Armour Residential REIT, Inc.
Form 10-Q
November 02, 2016

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

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2016
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

ARMOUR RESIDENTIAL REIT, INC.
(Exact name of registrant as specified in its charter)

Maryland	001-34766	26-1908763
(State or other jurisdiction of incorporation or organization)	(Commission File Number)	(I.R.S. Employer Identification No.)

3001 Ocean Drive, Suite 201, Vero Beach, FL 32963
(Address of principal executive offices)(zip code)

(772) 617-4340
(Registrant’s telephone number, including area code)

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

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 x NO o

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 x Accelerated filer o Non-accelerated filer o Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES o NO x

The number of outstanding shares of the Registrant’s common stock as of November 1, 2016 was 36,713,354.

ARMOUR Residential REIT, Inc. and Subsidiaries
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ARMOUR Residential REIT, Inc. and Subsidiaries
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except per share amounts)
(Unaudited)

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

	September 30, 2016	December 31, 2015
Assets		
Cash	$401,825	$289,925
Cash collateral posted to counterparties	281,397	263,799
Agency Securities, available for sale, at fair value (including pledged securities of $6,913,094 at September 30, 2016 and $12,109,868 at December 31, 2015)	7,041,228	12,461,556
Non-Agency Securities, trading, at fair value (including pledged securities of $1,001,319 at September 30, 2016 and $0 at December 31, 2015)	1,001,319	—
Interest-Only Securities, trading, at fair value	95,918	—
Derivatives, at fair value	10,194	999
Principal payments receivable	—	37
Accrued interest receivable	19,271	34,500
Prepaid and other	3,850	4,461
Total Assets	$8,855,002	$13,055,277
Liabilities and Stockholders' Equity		
Liabilities:		
Repurchase agreements	$7,360,670	$11,570,481
Cash collateral posted by counterparties	15,496	—
Derivatives, at fair value	243,223	233,301
Accrued interest payable- repurchase agreements	6,025	7,724
Accounts payable and other accrued expenses	9,271	18,605
Total Liabilities	$7,634,685	$11,830,111
Commitments and contingencies (Note 10)		
Stockholders' Equity:		
Preferred stock, $0.001 par value, 50,000 shares authorized;		
8.250% Series A Cumulative Preferred Stock; 2,181 issued and outstanding ($54,514 aggregate liquidation preference)	2	2
7.875% Series B Cumulative Preferred Stock; 5,650 issued and outstanding ($141,250 aggregate liquidation preference)	6	6
Common stock, $0.001 par value, 125,000 shares authorized, 36,713 and 36,682 shares issued and outstanding at September 30, 2016 and December 31, 2015	37	37
Additional paid-in capital	2,560,021	2,559,361
Accumulated deficit	(1,505,020)	(1,266,938)
Accumulated other comprehensive income (loss)	165,271	(67,302)
Total Stockholders' Equity	$1,220,317	$1,225,166
Total Liabilities and Stockholders' Equity	$8,855,002	$13,055,277

See notes to condensed consolidated financial statements.

ARMOUR Residential REIT, Inc. and Subsidiaries
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)
(Unaudited)

	For the Quarter Ended		For the Nine Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Interest Income:				
Agency Securities, net of amortization of premium and fees	$44,544	$85,643	$178,733	$276,896
Non-Agency Securities, including discount accretion	12,969	—	23,148	—
Interest-Only Securities	852	—	855	—
Total Interest Income	$58,365	$85,643	$202,736	$276,896
Interest expense- repurchase agreements	(17,040)	(14,431)	(54,464)	(42,539)
Net Interest Income	$41,325	$71,212	$148,272	$234,357
Other Income (Loss):				
Realized gain on sale of Agency Securities (reclassified from Other comprehensive income (loss))	2,421	69	18,937	1,562
Gain on Non-Agency Securities	39,522	—	53,795	—
Loss on Interest-Only Securities	(1,105)	—	(2,348)	—
Bargain purchase price on acquisition of JAVELIN	—	—	6,484	—
Subtotal	$40,838	$69	$76,868	$1,562
Realized gain (loss) on derivatives (1)	19,816	(17,400)	(338,804)	(69,280)
Unrealized gain (loss) on derivatives	25,824	(266,074)	2,907	(287,905)
Subtotal	$45,640	$(283,474)	$(335,897)	$(357,185)
Total Other Income (Loss)	$86,478	$(283,405)	$(259,029)	$(355,623)
Expenses:				
Management fees	6,521	6,851	19,549	20,595
Professional fees	1,090	878	4,756	2,329
Insurance	283	174	727	516
Compensation	530	543	1,636	1,731
Other	691	914	2,188	2,566
Total Expenses	$9,115	$9,360	$28,856	$27,737
Net Income (Loss)	$118,688	$(221,553)	$(139,613)	$(149,003)
Dividends on preferred stock	(3,905)	(3,905)	(11,716)	(11,716)
Net Income (Loss) related to common stockholders	$114,783	$(225,458)	$(151,329)	$(160,719)
Net Income (Loss) per share related to common stockholders (Note 13):				
Basic	$3.13	$(5.18)	$(4.12)	$(3.68)
Diluted	$3.12	$(5.18)	$(4.12)	$(3.68)
Dividends declared per common share	$0.66	$0.98	$2.36	$2.90
Weighted average common shares outstanding:				
Basic	36,703	43,561	36,693	43,709
Diluted	36,746	43,561	36,693	43,709

(1) Interest expense related to our interest rate swap contracts is recorded as realized loss on derivatives on the condensed consolidated statements of operations. For additional information, see Note 9 to the condensed consolidated financial statements.

See notes to condensed consolidated financial statements.

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ARMOUR Residential REIT, Inc. and Subsidiaries
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(in thousands)
(Unaudited)

	For the Quarter Ended		For the Nine Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Net Income (Loss)	$118,688	$(221,553)	$(139,613)	$(149,003)
Other comprehensive income (loss):				
Reclassification adjustment for realized gain on sale of available for sale Agency Securities	(2,421)	(69)	(18,937)	(1,562)
Net unrealized gain (loss) on available for sale Agency Securities	(7,526)	137,312	251,510	5,241
Other comprehensive income (loss)	$(9,947)	$137,243	$232,573	$3,679
Comprehensive Income (Loss)	$108,741	$(84,310)	$92,960	$(145,324)

See notes to the condensed consolidated financial statements.

ARMOUR Residential REIT, Inc. and Subsidiaries
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
(in thousands, except per share amounts)
(Unaudited)

	Preferred Stock 8.250% Series A			7.875% Series B			Common Stock						
	Shares	Par Amount	Additional Paid-in Capital	Shares	Par Amount	Additional Paid-in Capital	Shares	Par Amount	Additional Paid-in Capital	Total Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total
Balance, January 1, 2016	2,181	$2	$53,172	5,650	$6	$136,547	36,682	$37	$2,369,642	$2,559,361	$(1,266,938)	$(67,302)	$1,22
Series A Preferred dividends	—	—	—	—	—	—	—	—	—	—	(3,373)	—	(3,37
Series B Preferred dividends	—	—	—	—	—	—	—	—	—	—	(8,343)	—	(8,34
Common stock dividends	—	—	—	—	—	—	—	—	—	—	(86,753)	—	(86,75
Stock based compensation, net of withholding requirements	—	—	—	—	—	—	31	—	660	660	—	—	660
Net Loss	—	—	—	—	—	—	—	—	—	—	(139,613)	—	(139,6
Other comprehensive income	—	—	—	—	—	—	—	—	—	—	—	232,573	232,5
Balance, September 30, 2016	2,181	$2	$53,172	5,650	$6	$136,547	36,713	$37	$2,370,302	$2,560,021	$(1,505,020)	$165,271	$1,22

See notes to condensed consolidated financial statements.

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ARMOUR Residential REIT, Inc. and Subsidiaries
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(Unaudited)

	For the Nine Months Ended	
	September 30, 2016	September 30, 2015
Cash Flows From Operating Activities:		
Net Loss	$(139,613)	$(149,003)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Net amortization of premium on Agency Securities	60,127	85,203
Accretion of net discount on Non-Agency Securities	(1,336)	—
Net amortization of Interest-Only Securities	3,682	—
Realized gain on sale of Agency Securities	(18,937)	(1,562)
Gain on Non-Agency Securities	(53,795)	—
Loss on Interest-Only Securities	2,348	—
Stock based compensation	660	717
Bargain purchase price on acquisition of JAVELIN	(6,484)	—
Changes in operating assets and liabilities:		
Decrease in accrued interest receivable	16,597	4,348
(Increase) decrease in prepaid and other assets	1,440	(3,195)
(Increase) decrease in derivatives, at fair value	(16,825)	260,340
Decrease in accrued interest payable- repurchase agreements	(2,612)	(3,082)
Decrease in accounts payable and other accrued expenses	(16,951)	(13,278)
Net cash provided by (used in) operating activities	$(171,699)	$180,488
Cash Flows From Investing Activities:		
Purchases of Agency Securities	(391,277)	(3,485,806)
Purchases of Non-Agency Securities	(760,666)	—
Purchases of Interest-Only Securities	(101,947)	—
Principal repayments of Agency Securities	1,020,179	1,486,497
Principal repayments of Non-Agency Securities	37,698	—
Proceeds from sales of Agency Securities	5,428,174	3,395,902
Increase (decrease) in cash collateral	22,499	(333,103)
Net cash used in the acquisition of JAVELIN	(73,174)	—
Net cash provided by investing activities	$5,181,486	$1,063,490
Cash Flows From Financing Activities:		
Issuance of common stock, net of expenses	—	124
Proceeds from repurchase agreements	108,505,750	64,947,629
Principal repayments on repurchase agreements	(113,305,168)	(66,233,977)
Series A Preferred stock dividends paid	(3,373)	(3,373)
Series B Preferred stock dividends paid	(8,343)	(8,343)
Common stock dividends paid	(86,753)	(127,669)
Common stock repurchased	—	(36,441)
Net cash used in financing activities	$(4,897,887)	$(1,462,050)
Net increase (decrease) in cash	111,900	(218,072)
Cash - beginning of period	289,925	494,561
Cash - end of period	$401,825	$276,489
Supplemental Disclosure:		
Cash paid during the period for interest	$130,758	$184,928
Non-Cash Investing and Financing Activities:		

Net unrealized gain on available for sale Agency Securities	$251,510	$5,241
Amounts payable for common stock repurchased	$—	$(9,530)

See notes to condensed consolidated financial statements

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

Note 1 -Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X promulgated by the Securities and Exchange Commission (the “SEC”). Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Certain prior year amounts have been reclassified to conform to the current year's presentation. All per share amounts, common shares outstanding and stock-based compensation amounts for all periods presented reflect our one-for-eight reverse stock split (the “Reverse Stock Split”), which was effective July 31, 2015. Operating results for the quarter and nine months ended September 30, 2016 are not necessarily indicative of the results that may be expected for the calendar year ending December 31, 2016. These unaudited financial statements should be read in conjunction with the audited financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2015.

The condensed consolidated financial statements include the accounts of ARMOUR Residential REIT, Inc. and its subsidiaries including the results of JAVELIN Mortgage Investment Corp. ("JAVELIN") since its acquisition on April 6, 2016. All intercompany accounts and transactions have been eliminated. The preparation of the condensed consolidated financial statements in conformity with 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 period. Actual results could differ from those estimates. Significant estimates affecting the accompanying condensed consolidated financial statements include the valuation of MBS (as defined below), including an assessment of whether other-than-temporary impairment (“OTTI”) exists, and derivative instruments.

Note 2 -Organization and Nature of Business Operations

References to “we,” “us,” “our,” “ARMOUR” or the “Company” are to ARMOUR Residential REIT, Inc. References to “ACM are to ARMOUR Capital Management LP, a Delaware limited partnership.

We are a Maryland corporation incorporated in 2008. ARMOUR and its subsidiaries, including JAVELIN are managed by ACM, an investment advisor registered with the SEC (see Note 10 -Commitments and Contingencies and Note 15 -Related Party Transactions for additional discussion). We invest in residential mortgage backed securities issued or guaranteed by a United States (“U.S.”) Government-sponsored entity (“GSE”), such as the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac), or a government agency such as Government National Mortgage Administration (Ginnie Mae) (collectively, “Agency Securities”). Interest-only Securities are the interest portion of Agency Securities, which is separated and sold individually from the principal portion of the same payment. Other securities backed by residential mortgages in which we invest, for which the payment of principal and interest is not guaranteed by a GSE or government agency may benefit from credit enhancement derived from structural elements such as subordination, over collateralization or insurance (collectively, “Non-Agency Securities”). Agency Securities, Non-Agency Securities and Interest-only Securities are collectively referred to as “MBS”.

At September 30, 2016 and December 31, 2015, investments in Agency Securities accounted for 86.5% and 100.0% of our MBS portfolio, respectively. During the first quarter of 2016, we began to invest in Non-Agency Securities. At

September 30, 2016, investments in Non-Agency Securities accounted for 12.3% of our MBS portfolio. During the second quarter of 2016, we began to invest in Interest-only Securities. At September 30, 2016, investments in Interest-only Securities accounted for 1.2% of our MBS portfolio.

Our charter permits us to invest in Agency Securities, Non-Agency Securities and Interest-only Securities. Our MBS portfolio consists primarily of Agency Securities backed by fixed rate home loans. From time to time, a portion of our assets may be invested in Agency Securities backed by hybrid adjustable rate and adjustable rate home loans as well as unsecured notes and bonds issued by GSEs, U.S. Treasuries and money market instruments, subject to certain income tests we must satisfy for our qualification as a real estate investment trust ("REIT").

We have elected to be taxed as a REIT under the Internal Revenue Code, as amended ("the Code"). Our qualification as a REIT depends on our ability to meet, on a continuing basis, various complex requirements under the Code relating to, among other things, the sources of our gross income, the composition and values of our assets, our distribution levels and the concentration of ownership of our capital stock. We believe that we are organized in conformity with the requirements for qualification as a REIT under the Code and our manner of operations enables us to meet the requirements for taxation as a REIT for federal income tax purposes.

As a REIT, we will generally not be subject to federal income tax on the REIT taxable income that we currently distribute to our stockholders. If we fail to qualify as a REIT in any taxable year and do not qualify for certain statutory relief provisions, we will be subject to federal income tax at regular corporate rates. Even if we qualify as a REIT for federal income tax purposes, we may still be subject to some federal, state and local taxes on our income.

Note 3 -Summary of Significant Accounting Policies

Cash

Cash includes cash on deposit with financial institutions. We may maintain deposits in federally insured financial institutions in excess of federally insured limits. However, management believes we are not exposed to significant credit risk due to the financial position and creditworthiness of the depository institutions in which those deposits are held.

Cash Collateral Posted To/By Counterparties

Cash collateral posted to/by counterparties represents cash posted by us to counterparties or posted by counterparties to us as collateral. Cash collateral posted to/by counterparties may include collateral for interest rate swap contracts (including swaptions and basis swap contracts), Eurodollar Futures Contracts (“Futures Contracts”) and repurchase agreements on our MBS and our Agency Securities purchased or sold on a to-be-announced basis (“TBA Agency Securities”).
MBS, at Fair Value

We generally intend to hold most of our MBS for extended periods of time. We may, from time to time, sell any of our MBS as part of the overall management of our MBS portfolio. Management determines the appropriate classifications of the securities at the time they are acquired and evaluates the appropriateness of such classifications at each balance sheet date. Purchases and sales of our MBS are recorded on the trade date.

Agency Securities, Available For Sale - At September 30, 2016 and December 31, 2015, all of our Agency Securities were classified as available for sale securities. Agency Securities classified as available for sale are reported at their estimated fair values with unrealized gains and losses excluded from earnings and reported as part of the condensed consolidated statements of comprehensive income (loss).

Non-Agency Securities, Trading - At September 30, 2016, all of our Non-Agency Securities were classified as trading securities. Non-Agency Securities classified as trading are reported at their estimated fair values with unrealized gains and losses included in Other Income (Loss) as a component of the condensed consolidated statements of operations. We estimate future cash flows for each Non-Agency Security and then discount those cash flows based on our estimates of current market yield for each individual security. We then compare our calculated price with our pricing services and/or dealer marks. Our estimates for future cash flows and current market yields incorporate such factors as coupons, prepayment speeds, defaults, delinquencies and severities.

Interest-only Securities, Trading - At September 30, 2016, all of our Interest-only Securities were classified as trading securities. Interest-only Securities represent the right to receive a specified proportion of the contractual interest flows of specific Agency MBS. Interest-only Securities classified as trading are reported at their estimated fair values with unrealized gains and losses included in Other Income (Loss) as a component of the condensed consolidated statements of operations.

Receivables and Payables for Unsettled Sales and Purchases

We account for purchases and sales of securities on the trade date, including purchases and sales for forward settlement. Receivables and payables for unsettled trades represent the agreed trade price multiplied by the outstanding balance of the securities at the balance sheet date.

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

Accrued Interest Receivable and Payable

Accrued interest receivable includes interest accrued between payment dates on MBS. Accrued interest payable includes interest payable on our repurchase agreements and may, at certain times, contain interest payable on U.S. Treasury Securities sold short.

Repurchase Agreements

We finance the acquisition of our MBS through the use of repurchase agreements. Our repurchase agreements are secured by our MBS and bear interest rates that have historically moved in close relationship to the Federal Funds Rate and the London Interbank Offered Rate ("LIBOR"). Under these repurchase agreements, we sell MBS to a lender and agree to repurchase the same MBS in the future for a price that is higher than the original sales price. The difference between the sales price that we receive and the repurchase price that we pay represents interest paid to the lender. A repurchase agreement operates as a financing arrangement under which we pledge our MBS as collateral to secure a loan which is equal in value to a specified percentage of the estimated fair value of the pledged collateral. We retain beneficial ownership of the pledged collateral. At the maturity of a repurchase agreement, we are required to repay the loan and concurrently receive back our pledged collateral from the lender or, with the consent of the lender, we may renew such agreement at the then prevailing interest rate. The repurchase agreements may require us to pledge additional assets to the lender in the event the estimated fair value of the existing pledged collateral declines.

In addition to the repurchase agreement financing discussed above, at certain times we have entered into reverse repurchase agreements with certain of our repurchase agreement counterparties. Under a typical reverse repurchase agreement, we purchase U.S. Treasury Securities from a borrower in exchange for cash and agree to sell the same securities in the future in exchange for a price that is higher than the original purchase price. The difference between the purchase price originally paid and the sale price represents interest received from the borrower. Reverse repurchase agreement receivables and repurchase agreement liabilities are presented net when they meet certain criteria, including being with the same counterparty, being governed by the same master repurchase agreement ("MRA"), settlement through the same brokerage or clearing account and maturing on the same day. We did not have any reverse repurchase agreements outstanding at September 30, 2016 and December 31, 2015.

Obligations to Return Securities Received as Collateral, at Fair Value

At certain times, we also sell to third parties the U.S. Treasury Securities received as collateral for reverse repurchase agreements and recognize the resulting obligation to return said U.S. Treasury Securities as a liability on our condensed consolidated balance sheets. Interest is recorded on the repurchase agreements, reverse repurchase agreements and U.S. Treasury Securities sold short on an accrual basis and presented as interest expense. Both parties to the transaction have the right to make daily margin calls based on changes in the fair value of the collateral received and/or pledged. We did not have any obligations to return securities received as collateral at September 30, 2016 and December 31, 2015.

Derivatives, at Fair Value

We recognize all derivatives as either assets or liabilities at fair value on our condensed consolidated balance sheets. All changes in the fair values of our derivatives are reflected in our condensed consolidated statements of operations. We designate derivatives as hedges for tax purposes and any unrealized derivative gains or losses would not affect our distributable net taxable income. These transactions include interest rate swap contracts, interest rate swaptions and basis swap contracts. We also may utilize forward contracts for the purchase or sale of TBA Agency Securities. We account for TBA Agency Securities as derivative instruments if it is reasonably possible that we will not take or make physical delivery of the Agency Security upon settlement of the contract. We account for TBA dollar roll transactions as a series of derivative transactions.

We may also purchase and sell TBA Agency Securities as a means of investing in and financing Agency Securities (thereby increasing our “at risk” leverage) or as a means of disposing of or reducing our exposure to Agency Securities (thereby reducing our “at risk” leverage). Pursuant to TBA Agency Securities, we agree to purchase or sell, for future delivery, Agency Securities with certain principal and interest terms and certain types of collateral, but the particular Agency Securities to be delivered are not identified until shortly before the TBA settlement date. We may also choose, prior to settlement, to move the settlement of these securities out to a later date by entering into an offsetting short or long position (referred to as a “pair off”), net settling the paired off positions for cash, and simultaneously purchasing or selling a similar TBA Agency Security for a later settlement date. This transaction is commonly referred to as a “dollar roll.” When it is reasonably possible that we will pair off a TBA Agency Security, we account for that contract as a derivative.

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
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Revenue Recognition

Agency Securities, Available For Sale - Interest income is earned and recognized on Agency Securities based on their unpaid principal amounts and their contractual terms. Recognition of interest income commences on the settlement date of the purchase transaction and continues through the settlement date of the sale transaction. Premiums and discounts associated with the purchase of Multi-Family MBS, which are generally not subject to prepayment, are amortized or accreted into interest income over the contractual lives of the securities using a level yield method. Premiums and discounts associated with the purchase of other Agency Securities are amortized or accreted into interest income over the actual lives of the securities, reflecting actual prepayments as they occur.

Fair Value of Agency Securities: We invest in Agency Securities representing interests in or obligations backed by pools of fixed rate, hybrid adjustable rate and adjustable rate mortgage loans. GAAP requires us to classify our investments as either trading, available for sale or held to maturity securities. Management determines the appropriate classifications of the securities at the time they are acquired and evaluates the appropriateness of such classifications at each balance sheet date. We currently classify all of our Agency Securities as available for sale. Agency Securities classified as available for sale are reported at their estimated fair values with unrealized gains and losses excluded from earnings and reported as part of the statements of comprehensive income (loss).

Security purchase and sale transactions, including purchase of TBA Agency Securities, are recorded on the trade date to the extent it is probable that we will take or make timely physical delivery of the related securities. Gains or losses realized from the sale of securities are included in income and are determined using the specific identification method.

Impairment of Assets: We evaluate Agency Securities for other than temporary impairment at least on a quarterly basis and more frequently when economic or market concerns warrant such evaluation. We consider an impairment to be other than temporary if we (1) have the intent to sell the Agency Securities, (2) believe it is more likely than not that we will be required to sell the securities before recovery (for example, because of liquidity requirements or contractual obligations) or (3) a credit loss exists. Impairment losses recognized establish a new cost basis for the related Agency Securities.

Non-Agency Securities and Interest-only Securities, Trading - Interest income on Non-Agency Securities and Interest-only Securities is recognized using the effective yield method over the life of the securities based on the future cash flows expected to be received. Future cash flow projections and related effective yields are determined for each security and updated quarterly. Other than temporary impairments, which establish a new cost basis in the security for purposes of calculating effective yields, are recognized when the fair value of a security is less than its cost basis and there has been an adverse change in the future cash flows expected to be received. Other changes in future cash flows expected to be received are recognized prospectively over the remaining life of the security.

Comprehensive Income (Loss)

Comprehensive income (loss) refers to changes in equity during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period, except those resulting from investments by owners and distributions to owners.

Reclassification

Certain amounts included in other expenses in the first and second quarters of 2016 have been reclassified to Interest Income Agency Securities. All per share amounts, common shares outstanding and stock-based compensation amounts for all periods presented reflect the Reverse Stock Split, which was effective July 31, 2015. No other reclassifications have been made to previously reported amounts.

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
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Note 4 -Recent Accounting Pronouncements

In September 2015, the Financial Accounting Standards Board issued ASU 2015-16, Business Combinations Simplifying the Accounting for Measurement-Period Adjustments (Topic 805). The amendment simplifies the accounting for measurement-period adjustments. An acquirer is required to recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The amendment also requires acquirers to present separately on the face of the income statement or disclose in the notes, the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustments to the provisional amounts had been recognized as of the acquisition date. The amendment is effective for fiscal years beginning after December 15, 2015 and has not had a significant impact on the consolidated financial statements for the quarter.

In February 2016, the Financial Accounting Standards Board issued ASU 2016-02, Leases (Topic 842). The standard introduces a new lessee model that will require most leases to be recorded on the balance sheet recognizing a right-of-use lease asset and a liability to make lease payments. The standard will be effective for annual periods beginning after December 15, 2018. The Company is assessing the impact of this standard but does not expect it to have a significant impact on the consolidated financial statements.

In July 2016 the Financial Accounting Standards Board issued ASU 2016-13, Financial Instruments–Credit Losses (Topic 326). The standard introduces a new model for recognizing credit losses on financial instruments based on an estimate of current expected credit losses. The standard will apply to (1) loans, accounts receivable, trade receivables, and other financial assets measured at amortized cost, (2) loan commitments and certain other off–balance sheet credit, exposures, (3) debt securities and other financial assets measured at fair value through other comprehensive income, and (4) beneficial interests in securitized financial assets. The standard is effective for fiscal years beginning after December 15, 2019. The Company is assessing the impact of this standard but does not expect it to have significant impact on the consolidated financial statements.

Note 5 -Fair Value of Financial Instruments

Our valuation techniques for financial instruments use observable and unobservable inputs. Observable inputs reflect readily obtainable data from third party sources, while unobservable inputs reflect management's market assumptions. The Accounting Standards Codification Topic No. 820, "Fair Value Measurement," classifies these inputs into the following hierarchy:

Level 1 Inputs - Quoted prices for identical instruments in active markets.

Level 2 Inputs - Quoted prices for similar instruments 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 3 Inputs - Prices determined using significant unobservable inputs. Unobservable inputs may be used 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 reflect management's assumptions about the factors that market participants would use in pricing an asset or liability, and would be based on the best information available.

The following describes the valuation methodologies used for our assets and liabilities measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy. Any transfers between levels are assumed to occur at the beginning of the reporting period.

Cash - Cash includes cash on deposit with financial institutions. The carrying amount of cash is deemed to be its fair value and is classified as Level 1. Cash balances posted by us to counterparties or posted by counterparties to us as collateral are classified as Level 2 because they are integrally related to the Company's repurchase financing and interest rate swap agreements, which are classified as Level 2.

Agency Securities, Available for Sale - Fair value for the Agency Securities in our MBS portfolio is based on obtaining a valuation for each Agency Security from third party pricing services and/or dealer quotes. The third party pricing services use common market pricing methods that may include pricing models that may incorporate such factors as coupons, prepayment speeds, spread to the Treasury curves and interest rate swap curves, duration, periodic and life caps and credit enhancement. If the fair value of an Agency Security is not available from the third party pricing services or such data appears unreliable, we obtain

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pricing indications from up to three dealers who make markets in similar Agency Securities. Management reviews pricing used to ensure that current market conditions are properly reflected. This review includes, but is not limited to, comparisons of similar market transactions or alternative third party pricing services, dealer pricing indications and comparisons to a third party pricing model. Fair values obtained from the third party pricing services for similar instruments are classified as Level 2 securities if the inputs to the pricing models used are consistent with the Level 2 definition. If quoted prices for a security are not reasonably available from the third party pricing service, but dealer pricing indications are, the security will be classified as a Level 2 security. If neither is available, management will determine the fair value based on characteristics of the security that we receive from the issuer and based on available market information and classify it as a Level 3 security. At September 30, 2016 and December 31, 2015, all of our Agency Security fair values are classified as Level 2 based on the inputs used by our third party pricing services and dealer quotes.

Non-Agency Securities Trading - The fair value for the Non-Agency Securities in our MBS portfolio is based on estimates prepared by our Portfolio Management group, which organizationally reports to our Chief Investment Officer. In preparing the estimates, our Portfolio Management group uses commercially available and proprietary models and data as well as market intelligence gained from discussions with, and transactions by, other market participants. We estimate the fair value of our Non-Agency Securities by estimating the future cash flows for each Non-Agency Security and then discounting those cash flows based on our estimates of current market yield for each individual security. Our estimates for future cash flows and current market yields incorporate such factors as collateral type, bond structure and priority of payments, coupons, prepayment speeds, defaults, delinquencies and severities. Quarterly, we compare our estimates of fair value of our Non-Agency Securities with pricing from third party pricing services, dealer marks received and recent purchase and financing transaction history to validate our assumptions of cash flow and market yield and calibrate our models. Fair values calculated in this manner are considered Level 3. At September 30, 2016, all of our Non-Agency Security fair values are calculated in this manner and therefore were classified as Level 3.

Interest-Only Securities Trading - The fair value for the Interest-Only Securities in our MBS portfolio is based on obtaining a valuation for each Interest-Only Security from third party pricing services and/or dealer quotes. The third party pricing services use common market pricing methods that may include pricing models consistent with those models used to price Agency Securities underlying the Interest-Only Securities that may incorporate such factors as coupons, prepayment speeds, spread to the Treasury curves and interest rate swap curves, duration, periodic and life caps and credit enhancement. If the fair value of an Interest-Only Security is not available from the third party pricing services or such data appears unreliable, we obtain pricing indications from up to three dealers who make markets in similar Interest-Only Securities. Management reviews pricing used to ensure that current market conditions are properly reflected. This review includes, but is not limited to, comparisons of similar market transactions or alternative third party pricing services, dealer pricing indications and comparisons to a third party pricing model. Fair values obtained from the third party pricing services for similar instruments are classified as Level 2 securities if the inputs to the pricing models used are consistent with the Level 2 definition. If quoted prices for a security are not reasonably available from the third party pricing service, but dealer pricing indications are, the security will be classified as a Level 2 security. If neither is available, management will determine the fair value based on characteristics of the security that we receive from the issuer and based on available market information and classify it as a Level 3 security. At September 30, 2016, all of our Interest-Only Security fair values are classified as Level 2 based on the inputs used by our third party pricing services and dealer quotes.

Receivables and Payables for Unsettled Sales and Purchases - The carrying amount is generally deemed to be fair value because of the relatively short time to settlement. Such receivables and payables are classified as Level 2 because they are effectively secured by the related securities and could potentially be subject to counterparty credit considerations.

Repurchase Agreements - The fair value of repurchase agreements reflects the present value of the contractual cash flows discounted at the estimated LIBOR based market interest rates at the valuation date for repurchase agreements with a term equivalent to the remaining term to interest rate repricing, which may be at maturity, of our repurchase agreements. The fair value of the repurchase agreements approximates their carrying amount due to the short-term nature of these financial instruments. Our repurchase agreements are classified as Level 2.

Obligations to Return Securities Received as Collateral - The fair value of the obligations to return securities received as collateral are based upon the prices of the related U.S. Treasury Securities obtained from a third party pricing service. Such obligations are classified as Level 1.

Derivative Transactions - Our Futures Contracts are traded on the Chicago Mercantile Exchange (“CME”) and are classified as Level 1. The fair values of our interest rate swap contracts, interest rate swaptions and basis swaps are valued using

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third party pricing services that incorporate common market pricing methods that may include current interest rate curves, forward interest rate curves and market spreads to interest rate curves. We estimate the fair value of TBA Agency Securities based on similar methods used to value our Agency Securities. Management compares pricing used to dealer quotes to ensure that the current market conditions are properly reflected. The fair values of our interest rate swap contracts, interest rate swaptions, basis swap contracts and TBA Agency Securities are classified as Level 2.

The following tables provide a summary of our assets and liabilities that are measured at fair value on a recurring basis at September 30, 2016 and December 31, 2015.

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at September 30, 2016
Assets at Fair Value:				
Agency Securities, available for sale	$ —	$7,041,228	$ —	$7,041,228
Non-Agency Securities, trading	$ —	$—	$ 1,001,319	$1,001,319
Interest-Only Securities, trading	$ —	$95,918	$ —	$95,918
Derivatives	$ —	$10,194	$ —	$10,194
Liabilities at Fair Value:				
Derivatives	$ —	$243,223	$ —	$243,223

There were no transfers of assets or liabilities between the levels of the fair value hierarchy during the quarter and nine months ended September 30, 2016.

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at December 31, 2015
Assets at Fair Value:				
Agency Securities, available for sale	$ —	$12,461,556	$ —	$12,461,556
Derivatives	$ —	$999	$ —	$999
Liabilities at Fair Value:				
Derivatives	$ —	$233,301	$ —	$233,301

There were no transfers of assets or liabilities between the levels of the fair value hierarchy during the year ended December 31, 2015.

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The following tables provide a summary of the carrying values and fair values of our financial assets and liabilities not carried at fair value but for which fair value is required to be disclosed at September 30, 2016 and December 31, 2015.

September 30, 2016			Fair Value Measurements using:		
	Carrying Value	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial Assets:					
Cash	$401,825	$401,825	$401,825	$—	$ —
Cash collateral posted to counterparties	$281,397	$281,397	$—	$281,397	$ —
Accrued interest receivable	$19,271	$19,271	$—	$19,271	$ —
Financial Liabilities:					
Repurchase agreements	$7,360,670	$7,360,670	$—	$7,360,670	$ —
Cash collateral posted by counterparties	$15,496	$15,496	$—	$15,496	$ —
Accrued interest payable- repurchase agreements	$6,025	$6,025	$—	$6,025	$ —

December 31, 2015			Fair Value Measurements using:		
	Carrying Value	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial Assets:					
Cash	$289,925	$289,925	$289,925	$—	$ —
Cash collateral posted to counterparties	$263,799	$263,799	$—	$263,799	$ —
Principal payments receivable	$37	$37	$—	$37	$ —
Accrued interest receivable	$34,500	$34,500	$—	$34,500	$ —
Financial Liabilities:					
Repurchase agreements	$11,570,481	$11,570,481	$—	$11,570,481	$ —
Accrued interest payable- repurchase agreements	$7,724	$7,724	$—	$7,724	$ —

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The following table provides a summary of the changes in Level 3 assets measured at fair value on a recurring basis at September 30, 2016. We did not have Level 3 assets at December 31, 2015.

Non-Agency Securities	For the Quarter Ended September 30, 2016	For the Nine Months Ended September 30, 2016
Balance, beginning of period	$ 916,571	$ —
Non-Agency Securities acquired in the acquisition of JAVELIN, at fair value	—	223,220
Purchases of Non-Agency Securities, at cost	68,186	760,666
Principal repayments of Non-Agency Securities	(23,707)	(37,698)
Gain on Non-Agency Securities	39,522	53,795
Discount accretion	747	1,336
Balance, end of period	$ 1,001,319	$ 1,001,319
Gain on Non-Agency Securities	$ 39,522	$ 53,795

The significant unobservable inputs used in the fair value measurement of our Level 3 Non-Agency Securities include assumptions for underlying loan collateral, cumulative default rates and loss severities in the event of default, as well as discount rates.

The following table presents the range of our estimates of cumulative default and loss severities, together with the discount rates implicit in our Level 3 Non-Agency Security fair values at September 30, 2016. We did not have Level 3 assets at December 31, 2015.

September 30, 2016

Unobservable Level 3 Input	Minimum	Weighted Average	Maximum
Cumulative default	0.00 %	1.74 %	40.90 %
Loss severity (life)	0.00 %	23.00 %	75.73 %
Discount rate	2.38 %	4.08 %	7.84 %
Delinquency (life)	0.00 %	4.14 %	47.09 %
Voluntary prepayments (life)	1.56 %	15.71 %	28.14 %

The table above includes the effects of the structural elements of our Non-Agency Securities, such as subordination and over collateralization or insurance. Significant increases or decreases in any of these inputs in isolation would result in a significantly lower or higher fair value measurement. Generally, a change in the assumption used for the probability of cumulative default is accompanied by a directionally similar change in the assumption used for the delinquency and loss severity and a directionally opposite change in the assumption used for voluntary prepayment rates for the life of the security. However, given the interrelationship between loss estimates and the discount rate, overall Non-Agency Security market conditions would likely have a more significant impact on our Level 3 fair values than changes in any one unobservable input.

Note 6 -Agency Securities, Available for Sale

All of our Agency Securities are classified as available for sale and, as such, are reported at their estimated fair value and changes in fair value reported as part of the statements of comprehensive income (loss). At September 30, 2016 and December 31, 2015, investments in Agency Securities accounted for 86.5% and 100.0% of our MBS portfolio.

We evaluated our Agency Securities with unrealized losses at September 30, 2016, September 30, 2015 and December 31, 2015, to determine whether there was an other than temporary impairment. All of our Agency Securities are issued and guaranteed by GSEs or Ginnie Mae. The GSEs have a long term credit rating of AA+. At those dates, we also considered whether we intended to sell Agency Securities and whether it was more likely than not that we could meet our liquidity requirements and contractual

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obligations without selling Agency Securities. As a result of this evaluation, no other than temporary impairment was recognized for the quarters and nine months ended September 30, 2016 and September 30, 2015 and for the year ended December 31, 2015, respectively, because we determined that we 1) did not have the intent to sell the Agency Securities in an unrealized loss position, 2) did not believe it more likely than not that we were required to sell the securities before recovery (for example, because of liquidity requirements or contractual obligations), and/or (3) determined that a credit loss did not exist.

At September 30, 2016, we had the following Agency Securities in an unrealized gain or loss position as presented below. The components of the carrying value of our Agency Securities at September 30, 2016 are also presented below. Our Agency Securities had a weighted average coupon of 3.53% at September 30, 2016.

September 30, 2016	Amortized Cost	Gross Unrealized Loss	Gross Unrealized Gain	Fair Value	Percent of Total
Fannie Mae					
ARMs & Hybrids	$ 39,700	$ (93)	$ 351	$ 39,958	0.57 %
Multi-Family MBS	1,473,296	—	83,738	1,557,034	22.11
10 Year Fixed	96,512	(376)	866	97,002	1.38
15 Year Fixed	2,728,932	(10)	45,721	2,774,643	39.41
20 Year Fixed	590,738	(6)	5,520	596,252	8.47
25 Year Fixed					