 126,137 |
| Interest rate swaptions   | 23,671                          |   |                   | 4,733                         |    | 28,404  |
| Agency and Non-Agency Interest-Only Strips accounted for as derivatives | (1,124)                         | 28,273  | (18,010)          | (700)                         |    | 8,439   |
| Options   | (925)                           |   |                   |                               |    | (925)   |
| TBAs  | (1,499)                         |   |                   | (3,009)                       |    | (4,508) |
| Total   | \$ 85,428                       | \$ 5,341  | \$ (18,010)       | \$ 84,788                     | \$ | 157,547 |

- 
- (1) Contractual interest income (expense), net on derivative instruments includes interest settlement paid or received.

**Linked Transactions**

Starting in 2015, GAAP no longer requires the segregation and treatment of linked transactions as derivatives. Accordingly, beginning January 1, 2015, the Company reports such assets and the corresponding repurchase agreements on a gross basis on its Consolidated Balance Sheets with the corresponding interest income and interest expense reported in its Consolidated Statements of Operations. See "Recent accounting pronouncements" for details. Prior to January 1, 2015, when the initial transfer of a financial asset and repurchase financing were entered into contemporaneously with, or in contemplation of, one another, the transaction was considered linked unless all of the criteria found in the applicable accounting guidance were met at the inception of the transaction. If the transaction was determined to be linked, the Company recorded the initial transfer and repurchase financing on a net basis and recorded a forward commitment to purchase assets as a derivative instrument with changes in market value being recorded in the Gain (loss) on linked transactions, net on the Consolidated Statements of Operations. While linked transactions were treated as derivatives for GAAP through December 31, 2014, the fair value of linked transactions reflects the value of the underlying security's fair market value netted with the respective linked repurchase agreement borrowings.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 8 Derivative Instruments (Continued)**

The following tables present certain information related to the securities and repurchase agreements accounted for as part of linked transaction which is reported in Gain (loss) on linked transactions, net on the Consolidated Statements of Operations for the years ended December 31, 2014 and December 31, 2013 (dollars in thousands):

| Instrument                                    | For the year ended December 31, 2014 |                                  |   |                          |   |        | Weighted Average Coupon / Cost of Funds(2) | Weighted Average Life (years)/ Weighted Average days to Maturity(2) |
|---|--------------------------------------|----------------------------------|---|--------------------------|---|--------|--|---|
|   | Fair Value(2)                        | Net Interest Income(1) (Expense) | Mark-to-market adjustments on linked transactions | Net Realized Gain (loss) | Gain (loss) on linked transactions, net |        |  |   |
| Non-Agency RMBS                               | \$ 8,156                             | \$ 1,569                         | \$ 393  | \$ 1,589                 | \$ 3,551                                | 27.78% | 13.2 years                                 |   |
| Non-Agency CMBS, including Non U.S.           | 38,609                               | 961                              | (3,044)   |                          | (2,083)                                 | 6.83%  | 7.6 years                                  |   |
| Other securities                              | 5,719                                | 349                              | 9   | (192)                    | 166                                     | 4.50%  | 11.9 years                                 |   |
| Non-Agency Repurchase Agreement               | (6,559)                              | (346)                            |   |                          | (346)                                   | 1.66%  | 15 days                                    |   |
| CMBS Repurchase Agreement, including Non U.S. | (22,458)                             | (167)                            | 782   |                          | 615                                     | 1.94%  | 7 days                                     |   |
| Other securities Repurchase Agreement         | (2,840)                              | (33)                             |   |                          | (33)                                    | 1.93%  | 37 days                                    |   |
| Linked transactions, net, at fair value       | \$ 20,627                            | \$ 2,333                         | \$ (1,860)  | \$ 1,397                 | \$ 1,870                                | n/a    | n/a  |   |

(1) Net interest income includes amortization of premium of approximately \$3.3 million for Non-Agency RMBS and \$0 for Non-Agency CMBS and accretion of \$221 thousand for other securities.

(2) Includes information only for linked transactions at December 31, 2014.

| Instrument                      | For the Year Ended December 31, 2013 |                                  |   |                          |   |        | Weighted Average Coupon / Cost of Funds(2) | Weighted Average Life (years)/ Weighted Average days to Maturity(2) |
|---------------------------------|--------------------------------------|----------------------------------|---|--------------------------|---|--------|--|---|
|                                 | Fair Value(2)                        | Net Interest Income(1) (Expense) | Mark-to-market adjustments on linked transactions | Net Realized Gain (loss) | Gain (loss) on linked transactions, net |        |  |   |
| Agency RMBS                     | \$                                   | \$ 44                            | \$  | \$ (254)                 | \$ (210)                                | n/a    | n/a  |   |
| Non-Agency RMBS                 | 79,746                               | 1,371                            | (56)  | 3,303                    | 4,618                                   | 27.06% | 9.6 years                                  |   |
| Agency Repurchase Agreement     |                                      | (6)                              |   |                          | (6)                                     | n/a    | n/a  |   |
| Non-Agency Repurchase Agreement | (61,187)                             | (265)                            |   |                          | (265)                                   | 1.70%  | 63 days                                    |   |

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|  |    |        |    |       |    |      |    |       |    |       |     |     |
|--|----|--------|----|-------|----|------|----|-------|----|-------|-----|-----|
| Linked transactions, net, at<br>fair value | \$ | 18,559 | \$ | 1,144 | \$ | (56) | \$ | 3,049 | \$ | 4,137 | n/a | n/a |
|--|----|--------|----|-------|----|------|----|-------|----|-------|-----|-----|

- 
- (1) Net interest income includes amortization of premium of \$9 thousand for Agency RMBS and accretion of discount of \$555 thousand for Non-Agency RMBS.
- (2) Includes information only for linked transactions at December 31, 2013.



Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 8 Derivative Instruments (Continued)**

At December 31, 2014, the Company pledged MBS and other securities accounted for as linked transactions with a fair value of approximately \$52.5 million as collateral for the related linked repurchase agreements. The Company reduces credit risk on the majority of its derivative instruments by entering into agreements that permit the closeout and netting of transactions with the same counterparty upon occurrence of certain events.

**Note 9 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 December 31, 2015 and December 31, 2014:

**Offsetting of Derivative Assets**

As of December 31, 2015

| \$s in thousands<br>Description   | Gross<br>Amounts of<br>Recognized<br>Assets | Gross<br>Amounts<br>Offset in<br>the<br>Consolidated<br>Balance<br>Sheets | Net Amounts<br>of Assets<br>presented in<br>the<br>Consolidated<br>Balance<br>Sheets | Gross Amounts Not Offset<br>in the Consolidated<br>Balance<br>Sheets |                                | Net<br>Amount   |
|---|---|---|--|--|--------------------------------|-----------------|
|   |   |   |  | Financial<br>Instruments(1)  | Cash<br>Collateral<br>Received |                 |
| Agency and Non-Agency Interest-Only Strips,<br>accounted for as derivatives included in MBS | \$ 59,987                                   | \$  | \$ 59,987  | \$ (55,372)  | \$                             | \$ 4,615        |
| Derivative asset, at fair value(2)  | 21,915                                      |   | 21,915   | (10,177)   | (8,647)                        | 3,091           |
| <b>Total</b>  | <b>\$ 81,902</b>                            | <b>\$</b>   | <b>\$ 81,902</b>   | <b>\$ (65,549)</b>   | <b>\$ (8,647)</b>              | <b>\$ 7,706</b> |

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 9 Offsetting Assets and Liabilities (Continued)****Offsetting of Derivative Liabilities and Repurchase Agreements**

As of December 31, 2015

| \$s in thousands<br>Description              | Gross<br>Amounts of<br>Recognized<br>Liabilities | Gross<br>Amounts<br>Offset in<br>the<br>Balance<br>Sheets | Net Amounts<br>of Liabilities<br>Consolidated<br>Balance Sheets | Gross Amounts Not Offset<br>in the Consolidated Balance<br>Sheets |                                  | Net<br>Amount |
|--|--|---|---|---|----------------------------------|---------------|
|  |  |   |   | Financial<br>Instruments(1)                                       | Cash<br>Collateral<br>Pledged(1) |               |
| Derivative liability, at fair<br>value(2)(3) | \$ 180,177                                       | \$  | \$ 180,177  | \$ (10,177)   | \$ (169,887)                     | \$ 113        |
| Repurchase Agreements(4)                     | 2,585,801  |   | 2,585,801   | (2,585,801)   |                                  |               |
|  | \$ 2,765,978                                     | \$  | \$ 2,765,978  | \$ (2,595,978)  | \$ (169,887)                     | \$ 113        |

- (1) Amounts disclosed in the Financial Instruments column of the tables above represent securities, Whole-Loans and securitized commercial loan collateral pledged and derivative assets that are available to be offset against liability balances associated with repurchase agreement and derivative liabilities. Amounts disclosed in the Cash Collateral Pledged column of the tables above represents amounts pledged as collateral against derivative transactions.
- (2) Derivative asset, at fair value and Derivative liability, at fair value includes interest rate swaps, interest rate swaptions, mortgage put options, currency forwards, futures contracts and TBAs.
- (3) Cash collateral pledged against the Company's derivative counterparties was approximately \$211.3 million as of December 31, 2015.
- (4) The fair value of investments pledged against the Company's repurchase agreements was approximately \$3.0 billion as of December 31, 2015.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 9 Offsetting Assets and Liabilities (Continued)**

**Offsetting of Derivative Assets**

As of December 31, 2014

| \$s in thousands<br>Description   | Gross<br>Amounts of<br>Recognized<br>Assets | Gross<br>Amounts<br>Offset in the<br>Consolidated<br>Balance<br>Sheets | Net Amounts<br>of Assets<br>presented in<br>the<br>Consolidated<br>Balance Sheets | Gross Amounts Not Offset<br>in the Consolidated Balance<br>Sheets |                                | Net<br>Amount |
|---|---|--|---|---|--------------------------------|---------------|
|   |   |  |   | Financial<br>Instruments(1)                                       | Cash<br>Collateral<br>Received |               |
| Agency and Non-Agency Interest-Only Strips,<br>accounted for as derivatives included in MBS | \$ 88,229                                   | \$   | \$ 88,229   | \$ (80,771)   | \$                             | \$ 7,458      |
| Derivative asset, at fair value   | 73,256                                      |  | 73,256  | (53,256)  | (10,036)                       | 9,964         |
| Linked transactions, net, at fair value   | 52,484                                      | (31,857)   | 20,627  |   |                                | 20,627        |
| Total   | \$ 213,969                                  | \$ (31,857)  | \$ 182,112  | \$ (134,027)  | \$ (10,036)                    | \$ 38,049     |

**Offsetting of Derivative Liabilities and Repurchase Agreements**

As of December 31, 2014

| \$s in thousands<br>Description           | Gross<br>Amounts of<br>Recognized<br>Liabilities | Gross<br>Amounts<br>Offset in the<br>Consolidated<br>Balance<br>Sheets | Net Amounts<br>of Liabilities<br>presented in the<br>Consolidated<br>Balance Sheets | Gross Amounts Not Offset<br>in the Consolidated Balance<br>Sheets |                                  | Net<br>Amount |
|---|--|--|---|---|----------------------------------|---------------|
|   |  |  |   | Financial<br>Instruments(1)                                       | Cash<br>Collateral<br>Pledged(1) |               |
| Derivative liability, at fair<br>value(2) | \$ 180,280                                       | \$   | \$ 180,280  | \$ (53,256)   | \$ (116,791)                     | \$ 10,233     |
| Repurchase Agreements(3)                  | 3,875,721  |  | 3,875,721   | (3,875,721)   |                                  |               |
|   | \$ 4,056,001                                     | \$   | \$ 4,056,001  | \$ (3,928,977)  | \$ (116,791)                     | \$ 10,233     |

- (1) Amounts disclosed in the Financial Instruments column of the table above represent securities collateral pledged and derivative assets that are available to be offset against liability balances associated with repurchase agreement and derivative liabilities. Amounts disclosed in the Cash Collateral Pledged column of the table above represents amounts pledged as collateral against derivative transactions.
- (2) Cash collateral pledged against the Company's derivative counterparties was approximately \$159.0 million as of December 31, 2014.
- (3) The fair value of investments pledged against the Company's repurchase agreements was approximately \$4.4 billion as of December 31, 2014.



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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 9 Offsetting Assets and Liabilities (Continued)**

Certain of the Company's repurchase agreement and derivative transactions are governed by underlying agreements that generally provide for a right of setoff in the event of default or in the event of a bankruptcy of either party to the transaction.

**Note 10 Related Party Transactions**

***Management Agreement***

In connection with the Company's IPO in May 2012, the Company entered into a management agreement (the "Management Agreement") with the Manager, which describes the services to be provided by the Manager and compensation for such services. The Manager is responsible for managing the Company's operations, including: (i) performing all of its day-to-day functions; (ii) determining investment criteria in conjunction with the Board of Directors; (iii) sourcing, analyzing and executing investments, asset sales and financings; (iv) performing asset management duties; and (v) performing financial and accounting management, subject to the direction and oversight of the Company's Board of Directors. Pursuant to the terms of the Management Agreement, the Manager is paid a management fee equal to 1.50% per annum of the Company's stockholders' equity (as defined in the Management Agreement), calculated and payable (in cash) quarterly in arrears. For purposes of calculating the management fee, "stockholders' equity" means the sum of the net proceeds from any issuances of the Company's equity securities since inception (allocated on a pro rata daily basis for such issuances during the fiscal quarter of any such issuance), plus retained earnings, calculated in accordance with GAAP, at the end of the most recently completed fiscal quarter (without taking into account any non-cash equity compensation expense incurred in current or prior periods), less any amount paid for repurchases of the Company's shares of common stock, excluding any unrealized gains, losses or other non-cash items, including OTTI charges included in other loss on securities; unrealized gain (loss) on investments, net; and the non-cash portion of gain (loss) on derivative instruments, that have impacted stockholder's equity as reported in the Company's consolidated financial statements prepared in accordance with GAAP, regardless of whether such items are included in other comprehensive income or loss, or in net income, and excluding one-time events pursuant to changes in GAAP and certain other non-cash charges after discussions between the Manager and the Company's independent directors and after approval by a majority of the Company's independent directors. However, if the Company's stockholders' equity for any given quarter is negative based on the calculation described above, the Manager will not be entitled to receive any management fee for that quarter.

In addition, the Company may be required to reimburse the Manager for certain expenses as described below, and shall reimburse the Manager for the compensation paid to the Company's CFO and controller. Expense reimbursements to the Manager are made in cash on a regular basis. The Company's reimbursement obligation is not subject to any dollar limitation. Because the Manager's personnel perform certain legal, accounting, due diligence tasks and other services that outside professionals or outside consultants otherwise would perform, the Manager may be paid or reimbursed for the documented cost of performing such tasks, provided that such costs and reimbursements are in amounts which are no greater than those which would be payable to outside professionals or consultants engaged to perform such services pursuant to agreements negotiated on an arm's-length basis.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 10 Related Party Transactions (Continued)**

The Management Agreement may be amended, supplemented or modified by agreement between the Company and the Manager. The Management Agreement expires on May 16, 2017. It is automatically renewed for one-year terms on each May 15th unless previously terminated as described below. The Company's independent directors review the Manager's performance and any fees payable to the Manager annually and, the Management Agreement may be terminated annually upon the affirmative vote of at least two-thirds ( $\frac{2}{3}$ ) of the Company's independent directors, based upon: (i) the Manager's unsatisfactory performance that is materially detrimental to the Company; or (ii) the Company's determination that any fees payable to the Manager are not fair, subject to the Manager's right to prevent such termination due to unfair fees by accepting a reduction of management fees agreed to by at least two-thirds ( $\frac{2}{3}$ ) of the Company's independent directors. The Company will provide the Manager 180 days prior notice of any such termination. Unless terminated for cause, the Company will pay the Manager a termination fee equal to three times the average annual management fee earned by the Manager during the prior 24-month period immediately preceding the date of termination, calculated as of the end of the most recently completed fiscal quarter prior to the date of termination.

The Company may also terminate the Management Agreement at any time, without the payment of any termination fee, with 30 days prior written notice from the Company's Board of Directors for cause, which will be determined by at least two-thirds ( $\frac{2}{3}$ ) of the Company's independent directors, which is defined as: (i) the Manager's continued material breach of any provision of the Management Agreement (including the Manager's failure to comply with the Company's investment guidelines); (ii) the Manager's fraud, misappropriation of funds, or embezzlement against the Company; (iii) the Manager's gross negligence in the performance of its duties under the Management Agreement; (iv) the occurrence of certain events with respect to the bankruptcy or insolvency of the Manager, including an order for relief in an involuntary bankruptcy case or the Manager authorizing or filing a voluntary bankruptcy petition; (v) the Manager is convicted (including a plea of nolo contendere) of a felony; or (vi) the dissolution of the Manager.

For the years ended December 31, 2015, December 31, 2014 and December 31, 2013 the Company incurred approximately \$10.9 million, approximately \$9.6 million and approximately \$7.8 million in management fees, respectively. The increase in management fee for the year ended December 31, 2015 versus December 31, 2014 and December 31, 2014 versus December 31, 2013 is primarily attributable to the follow-on public offering completed in the second quarter of 2014.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 10 Related Party Transactions (Continued)**

In addition to the management fee, the Company is also responsible for reimbursing the Manager for certain expenses paid by the Manager on behalf of the Company, as defined in the Management Agreement. For the years ended December 31, 2015, December 31, 2014 and December 31, 2013, the Company recorded expenses included in general and administrative expense totaling approximately \$1.2 million, \$624 thousand and \$76 thousand, respectively, related to reimbursable employee costs. Any such expenses incurred by the Manager and reimbursed by the Company, including the employee compensation expense, are typically included in the Company's general and administrative expense on its Consolidated Statements of Operations, or may be reflected on the Consolidated Balance Sheets and associated Consolidated Statement of Changes in Stockholders' Equity, based on the nature of the item. At December 31, 2015 and December 31, 2014, approximately \$2.7 million and approximately \$2.5 million, respectively for management fees incurred but not yet paid was included in Payable to related party on the Consolidated Balance Sheets. In addition, at December 31, 2015 and December 31, 2014, approximately \$277 thousand and \$199 thousand, respectively of reimbursable costs incurred but not yet paid was included in Payable to related party on the Consolidated Balance Sheets.

***Securitized debt***

At December 31, 2015, the Company had securitized debt related to the consolidated VIEs, with a balance of \$11.0 million (and a fair value of \$11.0 million) which was held by an affiliate. The securitized debt of the VIEs can only be settled with the commercial loans that serve as collateral of the VIE and has non-recourse to the Company.

**Note 11 Share-Based Payments**

In conjunction with the Company's IPO and concurrent private placement, the Company's Board of Directors approved the Western Asset Mortgage Capital Corporation Equity Plan (the "Equity Plan") and the Western Asset Manager Equity Plan (the "Manager Equity Plan" and collectively the "Equity Incentive Plans"). The Equity Incentive Plans include provisions for grants of restricted common stock and other equity-based awards to the Manager, its employees and employees of its affiliates and to the Company's directors, officers and employees. The Company can issue up to 3.0% of the total number of issued and outstanding shares of its common stock (on a fully diluted basis) at the time of each award (other than any shares previously issued or subject to awards made pursuant to one of the Company's Equity Incentive Plans) under these Equity Incentive Plans. At May 15, 2012, there were 308,335 shares of common stock initially reserved for issuance under the Equity Incentive Plans. Upon the completion of the October 3, 2012 follow-on common stock offering, the stock portion of the Company's dividend declared December 19, 2013, and the April 9, 2014 follow-on offering (which includes the partial exercise of the greenshoe on May 7, 2014) and private placement of common stock, the number of shares of common stock available for issuance under the Equity Incentive Plans increased to 1,237,711, inclusive of 664,838 shares of restricted stock granted and 23,556 shares of restricted stock issued as a result of the stock portion of the dividend declared on December 19, 2013 and restricted stock attributed to dividends on restricted stock under the Director Deferred Fee Plan. As of December 31, 2015, 549,317 shares remained available for issuance under the Equity Incentive Plans.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 11 Share-Based Payments (Continued)**

The Company made the following grants under the Equity Plan for the years ended December 31, 2015 and 2014:

On March 1, 2015, the Company granted 200,000 shares of restricted common stock to the Manager under the Manager Equity Plan. One-third of the shares vested on March 1, 2016, one-third will vest on March 1, 2017 and the remaining one-third will vest on March 1, 2018.

On June 4, 2015, the Company granted a total of 10,500 (2,625 each) of restricted common stock under the Equity Plan to the Company's four independent directors. These restricted shares will vest in full on June 4, 2016, the first anniversary of the grant date. Each of the independent directors has elected to defer the shares granted to him under the Company's Director Deferred Fee Plan (the "Director Deferred Fee Plan"). The Director Deferred Fee Plan permits eligible members of the Company's board of directors to defer certain stock awards made under its director compensation programs. The Director Deferred Fee Plan allows directors to defer issuance of their stock awards and therefore defer payment of any tax liability until the deferral is terminated, pursuant to the election form executed each year by each eligible director.

On December 8, 2015 the Company's chief financial officer passed away and the board of directors approved the accelerated vesting of 13,980 shares of restricted common stock. The Company recognized \$66 thousand of compensation expense recorded in General and administrative expenses in the Consolidated Statement of Operations.

On March 12, 2014, the Company granted 200,000 shares of restricted common stock to the Manager under the Manager Equity Plan. One-third of these shares vested on March 1, 2015, one-third vested on March 1, 2016 and the remaining one-third will vest on March 1, 2017.

On March 12, 2014, the Company granted 15,180 shares of restricted common stock to its chief financial officer under the Equity Plan. One-third of these shares vested on January 1, 2015, and the remaining two-thirds vested in December 2015. As of January 1, 2014, the Company's chief financial officer became an employee of the Manager. As such, the stock based compensation expense for the unvested shares as of such date was accounted for as a non-employee grant subject to subsequent fair value re-measurement.

On June 11, 2014, the Company granted a total of 6,264 (2,088 each) of restricted common stock under the Equity Plan to the Company's three independent directors. These restricted shares vested full on June 11, 2015, the first anniversary of the grant date. Each of the independent directors has elected to defer the shares granted to him under the Company's Director Deferred Fee Plan (the "Director Deferred Fee Plan"). The Director Deferred Fee Plan permits eligible members of the Company's Board of Directors to defer certain stock awards made under its director compensation programs. The Director Deferred Fee Plan allows directors to defer issuance of their stock awards and therefore defer payment of any tax liability until the deferral is terminated, pursuant to the election form executed each year by each eligible director.

On November 10, 2014, the Company granted 1,334 shares of restricted common stock under the Equity Plan to the Company's new independent director. These restricted shares vested in full on November 10, 2015, the first anniversary of the grant date.



Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)****(in thousands except share and per share data)****Note 11 Share-Based Payments (Continued)**

During the years ended December 31, 2015, December 31, 2014 and December 31, 2013, 175,824, 87,819 and 25,038 restricted common shares vested, respectively, including shares whose issuance has been deferred under the Director Deferred Fee Plan. The Company recognized stock-based compensation expense of approximately \$2.3 million, approximately \$2.2 million and approximately \$1.1 million for the years ended December 31, 2015, December 31, 2014 and December 31, 2013, respectively. In addition, the Company had unamortized compensation expense of \$67 thousand for equity awards and approximately \$2.4 million for liability awards and \$57 thousand for equity awards and approximately \$3.2 million for liability awards at December 31, 2015 and December 31, 2014, respectively.

All restricted common shares granted, other than those whose issuance has been deferred pursuant to the Director Deferred Fee Plan, possess all incidents of ownership, including the right to receive dividends and distributions currently, and the right to vote. Dividend equivalent payments otherwise allocable to restricted common shares under the Deferred Compensation Plan are deemed to purchase additional phantom shares of the Company's common stock that are credited to each participant's deferral account. The award agreements include restrictions whereby the restricted shares cannot be sold, assigned, transferred, pledged, hypothecated or otherwise disposed of prior to the lapse of restrictions under the respective award agreement. The restrictions lapse on the unvested restricted shares awarded when vested, subject to the grantee's continuing to provide services to the Company as of the vesting date. Unvested restricted shares and rights to dividends thereon are forfeited upon termination of the grantee.

The following is a summary of restricted common stock vesting dates as of December 31, 2015 and December 31, 2014, including shares whose issuance has been deferred under the Director Deferred Fee Plan:

| <b>Vesting Date</b> | <b>December 31,<br/>2015<br/>Shares Vesting</b> | <b>December 31,<br/>2014<br/>Shares Vesting</b> |
|---------------------|---|---|
| January 2015        |   | 12,745  |
| March 2015          |   | 121,518   |
| May 2015            |   | 18,708  |
| June 2015           |   | 6,873   |
| November 2015       |   | 1,334   |
| January 2016        |   | 8,920   |
| March 2016          | 188,184   | 121,518   |
| June 2016           | 11,528  |   |
| January 2017        |   | 5,060   |
| March 2017          | 133,334   | 66,667  |
| March 2018          | 66,667  |   |
|                     | 399,713   | 363,343   |

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)****(in thousands except share and per share data)****Note 11 Share-Based Payments (Continued)**

The following table presents information with respect to the Company's restricted stock for the year ended December 31, 2015 including shares whose issuance has been deferred under the Director Deferred Fee Plan:

|                                    | Shares of<br>Restricted Stock | Weighted Average<br>Grant Date Fair<br>Value(1) |
|------------------------------------|-------------------------------|---|
| Outstanding at beginning of period | 476,200                       | \$ 18.49  |
| Granted(2)                         | 212,194                       | 14.93   |
| Cancelled/forfeited                |                               |   |
| Outstanding at end of period       | 688,394                       | \$ 17.39  |
| Unvested at end of period          | 399,713                       | \$ 16.24  |

- 
- (1) The grant date fair value of restricted stock awards is based on the closing market price of the Company's common stock at the grant date.
- (2) Included in Granted are restricted stock attributed to dividends on restricted stock under the Director Deferred Fee Plan of 1,694 shares.

The following table presents information with respect to the Company's restricted stock for the year ended December 31, 2014 including shares whose issuance has been deferred under the Director Deferred Fee Plan:

|                                    | Shares of<br>Restricted Stock | Weighted Average<br>Grant Date Fair<br>Value(1) |
|------------------------------------|-------------------------------|---|
| Outstanding at beginning of period | 252,517                       | \$ 20.34  |
| Granted                            | 223,683                       | 16.39   |
| Cancelled/forfeited                |                               |   |
| Outstanding at end of year         | 476,200                       | \$ 18.49  |
| Unvested at end of year            | 363,343                       | \$ 17.98  |

- 
- (1) The grant date fair value of restricted stock awards is based on the closing market price of the Company's common stock at the grant date.
- (2)

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Included in Granted are restricted stock attributed to dividends on restricted stock under the Director Deferred Fee Plan of 905 shares.

### **Note 12 Stockholders' Equity**

On May 9, 2012, the Company entered into agreements with certain institutional investors to sell 2,231,787 warrant units. Each warrant unit consists of one share of the Company's common stock and a warrant to purchase 0.5 of a share of the Company's common stock, subject to adjustment. As of December 31, 2015, the adjusted exercise price of the warrants was \$16.70 and there were a total of 1,232,916 warrant shares purchasable. The warrants expire on May 15, 2019.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 12 Stockholders' Equity (Continued)**

The Board of Directors of the Company authorized the repurchase of up to 2,050,000 shares of its common stock through December 31, 2015. Purchases made pursuant to the program will be made in the open market, in privately negotiated transactions, or pursuant to any trading plan that may be adopted in accordance with Rules 10b5-1 and 10b-18 of the Securities and Exchange Commission. The authorization does not obligate the Company to acquire any particular amount of common shares and the program may be suspended or discontinued at the Company's discretion without prior notice. The timing, manner, price and amount of any repurchases will be determined by the Company in its discretion and will be subject to economic and market conditions, stock price, applicable legal requirements and other factors. The Company has not yet entered into definitive agreements to utilize the authorization and, accordingly, had not repurchased any shares of common stock pursuant to the authorization as of December 31, 2015.

The following table presents cash dividends declared and paid by the Company on its common stock:

| <b>Declaration Date</b> | <b>Record Date</b> | <b>Payment Date</b> | <b>Amount per Share</b> | <b>Tax Characterization</b> |
|-------------------------|--------------------|---------------------|-------------------------|-----------------------------|
| <b>2015</b>             |                    |                     |                         |                             |
| December 17, 2015       | December 28, 2015  | January 26, 2016    | \$ 0.58                 | Ordinary income             |
| September 24, 2015      | October 5, 2015    | October 27, 2015    | \$ 0.60                 | Ordinary income             |
| June 18, 2015           | June 29, 2015      | July 28, 2015       | \$ 0.64                 | Ordinary income             |
| March 26, 2015          | April 6, 2015      | April 28, 2015      | \$ 0.67                 | Ordinary income             |
| <b>2014</b>             |                    |                     |                         |                             |
| December 18, 2014       | December 29, 2014  | January 27, 2015    | \$ 0.70                 | Ordinary income             |
| September 23, 2014      | October 3, 2014    | October 28, 2014    | \$ 0.70                 | Ordinary income             |
| June 19, 2014           | June 30, 2014      | July 29, 2014       | \$ 0.67                 | Ordinary income             |
| March 20, 2014          | March 31, 2014     | April 29, 2014      | \$ 0.67                 | Ordinary income             |
| <b>2013</b>             |                    |                     |                         |                             |
| April 1, 2013           | April 12, 2013     | April 30, 2013      | \$ 0.95                 | Ordinary income             |
| June 20, 2013           | July 1, 2013       | July 29, 2013       | \$ 0.90                 | Ordinary income             |
| September 19, 2013      | September 30, 2013 | October 29, 2013    | \$ 0.90                 | Ordinary income             |
| December 19, 2013       | December 30, 2013  | January 28, 2014    | \$ 2.35(1)              | Ordinary income             |

(1)

Consisting of cash and stock. For stockholders who elected to receive the entire \$2.35 per share dividend in stock, each stockholder received 0.1590 shares in newly issued common stock for each common share that they held as of the dividend record date. For stockholders who elected to receive the dividend in cash, or did not make an election, each stockholder received \$0.9159 per share in cash and 0.0970 shares in newly issued common stock for each common share that they held as of the dividend record date.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)****(in thousands except share and per share data)****Note 13 Net Income (Loss) per Common Share**

The table below presents basic and diluted net income (loss) per share of common stock using the two-class method for the years ended December 31, 2015, December 31, 2014 and December 31, 2013 (dollars, other than shares and per share amounts, in thousands):

|   | For the year<br>ended<br>December 31, 2015 | For the year<br>ended<br>December 31, 2014 | For the year<br>ended<br>December 31, 2013 |
|---|--|--|--|
| <i>Numerator:</i>   |  |  |  |
| Net income (loss) attributable to common stockholders and participating securities for basic and diluted earnings per share | \$ (9,484)                                 | \$ 100,713                                 | \$ (27,855)                                |
| <i>Less:</i>  |  |  |  |
| Dividends and undistributed earnings allocated to participating securities  | 1,045                                      | 944  | 961  |
| Net income (loss) allocable to common stockholders basic and diluted  | \$ (10,529)                                | \$ 99,769                                  | \$ (28,816)                                |
| <i>Denominator:</i>   |  |  |  |
| Weighted average common shares outstanding for basic earnings per share   | 41,490,556                                 | 37,337,460                                 | 24,185,037                                 |
| Weighted average diluted shares outstanding (stock awards)  |  |  |  |
| Weighted average diluted shares outstanding (warrants)  |  |  |  |
| Weighted average common shares outstanding for diluted earnings per share   |  |  |  |
|   | 41,490,556                                 | 37,337,460                                 | 24,185,037                                 |
| Basic earnings per common share   | \$ (0.25)                                  | \$ 2.67                                    | \$ (1.19)                                  |
| Diluted earnings per common share   | \$ (0.25)                                  | \$ 2.67                                    | \$ (1.19)                                  |

The following potential common shares, which are securities or other contracts that may entitle its holder to obtain common shares, were excluded from diluted earnings per share for the year ended December 31, 2013 as the Company had a net loss for the period and their inclusion would have been anti-dilutive: 67,257 related to warrants and 13,434 related to stock awards. For the years ended December 31, 2015 and December 31, 2014, the Company excluded the effects of the warrants from the computation of diluted earnings per share since the average market value per share of the Company's common stock was below the exercise price of the warrants.

**Note 14 Income Taxes**

As a REIT, the Company is not subject to federal income tax to the extent that it makes qualifying distributions to its stockholders and satisfies on a continuing basis, through actual investment and operating results, the REIT requirements including certain asset, income and stock ownership tests.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**(in thousands except share and per share data)**

**Note 14 Income Taxes (Continued)**

Based on the Company's analysis of any potential uncertain income tax positions, the Company concluded that it does not have any uncertain tax positions that meet the recognition or measurement criteria as of December 31, 2015. The Company files U.S. federal and state income tax returns. As of December 31, 2015, tax returns filed by the Company for 2014, 2013 and 2012 are open for examination pursuant to relevant statutes of limitation. In the event that the Company incurs income tax related interest and penalties, the Company's policy is to classify them as a component of its provision for income taxes.

Subject to the limitation under the REIT asset test rules, the Company is permitted to own up to 100% of the stock of one or more TRS. Currently, the Company owns one TRS that is taxable as a corporation and is subject to federal, state and local income tax on its net income at the applicable corporate rates. The TRS, which was formed in Delaware on July 28, 2014, is a limited liability company and a wholly-owned subsidiary of the Company. As of December 31, 2015, the cumulative taxable loss of the TRS was de-minimis. As there can be no certainty that the TRS will have taxable income in the future, no tax benefit was included in these consolidated financial statements.

**Note 15 Contingencies**

From time to time, the Company may become involved in various claims and legal actions arising in the ordinary course of business. Management is not aware of any material contingencies at December 31, 2015.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 16 Summarized Quarterly Results (unaudited)**

The following is a presentation of selected unaudited results of operations:

|  | Quarter Ended     |                  |                       |                      |
|--|-------------------|------------------|-----------------------|----------------------|
|  | March 31,<br>2015 | June 30,<br>2015 | September 30,<br>2015 | December 31,<br>2015 |
| <b>Net Interest Income:</b>  |                   |                  |                       |                      |
| Interest income  | \$ 40,806         | \$ 41,029        | \$ 35,821             | \$ 35,048            |
| Interest expense   | 6,402             | 6,577            | 6,981                 | 7,645                |
| Net Interest Income  | 34,404            | 34,452           | 28,840                | 27,403               |
| <b>Other Income (Loss):</b>  |                   |                  |                       |                      |
| Realized gain (loss) on sale of investments, net                         | 7,468             | 4,281            | (2,482)               | (988)                |
| Other loss on securities   | (4,651)           | (4,316)          | (5,917)               | (4,907)              |
| Unrealized gain (loss) on investments, net                               | 28,410            | (42,849)         | 24,723                | (44,295)             |
| Gain (loss) on derivative instruments, net                               | (48,302)          | 13,154           | (41,363)              | 7,616                |
| Other, net   | 2,384             | (611)            | (29)                  | 574                  |
| Other Income (Loss), net   | (14,691)          | (30,341)         | (25,068)              | (42,000)             |
| <b>Operating Expenses:</b>   |                   |                  |                       |                      |
| General and administrative   | 2,874             | 3,125            | 2,863                 | 2,747                |
| Management fee related party   | 2,693             | 2,679            | 2,761                 | 2,741                |
| Total Operating Expenses   | 5,567             | 5,804            | 5,624                 | 5,488                |
| Net income (loss) available to Common Stock and participating securities | \$ 14,146         | \$ (1,693)       | \$ (1,852)            | \$ (20,085)          |
| Net income (loss) per Common Share Basic                                 | \$ 0.34           | \$ (0.05)        | \$ (0.05)             | \$ (0.49)            |
| Net income (loss) per Common Share Diluted                               | \$ 0.34           | \$ (0.05)        | \$ (0.05)             | \$ (0.49)            |



Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 16 Summarized Quarterly Results (unaudited) (Continued)**

|  | Quarter Ended     |                  |                       |                      |
|--|-------------------|------------------|-----------------------|----------------------|
|  | March 31,<br>2014 | June 30,<br>2014 | September 30,<br>2014 | December 31,<br>2014 |
| <b>Net Interest Income:</b>  |                   |                  |                       |                      |
| Interest income  | \$ 23,430         | \$ 44,604        | \$ 40,718             | \$ 40,358            |
| Interest expense   | 3,390             | 5,971            | 6,468                 | 6,434                |
| Net Interest Income  | 20,040            | 38,633           | 34,250                | 33,924               |
| <b>Other Income (Loss):</b>  |                   |                  |                       |                      |
| Realized gain (loss) on sale of investments, net                         | 3,716             | (11,278)         | 4,912                 | 472                  |
| Other loss on securities   | (1,709)           | (2,999)          | (2,857)               | (9,449)              |
| Unrealized gain (loss) on investments, net                               | 31,091            | 114,117          | (4,453)               | 48,256               |
| Gain (loss) on linked transactions, net                                  | 2,219             | 688              | (1,241)               | 204                  |
| Gain (loss) on derivative instruments, net                               | (59,906)          | (66,677)         | (401)                 | (53,512)             |
| Other, net   | (12)              | 24               | 942                   | 479                  |
| Other Income (Loss), net   | (24,601)          | 33,875           | (3,098)               | (13,550)             |
| <b>Operating Expenses:</b>   |                   |                  |                       |                      |
| General and administrative   | 2,075             | 2,375            | 2,253                 | 2,424                |
| Management fee related party   | 1,805             | 2,559            | 2,763                 | 2,506                |
| Total Operating Expenses   | 3,880             | 4,934            | 5,016                 | 4,930                |
| Net income (loss) available to Common Stock and participating securities | \$ (8,441)        | \$ 67,574        | \$ 26,136             | \$ 15,444            |
| Net income (loss) per Common Share Basic                                 | \$ (0.32)         | \$ 1.68          | \$ 0.63               | \$ 0.37              |
| Net income (loss) per Common Share Diluted                               | \$ (0.32)         | \$ 1.68          | \$ 0.63               | \$ 0.37              |

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Notes to Consolidated Financial Statements (Continued)**

(in thousands except share and per share data)

**Note 16 Summarized Quarterly Results (unaudited) (Continued)**

|  | Quarter Ended     |                  |                       |                      |
|--|-------------------|------------------|-----------------------|----------------------|
|  | March 31,<br>2013 | June 30,<br>2013 | September 30,<br>2013 | December 31,<br>2013 |
| <b>Net Interest Income:</b>  |                   |                  |                       |                      |
| Interest income  | \$ 33,750         | \$ 32,742        | \$ 30,654             | \$ 28,182            |
| Interest expense   | 5,181             | 4,522            | 4,273                 | 4,043                |
| Net Interest Income  | 28,569            | 28,220           | 26,381                | 24,139               |
| <b>Other Income (Loss):</b>  |                   |                  |                       |                      |
| Realized gain (loss) on sale of investments, net                         | (11,660)          | (6,083)          | (46,142)              | (46,827)             |
| Other loss on securities   | (2,268)           | (3,533)          | (2,363)               | (3,694)              |
| Unrealized gain (loss) on investments, net                               | (54,759)          | (156,286)        | 37,528                | 13,408               |
| Gain (loss) on linked transactions, net                                  | 596               | 3,909            | (547)                 | 179                  |
| Gain (loss) on derivative instruments, net                               | 14,840            | 109,474          | (3,809)               | 37,042               |
| Other, net   | 33                | 12               | 11                    | 35                   |
| Other Income (Loss), net   | (53,218)          | (52,507)         | (15,322)              | 143                  |
| <b>Operating Expenses:</b>   |                   |                  |                       |                      |
| General and administrative   | 1,737             | 1,541            | 1,484                 | 1,684                |
| Management fee related party   | 2,113             | 1,826            | 2,032                 | 1,843                |
| Total Operating Expenses   | 3,850             | 3,367            | 3,516                 | 3,527                |
| Net income (loss) available to Common Stock and participating securities | \$ (28,499)       | \$ (27,654)      | \$ 7,543              | \$ 20,755            |
| Net income (loss) per Common Share Basic                                 | \$ (1.18)         | \$ (1.16)        | \$ 0.31               | \$ 0.83              |
| Net income (loss) per Common Share Diluted                               | \$ (1.18)         | \$ (1.16)        | \$ 0.31               | \$ 0.83              |

**Note 17 Subsequent Events****Stock Repurchase Plan**

On February 25, 2016, the Board of Directors of the Company reauthorized its repurchase program of up to 2,050,000 shares of its common stock through December 31, 2017. The original authorization expired on December 31, 2015. Purchases made pursuant to the program will be

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made in the open market, in privately negotiated transactions, or pursuant to any trading plan that may be adopted in accordance with Rules 10b5-1 and 10b-18 of the Securities and Exchange Commission. The authorization does not obligate the Company to acquire any particular amount of common shares and the program may be suspended or discontinued at the Company's discretion without prior notice. The timing, manner, price and amount of any repurchases will be determined by the Company in its discretion and will be subject to economic and market conditions, stock price, applicable legal requirements and other factors.

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**Western Asset Mortgage Capital Corporation and Subsidiaries**  
**Schedule IV**  
**Mortgage Loans on Real Estate**  
**As of December 31, 2015**

| \$ in thousands<br>Asset Type  | Description                                     | Number<br>of<br>Loans | Interest<br>Rate           | Maturity<br>Date            | Periodic<br>Payment<br>Terms(1) | Prior<br>Liens | Face<br>Amount<br>of<br>Mortgages | Carrying<br>Amount<br>of<br>Mortgages | Delinquent<br>Principal<br>or<br>Interest |
|--|---|-----------------------|----------------------------|-----------------------------|---------------------------------|----------------|-----------------------------------|---------------------------------------|---|
| Adjustable Rate Residential Mortgage Loan Held in Securitization Trusts  | Original Loan Balance \$0 - \$249,999           | 141                   | Hybrid ARM<br>4.0% to 6.7% | 1/9/2041<br>to<br>7/1/2045  | P&I                             | \$             | \$ 20,118                         | \$ 20,654                             | \$  |
| Adjustable Rate Residential Mortgage Loans Held in Securitization Trusts | Original Loan Balance \$250,000 - \$499,999     | 235                   | Hybrid ARM<br>4.1% to 6.3% | 1/12/2041<br>to<br>7/1/2045 | P&I                             |                | 77,971                            | 80,105                                |   |
| Adjustable Rate Residential Mortgage Loan Held in Securitization Trusts  | Original Loan Balance \$500,000 - \$749,999     | 61                    | Hybrid ARM<br>3.9% to 5.2% | 1/2/2042<br>to<br>6/1/2045  | P&I                             |                | 34,625                            | 35,615                                |   |
| Adjustable Rate Residential Mortgage Loan Held in Securitization Trusts  | Original Loan Balance \$750,000 - \$999,999     | 26                    | Hybrid ARM<br>4.2% to 5.0% | 1/9/2042<br>to<br>2/1/2045  | P&I                             |                | 20,670                            | 21,228                                |   |
| Adjustable Rate Residential Mortgage Loan Held in Securitization Trusts  | Original Loan Balance \$1,000,000 - \$1,249,999 | 14                    | Hybrid ARM<br>4.2% to 5.2% | 1/1/2042<br>to<br>8/1/2044  | P&I                             |                | 14,857                            | 15,297                                |   |
| Adjustable Rate Residential Mortgage Loan Held in Securitization Trusts  | Original Loan Balance \$1,250,000 - \$1,499,999 | 8                     | Hybrid ARM<br>4.2% to 5.2% | 1/12/2041<br>to<br>2/1/2044 | P&I                             |                | 9,942                             | 10,142                                |   |
| Adjustable Rate Residential Mortgage Loan Held in Securitization Trusts  | Original Loan Balance \$1,500,000 and above     | 11                    | Hybrid ARM<br>4.7% to 5.2% | 1/2/2042<br>to<br>1/1/2045  | P&I                             |                | 21,227                            | 21,870                                |   |
| Variable Rate Residential Mortgage Loan Held in Securitization Trusts    | Original Loan Balance \$0 - \$249,999           | 5                     | Variable<br>4.3%           | 1/5/2044<br>to<br>6/1/2044  | P&I                             |                | 875                               | 891                                   |   |
| Variable Rate Residential Mortgage Loan Held in Securitization Trusts    | Original Loan Balance \$250,000 - \$499,999     | 6                     | Variable<br>4.3%           | 1/4/2044<br>to<br>6/1/2044  | P&I                             |                | 2,084                             | 2,136                                 |   |
| Variable Rate Residential Mortgage Loan Held in Securitization Trusts    | Original Loan Balance \$500,000 - \$749,999     | 1                     | Variable<br>4.3%           | 4/1/2044                    | P&I                             |                | 486                               | 501                                   |   |
| Variable Rate Residential Mortgage Loan Held in Securitization Trusts    | Original Loan Balance \$1,000,000 - \$1,249,999 | 1                     | Variable<br>4.3%           | 2/1/2044                    | P&I                             |                | 968                               | 996                                   |   |
| Variable Rate Residential Mortgage Loan Held in Securitization Trusts    | Original Loan Balance \$1,250,000 - \$1,499,999 | 2                     | Variable<br>4.3%           | 5/1/2044                    | P&I                             |                | 2,593                             | 2,645                                 |   |
| Variable Rate Residential Mortgage Loan Held in Securitization Trusts    | Original Loan Balance \$1,500,000 and above     | 1                     | Variable<br>4.3%           | 4/1/2044                    | P&I                             |                | 1,457                             | 1,483                                 |   |



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| \$ in thousands<br>Asset Type   | Description  | Number<br>of<br>Loans | Interest<br>Rate         | Maturity<br>Date            | Periodic<br>Payment<br>Terms(1) | Prior<br>Liens | Face<br>Amount<br>of<br>Mortgages | Carrying<br>Amount<br>of<br>Mortgages | Principal<br>Amount<br>of<br>Loans<br>Subject<br>to<br>Delinquent<br>or<br>Interest |
|---|--|-----------------------|--------------------------|-----------------------------|---------------------------------|----------------|-----------------------------------|---------------------------------------|---|
| Fixed Rate Residential Mortgage Loan<br>Held in Securitization Trusts | Original Loan<br>Balance \$0 -<br>\$249,999              | 5                     | Fixed<br>4.9% to<br>6.8% | 1/9/2026<br>to<br>8/1/2041  | P&I                             |                | 564                               | 586                                   |   |
| Fixed Rate Residential Mortgage Loan<br>Held in Securitization Trusts | Original Loan<br>Balance<br>\$250,000 -<br>\$499,999     | 2                     | Fixed<br>5.7% to<br>5.9% | 1/9/2026<br>to<br>11/1/2041 | P&I                             |                | 427                               | 443                                   |   |
| Fixed Rate Residential Mortgage Loan<br>Held in Securitization Trusts | Original Loan<br>Balance<br>\$500,000 -<br>\$749,999     | 2                     | Fixed<br>5.4% to<br>5.8% | 1/8/2034<br>to<br>11/1/2034 | P&I                             |                | 911                               | 945                                   |   |
| Fixed Rate Residential Mortgage Loan<br>Held in Securitization Trusts | Original Loan<br>Balance<br>\$1,000,000 -<br>\$1,249,999 | 1                     | Fixed<br>6.3%            | 4/1/2040                    | P&I                             |                | 1,011                             | 1,056                                 |   |
| Fixed Rate Residential Mortgage Loan<br>Held in Securitization Trusts | Original Loan<br>Balance<br>\$1,250,000 -<br>\$1,499,999 | 1                     | Fixed<br>6.3%            | 2/1/2036                    | P&I                             |                | 1,071                             | 1,124                                 |   |
| Fixed Rate Residential Mortgage Loan<br>Held in Securitization Trusts | Original Loan<br>Balance<br>\$1,500,000 and<br>above     | 1                     | Fixed<br>6.5%            | 11/1/2036                   | P&I                             |                | 790                               | 821                                   |   |
| Commercial Mezzanine Loan Held in<br>Securitization Trust             | Original Loan<br>Balance<br>\$25,000,000                 | 1                     | Fixed<br>9.0%            | 7/6/2020                    | P&I(2)                          |                | 25,000                            | 25,000                                |   |
|   |  |                       |                          |                             |                                 |                | \$ 237,647                        | \$ 243,538                            | \$  |

- (1) Principal and interest ("P&I")
- (2) Interest only payments for initial 2 years. After 2 years, monthly P&I payments based on a 30 year amortization schedule and a balloon payment due on the maturity date.

**Reconciliation of Carrying Value of Mortgage Loans on Real Estate:**

|   | 2015       | 2014     | 2013 |
|---|------------|----------|------|
| Beginning balance                       | \$ 7,220   | \$       | \$   |
| Additions during period:                |            |          |      |
| New mortgage loans                      | 262,949    | 7,161    |      |
| Unrealized gains                        | 3,631      | 94       |      |
| Deductions during period:               |            |          |      |
| Collections of principal                | 29,105     | 9        |      |
| Amortization of premium and (discounts) | 1,074      | 25       |      |
| Unrealized losses                       | 83         | 1        |      |
| Balance at end of period                | \$ 243,538 | \$ 7,220 | \$   |



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**ITEM 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.**

None.

**ITEM 9A. Controls and Procedures**

***(a) Evaluation of Disclosure Controls and Procedures***

We maintain disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) that are designed to ensure that information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our Chief Executive Officer and Interim Chief Financial Officer as appropriate to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, we recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and therefore we are required to apply judgment in evaluating the cost-benefit relationship of possible controls and procedures.

The Company's Chief Executive Officer and Interim Chief Financial Officer evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of December 31, 2015. Based on that evaluation, our Chief Executive Officer and Interim Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

***(b) Management's Report on Internal Control over Financial Reporting***

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rules 13a-15(f) and 15d-15(f) promulgated under the Exchange Act as a process designed by, or under the supervision of, the Company's Chief Executive Officer and Interim Chief Financial Officer and effected by the Company's Board of Directors, management and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles, and includes those policies and procedures that:

pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company;

provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and

provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risks that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.



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Management of the Company has assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2015. In making its assessment of internal control over financial reporting, management used the criteria described in Internal Control Integrated Framework (2013 framework) issued by the Committee of Sponsoring Organizations of the Treadway Commission, ("COSO"). Based on this evaluation, management concluded that the Company's internal control over financial reporting was effective as of December 31, 2015 based on criteria in Internal Control Integrated Framework issued by the COSO.

This annual report does not include an attestation report of the company's registered public accounting firm due to a temporary exemption transition period established by rules of the Securities and Exchange Commission for emerging growth companies under the Jumpstart Our Business Startups Act of 2012 (the "JOBS Act").

**(c) Changes in Internal Control over Financial Reporting**

There have been no changes in our internal control over financial reporting during the three months ended December 31, 2015, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**ITEM 9B. Other Information**

None.

**ITEM 10. Directors, Executive Officers and Corporate Governance**

The information regarding the Company's directors, executive officers and certain other matters required by Item 401 of Regulation S-K is incorporated herein by reference to the Company's proxy statement relating to its annual meeting of stockholders to be held on or about June 2, 2016 (the "Proxy Statement"), to be filed with the SEC within 120 days after December 31, 2015.

The information regarding compliance with Section 16(a) of the Exchange Act required by Item 405 of Regulation S-K is incorporated herein by reference to the Proxy Statement to be filed with the SEC within 120 days after December 31, 2015.

The information regarding the Company's Code of Business Conduct and Ethics required by Item 406 of Regulation S-K is incorporated herein by reference to the Proxy Statement to be filed with the SEC within 120 days after December 31, 2015.

The information regarding certain matters pertaining to the Company's corporate governance required by Item 407(c)(3), (d)(4) and (d)(5) of Regulation S-K is incorporated by reference to the Proxy Statement to be filed with the SEC within 120 days after December 31, 2015.

**ITEM 11. Executive Compensation.**

The information regarding executive compensation and other compensation related matters required by Items 402 and 407(e)(4) and (e)(5) of Regulation S-K is incorporated herein by reference to the Proxy Statement to be filed with the SEC within 120 days after December 31, 2015.

**ITEM 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder**

The tables on equity compensation plan information and beneficial ownership of the Company required by Items 201(d) and 403 of Regulation S-K are incorporated herein by reference to the Proxy Statement to be filed with the SEC within 120 days after December 31, 2015.

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**ITEM 13. Certain Relationships and Related Transactions and Director Independence**

The information regarding transactions with related persons, promoters and certain control persons and director independence required by Items 404 and 407(a) of Regulation S-K is incorporated herein by reference to the Proxy Statement to be filed with the SEC within 120 days after December 31, 2015.

**ITEM 14. Principal Accounting Fees and Services**

The information concerning principal accounting fees and services and the Audit Committee's pre-approval policies and procedures required by Item 9(e) of Schedule 14A is incorporated herein by reference to the Proxy Statement to be filed with the SEC within 120 days after December 31, 2015.

**ITEM 15. Exhibits**

Documents filed as part of this report:

- 1) Financial Statements

**WESTERN ASSET MORTGAGE CAPITAL CORPORATION**

|  |            |
|--|------------|
| <u>Consolidated Balance Sheets as of December 31, 2015 and 2014</u>  | <u>114</u> |
| <u>Consolidated Statements of Operations for the years ended December 31, 2015, December 31, 2014 and December 31, 2013</u>                      | <u>115</u> |
| <u>Consolidated Statements of Changes in Stockholders' Equity for the years ended December 31, 2015, December 31, 2014 and December 31, 2013</u> | <u>116</u> |
| <u>Consolidated Statements of Cash Flow for the years ended December 31, 2015, December 31, 2014 and December 31, 2013</u>                       | <u>117</u> |
| <u>Notes to Consolidated Financial Statements</u>  | <u>120</u> |
| <u>Schedule IV Mortgage Loans on Real Estate</u>   | <u>189</u> |

Financial Statements Schedules other than the one listed above are omitted because the required information is not applicable or deemed not material, or the required information is presented in the financial statements and/or in the notes to financial statements.

- 2) Exhibits

The following exhibits are filed as part of this report.

| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 3.1*               | Amended and restated certificate of incorporation of Western Asset Mortgage Capital Corporation, incorporated by reference to Exhibit 3.1 to Amendment No. 10 Form S-11 (Registration Statement No. 333-159962), filed May 8, 2012 |
| 3.2*               | Amended and restated bylaws of Western Asset Mortgage Capital Corporation, incorporated by reference to Exhibit 3.2 to Amendment No. 10 Form S-11 (Registration Statement No. 333-159962), filed May 8, 2012                       |
| 4.1*               | Specimen Common Stock Certificate of Western Asset Mortgage Capital Corporation, incorporated by reference to Exhibit 4.1 to Amendment No. 10 Form S-11 (Registration Statement No. 333-159962), filed May 8, 2012                 |

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| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 10.1*              | Form of Unit Purchase Agreement between Western Asset Mortgage Capital Corporation and certain institutional accredited investors, incorporated by reference to Exhibit 10.1 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.                   |
| 10.2*              | Form of Warrant, incorporated by reference to Exhibit 10.2 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.   |
| 10.3*              | Management Agreement, dated May 9, 2012, between Western Asset Mortgage Capital Corporation and Western Asset Management Company, incorporated by reference to Exhibit 10.4 to the Quarterly Report on Form 10-Q, filed August 14, 2012.   |
| 10.4*              | Registration Rights Agreement, dated May 15, 2012, among Western Asset Mortgage Capital Corporation, Western Asset Management Company and certain individual holders named therein, incorporated by reference to Exhibit 10.5 to the Quarterly Report on Form 10-Q, filed August 14, 2012. |
| 10.5*              | Western Asset Mortgage Capital Corporation Equity Plan, incorporated by reference to Exhibit 10.5 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.  |
| 10.6*              | Western Asset Mortgage Capital Corporation Manager Equity Plan, incorporated by reference to Exhibit 10.6 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.  |
| 10.7*              | Form of Indemnification Agreement between Western Asset Mortgage Capital Corporation and a director, incorporated by reference to Exhibit 10.7 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.   |
| 10.8*              | Restricted Stock Award Agreement, dated May 15, 2012, for Western Asset Management Company, incorporated by reference to Exhibit 10.9 to the Quarterly Report on Form 10-Q, filed August 14, 2012.   |
| 10.9*              | Form of Restricted Stock Award Agreement for independent directors, incorporated by reference to Exhibit 10.2 to the Form S-8 dated May 15, 2012 (File No. 1-35543).   |
| 23.1               | Consent of Independent Registered Public Accounting Firm   |
| 31.1               | Rule 13a-14(a) / 15d-14(a) Certification of Chief Executive Officer.   |
| 31.2               | Rule 13a-14(a) / 15d-14(a) Certification of Interim Chief Financial Officer.   |
| 32.1               | Section 1350 Certifications of Chief Executive Officer and Interim Chief Financial Officer   |
| 101.INS            | XBRL Instance Document   |
| 101.SCH            | XBRL Taxonomy Extension Schema Document  |
| 101.CAL            | XBRL Taxonomy Extension Calculation Linkbase Document  |
| 101.DEF            | XBRL Taxonomy Extension Definition Linkbase Document   |
| 101.LAB            | XBRL Taxonomy Extension Label Linkbase Document  |
| 101.PRE            | XBRL Taxonomy Extension Presentation Linkbase Document   |

\*

Fully or partly previously filed.







Table of Contents

By: /s/ M. CHRISTIAN MITCHELL

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M. Christian Mitchell  
*Director*

March 11, 2016

By: /s/ RANJIT M. KRIPALANI

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Ranjit M. Kripalani  
*Director*

March 11, 2016  
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