DYNEX CAPITAL INC
Form 10-Q
November 08, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
FORM 10-Q

R Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended September 30, 2012
or
£ Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
Commission File Number: 1-9819

DYNEX CAPITAL, INC.
(Exact name of registrant as specified in its charter)

| Virginia | 52-1549373 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 4991 Lake Brook Drive, Suite 100, Glen Allen, Virginia | 23060-9245 |
| (Address of principal executive offices) | (Zip Code) |

(804) 217-5800
(Registrant’s telephone number, including area code)

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

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

| Large accelerated filer | £ | Accelerated filer | R |
|---|---|---|---|
| Non-accelerated filer | £ (Do not check if a smaller reporting company) | Smaller reporting company | £ |

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

On October 31, 2012, the registrant had 54,371,159 shares outstanding of common stock, $0.01 par value, which is the registrant’s only class of common stock.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

DYNEX CAPITAL, INC.
CONSOLIDATED BALANCE SHEETS
(amounts in thousands except share data)

| ASSETS | September 30, 2012 (unaudited) | December 31, 2011 |
|---|---|---|
| Agency MBS (including pledged of $3,506,618 and $1,879,831, respectively) | $3,650,672 | $1,965,159 |
| Non-Agency MBS (including pledged of $569,016 and $415,195, respectively) | 586,931 | 421,096 |
| Securitized mortgage loans, net | 77,748 | 113,703 |
| Other investments, net | 896 | 1,018 |
| | 4,316,247 | 2,500,976 |
| Cash and cash equivalents | 34,723 | 48,776 |
| Principal receivable on investments | 20,374 | 13,826 |
| Accrued interest receivable | 22,091 | 12,609 |
| Other assets, net | 11,595 | 6,006 |
| Total assets | $4,405,030 | $2,582,193 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Liabilities: | | |
| Repurchase agreements | $3,670,972 | $2,093,793 |
| Payable for securities pending settlement | 12,567 | — |
| Non-recourse collateralized financing | 31,295 | 70,895 |
| Derivative liabilities | 46,496 | 27,997 |
| Accrued interest payable | 2,381 | 2,165 |
| Accrued dividends payable | 16,582 | 11,307 |
| Other liabilities | 6,806 | 4,687 |
| Total liabilities | 3,787,099 | 2,210,844 |
| Commitments and Contingencies (Note 12) | | |
| Shareholders' equity: | | |
| Preferred stock, par value $.01 per share, 8.5% Series A Cumulative Redeemable; 8,000,000 shares authorized; 2,300,000 and no shares issued and outstanding, respectively ($57,500 aggregate liquidation preference) | 55,407 | — |
| Common stock, par value $.01 per share, 100,000,000 shares authorized; 54,368,714 and 40,382,530 shares issued and outstanding, respectively | 544 | 404 |
| Additional paid-in capital | 759,647 | 634,683 |
| Accumulated other comprehensive income (loss) | 55,890 | (3,255) |
| Accumulated deficit | (253,557) | (260,483) |
| Total shareholders' equity | 617,931 | 371,349 |
| Total liabilities and shareholders' equity | $4,405,030 | $2,582,193 |

See notes to unaudited consolidated financial statements.

DYNEX CAPITAL, INC.
CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)
(amounts in thousands except per share data)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Interest income: | | | | |
| Agency MBS | $19,677 | $14,898 | $54,784 | $41,660 |
| Non-Agency MBS | 7,577 | 4,442 | 22,452 | 11,963 |
| Securitized mortgage loans | 1,299 | 1,773 | 4,330 | 5,953 |
| Other investments | 21 | 30 | 405 | 97 |
| | 28,574 | 21,143 | 81,971 | 59,673 |
| Interest expense: | | | | |
| Repurchase agreements | 9,166 | 5,305 | 23,673 | 13,493 |
| Non-recourse collateralized financing | 308 | 1,278 | 1,043 | 3,856 |
| | 9,474 | 6,583 | 24,716 | 17,349 |
| Net interest income | 19,100 | 14,560 | 57,255 | 42,324 |
| Provision for loan losses | (110) | (300) | (170) | (750) |
| Net interest income after provision for loan losses | 18,990 | 14,260 | 57,085 | 41,574 |
| Litigation settlement and related costs | — | (8,240) | — | (8,240) |
| Loss on non-recourse collateralized financing | — | (1,970) | — | (1,970) |
| Gain on sale of investments, net | 3,480 | 581 | 6,418 | 1,323 |
| Fair value adjustments, net | (36) | (662) | (129) | (657) |
| Other income, net | (177) | (102) | 350 | 84 |
| General and administrative expenses: | | | | |
| Compensation and benefits | (1,699) | (1,106) | (5,276) | (3,447) |
| Other general and administrative | (1,391) | (1,229) | (3,959) | (3,261) |
| Net income | $19,167 | $1,532 | $54,489 | $25,406 |
| Preferred stock dividends | (814) | — | (814) | — |
| Net income to common shareholders | $18,353 | $1,532 | $53,675 | $25,406 |
| Weighted average common shares: | | | | |
| Basic | 54,367 | 40,353 | 52,752 | 37,973 |
| Diluted | 54,368 | 40,353 | 52,752 | 37,974 |
| Net income per common share: | | | | |
| Basic | $0.34 | $0.04 | $1.02 | $0.67 |
| Diluted | $0.34 | $0.04 | $1.02 | $0.67 |
| Dividends declared per common share | $0.29 | $0.27 | $0.86 | $0.81 |

See notes to unaudited consolidated financial statements.

DYNEX CAPITAL, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(UNAUDITED)
(amounts in thousands)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Net income | $19,167 | $1,532 | $54,489 | $25,406 |
| Other comprehensive income: | | | | |
| Change in fair value of available-for-sale investments | 44,905 | 7,145 | 80,671 | 13,310 |
| Reclassification adjustment for amounts included in statement of income | (3,275) | (581) | (3,275) | (1,323) |
| Change in fair value of interest rate swaps | (11,073) | (18,251) | (28,853) | (31,974) |
| Reclassification adjustment for amounts included in statement of income | 3,827 | 3,383 | 10,602 | 8,325 |
| Other comprehensive income (loss) | 34,384 | (8,304) | 59,145 | (11,662) |
| Comprehensive income (loss) | 53,551 | (6,772) | 113,634 | 13,744 |
| Dividends declared on preferred stock | (814) | — | (814) | — |
| Comprehensive income (loss) to common shareholders | $52,737 | $(6,772) | $112,820 | $13,744 |

See notes to unaudited consolidated financial statements.

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

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2012 | 2011 |
| Operating activities: | | |
| Net income | $53,675 | $25,406 |
| Adjustments to reconcile net income to cash provided by operating activities: | | |
| Increase in accrued interest receivable | (9,383) | (6,248) |
| Increase in accrued interest payable | 216 | 161 |
| Provision for loan losses | 170 | 750 |
| Gain on sale of investments, net | (6,418) | (1,323) |
| Loss on non-recourse collateralized financing | — | 1,970 |
| Fair value adjustments, net | 129 | 657 |
| Increase in litigation settlement and related costs reserve | — | 7,861 |
| Amortization and depreciation | 58,999 | 22,312 |
| Stock-based compensation expense | 1,410 | 492 |
| Cash payments on stock appreciation rights | (116) | — |
| Net change in other assets and other liabilities | (2,348) | 1,564 |
| Net cash and cash equivalents provided by operating activities | 96,334 | 53,602 |
| Investing activities: | | |
| Purchase of investments | (2,454,851) | (1,440,594) |
| Principal payments received on investments | 34,038 | 344,649 |
| Increase in principal receivable on investments | (6,548) | (6,566) |
| Proceeds from sales of investments | 185,485 | 124,797 |
| Principal payments received on securitized mortgage loans | 459,380 | 32,655 |
| Other investing activities | (3,001) | 77 |
| Net cash and cash equivalents used in investing activities | (1,785,497) | (944,982) |
| Financing activities: | | |
| Borrowings under repurchase agreements, net | 1,577,943 | 819,503 |
| Deferred borrowing costs paid | (825) | — |
| Principal payments on non-recourse collateralized financing | (39,773) | (2,094) |
| Proceeds from issuance of preferred stock | 55,407 | — |
| Proceeds from issuance of common stock | 123,832 | 95,261 |
| Dividends paid | (41,474) | (29,970) |
| Net cash and cash equivalents provided by financing activities | 1,675,110 | 882,700 |
| | | |
| Net decrease in cash and cash equivalents | (14,053) | (8,680) |
| Cash and cash equivalents at beginning of period | 48,776 | 18,836 |
| Cash and cash equivalents at end of period | $34,723 | $10,156 |
| Supplemental Disclosure of Cash Activity: | | |
| Cash paid for interest | $24,284 | $16,411 |

See notes to unaudited consolidated financial statements.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
DYNEX CAPITAL, INC.
(amounts in thousands except share and per share data)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying consolidated financial statements of Dynex Capital, Inc. and its qualified real estate investment trust ("REIT") subsidiaries and its taxable REIT subsidiary (together, "Dynex" or the "Company") have been prepared in accordance with the instructions to the Quarterly Report on Form 10-Q and Article 10, 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 notes required by accounting principles generally accepted in the United States of America ("GAAP") for complete financial statements. In the opinion of management, all significant adjustments, consisting of normal recurring accruals considered necessary for a fair presentation of the consolidated financial statements, have been included. Operating results for the three and nine months ended September 30, 2012 are not necessarily indicative of the results that may be expected for any other interim periods or for the entire year ending December 31, 2012. The unaudited consolidated financial statements included herein should be read in conjunction with the audited financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011, filed with the SEC.

Consolidation

The consolidated financial statements include the accounts of the Company, its qualified REIT subsidiaries and its taxable REIT subsidiary. The consolidated financial statements represent the Company's accounts after the elimination of intercompany balances and transactions. The Company consolidates entities in which it owns more than 50% of the voting equity and control does not rest with others and variable interest entities in which it is determined to be the primary beneficiary in accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 810-10. The Company follows the equity method of accounting for investments with greater than a 20% and less than 50% interest in partnerships and corporate joint ventures or when it is able to influence the financial and operating policies of the investee but owns less than 50% of the voting equity. As of September 30, 2012 and December 31, 2011, the Company did not have any investments in which it owned less than a 50% interest in the voting equity.

In accordance with ASC Topic 810-10, the Company also consolidates certain trusts through which it has securitized mortgage loans. Additional information regarding the accounting policy for securitized mortgage loans is provided below under "Investments".

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements as well as the reported amounts of revenue and expenses during the reported period. Actual results could differ from those estimates. The most significant estimates used by management include but are not limited to fair value measurements of its investments, allowance for loan losses, other-than-temporary impairments, commitments and contingencies, and amortization of premiums and discounts. These items are discussed further below within this note to the consolidated financial statements.

Federal Income Taxes

The Company believes it has complied with the requirements for qualification as a REIT under the Internal Revenue Code of 1986, as amended (the “Code”). As such, the Company believes that it qualifies as a REIT for federal income tax purposes, and it generally will not be subject to federal income tax on the amount of its income or gain that is distributed as dividends to shareholders. The Company uses the calendar year for both tax and financial reporting purposes. There may be differences between taxable income and income computed in accordance with GAAP.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand and highly liquid investments with original maturities of three months or less.

Investments

The Company's investments include Agency MBS, non-Agency MBS, securitized mortgage loans, and other investments.

Agency MBS. The Company accounts for its investment in Agency MBS in accordance with ASC Topic 320, which requires that investments in debt and equity securities be designated as either "held-to-maturity," "available-for-sale" or "trading" at the time of acquisition. As of September 30, 2012, the majority of the Company's Agency MBS are designated as available-for-sale with the remainder designated as trading. Although the Company generally intends to hold its available-for-sale securities until maturity, it may, from time to time, sell any of these securities as part of the overall management of its business. The available-for-sale designation provides the Company with this flexibility.

All of the Company's Agency MBS are recorded at their fair value on the consolidated balance sheet. In accordance with ASC Topic 820, the Company determines the fair value of its Agency MBS based upon prices obtained from a third-party pricing service and broker quotes. The Company's application of ASC Topic 820 guidance is discussed further in Note 10. Changes in the fair value of Agency MBS designated as trading are recognized in net income within "fair value adjustments, net". Gains (losses) realized upon the sale, impairment, or other disposal of a trading security are also recognized within "fair value adjustments, net". Alternatively, changes in the fair value of Agency MBS designated as available-for-sale are reported in other comprehensive income as unrealized gains (losses) until the security is collected, disposed of, or determined to be other than temporarily impaired. Upon the sale of an available-for-sale security, any unrealized gain or loss is reclassified out of accumulated other comprehensive income ("AOCI") into net income as a realized "gain (loss) on sale of investments, net" using the specific identification method.

Non-Agency MBS. The Company accounts for its investment in non-Agency MBS in accordance with ASC Topic 320. As of September 30, 2012, all of the Company's non-Agency MBS are designated as available-for-sale and are recorded at their fair value on the consolidated balance sheet. Changes in fair value are reported in other comprehensive income until the security is collected, disposed of, or determined to be other than temporarily impaired. Like Agency MBS, the Company generally intends to hold its investments in non-Agency MBS until maturity, but it may, from time to time sell any of these securities as part of the overall management of its business. Upon the sale of an available-for-sale security, any unrealized gain or loss is reclassified out of AOCI into net income as a realized "gain (loss) on sale of investments, net" using the specific identification method.

In accordance with ASC Topic 820, the Company determines the fair value for the majority of its non-Agency MBS based upon prices obtained from a third-party pricing service and broker quotes. The remainder of the non-Agency MBS are valued by discounting the estimated future cash flows derived from cash flow models that utilize information such as the security's coupon rate, estimated prepayment speeds, expected weighted average life, collateral composition, estimated future interest rates, expected losses, credit enhancement, as well as certain other relevant information.

Other-than-Temporary Impairment. The Company evaluates all MBS in its investment portfolio for other-than-temporary impairments by applying the guidance prescribed in ASC Topic 320-10. If the Company has decided to sell an investment in MBS with a fair value less than its amortized cost as of the balance sheet date of a reporting period, the MBS is considered to be other-than-temporarily impaired, and the Company will recognize an other-than-temporary impairment in the related period's income statement equal to the entire difference between the amortized cost basis and the fair value of the MBS as of the balance sheet date. If the Company does not intend to sell

the MBS, the Company assesses whether it is more likely than not will be able to recover its entire amortized cost basis before it is sold. If the Company determines that it will not be able to recover the entire amortized cost basis of the MBS before it is sold, the Company recognizes in the related period's income statement the difference between the present value of cash flows expected to be collected and the amortized cost basis of the debt security as an other-than-temporary impairment related to credit loss, and the difference between the amortized cost basis and the fair value of the MBS as of the balance sheet date is recognized in other comprehensive income.

In periods after the recognition of an other-than-temporary impairment loss for MBS, the Company shall account for the other-than-temporarily impaired MBS as if the MBS had been purchased on the measurement date of the other-than-temporary impairment at an amortized cost basis equal to the previous amortized cost basis less the other-than-temporary impairment recognized in earnings. For MBS for which other-than-temporary impairments were recognized in earnings, the difference between the new amortized cost basis and the cash flows expected to be collected shall be accreted into interest income using the effective interest method. The Company shall continue to estimate the present value of cash flows expected to be collected over the life of the MBS. For all other MBS, if upon subsequent evaluation, there is an increase in the cash flows expected to be collected or if actual cash flows are greater than cash flows previously expected, such changes shall be accounted for as a prospective adjustment to the accretable yield in accordance with Subtopic 310-30 even if the MBS would not otherwise be within the scope of that Subtopic. Subsequent increases and decreases in the fair value of the MBS that are not other-than-temporary shall be included in other comprehensive income.

Please see Note 10 for additional information related to the Company's evaluation for other-than-temporary impairments.

Securitized Mortgage Loans.  Securitized mortgage loans consist of loans pledged to support the repayment of securitization financing bonds that were issued by the Company prior to 2000. The associated securitization financing bonds are treated as debt of the Company and are presented as a portion of "non-recourse collateralized financing" on the consolidated balance sheet. In accordance with ASC Topic 310-10, the Company's securitized mortgage loans are reported at amortized cost.  Securitized mortgage loans can only be sold subject to the lien of the respective securitization financing indenture. An allowance has been established for currently existing and probable losses on such loans as further discussed below.

Other Investments.  Other investments include unsecuritized single-family and commercial mortgage loans which are carried at amortized cost in accordance with ASC Topic 310-10. An allowance has been established for currently existing and probable losses on these loans as further discussed below.

Allowance for Loan Losses.  An allowance for loan losses has been estimated and established for currently existing and probable losses for securitized and unsecuritized mortgage loans that are considered impaired in accordance with ASC Topic 310-10.  Provisions made to increase the allowance are charged as a current period expense.  Commercial mortgage loans are secured by income-producing real estate and are evaluated individually for impairment when the debt service coverage ratio on the mortgage loan is less than 1:1 or when the mortgage loan is delinquent.  Commercial mortgage loans not evaluated for individual impairment are evaluated for a general allowance.  Certain of the commercial mortgage loans are covered by mortgage loan guarantees that limit the Company's exposure on these mortgage loans.  Single-family mortgage loans are considered homogeneous and are evaluated on a pool basis for a general allowance.

The Company considers various factors in determining its specific and general allowance requirements, including whether a loan is delinquent, the Company's historical experience with similar types of loans, historical cure rates of delinquent loans, and historical and anticipated loss severity of the mortgage loans as they are liquidated.  The factors may differ by mortgage loan type (e.g., single-family versus commercial) and collateral type (e.g., multifamily versus office property).  The allowance for loan losses is evaluated and adjusted periodically by management based on the actual and estimated timing and amount of probable credit losses, using the above factors, as well as industry loss experience.

Repurchase Agreements

Repurchase agreements are treated as financings in accordance with the provision of ASC Topic 860 under which the Company pledges its securities as collateral to secure a loan, which is equal in value to a specified percentage of the estimated fair value of the pledged collateral. The Company retains beneficial ownership of the pledged collateral. At the maturity of a repurchase agreement, the Company is required to repay the loan and concurrently receives back its pledged collateral from the lender or, with the consent of the lender, the Company may renew the agreement at the then prevailing financing rate. A repurchase agreement lender may require the Company to pledge additional collateral in the event of a decline in the fair value of the collateral pledged. Repurchase agreement financing is recourse to the Company and the assets pledged. Most of the Company's repurchase agreements are based on the September 1996 version of the Bond Market Association Master Repurchase Agreement, which generally provides that the lender, as buyer, is responsible for obtaining collateral valuations from a generally recognized source agreed to by both the Company and the lender, or, in an instance when such source is not available, the value determination is made by the lender.

Derivative Instruments

The Company may enter into interest rate swap agreements, interest rate cap agreements, interest rate floor agreements, financial forwards, financial futures and options on financial futures (“interest rate agreements”) to manage its sensitivity to changes in interest rates.  The Company accounts for its interest rate agreements under ASC Topic 815, designating each as either a cash flow hedging position or a trading position using criteria established therein.  In order to qualify as a cash flow hedge, ASC Topic 815 requires formal documentation to be prepared at the inception of the interest rate agreement that meets certain conditions.  If these conditions are not met, an interest rate agreement will be classified as a trading position.

For interest rate agreements designated as trading positions, the Company records these instruments at fair value on the Company’s balance sheet in accordance with ASC Topic 815.  Changes in their market value are measured at each reporting date and recognized in the current period’s consolidated statement of income within "fair value adjustments, net".

For interest rate agreements designated as cash flow hedges, the Company evaluates the effectiveness of these hedges against the financial instrument being hedged.  The effective portion of the hedge relationship on an interest rate agreement designated as a cash flow hedge is reported in AOCI and is later reclassified into the consolidated statement of income in the same period during which the hedged transaction affects earnings.  The ineffective portion of such hedge is immediately reported in the current period’s consolidated statement of income.  These derivative instruments are carried at fair value on the Company’s consolidated balance sheet in accordance with ASC Topic 815.  Cash posted to meet margin calls, if any, is included on the consolidated balance sheet in other assets.

In the event a hedging instrument is terminated, any basis adjustments or changes in the fair value of hedges recorded in AOCI are recognized into income or expense in conjunction with the original hedge or hedged exposure.

If the underlying asset, liability or commitment is sold or matures, the hedge is deemed partially or wholly ineffective, or if the criterion that was established at the time the hedging instrument was entered into no longer exists, the interest rate agreement no longer qualifies as a designated hedge.  Under these circumstances, such changes in the market value of the interest rate agreement are recognized in the current period’s statement of income.

The Company has elected to use the portfolio exception in ASC 820-10-35-18D with respect to measuring counterparty credit risk for derivative instruments. The Company manages credit risk for its derivative positions on a counterparty-by-counterparty basis (that is, on the basis of its net portfolio exposure with each counterparty), consistent with its risk management strategy for such transactions. The Company manages credit risk by considering indicators of risk such as credit ratings, and by negotiating terms in its ISDA master netting arrangements and, if applicable, any associated Credit Support Annex documentation, with each individual counterparty. Since the effective date of ASC 820, management has monitored and measured credit risk and calculated credit valuation adjustments for its derivative transactions on the basis of its relationships at the counterparty portfolio level. Management receives reports from an independent third-party valuation specialist on a monthly basis providing the credit valuation adjustments at the counterparty portfolio level for purposes of reviewing and managing its credit risk exposures. Since the portfolio exception applies only to the fair value measurement and not to financial statement presentation, the portfolio-level adjustments are then allocated in a reasonable and consistent manner each period to the individual assets or liabilities that make up the group, in accordance with other applicable accounting guidance and the Company's accounting policy elections.

Interest Income, Premium Amortization, and Discount Accretion

Interest income is accrued based on the outstanding principal balance (or notional balance in the case of interest-only, or "IO", securities) on the Company's investment securities and their contractual terms. Premiums and discounts on Agency and non-Agency MBS and on loans are recognized over the expected life of the investment using the effective yield method in accordance with ASC Topic 310-20. Adjustments to premium amortization are made for actual prepayment activity as well as changes in projected future cash flows. Interest income on non-Agency MBS that are rated lower than “AA” are recognized over the expected life as adjusted for the estimated prepayments and credit losses of the securities in accordance with ASC Topic 310-30. Actual prepayment and credit loss experience is reviewed and effective yields are adjusted when projected prepayments and credit losses differ from the amounts actually received as well as for changes in anticipated future prepayments.

The Company's projections of future cash flows are based on input and analysis received from external sources and internal models, and includes assumptions about the amount and timing of credit losses, loan prepayment rates, fluctuations in interest rates, and other factors. On at least a quarterly basis, the Company reviews and makes any necessary adjustments to its cash flow projections and updates the yield recognized on these assets.

For securities, the accrual of interest is discontinued when, in the opinion of management, it is probable that all amounts contractually due will not be collected, and in certain instances, as a result of the other-than-temporary impairment analysis. For loans, the accrual of interest is discontinued when, in the opinion of management, the interest is not collectible in the normal course of business, when the loan is significantly past due or when the primary servicer of the loan fails to advance the interest and/or principal due on the loan.  Loans are considered past due when the borrower fails to make a timely payment in accordance with the underlying loan agreement.  All interest accrued but not collected for investments that are placed on a non-accrual status or are charged-off is reversed against interest income.  Interest on these investments is accounted for on the cash-basis or cost-recovery method until qualifying for return to accrual status.  Investments are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Stock-Based Compensation

Pursuant to the Company’s 2009 Stock and Incentive Plan ("SIP"), the Company may grant stock-based compensation to eligible employees, directors or consultants or advisers to the Company, including stock awards, stock options, stock appreciation rights (“SARs”), dividend equivalent rights, performance shares, and restricted stock units.  Currently, the Company's stock options and restricted stock issued under this plan may be settled only in shares of its common stock, and therefore are treated as equity awards with their fair value measured at the grant date as required by ASC Topic 718. Outstanding SARs issued by the Company may be settled only in cash, and therefore have been treated as liability awards with their fair value estimated at the grant date and remeasured at the end of each reporting period using the Black-Scholes option valuation model as required by ASC Topic 718.  Please see Note 11 for additional disclosures regarding the Company's SIP.

Contingencies

In the normal course of business, there are various lawsuits, claims, and other contingencies pending against the Company.  We evaluate whether to establish provisions for estimated losses from those matters in accordance with ASC Topic 450, which states that a liability is recognized for a contingent loss when: (a) the underlying causal event has occurred prior to the balance sheet date; (b) it is probable that a loss has been incurred; and (c) there is a reasonable basis for estimating that loss. A liability is not recognized for a contingent loss when it is only possible or remote that a loss has been incurred, however, possible contingent losses shall be disclosed. Please refer to Note 12 for details on the most significant matters currently pending.

Recent Accounting Pronouncements

There are no recently issued accounting pronouncements that are expected to materially impact the Company's financial condition or results of operations which are not effective as of the date of this Quarterly Report on Form 10-Q for the three months ended September 30, 2012.

In December 2011, FASB issued Accounting Standards Update ("ASU") No. 2011-11 which amends ASC Topic 210 to require an entity to disclose information about offsetting assets and liabilities and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. Offsetting, otherwise known as netting, is the presentation of assets and liabilities as a single net amount in the balance sheet. GAAP gives companies the option to present in their consolidated balance sheets, on a net basis, derivatives that are

subject to a legally enforceable netting arrangement with the same party where rights of set-off are only available in the event of default or bankruptcy. This amendment is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods, and should be applied retrospectively for all comparative periods presented. The Company does not currently offset any of its assets and liabilities, and as such, does not anticipate that ASU No. 2011-11 will have a material impact on the Company's financial condition or results of operations.

NOTE 2 – NET INCOME PER COMMON SHARE

Net income per common share is presented on both a basic and diluted basis. Diluted net income per common share assumes the exercise of stock options using the treasury stock method. The following table presents the calculation of the numerator and denominator for both basic and diluted net income per common share:

| | Three Months Ended September 30, | | | |
|---|---|---|---|---|
| | 2012 | | 2011 | |
| | Income | Weighted-Average Common Shares | Income | Weighted-Average Common Shares |
| Net income to common shareholders | $18,353 | 54,367,349 | $1,532 | 40,353,219 |
| Effect of dilutive stock options | — | 866 | — | 82 |
| Diluted | $18,353 | 54,368,215 | $1,532 | 40,353,301 |
| Net income per common share: | | | | |
| Basic | | $ 0.34 | | $0.04 |
| Diluted [(1)] | | $ 0.34 | | $0.04 |

(1) For the three months ended September 30, 2011, the calculation of diluted net income per common share excludes the effect of 15,000 unexercised stock option awards because their inclusion would have been anti-dilutive.

| | Nine Months Ended September 30, | | | |
|---|---|---|---|---|
| | 2012 | | 2011 | |
| | Income | Weighted-Average Common Shares | Income | Weighted-Average Common Shares |
| Net income to common shareholders | $53,675 | 52,751,763 | $25,406 | 37,972,766 |
| Effect of dilutive stock options | — | — | — | 1,183 |
| Diluted | $53,675 | 52,751,763 | $25,406 | 37,973,949 |
| Net income per common share: | | | | |
| Basic | | $ 1.02 | | $0.67 |
| Diluted [(1)] | | $ 1.02 | | $0.67 |

(1) For the nine months ended September 30, 2012 and September 30, 2011, the calculation of diluted net income per common share excludes the effect of 15,000 unexercised stock option awards because their inclusion would have been anti-dilutive.

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NOTE 3 – AGENCY MBS

The following table presents the components of the Company's investment in Agency MBS as of September 30, 2012 and December 31, 2011:

| | September 30, 2012 | | | |
|---|---|---|---|---|
| | RMBS | CMBS | CMBS IO [(1)] | Total |
| Principal/par value | $2,627,300 | $289,726 | $— | $2,917,026 |
| Unamortized premium | 145,922 | 21,898 | 508,326 | 676,146 |
| Unamortized discount | (14) | — | — | (14) |
| Amortized cost | 2,773,208 | 311,624 | 508,326 | 3,593,158 |
| Available for sale (recognized in statement of comprehensive income): | | | | |
| Gross unrealized gains | 32,315 | 20,843 | 10,880 | 64,038 |
| Gross unrealized losses | (5,428) | (2) | (3,693) | (9,123) |
| Trading (recognized in income statement): | | | | |
| Gross unrealized gains | — | 2,599 | — | 2,599 |
| Total Agency MBS fair value: | $2,800,095 | $335,064 | $515,513 | $3,650,672 |
| Weighted average coupon | 3.73% | 5.20% | 0.96% | |

(1) The combined notional balance for the Agency CMBS IO securities is $9,251,338 as of September 30, 2012.

| | December 31, 2011 | | | |
|---|---|---|---|---|
| | RMBS | CMBS | CMBS IO [(1)] | Total |
| Principal/par value | $1,488,397 | $266,952 | $— | $1,755,349 |
| Unamortized premium | 85,488 | 21,627 | 86,358 | 193,473 |
| Unamortized discount | (17) | — | — | (17) |
| Amortized cost | 1,573,868 | 288,579 | 86,358 | 1,948,805 |
| Available for sale (recognized in statement of comprehensive income): | | | | |
| Gross unrealized gains | 10,787 | 11,746 | 350 | 22,883 |
| Gross unrealized losses | (7,405) | — | (1,043) | (8,448) |
| Trading (recognized in income statement): | | | | |
| Gross unrealized gains | — | 1,919 | — | 1,919 |
| Total Agency MBS fair value: | $1,577,250 | $302,244 | $85,665 | $1,965,159 |
| Weighted average coupon | 4.54% | 5.20% | 0.96% | |

(1) The combined notional balance for the Agency CMBS IO securities is $1,813,096 as of December 31, 2011.

The Company purchased $1,707,077 of Agency RMBS and $477,774 of Agency CMBS, consisting principally of CMBS IOs, since December 31, 2011. Agency CMBS IOs are secured by excess interest payments on pools of multifamily housing mortgage loans. As these securities have no principal associated with them, the interest payments received are based on the unpaid principal balance (often referred to as the notional amount) of the underlying pool of mortgage loans. The IO securities have prepayment protection in the form of lock-outs and/or yield maintenance associated with the underlying loans.

As of September 30, 2012 and December 31, 2011, the amortized cost of Agency CMBS designated as trading was $27,687 and $28,119, respectively. The Company recognized a net unrealized gain for the three and nine months ended September 30, 2012 of $283 and $716 compared to $744 and $1,819 for the three and nine ended September 30, 2011, respectively, related to

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changes in fair value, which is included within “fair value adjustments, net” in the Company's consolidated statements of income. The Company also has derivatives designated as trading instruments, and the changes in their fair value are also included within "fair value adjustments, net". Please refer to Note 7 for additional information on these derivatives designated as trading instruments.

The following table presents certain information for those Agency MBS in an unrealized loss position as of September 30, 2012 and December 31, 2011:

| | September 30, 2012 | | | December 31, 2011 | | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Loss | # of Securities | Fair Value | Unrealized Loss | # of Securities |
| Unrealized loss position for: | | | | | | |
| Less than one year | $392,903 | $(4,281) | 42 | $680,101 | $(6,765) | 54 |
| One year or more | 323,732 | (4,832) | 35 | 160,544 | (1,684) | 27 |
| | $716,635 | $(9,113) | 77 | $840,645 | $(8,449) | 81 |

Because the principal and interest related to Agency MBS are guaranteed by the government-sponsored entities Fannie Mae and Freddie Mac who have the implicit guarantee of the U.S. government, the Company does not consider any of the unrealized losses on its Agency MBS to be credit related. Although the unrealized losses are not credit related, the Company assesses its ability and intent to hold any Agency MBS with an unrealized loss until the recovery in its value. This assessment is based on the amount of the unrealized loss and significance of the related investment as well as the Company’s current leverage and anticipated liquidity. Based on this analysis, the Company has determined that the unrealized losses on its Agency MBS as of September 30, 2012 and December 31, 2011 were temporary.

NOTE 4 – NON-AGENCY MBS

The following table presents the components of the Company’s non-Agency MBS as of September 30, 2012 and December 31, 2011:

| | September 30, 2012 | | | |
|---|---|---|---|---|
| | RMBS | CMBS | CMBS IO [(1)] | Total |
| Principal/par value | $15,007 | $452,975 | $— | $467,982 |
| Unamortized premium | — | 2,726 | 93,096 | 95,822 |
| Unamortized discount | (812) | (20,732) | — | (21,544) |
| Amortized cost | 14,195 | 434,969 | 93,096 | 542,260 |
| Gross unrealized gains | 470 | 41,507 | 4,317 | 46,294 |
| Gross unrealized losses | (424) | (1,194) | (5) | (1,623) |
| Fair value | $14,241 | $475,282 | $97,408 | $586,931 |
| Weighted average coupon | 4.38% | 4.64% | 0.69% | |

(1) The combined notional balance for the non-Agency CMBS IO securities is $2,252,064 as of September 30, 2012.

| | December 31, 2011 | | | |
|---|---|---|---|---|
| | RMBS | CMBS | CMBS IO (1) | Total |
| Principal/par value | $17,119 | $359,853 | $— | $376,972 |
| Unamortized premium | — | 3,646 | 51,239 | 54,885 |
| Unamortized discount | (1,003) | (17,511) | — | (18,514) |
| Amortized cost | 16,116 | 345,988 | 51,239 | 413,343 |
| Gross unrealized gains | 507 | 11,806 | 893 | 13,206 |
| Gross unrealized losses | (1,353) | (3,724) | (376) | (5,453) |
| Fair value | $15,270 | $354,070 | $51,756 | $421,096 |
| Weighted average coupon | 4.41% | 5.91% | 1.24% | |

(1) The combined notional balance for the non-Agency CMBS IO securities is $906,202 as of December 31, 2011.

All of the Company’s non-Agency MBS are designated as available-for-sale and are comprised primarily of investment-grade rated securities.  The Company has purchased $7,500 on non-Agency RMBS, $120,697 of non-Agency CMBS since December 31, 2011. In addition, the Company paid premiums of $48,812 for non-Agency CMBS IO securities.

The following table presents certain information for those non-Agency MBS that were in an unrealized loss position as of September 30, 2012 and December 31, 2011:

| | September 30, 2012 | | | December 31, 2011 | | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Loss | # of Securities | Fair Value | Unrealized Loss | # of Securities |
| Unrealized loss position for: | | | | | | |
| Less than one year: | $4,351 | $(120) | 3 | $153,974 | $(5,075) | 6 |
| One year or more: | 11,700 | (1,504) | 9 | 2,993 | (379) | 7 |
| | $16,051 | $(1,624) | 12 | $156,967 | $(5,454) | 13 |

The Company reviews any non-Agency MBS in an unrealized loss position to evaluate whether any decline in fair value represents an other-than-temporary impairment. The evaluation includes a review of the credit ratings of these non-Agency MBS and the seasoning of the mortgage loans collateralizing these securities as well as the estimated future cash flows which include projected losses. The Company performed this evaluation for the non-Agency MBS in an unrealized loss position as of September 30, 2012 and has determined that there have not been any adverse changes in the timing or amount of estimated future cash flows that necessitate a recognition of other-than-temporary impairment amounts as of September 30, 2012.

NOTE 5 – SECURITIZED MORTGAGE LOANS, NET

The Company's securitized mortgage loans are pledged as collateral for its associated securitization financing bonds, which are discussed further in Note 9. Please also refer to Note 6 for disclosures related to impaired securitized mortgage loans and the related allowance for loans losses. The following table summarizes the components of securitized mortgage loans as of September 30, 2012 and December 31, 2011:

| | September 30, 2012 | | | December 31, 2011 | | |
|---|---|---|---|---|---|---|
| | Commercial | Single-family | Total | Commercial | Single-family | Total |
| Principal/par value [(1)] | $34,591 | $43,007 | $77,598 | $68,029 | $47,657 | $115,686 |
| Unamortized premium, net | — | 644 | 644 | — | 770 | 770 |
| Unamortized discount, net | (77) | — | (77) | (254) | — | (254) |
| Amortized cost | 34,514 | 43,651 | 78,165 | 67,775 | 48,427 | 116,202 |
| Allowance for loan losses | (150) | (267) | (417) | (2,268) | (231) | (2,499) |
| | $34,364 | $43,384 | $77,748 | $65,507 | $48,196 | $113,703 |

(1) Includes funds held by trustees.

The balance of the Company's securitized commercial mortgage loans has decreased since December 31, 2011 primarily due to principal payments, including amounts received on defeased loans, of $29,600. The Company's securitized commercial mortgage loans were originated principally in 1996 and 1997 and are collateralized by first deeds of trust on income producing properties. Approximately 69% of these securitized commercial mortgage loans are secured by multifamily properties. As of September 30, 2012 and December 31, 2011, the loan-to-value ratio based on original appraisal was 42% and 42%, respectively. There were no securitized commercial mortgage loans identified as seriously delinquent (60 or more days past due) and therefore on nonaccrual status on the Company's balance sheet as of September 30, 2012 compared to nonaccrual loans with an unpaid principal balance of $14,997 as of December 31, 2011.

The balance of the Company's securitized single-family mortgage loans have decreased since December 31, 2011 due to principal payments on the loans of $4,438. These single-family mortgage loans are secured by first deeds of trust on residential real estate and were originated principally from 1992 to 1997. As of September 30, 2012 and December 31, 2011, the current loan-to-value ratio based on original appraisal was approximately 44% and 46%, respectively. The unpaid principal balance of the Company's securitized single-family mortgage loans identified as seriously delinquent as of September 30, 2012 is $3,382 compared to $3,366 as of December 31, 2011. The Company continues accruing interest on any seriously delinquent securitized single-family mortgage loan so long as the primary servicer continues to advance the interest and/or principal due on the loan.

NOTE 6 – ALLOWANCE FOR LOAN LOSSES

As discussed in Note 1, the Company estimates for currently existing and probable losses for its mortgage loans that are considered impaired. A loan can be considered impaired even if it is not delinquent. The following table summarizes the aggregate activity for the portion of the allowance for loan losses that relates to the securitized mortgage loan portfolio for the periods indicated:

| | Three Months Ended September 30, | | | |
|---|---|---|---|---|
| | 2012 | | 2011 | |
| | Commercial | Single-family | Commercial | Single-family |
| Allowance at beginning of period | $1,355 | $231 | $3,069 | $208 |
| Provision for loan losses | (36) | 146 | 300 | — |
| Credit losses, net of recoveries | (1,169) | (110) | (1,196) | — |
| Allowance at end of period | $150 | $267 | $2,173 | $208 |

| | Nine Months Ended September 30, | | | |
|---|---|---|---|---|
| | 2012 | | 2011 | |
| | Commercial | Single-family | Commercial | Single-family |
| Allowance at beginning of period | $2,268 | $231 | $4,200 | $270 |
| Provision for loan losses | 24 | 146 | 750 | — |
| Credit losses, net of recoveries | (2,142) | (110) | (2,777) | (62) |
| Allowance at end of period | $150 | $267 | $2,173 | $208 |

The following table presents certain information on impaired securitized commercial and single-family mortgage loans as of September 30, 2012 and December 31, 2011:

| | September 30, 2012 | | December 31, 2011 | |
|---|---|---|---|---|
| | Commercial | Single-family | Commercial | Single-family |
| Unpaid principal balance of impaired securitized loans | $— | $3,382 | $4,724 | $3,000 |
| Basis adjustments related to impaired securitized loans | — | 51 | 8 | 48 |
| Amortized cost basis of impaired securitized loans | — | 3,433 | 4,732 | 3,048 |
| Allowance for loan losses | (150) | (267) | (2,268) | (231) |
| Investment in excess of allowance | $(150) | $3,166 | $2,464 | $2,817 |

Although the Company does not currently have specific securitized commercial mortgage loans identified as impaired, the Company is maintaining a general allowance for commercial mortgage loan losses of $150 as indicated in the table above. The Company recognized $0 and $50 of interest income on impaired securitized commercial mortgage loans for the three and nine months ended September 30, 2012, respectively, compared to $27 and $83 of interest income for the three and nine months ended September 30, 2011, respectively. The Company recognized $47 and $141 of interest income on impaired securitized single-family mortgage loans for the three and nine months ended September 30, 2012, respectively, compared to $49 and $146 of interest income for the three and nine months ended September 30, 2011, respectively.

NOTE 7 – DERIVATIVES

As of September 30, 2012 and December 31, 2011, the Company's derivative financial instruments are comprised entirely of interest rate swaps, and are designated as either hedging instruments or trading instruments. The tables below summarize information about the Company's derivative financial instruments on the balance sheet as of the dates indicated:

| | | September 30, 2012 | | | December 31, 2011 | | |
|---|---|---|---|---|---|---|---|
| Accounting Designation: | Balance Sheet Location: | Fair Value | Cumulative Notional Amount | Weighted-average Fixed Rate Swapped | Fair Value | Cumulative Notional Amount | Weighted-average Fixed Rate Swapped |
| Hedging instruments | | $(43,802) | $1,485,000 | 1.50 % | $(25,512) | $1,065,000 | 1.55 % |
| Trading instruments | | (2,694) | 27,000 | 2.88 % | (2,485) | 27,000 | 2.88 % |
| | Derivative liabilities | $(46,496) | | | $(27,997) | | |

Included in the balance as of September 30, 2012 are seven forward-starting interest rate swaps with a combined notional balance of $275,000 and a weighted average pay-fixed rate of 1.62% which are not effective until 2013.

The following table summarizes the contractual maturities remaining for the Company's outstanding interest rate swap agreements as of September 30, 2012:

| Remaining Maturity | Notional Amount: Trading | Notional Amount: Hedging | Notional Amount: Total | Number of Swaps | Weighted-Average Fixed Rate Swapped | |
|---|---|---|---|---|---|---|
| 0-12 months | $— | $75,000 | $75,000 | 2 | 1.30 | % |
| 13-36 months | — | 565,000 | 565,000 | 10 | 1.44 | % |
| 37-60 months | 27,000 | 445,000 | 472,000 | 16 | 1.60 | % |
| Over 60 months | — | 400,000 | 400,000 | 14 | 1.60 | % |
| | $27,000 | $1,485,000 | $1,512,000 | 42 | 1.53 | % |

With respect to hedging instruments, the Company's objective for using interest rate swaps is to minimize its exposure to the risk of increased interest expense resulting from its existing and forecasted short-term, fixed-rate borrowings. The Company continuously borrows funds via sequential fixed-rate, short-term repurchase agreement borrowings. As each fixed-rate repurchase agreement matures, it is replaced with new fixed-rate agreements based on the market interest rate in effect at the time of such replacement. This sequential rollover borrowing program creates a variable interest expense pattern. The changes in the cash flows of the interest rate swaps are expected to be highly effective at offsetting changes in the interest portion of the cash flows expected to be paid at maturity of each borrowing.

The table below presents the effect of the derivatives designated as hedging instruments on the Company's consolidated statement of comprehensive income for the periods indicated:

| Type of Derivative Designated as Cash Flow Hedge | Amount of Gain (Loss) Recognized in OCI (Effective Portion) | Location of Amount Reclassified from OCI into Net Income (Effective Portion) | Amount Reclassified from OCI into Net Income (Effective Portion) | Location of Loss Recognized in Net Income (Ineffective Portion) | Amount of Gain (Loss) Recognized in Net Income (Ineffective Portion) |
|---|---|---|---|---|---|
| For the three months ended September 30, 2012: | | | | | |
| Interest rate swaps | $(11,073) | Interest expense | $3,827 | Other income, net | $(107) |
| For the three months ended September 30, 2011: | | | | | |
| Interest rate swaps | $(18,251) | Interest expense | $3,383 | Other income, net | $(31) |
| For the nine months ended September 30, 2012: | | | | | |
| Interest rate swaps | $(28,853) | Interest expense | $10,602 | Other income, net | $(38) |
| For the nine months ended September 30, 2011: | | | | | |
| Interest rate swaps | $(31,974) | Interest expense | $8,325 | Other income, net | $(55) |

As of September 30, 2012, the Company estimates that $17,094 will be reclassified from AOCI into earnings as an increase to interest expense within the next 12 months.

The Company's objective for designating certain interest rate swaps as trading instruments is to offset the changes in market value for a portion of its Agency CMBS investments that are also designated as trading. The table below presents the effect of the derivatives designated as trading instruments on the Company's consolidated statements of income for the periods indicated.

| Type of Derivative Designated as Trading | Location On Income Statement | Amount of Loss Recognized in Net Income | |
|---|---|---|---|
| | | Three Months Ended | Nine Months Ended |

| | | September 30, 2012 | September 30, 2011 | September 30, 2012 | September 30, 2011 |
|---|---|---|---|---|---|
| Interest rate swaps | Fair value adjustments, net | $(333) | $(1,446) | $(907) | $(2,649) |

These interest rate swap agreements contain various covenants related to the Company's credit risk. Specifically, if the Company defaults on any of its indebtedness, including those circumstances whereby repayment of the indebtedness has not been accelerated by the lender, or is declared in default of any of its covenants with any counterparty, then the Company could also be

declared in default of its derivative obligations. Additionally, the agreements outstanding with its derivative counterparties allow those counterparties to require settlement of its outstanding derivative transactions if the Company fails to earn GAAP net income greater than one dollar as measured on a rolling two quarter basis. These interest rate agreements also contain provisions whereby, if the Company fails to maintain a minimum net amount of shareholders' equity, then the Company may be declared in default on its derivative obligations. As of September 30, 2012, the Company had derivatives in a net liability position with its derivative counterparties for which it had pledged Agency MBS with a fair value of $50,966 and cash of $38 as collateral. If the Company had breached any of these agreements as of September 30, 2012, it could have been required to settle those derivatives at their estimated termination value of $47,115, which includes accrued interest but excludes any adjustment for nonperformance risk. As of September 30, 2012, the Company was in compliance with all covenants.

## NOTE 8 – REPURCHASE AGREEMENTS

The Company uses repurchase agreements, which are recourse to the Company, to finance certain of its investments. As of September 30, 2012, the Company had repurchase agreement borrowings outstanding with a weighted average rate of 0.63% with 21 of its 28 available repurchase agreement counterparties compared to a weighted average borrowing rate of 0.61% with 20 counterparties as of December 31, 2011. The Company had approximately 18% of its shareholders' equity at risk with one counterparty, Wells Fargo Securities, LLC, with whom the Company had $346,602 outstanding as of September 30, 2012. The shareholders' equity at risk did not exceed 10% for any of the Company's other counterparties.

The following tables present the components of the Company's repurchase agreements as of September 30, 2012 and December 31, 2011 by the fair value and type of securities pledged as collateral to the repurchase agreements:

| | September 30, 2012 | | |
|---|---|---|---|
| Collateral Type | Balance | Weighted Average Rate | Fair Value of Collateral Pledged |
| Agency RMBS | $2,560,779 | 0.41 % | $2,665,860 |
| Agency CMBS and CMBS IOs | 634,327 | 0.93 % | 789,792 |
| Non-Agency RMBS | 11,042 | 1.82 % | 12,761 |
| Non-Agency CMBS and CMBS IOs | 431,039 | 1.39 % | 540,332 |
| Securitization financing bonds | 34,549 | 1.67 % | 36,342 |
| Deferred fees | (764) | n/a | n/a |
| | $3,670,972 | 0.63 % | $4,045,087 |

| | December 31, 2011 | | |
|---|---|---|---|
| Collateral Type | Balance | Weighted Average Rate | Fair Value of Collateral Pledged |
| Agency RMBS | $1,447,508 | 0.38 % | $1,521,107 |
| Agency CMBS and CMBS IOs | 290,362 | 0.59 % | 329,612 |
| Non-Agency RMBS | 12,195 | 1.85 % | 13,597 |
| Non-Agency CMBS and CMBS IOs | 283,266 | 1.54 % | 336,124 |
| Securitization financing bonds | 60,462 | 1.65 % | 67,872 |
| | $2,093,793 | 0.61 % | $2,268,312 |

The combined weighted average original term to maturity for the Company's repurchase agreements was 52 days as of September 30, 2012 and 57 days as of December 31, 2011. The following table provides a summary of the original maturities as of September 30, 2012 and December 31, 2011:

| Original Maturity | September 30, 2012 | December 31, 2011 |
|---|---|---|
| 30 days or less | $1,663,679 | $180,387 |
| 31 to 60 days | 898,021 | 880,491 |
| 61 to 90 days | 472,705 | 496,509 |
| Greater than 90 days | 636,567 | 536,406 |
| | $3,670,972 | $2,093,793 |

Our repurchase agreement counterparties, as set forth in the master repurchase agreement with the counterparty, require us to comply with various customary operating and financial covenants, including, but not limited to, minimum net worth, maximum declines in net worth in a given period, and maximum leverage requirements as well as maintaining our REIT status. In addition, some of the agreements contain cross default features, whereby default under an agreement with one lender simultaneously causes default under agreements with other lenders. To the extent that we fail to comply with the covenants contained in our financing agreements or are otherwise found to be in default under the terms of such agreements, the counterparty has the right to accelerate amounts due under the master repurchase agreement. The Company was in compliance with all covenants as of September 30, 2012.

NOTE 9 – NON-RECOURSE COLLATERIZED FINANCING

The following table summarizes information about the Company's non-recourse collateralized financing for the periods indicated:

| | September 30, 2012 | | | |
|---|---|---|---|---|
| | Interest Rate | Weighted Average Life Remaining (in years) | Balance Outstanding | Value of Collateral |
| Securitization financing: | | | | |
| Secured by non-Agency CMBS | 6.2% fixed | 1.7 | $15,000 | $15,923 |
| Secured by single-family mortgage loans | 1-month LIBOR plus 0.30% | 3.1 | 16,826 | 17,768 |
| Unamortized net bond premium and deferred costs | | | (531) | n/a |
| | | | $31,295 | $33,691 |

| | December 31, 2011 | | | |
|---|---|---|---|---|
| | Interest Rate | Weighted Average Life Remaining (in years) | Balance Outstanding | Value of Collateral |
| Securitization financing: | | | | |
| Secured by non-Agency CMBS | 6.2% fixed | 2.1 | $15,000 | $16,388 |
| Secured by single-family mortgage loans | 1-month LIBOR plus 0.30% | 3.2 | 18,928 | 19,843 |
| TALF financing:(1) | | | | |
| Secured by non-Agency CMBS | 2.7% fixed | 1.2 | 37,672 | 49,087 |
| Unamortized net bond premium and deferred costs | | | (705 ) | n/a |
| | | | $70,895 | $85,318 |

(1) Financing provided by the Federal Reserve Bank of New York under its Term Asset-Backed Securities Loan Facility (“TALF”). The balance as of December 31, 2011 was paid off during the first quarter of 2012.

NOTE 10 – FAIR VALUE OF FINANCIAL INSTRUMENTS

ASC Topic 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC 820 clarifies that fair value should be based on the assumptions market participants would use when pricing as asset or liability and also requires an entity to consider all aspects of nonperformance risk, including the entity's own credit standing, when measuring fair value of a liability. ASC Topic 820 established a valuation hierarchy of three levels as follows:

- Level 1 – Inputs are unadjusted, quoted prices in active markets for identical assets or liabilities as of the measurement date.
- Level 2 – Inputs include quoted prices in active markets for similar assets or liabilities; quoted prices in inactive markets for identical or similar assets or liabilities; or inputs are either directly observable or indirectly observable through correlation with market data at the measurement date and for the duration of the instrument’s anticipated life. The Company’s fair valued assets and liabilities that are generally included in this category are Agency MBS, certain non-Agency MBS, and derivatives.
- Level 3 – Unobservable inputs are supported by little or no market activity. The unobservable inputs represent management’s best estimate of how market participants would price the asset or liability at the measurement date. Consideration is given to the risk inherent in the valuation technique and the risk inherent in the inputs to the model. The Company’s fair valued assets and liabilities that are generally included in this category are certain non-Agency MBS.

The following table presents the fair value of the Company’s assets and liabilities measured at fair value on a recurring basis as of September 30, 2012, segregated by the hierarchy level of the fair value estimate:

| | Fair Value | Fair Value Measurements Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| Assets: | | | | |
| Agency MBS | $3,650,672 | $— | $3,650,672 | $— |
| Non-Agency MBS: | | | | |
| CMBS (including CMBS IO) | 572,690 | — | 472,374 | 100,316 |
| RMBS | 14,241 | — | 5,640 | 8,601 |
| Other investments | 25 | — | — | 25 |
| Total assets carried at fair value | $4,237,628 | $— | $4,128,686 | $108,942 |
| Liabilities: | | | | |
| Derivative liabilities | $46,496 | $— | $46,496 | $— |
| Total liabilities carried at fair value | $46,496 | $— | $46,496 | $— |

The Company's Agency MBS, as well a portion of its non-Agency CMBS, are substantially similar to securities that either are currently actively traded or have been recently traded in their respective market. Their fair values are derived from an average of multiple dealer quotes and thus are considered Level 2 fair value measurements.

The Company's remaining non-Agency CMBS and non-Agency RMBS are comprised of securities for which there are not substantially similar securities that trade frequently. As such, the Company determines the fair value of those securities by discounting the estimated future cash flows derived from cash flow models using assumptions that are confirmed to the extent possible by third party dealers or other pricing indicators. Significant inputs into those pricing models are Level 3 in nature due to the lack of readily available market quotes. Information utilized in those pricing models include the security's credit rating, coupon rate, estimated prepayment speeds, expected weighted average life, collateral composition, estimated future interest rates, expected credit losses, and credit enhancement as well as certain other relevant information. Significant increases (decreases) in any of these inputs in isolation would result in a significantly lower (higher) fair value measurement. A change in the assumption used for the probability of default may be accompanied by a directionally similar change in the assumption used for the loss severity and a directionally opposite change in the assumption used for prepayment rates.

The table below presents information about the significant unobservable inputs used in the fair value measurement for the Company's Level 3 non-Agency RMBS and CMBS during the three and nine months ended September 30, 2012:

| | Quantitative Information about Level 3 Fair Value Measurements[1] Prepayment Speed | | Default Rate | | Severity | | Discount Rate | |
|---|---|---|---|---|---|---|---|---|
| Non-Agency CMBS | 20 CPY | | 2.5 | % | 35.0 | % | 4.4 | % |
| Non-Agency RMBS | 5 | CPR | 0.5 | % | 9.0 | % | 5.1 | % |

(1) Data presented are weighted averages.

The following tables present the activity of the instruments fair valued at Level 3 for the three and nine months ended September 30, 2012:

| | For the Three Months Ended September 30, 2012 | | | |
|---|---|---|---|---|
| | Level 3 Fair Values | | | |
| | Non-Agency CMBS | Non-Agency RMBS | Other | Total assets |
| Balance as of June 30, 2012 | $104,515 | $12,657 | $25 | $117,197 |
| Total unrealized losses: | | | | |
| Included in other comprehensive income | 90 | 41 | — | 131 |
| Principal payments | (4,194) | (4,108) | — | (8,302) |
| Amortization | (95) | 11 | — | (84) |
| Balance as of September 30, 2012 | $100,316 | $8,601 | $25 | $108,942 |

| | For the Nine Months Ended September 30, 2012 | | | |
|---|---|---|---|---|
| | Level 3 Fair Values | | | |
| | Non-Agency CMBS | Non-Agency RMBS | Other | Total assets |
| Balance as of December 31, 2011 | $123,703 | $10,296 | $25 | $134,024 |
| Purchases | — | 7,500 | — | 7,500 |
| Transfers out to Level 2 | (4,670) | — | — | (4,670) |
| Total unrealized losses: | | | | |
| Included in other comprehensive income | (1,934) | 117 | — | (1,817) |
| Principal payments | (16,409) | (9,349) | — | (25,758) |
| Amortization | (374) | 37 | — | (337) |
| Balance as of September 30, 2012 | $100,316 | $8,601 | $25 | $108,942 |

The Company evaluates the availability and quality of valuation inputs for its Level 3 securities on a monthly basis. When it determines that there are sufficient observable market inputs for the same or similar securities, the securities are transferred to Level 2 at the end of the reporting period in which that determination is made. As shown in the tables above for the nine months ended September 30, 2012, the Company transferred two of its non-Agency CMBS from Level 3 to Level 2 during the second quarter of 2012. The liquidity for securities similar to these non-Agency CMBS improved such that the Company was able to obtain market discount rates and prepayment speeds which it used in establishing the fair value of these two non-Agency CMBS.

The following table presents the recorded basis and estimated fair values of the Company's financial instruments as of September 30, 2012 and December 31, 2011:

| | September 30, 2012 | | December 31, 2011 | |
|---|---|---|---|---|
| | Recorded Basis | Fair Value | Recorded Basis | Fair Value |
| Assets: | | | | |
| Agency MBS | $3,650,672 | $3,650,672 | $1,965,159 | $1,965,159 |
| Non-Agency CMBS | 572,690 | 572,690 | 405,826 | 405,826 |
| Non-Agency RMBS | 14,241 | 14,241 | 15,270 | 15,270 |
| Securitized mortgage loans, net | 77,748 | 66,879 | 113,703 | 101,116 |
| Other investments | 896 | 842 | 1,018 | 892 |
| Liabilities: | | | | |
| Repurchase agreements | $3,670,972 | $3,670,972 | $2,093,793 | $2,093,793 |
| Non-recourse collateralized financing | 31,295 | 31,013 | 70,895 | 69,752 |
| Derivative liabilities | 46,496 | 46,496 | 27,997 | 27,997 |

There were no assets or liabilities which were measured at fair value on a non-recurring basis as of September 30, 2012 or December 31, 2011.

## NOTE 11 – SHAREHOLDERS' EQUITY

### Preferred Stock

On August 1, 2012, the Company closed an offering of 2,300,000 shares of 8.50% Series A Cumulative Redeemable Preferred Stock, par value of $0.01 per share and liquidation preference $25.00 per share. The Company received net proceeds before expenses of $55,689, including the additional proceeds from the underwriters' overallotment option which was fully exercised.

### Common Stock

The following table presents a summary of the changes in the number of common shares outstanding for the periods indicated:

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2012 | 2011 |
| Balance at beginning of period | 40,382,530 | 30,342,897 |
| Common stock issued under ATM program | 402,494 | 409,237 |
| Common stock issued under DRIP | 9,279 | 2,111 |
| Common stock issued via public offering | 13,332,748 | 9,200,000 |
| Common stock issued or redeemed under Stock and Incentive Plans | 241,663 | 426,031 |
| Balance at end of period | 54,368,714 | 40,380,276 |

The Company has a continuous equity placement program (also known as an "at the market" program, or "ATM") whereby the Company may offer and sell through its sales agent, JMP Securities LLC, up to 8,000,000 shares of its common stock. During the nine months ended September 30, 2012, the Company received proceeds of $3,721, net of $57 in broker sales commission, for 402,494 shares of common stock sold under this program at an average price of $9.39. The Company did not issue any common stock under this program during the three months ended September 30, 2012.

The Company has a Dividend Reinvestment and Share Purchase Plan ("DRIP") which allows registered shareholders to automatically reinvest some or all of their quarterly dividends in shares of the Company's stock and provides an opportunity for investors to purchase shares of the Company's stock, potentially at a discount to the prevailing market price. The Company declared a third quarter common stock dividend of $0.29 per share payable on October 31, 2012 to shareholders of record as of October 5, 2012. There is no dividend reinvestment discount for third quarter dividends reinvested through the DRIP.

In February 2012, the Company closed a secondary offering of 13,332,748 shares of its common stock which includes 832,487 shares issued pursuant to an option to purchase additional shares that was exercised by the underwriters, at a public offering price of $9.12 per share for total net proceeds of approximately $119,992 after deduction of underwriters' compensation and expenses.

Incentive Plans. Pursuant to the Company's 2009 Stock and Incentive Plan, the Company may grant stock-based compensation to eligible employees, directors or consultants or advisers to the Company, including stock awards, stock options, SARs, dividend equivalent rights, performance shares, and restricted stock units. Of the 2,500,000 shares of common stock authorized for issuance under this plan, 1,805,276 shares remain available for issuance as of September 30, 2012.

The following table presents a rollforward of the restricted stock activity for the periods presented:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Restricted stock at beginning of period | 454,117 | 330,500 | 365,506 | 25,000 |
| Restricted stock granted | — | 35,006 | 220,821 | 358,006 |
| Restricted stock vested | (2,917) | — | (135,127) | (17,500) |
| Restricted stock outstanding at end of period | 451,200 | 365,506 | 451,200 | 365,506 |

As of September 30, 2012, the fair value of the Company's outstanding restricted stock remaining to be amortized into compensation expense is $3,438.

During the three months ended September 30, 2012, 25,000 SARs were exercised with a weighted average exercise price of $6.61. During the nine months ended September 30, 2012, 31,875 SARs were exercised with a weighted average exercise price of $6.71. No SARs were granted, forfeited, or exercised during the three and nine months ended September 30, 2011. As of September 30, 2012, the Company has 27,500 SARs outstanding, all of which are vested and exercisable at an exercise price of $7.06 per share. The remaining contractual term on these outstanding SARs as of September 30, 2012 is 15 months. As of September 30, 2012 and December 31, 2011, the fair value of the Company's outstanding SARs of $103 and $77, respectively, are recorded as liabilities on its consolidated balance sheet for the respective periods.

Total stock-based compensation expense recognized by the Company for the three and nine months ended September 30, 2012 was $490 and $1,410, respectively, compared to $139 and $492, respectively, for the three and nine months ended September 30, 2011.

Additional Paid-In Capital

The following table presents a rollforward of the Company's changes in additional paid-in capital for the nine months ended September 30, 2012:

| | Additional Paid-In Capital |
|---|---|
| Balance as of January 1, 2012 | $634,683 |
| Common stock issuances: | |
| DRIP issuances | 90 |
| ATM issuances | 3,674 |
| Secondary offering | 119,859 |
| Incentive plans | 192 |
| Amortization of restricted stock | 1,268 |
| Capitalized expenses | (119) |
| Balance as of September 30, 2012 | $759,647 |

Accumulated Other Comprehensive Income

Accumulated other comprehensive income as of September 30, 2012 and December 31, 2011 is comprised of the following items:

| | September 30, 2012 | December 31, 2011 |
|---|---|---|
| Available for sale investments: | | |
| Unrealized gains | $110,332 | $36,091 |
| Unrealized losses | (10,747) | (13,902) |
| | 99,585 | 22,189 |
| Hedging instruments: | | |
| Unrealized losses | (43,695) | (25,444) |
| | (43,695) | (25,444) |
| Accumulated other comprehensive income (loss) | $55,890 | $(3,255) |

Due to the Company’s REIT status, the items comprising other comprehensive income do not have related tax effects.

NOTE 12 – COMMITMENTS AND CONTINGENCIES

The Company and its subsidiaries are parties to various legal proceedings, including those described below. Although the ultimate outcome of these legal proceedings cannot be ascertained at this time, and the results of legal proceedings cannot be predicted with certainty, the Company believes, based on current knowledge, that the resolution of any of these proceedings, including those described below, will not have a material effect on the Company’s consolidated financial condition or liquidity. However, the resolution of any of the proceedings described below could have a material impact on consolidated results of operations or cash flows in a given future reporting period as the proceedings are resolved.

One of the Company's subsidiaries, GLS Capital, Inc. (“GLS”), and the County of Allegheny, Pennsylvania ("Allegheny County") are defendants in a class action lawsuit filed in 1997 in the Court of Common Pleas of Allegheny County, Pennsylvania (the “Court”). Between 1995 and 1997, GLS purchased from Allegheny County delinquent property tax receivables for properties located in the county. The plaintiffs in this matter have alleged that GLS improperly recovered or sought recovery for certain fees, costs, interest, and attorneys' fees and expenses in connection with GLS' collection of the property tax receivables. The Court granted class action status in this matter in August 2007. In February 2011, the Court refined the class to include only owners of real estate in Allegheny County who paid an attorneys' fee between 1996 and 2003 in connection with the forced collection of delinquent property tax receivables

by GLS (generally through the initiation of a foreclosure action). As a result, the Court dismissed

certain claims against GLS and narrowed the issues being litigated to whether attorneys' fees and related expenses charged by GLS in connection with the collection of the receivables were reasonable. Such attorneys' fees and related expenses were assessed by GLS in its collection efforts pursuant to prevailing Allegheny County ordinance. On April 23, 2012, as a result of a petition to discontinue filed by the plaintiffs, the Court dismissed the remaining claims against GLS. The claims made by plaintiff that can be appealed include the legality of charging and recovering attorneys' fees and lien revival and filing costs from the class members. Plaintiff has filed an appeal of the Court's ruling to the Pennsylvania Commonwealth Court of Appeals. Plaintiffs have not enumerated their damages in this matter.

The Company, GLS, and Allegheny County are named defendants in a putative class action lawsuit filed in June 2012 in the Court of Common Pleas of Allegheny County, Pennsylvania. The proposed class in this action consists of owners of real estate in Allegheny County whose property is or has been subject to a tax lien filed by Allegheny County that Allegheny County either retained or sold to GLS and who were billed by Allegheny County or GLS for attorneys' fees, interest, or prothonotary fees and who sustained economic damages on and after August 14, 2003, in connection with attempts to collect delinquent real estate taxes. The putative class allegations are that Allegheny County, GLS, and the Company violated the class's constitutional due process rights in connection with delinquent tax collection efforts. There are also allegations that amounts recovered from the class by GLS and / or Allegheny County are an unconstitutional taking of private property. The claims against the Company are solely based upon its ownership of GLS. The complaint requests that the Court order GLS to account for the amounts alleged to have been collected in violation of the putative class members' rights and create a constructive trust for the return of such amounts to members of the purported class. The same class previously filed substantially the same lawsuit in 2004 against GLS and Allegheny County, and GLS's Motion for Summary Judgment is pending in that action. The Company believes the claims are without merit and intends to defend against them vigorously.

The Company and DCI Commercial, Inc. ("DCI"), a former affiliate of the Company and formerly known as Dynex Commercial, Inc., are appellees (or respondents) in the matter of Basic Capital Management, Inc. et al. (collectively, “BCM” or the “Plaintiffs”) versus DCI et al. currently pending in the Fifth Court of Appeals in Dallas. The matter was initially filled in the state court in Dallas County, Texas in April 1999 against DCI, and in March 2000, BCM amended the complaint and added the Company as a defendant. The appeal seeks to overturn a judgment rendered by the trial court in the favor of the Company and DCI. Specifically, Plaintiffs are seeking reversal of the trial court's judgment and rendition of judgment against the Company for alleged breach of loan agreements for tenant improvements in the amount of $250. They also seek reversal of the trial court's judgment and rendition of judgment against DCI in favor of BCM under two mutually exclusive damage models, for $2,200 and $25,600, respectively, related to the alleged breach by DCI of a $160,000 “master” loan commitment. Plaintiffs also seek reversal and rendition of a judgment in their favor for attorneys' fees in the amount of $2,100. Alternatively, Plaintiffs seek a new trial. Even if Plaintiffs were to be successful on appeal, management does not believe the Company would be obligated for any amounts awarded against DCI.

NOTE 13 – SUBSEQUENT EVENTS

Management has evaluated events and circumstances occurring as of and through the date this Quarterly Report on Form 10-Q was filed with the SEC and made available to the public and has determined that there have been no significant events or circumstances that qualify as "recognized" or "nonrecognized" subsequent events as defined by ASC Topic 855.

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

The following discussion and analysis should be read in conjunction with our unaudited consolidated financial statements and accompanying notes included in this Quarterly Report on Form 10-Q for the three months ended September 30, 2012 and our audited Annual Report on Form 10-K for the year ended December 31, 2011. References herein to "Dynex," the "Company," "we," "us," and "our" include Dynex Capital, Inc. and its consolidated subsidiaries, unless the context otherwise requires. In addition to current and historical information, the following discussion and analysis contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to our future business, financial condition or results of operations. For a description of certain factors that may have a significant impact on our future business, financial condition or results of operations, see "Forward-Looking Statements" at the end of this discussion and analysis.

EXECUTIVE OVERVIEW

Company Overview

We are an internally managed mortgage real estate investment trust, or mortgage REIT, which invests in mortgage assets on a leveraged basis. Our objective is to provide attractive risk-adjusted returns to our shareholders over the long term that are reflective of a leveraged, high quality fixed income portfolio with a focus on capital preservation. We seek to provide returns to our shareholders through regular quarterly dividends and through capital appreciation.

We were formed in 1987 and commenced operations in 1988. Beginning with our inception through 2000, our operations largely consisted of originating and securitizing various types of loans, principally single-family and commercial mortgage loans and manufactured housing loans. Since 2000, we have been an investor in Agency and non-Agency mortgage-backed securities ("MBS"). Agency MBS consist of residential MBS ("RMBS") and commercial MBS ("CMBS"), which come with a guaranty of payment by the U.S. government or a U.S. government-sponsored entity such as Fannie Mae and Freddie Mac. Non-Agency MBS (also consisting of RMBS and CMBS) have no such guaranty of payment.

Our primary source of income is net interest income, which is the excess of the interest income earned on our investments over the cost of financing these investments. Our investment strategy as approved by our Board of Directors is a diversified investment strategy that currently targets higher credit quality, shorter duration investments in Agency MBS and non-Agency MBS. Investments considered to be of higher credit quality have less or limited exposure to loss of principal while investments which have shorter durations have less exposure to changes in interest rates. We currently target an overall investment portfolio composition of 60%-80% in Agency MBS with the balance in non-Agency MBS and securitized mortgage loans. Our securitized mortgage loans are single-family and commercial mortgage loans which were originated or purchased by us during the 1990s. We are not actively originating, purchasing, or securitizing mortgage loans.

RMBS

Currently, the Company's RMBS investments are primarily Agency RMBS. Agency RMBS are comprised primarily of hybrid Agency adjustable-rate mortgage loans ("ARMs") and Agency ARMs. Hybrid Agency ARMs are MBS collateralized by hybrid adjustable-rate mortgage loans which are loans that have a fixed rate of interest for a specified period (typically three to ten years) and which then adjust their interest rate at least annually to an increment over a specified interest rate index as further discussed below. Agency ARMs are MBS collateralized by adjustable-rate mortgage loans which have interest rates that generally will adjust at least annually to an increment over a specified interest rate index. Agency ARMs also include hybrid Agency ARMs that are past their fixed-rate periods or within

twelve months of their initial reset period. The Company may also invest in fixed-rate Agency RMBS from time to time.

Interest rates on the adjustable-rate mortgage loans collateralizing hybrid Agency ARMs or Agency ARMs are based on specific index rates, such as the London Interbank Offered Rate, or LIBOR, the one-year constant maturity treasury rate, or CMT, the Federal Reserve U.S. 12-month cumulative average one-year CMT, or MTA, or the 11th District Cost of Funds Index, or COFI. These loans will typically have interim and lifetime caps on interest rate adjustments, or interest rate caps, limiting the amount that the rates on these loans may reset in any given period.

CMBS

The Company’s Agency and non-Agency CMBS are comprised of fixed-rate securities collateralized by first mortgage loans on multifamily properties that are typically prohibited from voluntary prepayment or have yield maintenance provisions. These features of CMBS provide the Company some measure of protection against prepayment of the investment. A portion of the Company's Agency and non-Agency CMBS also include interest only securities ("IOs") which represent the right to receive excess interest payments (but not principal cash flows) based on the underlying unpaid principal balance of the underlying pool of mortgage loans.

Investment Risk

In executing our investment strategy, we seek to balance the various risks of owning mortgage assets, such as interest rate, credit, prepayment, and liquidity risk with the earnings opportunity on the investment. We believe our strategy of investing in Agency and non-Agency MBS provides superior diversification of these risks across our investment portfolio and therefore provides ample opportunities to generate attractive risk-adjusted returns while preserving our shareholders’ capital. We also believe that our shorter duration strategy will provide less volatility in our results and in our book value per common share than strategies which invest in longer duration assets with that may be more exposed to interest rate risk.

For further discussion of the Company, its operating policies and restrictions, its investment philosophy and strategy, and its financing and hedging strategy, see the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

Factors that Affect Our Results of Operations and Financial Condition

The performance of our investment portfolio will depend on many factors, many of which are beyond our control. These factors include, but are not limited to, interest rates, trends of interest rates, the relative steepness of interest rate curves, prepayment rates on our investments, competition for investments, economic conditions and their impact on the credit performance of our investments, and actions taken by the U.S. government, including the U.S. Federal Reserve and the U. S. Department of the Treasury (the "Treasury").

In addition, our business model may be impacted by other factors such as the availability and cost of financing and the state of the overall credit markets. Reductions in the availability of financing for our investments could significantly impact our business and force us to sell assets that we otherwise would not sell, potentially at losses or at amounts below their true fair value. Other factors also impacting our business include changes in regulatory requirements, including requirements to qualify for registration under the Investment Company Act of 1940 and REIT requirements.

Investing in mortgage-related securities on a leveraged basis subjects us to a number of risks which are discussed in Item 3, "Quantitative and Qualitative Disclosures about Market Risk" and in the "Liquidity and Capital Resources" section of this Item 2, including interest rate risk, prepayment and reinvestment risk, credit risk, market value risk and liquidity risk. Please see these Items for detailed discussion of these risks and the potential impact on our results of operations and financial condition.

Trends and Recent Market Impacts

The following marketplace conditions and prospective trends have impacted and may continue to impact our future results of operations and our financial condition. For additional information about risks that may be posed by these trends, please refer to Part I, Item 3, "Quantitative and Qualitative Disclosures about Market Risk" as well as Part II,

Item 3, "Risk Factors" contained within this Quarterly Report on Form 10-Q for the three months ended September 30, 2012 in addition to Part I, Item 1A, "Risk Factors" of our Annual Report on Form 10-K for the year ended December 31, 2011.

Federal Reserve Monetary Policy and the Effects on Agency RMBS and Prepayments

In September 2012, the Federal Open Market Committee ("FOMC") announced "QE3" by indicating that it will purchase $40 billion per month in fixed-rate Agency RMBS, continue to reinvest principal repayments on its existing Agency RMBS portfolio, and extend the average maturity of its holdings of securities. These actions are expected to increase the FOMC's holdings

of longer-term securities by about $85 billion each month through the end of the year. The Federal Reserve expects these measures to put downward pressure on long-term interest rates. While the Federal Reserve hopes that QE3 will expedite an economic recovery, stabilize prices, reduce unemployment and restart business and household spending, there is no way of knowing what impact QE3 or any future actions by the Federal Reserve will have on the prices and liquidity of Agency RMBS or other securities in which we invest.

During the third quarter of 2012, we received principal payments on our Agency RMBS of $179.1 million. Our average constant prepayment rate, or CPR, for our Agency RMBS during the third quarter of 2012 was 23.4% versus 20.8% for the second quarter of 2012 and 21.4% for the first quarter of 2012. As of September 30, 2012, the weighted average coupon on the mortgage loans underlying our Agency RMBS was 4.22%, while the monthly average 30-year fixed mortgage rate and the 5-year hybrid ARM mortgage rate as of that date, as published by Freddie Mac, were 3.47% and 2.73%, respectively.

Generally, the lower coupons available on new mortgage loans, the actions by the Federal Reserve and the low interest rate environment should entice borrowers to refinance their mortgage loans at lower rates. Today, however, many obstacles exist to refinancing, including but not limited to, tighter lender underwriting standards, the lack of borrower's equity in the underlying real estate and the lack of an acceptable level of income. These obstacles are currently contributing to limited refinancing of loans in our Agency RMBS portfolio and are keeping prepayment speeds low relative to expectations and to historic prepayment rates in such a low interest rate environment. In an effort to increase refinancing of Agency RMBS, the U.S. Treasury created the Home Affordable Refinance Program, or HARP, which seeks to ease refinancing restrictions for high LTV borrowers. The HARP program eases underwriting requirements for lenders and qualification conditions for borrows to extend loans which qualify for inclusion in Agency RMBS.

Given the continued low interest rate environment, the changes to HARP, and the commitment by the Federal Reserve to keep long-term interest rates low, including the Federal Reserve's actions through QE3, we continue to expect somewhat elevated prepayment speeds on our Agency RMBS for the balance of 2012. As noted elsewhere, increased prepayments impact our net interest income by increasing the amortization expense on any investments we own at premiums to their par balance and lowers security yields.

Asset Spreads and Competition for Assets

Over the past few years, credit markets in the United States have generally experienced tightening credit spreads (where credit spreads are defined as the difference between yields on securities with credit risk and yields on benchmark U.S. Treasury securities). Spreads in assets that we invest in particular have tightened over the past several quarters from increased competition for these assets from lack of supply and from favorable market conditions in large part due to the Federal Reserve's involvement in the markets (as discussed above and below). Reductions in credit spreads will generally result in increased asset prices (assuming no corresponding increase in the benchmark Treasury rate) which increases our book value. However, when credit spreads tighten and asset prices increase, yields on potential new investment opportunities will decrease. On balance we have seen declining new investment yields during 2012 from tighter credit spreads and from declining benchmark Treasury rates.

Government Policy Initiatives

The U.S. government is actively seeking to support the U.S. housing market and has introduced programs such as the HARP program noted above. Changes in the HARP program initiated in the second quarter of 2012 represent continued efforts to spur refinance activity. The U.S. government has also introduced the Home Affordable Mortgage Program, or HAMP, which seeks to assist borrowers through the modification of mortgage loans to reduce the principal amount of the loan, the rate on the loan, or to extend the payment terms of the loan. We expect that the U.S.

government will continue to introduce and experiment with housing programs and policies to assist the recovery of the housing market. These programs could increase prepayment rates which would result in lower yields on our Agency RMBS.

Interest Rates

The Federal Reserve continues to maintain a very accommodative monetary policy. The FOMC in September reiterated its target range for the federal funds rate (the rate at which U.S. banks may borrow from each other) at 0%-0.25%. The FOMC continues to emphasize that economic growth might not be strong enough to generate sustained improvement in labor market

conditions and that strains in global financial markets continue to pose significant downside risks to the economic outlook. The FOMC has indicated that inflation over the medium term is expected to run below the Federal Reserve's current interest rate objective of 2%. The FOMC at the same time noted that if the outlook for the labor market does not improve substantially, the Committee will continue its purchases of Agency MBS (including through QE3 as noted above), undertake additional asset purchases, and employ other policy tools until such improvement is achieved in a context of price stability. The FOMC indicated that it expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens and noted that exceptionally low levels for the federal funds rate are likely to be warranted at least through mid-2015.

The actions by the FOMC noted above have continued to keep overall interest rates low and the Treasury yield curve relatively flat (as measured by the difference of 1.40% between the two year Treasury rate and the ten year Treasury rate as of September 30, 2012 versus 1.64% as of December 31, 2011). Asset credit spreads also remain tight despite continued economic uncertainty both domestically and abroad, in our judgment primarily due to the extraordinary involvement by the Federal Reserve in the markets. While our borrowing costs are based on short-term market rates such as LIBOR and the Federal Funds Target Rate, our asset yields more closely correlate with longer-term Treasury rates and longer-term swap rates. In general, a flat yield curve will result in reduced net interest spreads for new investments and will impact our ability to reinvest our capital on an accretive basis.

A negative impact of a flattening yield curve is the prospective reduction of our net interest spread (and the related return on our invested capital) for new investments. Since the first quarter of 2012, we have seen declining net interest spreads on our new investment purchases in part as a result of the flattening yield curve and in part as a result of reduced credit spreads discussed further below.

Financing

Our business model requires that we have access to leverage, principally through the repurchase agreement market. We access the repurchase agreement markets through relationships with broker-dealers and financial institutions. Repurchase agreement financing is uncommitted financing and as such, there can be no guarantee that we will always have access to this financing. During periods of sustained volatility in the credit markets, such as was experienced in 2008, or other disruptions to the credit and financing markets, access to repurchase agreement financing may be limited as liquidity providers reduce their exposure to the short-term funding credit markets. Repurchase agreement markets also fund many different types of assets for many different types of borrowers including MBS, asset-backed securities, commercial paper and government securities. Recent activities by the Federal Reserve, including Operation Twist, have increased the supply of these other types of assets which has increased competition for financing. Consequently, we have seen a modest increase in our repurchase agreement financing costs during the first nine months of 2012.

Regulatory Reform

In July 2010 the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) was enacted into law. This legislation aims to restore responsibility and accountability to the financial system. It remains unclear how this legislation may ultimately impact the Company (including, but not limited to, whether the Company will be required to register with, or report to, the Commodity Futures Trading Commission (the "CFTC") or a designee thereof), credit markets and the market for repurchase agreements or other borrowing facilities, the investing environment for Agency and non-Agency MBS, or interest rate swaps and other derivatives, since the rules and regulations under the Dodd-Frank Act continue to be promulgated, implemented and interpreted by the CFTC. For instance, as it is now constructed, the Dodd-Frank Act would require the Company to transact interest rate swaps in the future through a clearing exchange which would likely require the Company to post significantly more margin at the inception of an interest rate swap transaction. Currently, the Company's initial margin requirements with

counterparties are de minimis. As such, the effective cost to the Company for interest rate swaps may increase in the future which could limit our ability to continue to use swaps to hedge our interest rate and market value risk.

On August 31, 2011, the SEC issued a concept release relating to the exclusion from registration as an investment company provided to mortgage companies by Section 3(c)5(C) of the Investment Company Act of 1040 (the "1940 Act"). This release raises concerns regarding the ability of mortgage REITs to continue to rely on the exclusion in the future. In particular, the release states the SEC is concerned that certain types of mortgage-related pools today appear to resemble in many respects investment companies

such as closed-end funds and may not be the kinds of companies that were intended to be excluded from regulation under the 1940 Act by Section 3(c)5(C). The outcome of the review by the SEC at this time is not determinable. For a discussion of the uncertainties and risks related to the SEC's review, please refer to "Risk Factors" contained within Item 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2011.

GSE Reform

On February 11, 2011, the Treasury released proposals to limit or potentially wind down the role that Fannie Mae and Freddie Mac play in the mortgage market. Similar proposals to limit or wind down the role of Fannie Mae and Freddie Mac have been proposed by a number of other parties. Any such proposals, if enacted, may have broad adverse implications for the MBS market and our business, results of operations, and financial condition. We expect such proposals to be the subject of significant discussion, and it is not yet possible to determine whether such proposals will be enacted. We do not believe the ultimate reform of Fannie Mae and Freddie Mac will occur in 2012. However, it is possible that new types of Agency MBS could be proposed and sold by Fannie Mae and Freddie Mac that are structured differently from current Agency MBS. This may have the effect of reducing the amount of available investment opportunities for the Company. No such new structures have as yet been proposed. For further discussion of the uncertainties and risks related to GSE reform, please refer to "Risk Factors" contained within Item 1A of Part II of this Quarterly Report on Form 10-Q and within Item 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2011.

Highlights of the Third Quarter and Fourth Quarter Outlook

During the third quarter of 2012, we reported net income of $18.4 million, or $0.34 per common share versus $18.8 million, or $0.35 per common share for the second quarter of 2012. We also reported net interest income of $19.1 million compared to $19.0 million for the second quarter of 2012 and $19.1 million for the first quarter of 2012. Our slight increase in net interest income for the third quarter of 2012 compared to the second quarter of 2012 is due to the higher average balance of our investment portfolio during the third quarter of $3,729.1 million versus $3,339.5 million for the second quarter of 2012. Partially offsetting the increase in average interest earning assets was a decline in the weighted average net interest spread to 2.00% from 2.18% for the second quarter of 2012, which is primarily the result of purchasing lower spread assets and also from interest-rate resets on our Agency ARM portfolio during the third quarter of 2012.

The following table summarizes the average annualized yield by type of MBS investment for the third quarter of 2012 and for each of the preceding four quarters:

| | Three Months Ended | | | | |
|---|---|---|---|---|---|
| | September 30, 2012 | June 30, 2012 | March 31, 2012 | December 31, 2011 | September 30, 2011 |
| Average annualized yields: | | | | | |
| Agency RMBS | 2.15% | 2.33% | 2.70% | 2.83% | 2.89% |
| Agency CMBS (includes IOs) | 4.35% | 4.32% | 4.05% | 4.49% | 4.49% |
| Non-Agency RMBS | 5.63% | 5.60% | 5.69% | 6.27% | 6.58% |
| Non-Agency CMBS (includes IOs) | 5.68% | 6.07% | 6.52% | 6.37% | 6.03% |
| All other investments | 5.31% | 4.97% | 4.13% | 5.74% | 5.59% |
| Costs of financing | (1.12)% | (1.11)% | (1.17)% | (1.20)% | (1.16)% |
| Net interest spread | 2.00% | 2.18% | 2.41% | 2.56% | 2.43% |

Our results of operations for third quarter of 2012 included a gain of $2.1 million related to the sale of $56.1 million in Agency RMBS collateralized by reverse-mortgage securities and a gain of $1.2 million related to the sale of $15.0 million in non-Agency CMBS that were mezzanine bonds from the Freddie K Multifamily Program.

Although our targeted investment mix has been to invest 60% to 80% in Agency MBS with the balance in non-Agency MBS and securitized mortgage loans, Agency MBS allocation in recent quarters has increased outside of this range due to our recent discovery of attractive investment opportunities in Agency CMBS IO. The following table provides our asset allocation as of September 30, 2012 and as of the end of each of the four preceding financial reporting period:

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| | September 30, 2012 | June 30, 2012 | March 31, 2012 | December 31, 2011 | September 30, 2011 |
|---|---|---|---|---|---|
| Agency MBS | 84% | 82% | 81% | 79% | 80% |
| Non-Agency MBS | 14% | 15% | 14% | 17% | 16% |
| Other investments | 2% | 3% | 5% | 4% | 4% |

Our shareholders' equity increased to $617.9 million as of September 30, 2012, or $10.31 per common share, from $371.3 million, or $9.20 per common share as of December 31, 2011, and $525.1 million, or $9.66 per common share as of June 30, 2012.
The increase in shareholders' equity since June 30, 2012 resulted primarily from the issuance of 2,300,000 shares of 8.50% Series A cumulative redeemable preferred stock, an underwritten public offering that closed on August 1, 2012. We received $55.7 million in net proceeds which we used to acquire additional investments consistent with our investment strategy and for general corporate purposes. Additionally, our shareholders' equity has increased since June 30, 2012 because of a net increase in accumulated other comprehensive income of $34.4 million. The increase in accumulated other comprehensive income was due to an increase in fair value of available for sale investments of $41.6 million, partially offset by a reduction in the fair value of our interest rate swaps by $(7.2) million. These securities increased in fair value from changing market expectations on performance of these securities and their liquidity which we believe may be related to the perceived improvement in economic conditions in the U.S. and stabilizing conditions in the Eurozone.

As of December 31, 2011, we had an estimated net operating loss ("NOL") carryfoward of $143.0 million. As a result of our common stock offering in February 2012, we have incurred an "ownership change" under Section 382 of the Internal Revenue Code ("Section 382"). In general, if a company incurs an ownership change under Section 382, the company's ability to utilize an NOL carryforward to offset its taxable income (and, in our case, after taking the REIT distribution requirements into account), becomes limited to a certain amount per year. For purposes of Section 382, an ownership change occurs if over a rolling three-year period, the percentage of the company stock owned by 5% or greater shareholders has increased by more than 50 percentage points over the lowest percentage of common stock owned by such shareholders during the three-year period. Based on management's analysis and expert third-party advice, which necessarily includes certain assumptions regarding the characterization under Section 382 of our use of capital raised by us, we determined that the ownership change under Section 382 will limit our ability to use our NOL carryforward to offset our taxable income to an estimated maximum amount of $13.4 million per year. The NOL carryforward expires substantially beginning in 2019.

We believe that the outlook for our business model is favorable given the economic backdrop, despite the uncertainty regarding government policy and its potential effects on prepayments of our investments, the impact on our portfolio from asset purchases by the Federal Reserve under QE3, and the uncertainty in Europe and its potential impact on the U.S. credit markets. In recent quarters we have expanded our investment portfolio to include Agency CMBS IO and non-Agency CMBS and CMBS IO given the attractive risk-adjusted return and prepayment protection profile of these investments. With respect to non-Agency CMBS and CMBS IO, we have purchased higher quality securities (A-rated CMBS and AAA-rated CMBS IO) which will have higher yields than Agency CMBS and CMBS IO but which carry higher financing risks and costs and can exhibit more price volatility.

## CRITICAL ACCOUNTING POLICIES

The discussion and analysis of our financial condition and results of operations are based in large part upon our consolidated financial statements, which have been prepared in accordance with GAAP. The preparation of these financial statements requires management to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and disclosure of contingent assets and liabilities. We base these

estimates and judgments on historical experience and assumptions believed to be reasonable under current facts and circumstances.  Actual results, however, may differ from the estimated amounts we have recorded.

Our accounting policies that require the most significant management estimates, judgments, or assumptions and considered most critical to our results of operations or financial position relate to amortization of premiums on our investments, other-than-temporary impairments, allowance for loan losses, derivatives, and fair value measurements.  Our critical accounting policies are discussed in our Annual Report on Form 10-K for the year ended December 31, 2011 under "Management's Discussion and

Analysis of Financial Condition and Results of Operations – Critical Accounting Policies" and in Note 1 of the Notes to the Unaudited Consolidated Financial Statements included in this Quarterly Report on Form 10-Q. There have been no significant changes in our critical accounting policies discussed in our Annual Report on Form 10-K for the year ended December 31, 2011.

FINANCIAL CONDITION

The following discussion addresses our items from our Consolidated Balance Sheet that had significant activity during the past nine months and should be read in conjunction with the Notes to the Unaudited Consolidated Financial Statements contained within Item 1 of Part I of this Quarterly Report on Form 10-Q.

Agency MBS

Activity related to our Agency MBS for the nine months ended September 30, 2012 is as follows:

| (amounts in thousands) | RMBS | CMBS | CMBS IO | Total |
|---|---|---|---|---|
| Beginning balance as of January 1, 2012 | $1,577,250 | $302,244 | $85,665 | $1,965,159 |
| Purchases | 1,707,077 | 28,836 | 448,938 | 2,184,851 |
| Principal payments | (423,168) | (3,178) | — | (426,346) |
| Sales | (61,534) | — | — | (61,534) |
| Change in net unrealized gain | 23,500 | 9,806 | 7,901 | 41,207 |
| Net amortization | (23,030) | (2,644) | (26,991) | (52,665) |
| Ending balance as of September 30, 2012 | $2,800,095 | $335,064 | $515,513 | $3,650,672 |

Agency CMBS IO securities are issued and guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae and secured by excess interest payments on pools of multifamily housing mortgage loans. These securities have no principal associated with them; rather, the interest payments are based on the unpaid principal balance (often referred to as the notional amount) of the underlying pool of mortgage loans. The combined notional balance of our investment in Agency CMBS IO securities as of September 30, 2012 was $9.3 billion. Our CMBS IO securities have prepayment protection in the form of prepayment lock-outs and yield maintenance payment requirements associated with the underlying loans.

As of September 30, 2012, 66% of our Agency portfolio was comprised of Fannie Mae investments with the balance being comprised of 28% Freddie Mac and 6% Ginnie Mae compared to 67% Fannie Mae and 33% Freddie Mac as of December 31, 2011. As of September 30, 2012, 76% of our Agency MBS investments are variable-rate MBS with the remainder invested in fixed-rate MBS.

The following table presents the weighted average coupon ("WAC") by weighted average months-to-reset ("MTR") for the variable-rate portion of our Agency MBS portfolio based on par value as of September 30, 2012 and December 31, 2011:

| | September 30, 2012 | | December 31, 2011 | |
|---|---|---|---|---|
| (amounts in thousands) | Par Value | WAC [1] | Par Value | WAC [2] |
| 0-12 months | $556,758 | 4.11% | $321,942 | 4.32% |
| 13-24 months | 98,023 | 4.63% | 384,184 | 5.09% |
| 25-36 months | 223,847 | 4.01% | 142,321 | 4.78% |
| Over 36 months | 1,727,970 | 3.55% | 618,318 | 4.33% |
| | $ | | | |