

MFA FINANCIAL, INC.  
Form 10-Q  
May 01, 2014  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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FORM 10-Q

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

For the quarterly period ended March 31, 2014

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 1-13991

MFA FINANCIAL, INC.  
(Exact name of registrant as specified in its charter)

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Maryland (State or other jurisdiction of incorporation or organization)	13-3974868 (I.R.S. Employer Identification No.)
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350 Park Avenue, 20th Floor, New York, New York (Address of principal executive offices)	10022 (Zip Code)
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(212) 207-6400  
(Registrant's telephone number, including area code)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting

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company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

366,631,614 shares of the registrant’s common stock, \$0.01 par value, were outstanding as of April 28, 2014.

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## MFA FINANCIAL, INC.

## CONSOLIDATED BALANCE SHEETS

(In Thousands Except Per Share Amounts)	March 31, 2014 (Unaudited)	December 31, 2013
<b>Assets:</b>		
<b>Mortgage-backed securities ("MBS"):</b>		
Agency MBS, at fair value (\$6,404,803 and \$6,142,306 pledged as collateral, respectively)	\$6,841,033	\$6,519,221
Non-Agency MBS, at fair value (\$1,776,353 and \$1,778,067 pledged as collateral, respectively)	2,801,336	2,569,766
Non-Agency MBS transferred to consolidated variable interest entities ("VIEs") (1)	2,243,819	2,282,371
Securities obtained and pledged as collateral, at fair value	435,888	383,743
Cash and cash equivalents	274,672	565,370
Restricted cash	26,139	37,520
Interest receivable	36,680	35,828
<b>Derivative instruments:</b>		
MBS linked transactions, net ("Linked Transactions"), at fair value	59,826	28,181
Interest rate swap agreements ("Swaps"), at fair value	5,485	13,000
Goodwill	7,189	7,189
Prepaid and other assets	60,922	29,719
<b>Total Assets</b>	<b>\$12,792,989</b>	<b>\$12,471,908</b>
<b>Liabilities:</b>		
Repurchase agreements	\$8,606,129	\$8,339,297
Securitized debt (2)	292,526	366,205
Obligation to return securities obtained as collateral, at fair value	435,888	383,743
8% Senior Notes due 2042 ("Senior Notes")	100,000	100,000
Accrued interest payable	11,743	14,726
Swaps, at fair value	32,755	28,217
Dividends and dividend equivalents rights ("DERs") payable	73,875	73,643
Excise tax and interest payable	6,198	6,398
Accrued expenses and other liabilities	29,288	17,428
<b>Total Liabilities</b>	<b>\$9,588,402</b>	<b>\$9,329,657</b>
<b>Commitments and contingencies (Note 10)</b>		
<b>Stockholders' Equity:</b>		
Preferred stock, \$.01 par value; 7.50% Series B cumulative redeemable; 8,050 shares authorized; 8,000 shares issued and outstanding (\$200,000 aggregate liquidation preference)	\$80	\$80
Common stock, \$.01 par value; 886,950 shares authorized; 366,217 and 365,125 shares issued and outstanding, respectively	3,662	3,651
Additional paid-in capital, in excess of par	2,981,287	2,972,369
Accumulated deficit	(572,627)	(571,544)
Accumulated other comprehensive income	792,185	737,695
<b>Total Stockholders' Equity</b>	<b>\$3,204,587</b>	<b>\$3,142,251</b>

Total Liabilities and Stockholders' Equity	\$12,792,989	\$12,471,908
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(1) Non-Agency MBS transferred to consolidated VIEs represent assets of the consolidated VIEs that can be used only to settle the obligations of each respective VIE.

Securitized Debt represents third-party liabilities of consolidated VIEs and excludes liabilities of the VIEs acquired (2) by the Company that eliminate on consolidation. The third-party beneficial interest holders in the VIEs have no recourse to the general credit of the Company. (See Notes 10 and 15 for further discussion.)

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

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CONSOLIDATED STATEMENTS OF OPERATIONS  
(UNAUDITED)

(In Thousands, Except Per Share Amounts)	Three Months Ended		
	March 31,		
	2014	2013	
Interest Income:			
Agency MBS	\$39,329	\$42,787	
Non-Agency MBS	43,155	41,047	
Non-Agency MBS transferred to consolidated VIEs	38,664	38,868	
Cash and cash equivalent investments	26	36	
Interest Income	\$121,174	\$122,738	
Interest Expense:			
Repurchase agreements	\$36,729	\$34,675	
Securitized debt	2,185	3,476	
Senior Notes	2,007	2,007	
Total Interest Expense	\$40,921	\$40,158	
Net Interest Income	\$80,253	\$82,580	
Other Income, net:			
Unrealized net gains and net interest income from Linked Transactions	\$3,251	\$1,536	
Gain on sales of MBS and U.S. Treasury securities, net	3,571	1,633	
Other, net	(416)	55	
Other Income, net	\$6,406	\$3,224	
Operating and Other Expense:			
Compensation and benefits	\$6,507	\$5,273	
Other general and administrative expense	3,964	3,180	
Operating and Other Expense	\$10,471	\$8,453	
Net Income	\$76,188	\$77,351	
Less Preferred Stock Dividends	3,750	2,040	
Net Income Available to Common Stock and Participating Securities	\$72,438	\$75,311	
Earnings per Common Share - Basic and Diluted	\$0.20	\$0.21	
Dividends Declared per Share of Common Stock	\$0.20	\$0.72	(1)

(1) Includes a special dividend of \$0.50 per share declared on March 4, 2013.

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

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CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(UNAUDITED)

(In Thousands)	Three Months Ended	
	March 31,	
	2014	2013
Net income	\$76,188	\$77,351
Other Comprehensive Income:		
Unrealized gain/(loss) on Agency MBS, net	17,843	(27,291 )
Unrealized gain on Non-Agency MBS, net	51,417	146,730
Reclassification adjustment for MBS sales included in net income	(2,950	) (1,360 )
Unrealized (loss)/gain on derivative hedging instruments, net	(12,267	) 12,316
Reclassification of unrealized loss on de-designated derivative hedging instruments	447	—
Other Comprehensive Income	54,490	130,395
Comprehensive income before preferred stock dividends	\$130,678	\$207,746
Dividends declared on preferred stock	(3,750	) (2,040 )
Comprehensive Income Available to Common Stock and Participating Securities	\$126,928	\$205,706

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

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MFA FINANCIAL, INC.  
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY  
(UNAUDITED)

(In Thousands, Except Per Share Amounts)	Three Months Ended March 31, 2014	
	Dollars	Shares
Preferred Stock, 7.50% Series B Cumulative Redeemable - Liquidation Preference \$25.00 per Share:		
Balance at March 31, 2014 and December 31, 2013	\$80	8,000
Common Stock, Par Value \$.01:		
Balance at December 31, 2013	\$3,651	365,125
Issuance of common stock (1)	11	1,141
Repurchase of shares of common stock (1)	—	(49)
Balance at March 31, 2014	\$3,662	366,217
Additional Paid-in Capital, in excess of Par:		
Balance at December 31, 2013	\$2,972,369	
Issuance of common stock, net of expenses (1)	7,605	
Equity-based compensation expense	1,430	
Repurchase of shares of common stock (1)	(117)	)
Balance at March 31, 2014	\$2,981,287	
Accumulated Deficit:		
Balance at December 31, 2013	\$(571,544)	)
Net income	76,188	
Dividends declared on common stock	(73,332)	)
Dividends declared on preferred stock	(3,750)	)
Dividends attributable to DERs	(189)	)
Balance at March 31, 2014	\$(572,627)	)
Accumulated Other Comprehensive Income:		
Balance at December 31, 2013	\$737,695	
Change in unrealized gains on MBS, net	66,310	
Change in unrealized losses on derivative hedging instruments, net	(11,820)	)
Balance at March 31, 2014	\$792,185	
Total Stockholders' Equity at March 31, 2014	\$3,204,587	

(1) For the three months ended March 31, 2014, includes approximately \$356,000 (48,904 shares) surrendered for tax purposes related to equity-based compensation awards.

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



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MFA FINANCIAL, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)

(In Thousands)	Three Months Ended March 31,	
	2014	2013
<b>Cash Flows From Operating Activities:</b>		
Net income	\$76,188	\$77,351
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sales of MBS and U.S. Treasury securities	(3,571	) (1,633 )
Accretion of purchase discounts on MBS	(27,434	) (12,058 )
Amortization of purchase premiums on MBS	10,215	14,793
Depreciation and amortization on fixed assets and other assets	327	1,097
Equity-based compensation expense	1,484	885
Unrealized gains on derivative instruments	(2,076	) (1,136 )
(Increase)/decrease in interest receivable	(863	) 1,891
Increase in prepaid and other assets	(9,644	) (4,088 )
Decrease in accrued expenses and other liabilities, and excise tax and interest	(3,745	) (2,699 )
Increase/(decrease) in accrued interest payable on financial instruments	7,384	(3,237 )
Net cash provided by operating activities	\$48,265	\$71,166
<b>Cash Flows From Investing Activities:</b>		
Principal payments on MBS	\$438,149	\$711,901
Proceeds from sale of MBS and U.S. Treasury securities	15,501	206,203
Purchases of MBS	(888,106	) (569,006 )
Additions to leasehold improvements, furniture and fixtures	(85	) (54 )
Net cash (used in)/provided by investing activities	\$(434,541	) \$349,044
<b>Cash Flows From Financing Activities:</b>		
Principal payments on repurchase agreements	\$(20,203,589)	\$(18,024,857)
Proceeds from borrowings under repurchase agreements	20,470,421	18,175,212
Principal payments on securitized debt	(73,262	) (104,802 )
Payments made on obligation to return securities obtained as collateral	—	(200,050 )
Cash disbursements on financial instruments underlying Linked Transactions	(374,073	) (57,977 )
Cash received from financial instruments underlying Linked Transactions	344,504	59,245
Payments made for margin calls on repurchase agreements and Swaps	(29,000	) —
Proceeds from reverse margin calls on repurchase agreements and Swaps	30,000	—
Proceeds from issuances of common stock	7,616	7,278
Dividends paid on preferred stock	(3,750	) (2,040 )
Dividends paid on common stock and DERs	(73,289	) (71,942 )
Net cash provided by/(used in) financing activities	\$95,578	\$(219,933 )
Net (decrease)/increase in cash and cash equivalents	\$(290,698	) \$200,277
Cash and cash equivalents at beginning of period	\$565,370	\$401,293
Cash and cash equivalents at end of period	\$274,672	\$601,570
<b>Non-cash Investing and Financing Activities:</b>		
Net increase in securities obtained as collateral/obligation to return securities obtained as collateral	\$47,768	\$200,099

Dividends and DERs declared and unpaid	\$73,875	\$259,607
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The accompanying notes are an integral part of the consolidated financial statements.

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MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2014

1. Organization

MFA Financial, Inc. (the “Company”) was incorporated in Maryland on July 24, 1997 and began operations on April 10, 1998. The Company has elected to be treated as a real estate investment trust (“REIT”) for federal income tax purposes. In order to maintain its qualification as a REIT, the Company must comply with a number of requirements under federal tax law, including that it must distribute at least 90% of its annual REIT taxable income to its stockholders. (See Note 11)

2. Summary of Significant Accounting Policies

(a) Basis of Presentation and Consolidation

The interim unaudited financial statements of the Company have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (the “SEC”). Certain information and note disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) have been condensed or omitted according to these SEC rules and regulations. Management believes that the disclosures included in these interim financial statements are adequate to make the information presented not misleading. The accompanying financial statements should be read in conjunction with the financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2013. In the opinion of management, all normal and recurring adjustments necessary to present fairly the financial condition of the Company at March 31, 2014 and results of operations for all periods presented have been made. The results of operations for the three months ended March 31, 2014 should not be construed as indicative of the results to be expected for the full year.

The accompanying consolidated financial statements of the Company have been prepared on the accrual basis of accounting in accordance with GAAP. 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 disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although the Company’s estimates contemplate current conditions and how it expects them to change in the future, it is reasonably possible that actual conditions could be worse than anticipated in those estimates, which could materially impact the Company’s results of operations and its financial condition. Management has made significant estimates in several areas, including other-than-temporary impairment (“OTTI”) on Agency and Non-Agency MBS (Note 3), valuation of Agency and Non-Agency MBS (Notes 3 and 14), derivative instruments (Notes 5 and 14) and income recognition on certain Non-Agency MBS purchased at a discount (Note 3). In addition, estimates are used in the determination of taxable income used in the assessment of REIT compliance and contingent liabilities for related taxes, penalties and interest (Note 2(m)). Actual results could differ from those estimates.

The consolidated financial statements of the Company include the accounts of all subsidiaries; significant intercompany accounts and transactions have been eliminated. Certain prior period amounts have been reclassified to conform to the current period presentation.

(b) Agency and Non-Agency MBS (including Non-Agency MBS transferred to a consolidated VIE)

The Company has investments in residential MBS that are issued or guaranteed as to principal and/or interest by a federally chartered corporation, such as Fannie Mae or Freddie Mac, or any agency of the U.S. Government, such as Ginnie Mae (collectively, “Agency MBS”), and residential MBS that are not guaranteed by any U.S. Government agency or any federally chartered corporation (“Non-Agency MBS”), as described in Note 3.

#### Designation

The Company generally intends to hold its MBS until maturity; however, from time to time, it may sell any of its securities as part of the overall management of its business. As a result, all of the Company’s MBS are designated as “available-for-sale” and, accordingly, are carried at their fair value with unrealized gains and losses excluded from earnings (except when an OTTI is recognized, as discussed below) and reported in accumulated other comprehensive income/(loss) (“AOCI”), a component of stockholders’ equity.

Upon the sale of an investment security, any unrealized gain or loss is reclassified out of AOCI to earnings as a realized gain or loss using the specific identification method.

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MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2014

Revenue Recognition, Premium Amortization and Discount Accretion

Interest income on securities is accrued based on the outstanding principal balance and their contractual terms. Premiums and discounts associated with Agency MBS and Non-Agency MBS rated AA and higher at the time of purchase are amortized into interest income over the life of such securities using the effective yield method. Adjustments to premium amortization are made for actual prepayment activity.

Interest income on the Non-Agency MBS that were purchased at a discount to par value and/or are considered to be of less than high credit quality is recognized based on the security's effective interest rate. The effective interest rate is based on management's estimate of the projected cash flows for each security, which are based on the Company's observation of current information and events and include assumptions related to fluctuations in interest rates, prepayment speeds and the timing and amount of credit losses. On at least a quarterly basis, the Company reviews and, if appropriate, makes adjustments to its cash flow projections based on input and analysis received from external sources, internal models, and its judgment about interest rates, prepayment rates, the timing and amount of credit losses, and other factors. Changes in cash flows from those originally projected, or from those estimated at the last evaluation, may result in a prospective change in the yield/interest income recognized on these securities or in the recognition of OTTI. (See Note 3)

Based on the projected cash flows from the Company's Non-Agency MBS purchased at a discount to par value, a portion of the purchase discount may be designated as non-accretable purchase discount ("Credit Reserve"), which effectively mitigates the Company's risk of loss on the mortgages collateralizing such MBS and is not expected to be accreted into interest income. The amount designated as Credit Reserve may be adjusted over time, based on the actual performance of the security, its underlying collateral, actual and projected cash flow from such collateral, economic conditions and other factors. If the performance of a security with a Credit Reserve is more favorable than forecasted, a portion of the amount designated as Credit Reserve may be reallocated to accretable discount and recognized into interest income over time. Conversely, if the performance of a security with a Credit Reserve is less favorable than forecasted, the amount designated as Credit Reserve may be increased, or impairment charges and write-downs of such securities to a new cost basis could result.

Determination of MBS Fair Value

In determining the fair value of the Company's MBS, management considers a number of observable market data points, including prices obtained from pricing services, brokers and repurchase agreement counterparties, dialogue with market participants, as well as management's observations of market activity. (See Note 14)

Impairments/OTTI

When the fair value of an investment security is less than its amortized cost at the balance sheet date, the security is considered impaired. The Company assesses its impaired securities on at least a quarterly basis and designates such impairments as either "temporary" or "other-than-temporary." If the Company intends to sell an impaired security, or it is more likely than not that it will be required to sell the impaired security before its anticipated recovery, then the Company must recognize an OTTI through charges to earnings equal to the entire difference between the investment's amortized cost and its fair value at the balance sheet date. If the Company does not expect to sell an other-than-temporarily impaired security, only the portion of the OTTI related to credit losses is recognized through charges to earnings with the remainder recognized through AOCI on the consolidated balance sheets. Impairments

recognized through other comprehensive income/(loss) (“OCI”) do not impact earnings. Following the recognition of an OTTI through earnings, a new cost basis is established for the security and may not be adjusted for subsequent recoveries in fair value through earnings. However, OTTIs recognized through charges to earnings may be accreted back to the amortized cost basis of the security on a prospective basis through interest income. The determination as to whether an OTTI exists and, if so, the amount of credit impairment recognized in earnings is subjective, as such determinations are based on factual information available at the time of assessment as well as the Company’s estimates of the future performance and cash flow projections. As a result, the timing and amount of OTTIs constitute material estimates that are susceptible to significant change. (See Note 3)

Non-Agency MBS that are purchased at significant discounts to par/and are otherwise assessed to be of less than high credit quality on which impairments are recognized have experienced, or are expected to experience, credit-related adverse cash flow changes. The Company’s estimate of cash flows for its Non-Agency MBS is based on its review of the underlying mortgage loans securing the MBS. The Company considers information available about the past and expected future performance of underlying

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MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2014

mortgage loans, including timing of expected future cash flows, prepayment rates, default rates, loss severities, delinquency rates, percentage of non-performing loans, Fair Isaac Corporation (“FICO”) scores at loan origination, year of origination, loan-to-value ratios (“LTVs”), geographic concentrations, as well as reports by credit rating agencies, such as Moody’s Investors Services, Inc. (“Moody’s”), Standard & Poor’s Corporation (“S&P”), or Fitch, Inc. (collectively, “Rating Agencies”), general market assessments, and dialogue with market participants. As a result, significant judgment is used in the Company’s analysis to determine the expected cash flows for its Non-Agency MBS. In determining the OTTI related to credit losses for securities that were purchased at significant discounts to par and/or are considered to be of less than high credit quality, the Company compares the present value of the remaining cash flows expected to be collected at the purchase date (or last date previously revised) against the present value of the cash flows expected to be collected at the current financial reporting date. The discount rate used to calculate the present value of expected future cash flows is the current yield used for income recognition purposes. Impairment assessment for Non-Agency MBS that were purchased at prices close to par and are considered to be of high credit quality involves comparing the present value of the remaining cash flows expected to be collected against the amortized cost of the security at the assessment date. The discount rate used to calculate the present value of the expected future cash flows is based on the instrument’s effective interest rate.

Balance Sheet Presentation

The Company’s MBS pledged as collateral against repurchase agreements and Swaps are included in MBS on the consolidated balance sheets with the fair value of the MBS pledged disclosed parenthetically. Purchases and sales of securities are recorded on the trade date. However, if on the purchase settlement date, a repurchase agreement is used to finance the purchase of an MBS with the same counterparty and such transactions are determined to be linked, then the MBS and linked repurchase borrowing will be reported on the same settlement date as Linked Transactions. (See Notes 2(n) and 5)

(c) Securities Obtained and Pledged as Collateral/Obligation to Return Securities Obtained as Collateral

The Company has obtained securities as collateral under collateralized financing arrangements in connection with its financing strategy for Non-Agency MBS. Securities obtained as collateral in connection with these transactions are recorded on the Company’s consolidated balance sheets as an asset along with a liability representing the obligation to return the collateral obtained, at fair value. While beneficial ownership of securities obtained remains with the counterparty, the Company has the right to sell the collateral obtained or to pledge it as part of a subsequent collateralized financing transaction. (See Note 2(i) for Repurchase Agreements and Reverse Repurchase Agreements)

(d) Cash and Cash Equivalents

Cash and cash equivalents include cash on deposit with financial institutions and investments in money market funds, all of which have original maturities of three months or less. Cash and cash equivalents may also include cash pledged as collateral to the Company by its repurchase agreement and/or Swap counterparties as a result of reverse margin calls (i.e., margin calls made by the Company). The Company did not hold any cash pledged by its counterparties at March 31, 2014 or December 31, 2013. At March 31, 2014 and December 31, 2013, all of the Company’s cash investments were comprised of overnight money market funds, which are not bank deposits and are not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. (See Notes 7 and 14)

(e) Restricted Cash

Restricted cash represents the Company's cash held by its counterparties as collateral against the Company's Swaps and/or repurchase agreements. Restricted cash, which earns interest, is not available to the Company for general corporate purposes, but may be applied against amounts due to counterparties to the Company's repurchase agreements and/or Swaps, or returned to the Company when the collateral requirements are exceeded or at the maturity of the Swap or repurchase agreement. The Company had aggregate restricted cash held as collateral against its Swaps of \$26.1 million and \$37.5 million at March 31, 2014 and December 31, 2013, respectively. (See Notes 5, 6, 7 and 14)

(f) Goodwill

At March 31, 2014 and December 31, 2013, the Company had goodwill of \$7.2 million, which represents the unamortized portion of the excess of the fair value of its common stock issued over the fair value of net assets acquired in connection with its formation in 1998. Goodwill is tested for impairment at least annually, or more frequently under certain circumstances, at the entity level. Through March 31, 2014, the Company had not recognized any impairment against its goodwill.



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MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2014

(g) Depreciation

Leasehold Improvements and Other Depreciable Assets

Depreciation is computed on the straight-line method over the estimated useful life of the related assets or, in the case of leasehold improvements, over the shorter of the useful life or the lease term. Furniture, fixtures, computers and related hardware have estimated useful lives ranging from five to eight years at the time of purchase.

(h) Resecuritization and Senior Notes Related Costs

Resecuritization related costs are costs associated with the issuance of beneficial interests by consolidated VIEs and incurred by the Company in connection with various securitization transactions completed by the Company. Senior Notes related costs are costs incurred by the Company in connection with the issuance of its Senior Notes in April, 2012. These costs may include underwriting, rating agency, legal, accounting and other fees. Such costs, which reflect deferred charges, are included on the Company's consolidated balance sheets in Prepaid and other assets. These deferred charges are amortized as an adjustment to interest expense using the effective interest method, based upon the actual repayments of the associated beneficial interests issued to third parties and over the stated legal maturity of the Senior Notes. The Company periodically reviews the recoverability of these deferred costs and in the event an impairment charge is required, such amount shall be included within Operating and other expense on the Company's consolidated statement of operations.

(i) Repurchase Agreements and Reverse Repurchase Agreements

The Company finances the acquisition of a significant portion of its MBS with repurchase agreements. Under repurchase agreements, the Company sells securities to a lender and agrees to repurchase the same securities in the future for a price that is higher than the original sale price. The difference between the sale price that the Company receives and the repurchase price that the Company pays represents interest paid to the lender. Although legally structured as sale and repurchase transactions, the Company accounts for repurchase agreements as secured borrowings, with the exception of certain repurchase agreements accounted for as components of Linked Transactions. (See Note 2(n) below.) Under its repurchase agreements, the Company pledges its securities as collateral to secure the borrowing, which is equal in value to a specified percentage of the fair value of the pledged collateral, while the Company retains beneficial ownership of the pledged collateral. At the maturity of a repurchase financing, unless the repurchase financing is renewed with the same counterparty, the Company is required to repay the loan including any accrued interest and concurrently receives back its pledged collateral from the lender. With the consent of the lender, the Company may renew a repurchase financing at the then prevailing financing terms. Margin calls, whereby a lender requires that the Company pledge additional securities or cash as collateral to secure borrowings under its repurchase financing with such lender, are routinely experienced by the Company when the value of the MBS pledged as collateral declines as a result of principal amortization and prepayments or due to changes in market interest rates, spreads or other market conditions. The Company also may make margin calls on counterparties when collateral values increase.

The Company's repurchase financings typically have terms ranging from one month to six months at inception, but may also have longer or shorter terms. Should a counterparty decide not to renew a repurchase financing at maturity, the Company must either refinance elsewhere or be in a position to satisfy the obligation. If, during the term of a repurchase financing, a lender should default on its obligation, the Company might experience difficulty recovering its

pledged assets which could result in an unsecured claim against the lender for the difference between the amount loaned to the Company plus interest due to the counterparty and the fair value of the collateral pledged by the Company to such lender, including accrued interest receivable or such collateral. (See Notes 2(n), 5, 6, 7 and 14)

In addition to the repurchase agreement financing arrangements discussed above, as part of its financing strategy for Non-Agency MBS, the Company has entered into contemporaneous repurchase and reverse repurchase agreements with a single counterparty. Under a typical reverse repurchase agreement, the Company buys securities from a borrower for cash and agrees to sell the same securities in the future for a price that is higher than the original purchase price. The difference between the purchase price the Company originally paid and the sale price represents interest received from the borrower. In contrast, the contemporaneous repurchase and reverse repurchase transactions effectively resulted in the Company pledging Non-Agency MBS as collateral to the counterparty in connection with the repurchase agreement financing and obtaining U.S. Treasury securities as collateral from the same counterparty in connection with the reverse repurchase agreement. No net cash was exchanged between the Company and counterparty at the inception of the transactions. Securities obtained and pledged as collateral are recorded as

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an asset on the Company's consolidated balance sheets. Interest income is recorded on the reverse repurchase agreement and interest expense is recorded on the repurchase agreement on an accrual basis. Both the Company and the counterparty have the right to make daily margin calls based on changes in the value of the collateral obtained and/or pledged. The Company's liability to the counterparty in connection with this financing arrangement is recorded on the Company's consolidated balance sheets and disclosed as "Obligation to return securities obtained as collateral." (See Note 2(c))

(j) Equity-Based Compensation

Compensation expense for equity based awards is recognized ratably over the vesting period of such awards, based upon the fair value of such awards at the grant date. With respect to awards granted in 2009 and prior years, the Company has applied a zero forfeiture rate for these awards, as they were granted to a limited number of employees, and historical forfeitures have been minimal. Forfeitures, or an indication that forfeitures are expected to occur, may result in a revised forfeiture rate and would be accounted for prospectively as a change in estimate.

During 2010, the Company granted certain restricted stock units ("RSUs") that vest after either two or four years of service and provided that certain criteria are met, which are based on a formula that includes changes in the Company's closing stock price over a two- or four-year period and dividends declared on the Company's common stock during those periods. From 2011 through 2013, the Company granted certain RSUs that vest annually over a one or three-year period, provided that certain criteria are met, which are based on a formula that includes changes in the Company's closing stock price over the annual vesting period and dividends declared on the Company's common stock during those periods. During the first quarter of 2014, the Company made grants of RSUs certain of which generally cliff vest after a three-year period and certain of which generally cliff vest after a three-year period subject to the achievement of a market-based condition that is based on a formula tied to the Company's achievement of average total stockholder return during the three-year period. Such criteria constitute a "market condition" which impacts the amount of compensation expense recognized for these awards. Specifically, the uncertainty regarding whether the market condition will be achieved is reflected in the grant date fair valuation of the RSUs, which in addition to estimates regarding the amount of RSUs expected to be forfeited during the associated service period, determines the amount of compensation expense that is recognized. Compensation expense is not reversed should the market condition not be achieved, while differences in actual forfeiture experience relative to estimated forfeitures will result in adjustments to the timing and amount of compensation expense recognized.

The Company has awarded DERs that may be attached to or awarded separately from other equity based awards. Compensation expense for separately awarded DERs is based on the grant date fair value of such awards and is recognized over the vesting period. Payments pursuant to these DERs are charged to stockholders' equity. Payments pursuant to DERs that are attached to equity based awards are charged to stockholders' equity to the extent that the attached equity awards are expected to vest. Compensation expense is recognized for payments made for DERs to the extent that the attached equity awards do not or are not expected to vest and grantees are not required to return payments of dividends or DERs to the Company. (See Notes 2(k) and 13)

(k) Earnings per Common Share ("EPS")

Basic EPS is computed using the two-class method, which includes the weighted-average number of shares of common stock outstanding during the period and other securities that participate in dividends, such as the Company's unvested restricted stock and RSUs that have non-forfeitable rights to dividends and DERs attached to/associated with RSUs and vested stock options to arrive at total common equivalent shares. In applying the two-class method,

earnings are allocated to both shares of common stock and securities that participate in dividends based on their respective weighted-average shares outstanding for the period. For the diluted EPS calculation, common equivalent shares are further adjusted for the effect of dilutive unexercised stock options and RSUs outstanding that are unvested and have dividends that are subject to forfeiture using the treasury stock method. Under the treasury stock method, common equivalent shares are calculated assuming that all dilutive common stock equivalents are exercised and the proceeds, along with future compensation expenses associated with such instruments, are used to repurchase shares of the Company's outstanding common stock at the average market price during the reported period. (See Note 12)

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(l) Comprehensive Income/(Loss)

The Company's comprehensive income/(loss) available to common stock and participating securities includes net income, the change in net unrealized gains/(losses) on its MBS and Swaps, (to the extent that such changes are not recorded in earnings), adjusted by realized net gains/(losses) reclassified out of AOCI for MBS and is reduced by dividends declared on the Company's preferred stock and issuance costs of redeemed preferred stock.

(m) U.S. Federal Income Taxes

The Company has elected to be taxed as a REIT under the provisions of the Internal Revenue Code of 1986, as amended, (the "Code") and the corresponding provisions of state law. The Company expects to operate in a manner that will enable it to satisfy the various requirements to maintain its status as a REIT. In order to maintain its status as a REIT, the Company must, among other things, distribute at least 90% of its REIT taxable income (excluding net long-term capital gains) to stockholders in the timeframe permitted by the Code. As long as the Company maintains its status as a REIT, the Company will not be subject to regular Federal income tax to the extent that it distributes 100% of its REIT taxable income (including net long-term capital gains) to its stockholders within the permitted timeframe. Should this not occur, the Company would be subject to federal taxes at prevailing corporate tax rates on the difference between its REIT taxable income and the amounts deemed to be distributed for that tax year. As the Company's objective is to distribute 100% of its REIT taxable income to its stockholders within the permitted timeframe, no provision for current or deferred income taxes has been made in the accompanying consolidated financial statements. Should the Company incur a liability for corporate income tax, such amounts would be recorded as REIT income tax expense on the Company's consolidated statements of operations. Furthermore, if the Company fails to distribute during each calendar year, or by the end of January following the calendar year in the case of distributions with declaration and record dates falling in the last three months of the calendar year, at least the sum of (i) 85% its REIT ordinary income for such year; (ii) 95% of its REIT capital gain income for such year and; (iii) any undistributed taxable income from prior periods, the Company will be subject to a 4% nondeductible excise tax on the excess of such required distribution over the amounts actually distributed. To the extent that the Company incurs interest, penalties or related excise taxes in connection with its tax obligations, including as a result of its assessment of uncertain tax positions, such amounts shall be included within Operating and other expense on the Company's consolidated statements of operations.

Based on its analysis of any potential uncertain tax positions, the Company concluded that it does not have any material uncertain tax positions that meet the relevant recognition or measurement criteria as of March 31, 2014, December 31, 2013, or March 31, 2013. The Company filed its 2012 tax return prior to September 15, 2013. The Company's tax returns for tax years 2009 through 2012 are open to examination.

(n) Derivative Financial Instruments

The Company uses a variety of derivative instruments to economically hedge a portion of its exposure to market risks, including interest rate risk, prepayment risk and extension risk. The objective of the Company's risk management strategy is to reduce fluctuations in net book value over a range of interest rate scenarios. In particular, the Company attempts to mitigate the risk of the cost of its variable rate liabilities increasing during a period of rising interest rates. The Company's derivative instruments are primarily comprised of Swaps, the majority of which are designated as cash flow hedges against the interest rate risk associated with its borrowings. During 2013, the Company also entered into forward contracts for the sale of Agency MBS securities on a generic pool, or to-be-announced basis ("TBA short positions") and Linked Transactions. TBA short positions and Linked Transactions are not designated as hedging

instruments.

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Linked Transactions

It is presumed that the initial transfer of a financial asset (i.e., the purchase of an MBS by the Company) and contemporaneous repurchase financing of such MBS with the same counterparty are considered part of the same arrangement, or a “linked transaction,” unless certain criteria are met. The two components of a linked transaction (MBS purchase and repurchase financing) are not reported separately but are evaluated on a combined basis and reported as a forward (derivative) contract and are presented as “Linked Transactions” on the Company’s consolidated balance sheets. Changes in the fair value of the assets and liabilities underlying Linked Transactions and associated interest income and expense are reported as “unrealized net gains/(losses) and net interest income from Linked Transactions” on the Company’s consolidated statements of operations and are not included in OCI. However, if certain criteria are met, the initial transfer (i.e., the purchase of a security by the Company) and repurchase financing will not be treated as a Linked Transaction and will be evaluated and reported separately, as an MBS purchase and repurchase financing. When or if a transaction is no longer considered to be linked, the MBS and repurchase financing will be reported on a gross basis. In this case, the fair value of the MBS at the time the transactions are no longer considered linked will become the cost basis of the MBS, and the income recognition yield for such MBS will be calculated prospectively using this new cost basis. (See Notes 5 and 14)

Swaps

The Company documents its risk-management policies, including objectives and strategies, as they relate to its hedging activities and the relationship between the hedging instrument and the hedged liability for all Swaps designated as hedging transactions. The Company assesses, both at inception of a hedge and on a quarterly basis thereafter, whether or not the hedge is “highly effective.”

Swaps are carried on the Company’s balance sheets at fair value, as assets, if their fair value is positive, or as liabilities, if their fair value is negative. Changes in the fair value of the Company’s Swaps designated in hedging transactions are recorded in OCI provided that the hedge remains effective. Changes in fair value for any ineffective amount of a Swap are recognized in earnings. The Company has not recognized any change in the value of its existing Swaps designated as hedges through earnings as a result of hedge ineffectiveness.

The Company discontinues hedge accounting on a prospective basis and recognizes changes in the fair value through earnings when: (i) it is determined that the derivative is no longer effective in offsetting cash flows of a hedged item (including forecasted transactions); (ii) it is no longer probable that the forecasted transaction will occur; or (iii) it is determined that designating the derivative as a hedge is no longer appropriate.

Although permitted under certain circumstances, the Company does not offset cash collateral receivables or payables against its net derivative positions. (See Notes 5, 7 and 14)

TBA Short Positions

During 2013, the Company entered into TBA short positions as a means of managing interest rate risk and MBS basis risk associated with its investment and financing activities. A TBA short position is a forward contract for sale of Agency MBS at a predetermined price, face amount, issuer, coupon and stated maturity on an agreed-upon future date. The specific Agency MBS that could be delivered into the contract upon the settlement date, published each month by the Securities Industry and Financial Markets Association (“SIFMA”), are not known at the time of the transaction.

The Company accounts for TBA short positions as derivative instruments since it cannot assert that it is probable at inception and throughout the term of the TBA contract that it will physically deliver the agency security upon settlement of the contract. The Company presents TBA short positions as either derivative assets or liabilities, at fair value on its consolidated balance sheets. Gains and losses associated with TBA short positions are reported in Other income on the Company's consolidated statements of operations.

The Company did not have any TBA short positions at March 31, 2014 and December 31, 2013.



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(o) Fair Value Measurements and the Fair Value Option for Financial Assets and Financial Liabilities

The Company's presentation of fair value for its financial assets and liabilities is determined within a framework that stipulates that the fair value of a financial asset or liability is an exchange price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability. The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. This definition of fair value focuses on exit price and prioritizes the use of market-based inputs over entity-specific inputs when determining fair value. In addition, the framework for measuring fair value establishes a three-level hierarchy for fair value measurements based upon the observability of inputs to the valuation of an asset or liability as of the measurement date. (See Note 14)

Although permitted under GAAP to measure many financial instruments and certain other items at fair value, the Company has not elected the fair value option for any of its assets or liabilities. If the fair value option is elected, unrealized gains and losses on such items for which fair value is elected would be recognized in earnings at each subsequent reporting date. A decision to elect the fair value option for an eligible financial instrument, which may be made on an instrument by instrument basis, is irrevocable.

(p) Variable Interest Entities

An entity is referred to as a VIE if it meets at least one of the following criteria: (i) the entity has equity that is insufficient to permit the entity to finance its activities without additional subordinated financial support of other parties; or (ii) as a group, the holders of the equity investment at risk lack (a) the power to direct the activities of an entity that most significantly impact the entity's economic performance; (b) the obligation to absorb the expected losses; or (c) the right to receive the expected residual returns; or (iii) have disproportional voting rights and the entity's activities are conducted on behalf of the investor that has disproportionately few voting rights.

The Company consolidates a VIE when it has both the power to direct the activities that most significantly impact the economic performance of the VIE and a right to receive benefits or absorb losses of the entity that could be potentially significant to the VIE. The Company is required to reconsider its evaluation of whether to consolidate a VIE each reporting period, based upon changes in the facts and circumstances pertaining to the VIE.

The Company has entered into securitization transactions which result in the Company consolidating the VIEs that were created to facilitate the transactions and to which the underlying assets in connection with the securitizations were transferred. In determining the accounting treatment to be applied to these securitization transactions, the Company evaluated whether the entities used to facilitate these transactions were VIEs and, if so, whether they should be consolidated. Based on its evaluation, the Company concluded that the VIEs should be consolidated. If the Company had determined that consolidation was not required, it would have then assessed whether the transfer of the underlying assets would qualify as a sale or should be accounted for as secured financings under GAAP.

Prior to the completion of its initial securitization transaction in October 2010, the Company had not transferred assets to VIEs or Qualifying Special Purpose Entities ("QSPEs") and other than acquiring MBS issued by such entities, had no other involvement with VIEs or QSPEs. (See Note 15)

(q) Offering Costs Related to Issuance and Redemption of Preferred Stock

Offering costs related to issuance of preferred stock are recorded as a reduction in Additional paid-in capital, a component of stockholders' equity, at the time such preferred stock is issued. On redemption of preferred stock, any excess of the fair value of the consideration transferred to the holders of the preferred stock over the carrying amount of the preferred stock in the Company's consolidated balance sheets is included in the determination of Net Income Available to Common Stock and Participating Securities in the calculation of EPS. (See Note 11)

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(r) New and Proposed Accounting Standards and Interpretations

Accounting Standards Adopted in 2014

Financial Services - Investment Companies

In June 2013, the Financial Accounting Standard Board (“FASB”) issued Accounting Standards Update (“ASU”) 2013-08, Financial Services - Investment Companies: Amendments to the Scope, Measurement, and Disclosure Requirements (“ASU 2013-08”). In general, the amendments of this ASU: (i) revise the definition of an investment company; (ii) require an investment company to measure non-controlling ownership interests in other investment companies at fair value rather than using the equity method of accounting; and (iii) require information to be disclosed concerning the status of the entity and any financial support provided, or contractually required to be provided, by the investment company to its investees. The Company’s adoption of ASU 2013-08 beginning on January 1, 2014 did not have a material impact on the Company’s consolidated financial statements as the FASB has decided to retain the current U.S. GAAP scope exception from investment company accounting and financial reporting for real estate investment trusts.

3. MBS

The Company’s MBS are comprised of Agency MBS and Non-Agency MBS. These MBS are secured by: (i) hybrid mortgages (“Hybrids”), which have interest rates that are fixed for a specified period of time and, thereafter, generally adjust annually to an increment over a specified interest rate index; (ii) adjustable-rate mortgages (“ARMs”); (iii) mortgages that have interest rates that reset more frequently (collectively, “ARM-MBS”); and (iv) 15 year and longer-term fixed rate mortgages. MBS do not have a single maturity date, and further, the mortgage loans underlying ARM-MBS do not all reset at the same time.

The Company pledges a significant portion of its MBS as collateral against its borrowings under repurchase agreements and Swaps. Non-Agency MBS that are accounted for as components of Linked Transactions are not reflected in the tables set forth in this note, as they are accounted for as derivatives. (See Notes 5 and 7)

Agency MBS: Agency MBS are guaranteed as to principal and/or interest by a federally chartered corporation, such as Fannie Mae or Freddie Mac, or an agency of the U.S. Government, such as Ginnie Mae. The payment of principal and/or interest on Ginnie Mae MBS is explicitly backed by the full faith and credit of the U.S. Government. Since the third quarter of 2008, Fannie Mae and Freddie Mac have been under the conservatorship of the Federal Housing Finance Agency, which significantly strengthened the backing for these government-sponsored entities.

Non-Agency MBS (including Non-Agency MBS transferred to consolidated VIEs): The Company’s Non-Agency MBS are secured by pools of residential mortgages, which are not guaranteed by an agency of the U.S. Government or any federally chartered corporation. Credit risk associated with Non-Agency MBS is regularly assessed as new information regarding the underlying collateral becomes available and based on updated estimates of cash flows generated by the underlying collateral.

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The following tables present certain information about the Company's MBS at March 31, 2014 and December 31, 2013:

March 31, 2014

(In Thousands)	Principal/ Current Face	Purchase Premiums	Accretable Purchase Discounts	Discount Designated as Credit Reserve and OTTI (1)	Amortized Cost (2)	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Net Unrealized Gain/(Loss)
Agency MBS:									
Fannie Mae	\$5,411,010	\$206,174	\$(83)	) \$—	\$5,617,101	\$5,666,693	\$96,973	\$(47,381)	\$49,592
Freddie Mac	1,133,983	43,598	—	—	1,179,123	1,161,428	10,569	(28,264)	(17,695)
Ginnie Mae	12,379	212	—	—	12,591	12,912	321	—	321
Total Agency MBS	6,557,372	249,984	(83)	) —	6,808,815	6,841,033	107,863	(75,645)	32,218
Non-Agency MBS:									
Expected to Recover Par (3)	239,898	597	(24,442)	) —	216,053	237,590	22,748	(1,211)	21,537
Expected to Recover Less Than Par (3)(4)	5,501,745	—	(417,714)	) (1,041,933)	4,042,098	4,807,565	767,029	(1,562)	765,467
Total Non-Agency MBS	5,741,643	597	(442,156)	) (1,041,933)	4,258,151	5,045,155	789,777	(2,773)	787,004
Total MBS	\$12,299,015	\$250,581	\$(442,239)	\$(1,041,933)	\$11,066,966	\$11,886,188	\$897,640	\$(78,418)	\$819,222

December 31, 2013

(In Thousands)	Principal/ Current Face	Purchase Premiums	Accretable Purchase Discounts	Discount Designated as Credit Reserve and OTTI (1)	Amortized Cost (2)	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Net Unrealized Gain/(Loss)
Agency MBS:									
Fannie Mae	\$5,092,410	\$181,710	\$(87)	) \$—	\$5,274,033	\$5,315,363	\$96,516	\$(55,186)	\$41,330
Freddie Mac	1,171,841	44,967	—	—	1,217,927	1,190,670	9,842	(37,099)	(27,257)
Ginnie Mae	12,668	218	—	—	12,886	13,188	302	—	302
Total Agency MBS	6,276,919	226,895	(87)	) —	6,504,846	6,519,221	106,660	(92,285)	14,375
Non-Agency MBS:									
Expected to Recover Par (3)	234,187	638	(24,450)	) —	210,375	230,738	21,720	(1,357)	20,363

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Expected to Recover Less Than Par (3)(4) Total	5,381,851	—	(435,589 )	(1,043,037 )	3,903,225	4,621,399	720,566	(2,392 )	718,174
Non-Agency MBS	5,616,038	638	(460,039 )	(1,043,037 )	4,113,600	4,852,137	742,286	(3,749 )	738,537
Total MBS	\$11,892,957	\$227,533	\$(460,126)	\$(1,043,037)	\$10,618,446	\$11,371,358	\$848,946	\$(96,034)	\$752,912

(1) Discount designated as Credit Reserve and amounts related to OTTI are generally not expected to be accreted into interest income. Amounts disclosed at March 31, 2014 reflect Credit Reserve of \$997.6 million and OTTI of \$44.4 million. Amounts disclosed at December 31, 2013 reflect Credit Reserve of \$998.5 million and OTTI of \$44.5 million.

(2) Includes principal payments receivable of \$1.5 million and \$1.1 million at March 31, 2014 and December 31, 2013, respectively, which are not included in the Principal/Current Face.

(3) Based on management's current estimates of future principal cash flows expected to be received.

(4) At March 31, 2014 and December 31, 2013, the Company expected to recover approximately 81% of the then-current face amount of Non-Agency MBS.

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## Unrealized Losses on MBS and Impairments

The following table presents information about the Company's MBS that were in an unrealized loss position at March 31, 2014:

## Unrealized Loss Position For:

(In Thousands)	Less than 12 Months			12 Months or more			Total	
	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses
Agency MBS:								
Fannie Mae	\$2,191,042	\$41,548	190	\$157,376	\$5,833	38	\$2,348,418	\$47,381
Freddie Mac	644,218	21,799	86	143,959	6,465	22	788,177	28,264
Total Agency MBS	2,835,260	63,347	276	301,335	12,298	60	3,136,595	75,645
Non-Agency MBS:								
Expected to Recover Par (1)	2,167	21	1	25,361	1,190	8	27,528	1,211
Expected to Recover Less Than Par (1)	104,551	830	15	5,231	732	3	109,782	1,562
Total Non-Agency MBS	106,718	851	16	30,592	1,922	11	137,310	2,773
Total MBS	\$2,941,978	\$64,198	292	\$331,927	\$14,220	71	\$3,273,905	\$78,418

(1) Based on management's current estimates of future principal cash flows expected to be received.

At March 31, 2014, the Company did not intend to sell any of its MBS that were in an unrealized loss position, and it is "more likely than not" that the Company will not be required to sell these MBS before recovery of their amortized cost basis, which may be at their maturity. With respect to Non-Agency MBS held by consolidated VIEs, the ability of any entity to cause the sale by the VIE prior to the maturity of these Non-Agency MBS is either specifically precluded, or is limited to specified events of default, none of which has occurred to date.

Gross unrealized losses on the Company's Agency MBS were \$75.6 million at March 31, 2014. Agency MBS are issued by Government Sponsored Entities ("GSEs") that enjoy either the implicit or explicit backing of the full faith and credit of the U.S. Government. While the Company's Agency MBS are not rated by any rating agency, they are currently perceived by market participants to be of high credit quality, with risk of default limited to the unlikely event that the U.S. Government would not continue to support the GSEs. In addition, the GSEs are currently profitable on a stand-alone basis with such profits being remitted to the U.S. Treasury. Given the credit quality inherent in Agency MBS, the Company does not consider any of the current impairments on its Agency MBS to be credit related. In assessing whether it is more likely than not that it will be required to sell any impaired security before its anticipated recovery, which may be at its maturity, the Company considers for each impaired security, the significance of each investment, the amount of impairment, the projected future performance of such impaired securities, as well as the Company's current and anticipated leverage capacity and liquidity position. Based on these analyses, the Company determined that at March 31, 2014 any unrealized losses on its Agency MBS were temporary.

Unrealized losses on the Company's Non-Agency MBS (including Non-Agency MBS transferred to consolidated VIEs) were \$2.8 million at March 31, 2014. Based upon the most recent evaluation, the Company does not consider these unrealized losses to be indicative of OTTI and does not believe that these unrealized losses are credit related, but

are rather due to non-credit related factors. The Company has reviewed its Non-Agency MBS that are in an unrealized loss position to identify those securities with losses that are other-than-temporary based on an assessment of changes in expected cash flows for such MBS, which considers recent bond performance and expected future performance of the underlying collateral.

The Company did not recognize any credit-related OTTI losses through earnings related to its MBS during the three months ended March 31, 2014 and 2013.

Non-Agency MBS on which OTTI is recognized have experienced, or are expected to experience, credit-related adverse cash flow changes. The Company's estimate of cash flows for its Non-Agency MBS is based on its review of the underlying mortgage loans securing these MBS. The Company considers information available about the structure of the securitization, including structural credit enhancement, if any, and the past and expected future performance of underlying mortgage loans, including timing

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of expected future cash flows, prepayment rates, default rates, loss severities, delinquency rates, percentage of non-performing loans, FICO scores at loan origination, year of origination, loan-to-value ratios, geographic concentrations, as well as Rating Agency reports, general market assessments, and dialogue with market participants. Changes in the Company's evaluation of each of these factors impacts the cash flows expected to be collected at the OTTI assessment date. For Non-Agency MBS purchased at a discount to par that were assessed for OTTI during the quarter, such cash flow estimates indicated that the amount of expected losses decreased compared to the previous OTTI assessment date. These positive cash flow changes are primarily driven by recent improvements in loan-to-value ratios due to loan amortization and home price appreciation, which, in turn, positively impacts the Company's estimates of default rates and loss severities for the underlying collateral. In addition, voluntary prepayments (i.e. loans that prepay in full with no loss) have generally trended higher for these MBS which also positively impacts the Company's estimate of expected loss. Overall, the combination of higher voluntary prepayments and lower loan-to-value ratios supports the Company's assessment that such MBS are not other-than-temporarily impaired. Significant judgment is used in both the Company's analysis of the expected cash flows for its Non-Agency MBS and any determination of the credit component of OTTI.

The following table presents a roll-forward of the credit loss component of OTTI on the Company's Non-Agency MBS for which a non-credit component of OTTI was previously recognized in OCI. Changes in the credit loss component of OTTI are presented based upon whether the current period is the first time OTTI was recorded on a security or a subsequent OTTI charge was recorded.

(In Thousands)	Three Months Ended March 31,	
	2014	2013
Credit loss component of OTTI at beginning of period	\$36,115	\$36,115
Additions for credit related OTTI not previously recognized	—	—
Subsequent additional credit related OTTI recorded	—	—
Credit loss component of OTTI at end of period	\$36,115	\$36,115

## Purchase Discounts on Non-Agency MBS

The following tables present the changes in the components of the Company's purchase discount on its Non-Agency MBS between purchase discount designated as Credit Reserve and OTTI and accretable purchase discount for the three months ended March 31, 2014 and 2013:

(In Thousands)	Three Months Ended March 31,			
	2014		2013	
	Discount Designated as Credit Reserve and OTTI (1)	Accretable Discount (1)(2)	Discount Designated as Credit Reserve and OTTI (3)	Accretable Discount (2)(3)
Balance at beginning of period	\$(1,043,037 )	\$(460,039 )	\$(1,380,506 )	\$(371,626 )
Accretion of discount	—	27,431	—	12,051
Realized credit losses	25,037	—	50,307	—
Purchases	(63,317 )	23,406	(23,535 )	11,229
Sales	3,487	2,943	6,283	932
Transfers/release of credit reserve	35,897	(35,897 )	34,499	(34,499 )
Balance at end of period	\$(1,041,933 )	\$(442,156 )	\$(1,312,952 )	\$(381,913 )



- (1) The Company reallocated \$115,000 of purchase discount designated as Credit Reserve to accretable purchase discount on Non-Agency MBS underlying Linked Transactions during the three months ended March 31, 2014.
- (2) Together with coupon interest, accretable purchase discount is recognized as interest income over the life of the security.
- (3) In addition, the Company reallocated \$13,000 of purchase discount designated as Credit Reserve to accretable purchase discount on Non-Agency MBS underlying Linked Transactions during the three months ended March 31, 2013.

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## Impact of MBS on AOCI

The following table presents the impact of the Company's MBS on its AOCI for the three months ended March 31, 2014 and 2013:

(In Thousands)	Three Months Ended March 31,	
	2014	2013
AOCI from MBS:		
Unrealized gain on MBS at beginning of period	\$752,912	\$824,808
Unrealized gain/(loss) on Agency MBS, net	17,843	(27,291)
Unrealized gain on Non-Agency MBS, net	51,417	146,730
Reclassification adjustment for MBS sales included in net income	(2,950)	(1,360)
Change in AOCI from MBS	66,310	118,079
Balance at end of period	\$819,222	\$942,887

## Sales of MBS

During the three months ended March 31, 2014, the Company sold certain Non-Agency MBS for \$15.5 million, realizing gross gains of \$3.6 million. During the three months ended March 31, 2013, the Company sold certain Non-Agency MBS for \$6.1 million, realizing gross gains of \$1.7 million. The Company has no continuing involvement with any of the sold MBS.

## MBS Interest Income

The following table presents the components of interest income on the Company's Agency MBS for the three months ended March 31, 2014 and 2013:

(In Thousands)	Three Months Ended March 31,	
	2014	2013
Coupon interest	\$49,499	\$57,504
Effective yield adjustment (1)	(10,170)	(14,717)
Agency MBS interest income	\$39,329	\$42,787

(1) Includes amortization of premium paid net of accretion of purchase discount. For Agency MBS, interest income is recorded at an effective yield, which reflects net premium amortization based on actual prepayment activity.

The following table presents components of interest income for the Company's Non-Agency MBS (including MBS transferred to consolidated VIEs) for the three months ended March 31, 2014 and 2013:

(In Thousands)	Three Months Ended March 31,	
	2014	2013
Coupon interest	\$54,430	\$67,933
Effective yield adjustment (1)	27,389	11,982
Non-Agency MBS interest income	\$81,819	\$79,915

(1) The effective yield adjustment is the difference between the net income calculated using the net yield, which is based on management's estimates of future cash flows for Non-Agency MBS, less the current coupon yield.

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## 4. Interest Receivable

The following table presents the Company's interest receivable by investment category at March 31, 2014 and December 31, 2013:

(In Thousands)	March 31, 2014	December 31, 2013
MBS interest receivable:		
Fannie Mae	\$ 14,509	\$ 13,760
Freddie Mac	2,994	3,110
Ginnie Mae	19	19
Non-Agency MBS	19,138	18,917
Total MBS interest receivable	36,660	35,806
Money market and other investments	20	22
Total interest receivable	\$ 36,680	\$ 35,828

## 5. Derivative Instruments

The Company's derivative instruments are primarily comprised of Swaps, the majority of which are designated as cash flow hedges against the interest rate risk associated with its borrowings. The Company has also entered into Linked Transactions, which are not designated as hedging instruments. The following table presents the fair value of the Company's derivative instruments and their balance sheet location at March 31, 2014 and December 31, 2013:

Derivative Instrument	Designation	Balance Sheet Location	March 31, 2014 Notional Amount	March 31, 2014 Fair Value	December 31, 2013
(In Thousands)					
Linked Transactions	Non-Hedging	Assets	N/A	\$ 59,826	\$ 28,181
Non-cleared legacy Swaps (1)	Hedging	Assets	\$ 450,000	\$ 4,715	\$ 4,925
Cleared Swaps (2)	Hedging	Assets	\$ 500,000	\$ 770	\$ 8,075
Non-cleared legacy Swaps (1)	Hedging	Liabilities	\$ 1,278,361	\$(18,230)	\$(24,437)
Non-cleared legacy Swaps (1)	Non-Hedging	Liabilities	\$ 125,000	\$(233)	\$—
Cleared Swaps (2)	Hedging	Liabilities	\$ 1,850,000	\$(14,292)	\$(3,780)

(1) Non-cleared legacy Swaps include Swaps executed and settled bilaterally with counterparties without the use of an organized exchange or central clearing house.

(2) Cleared Swaps include Swaps executed bilaterally with a counterparty in the over-the-counter market but then novated to a central clearing house, whereby the central clearing house becomes the counterparty to both of the original counterparties.

## Linked Transactions

The Company's Linked Transactions are evaluated on a combined basis, reported as forward (derivative) instruments and presented as assets on the Company's consolidated balance sheets at fair value. The fair value of Linked Transactions reflect the value of the underlying Non-Agency MBS, linked repurchase agreement borrowings and

accrued interest receivable/payable on such instruments. The Company's Linked Transactions are not designated as hedging instruments and, as a result, the change in the fair value and net interest income from Linked Transactions is reported in other income on the Company's consolidated statements of operations.

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The following tables present certain information about the Non-Agency MBS and repurchase agreements underlying the Company's Linked Transactions at March 31, 2014 and December 31, 2013:

## Linked Transactions at March 31, 2014

Linked Repurchase Agreements	Linked MBS						
	Balance	Weighted Average Interest Rate	Non-Agency MBS	Fair Value	Amortized Cost	Par/Current Face	Weighted Average Coupon Rate
Maturity or Repricing							
(Dollars in Thousands)			(Dollars in Thousands)				
Within 30 days	\$173,386	1.75	% Total	\$265,548	\$259,493	\$272,375	3.92 %
>30 days to 90 days	32,600	1.57					
Total	\$205,986	1.72	%				

## Linked Transactions at December 31, 2013

Linked Repurchase Agreements	Linked MBS						
	Balance	Weighted Average Interest Rate	Non-Agency MBS	Fair Value	Amortized Cost	Par/Current Face	Weighted Average Coupon Rate
Maturity or Repricing							
(Dollars in Thousands)			(Dollars in Thousands)				
Within 30 days	\$93,835	1.76	% Total	\$130,790	\$126,497	\$134,430	3.96 %
>30 days to 90 days	8,902	1.44					
Total	\$102,737	1.73	%				

At March 31, 2014, Linked Transactions also included approximately \$423,000 of associated accrued interest receivable and \$159,000 of accrued interest payable. At December 31, 2013, Linked Transactions also included approximately \$210,000 of associated accrued interest receivable and \$82,000 of accrued interest payable.

The following table presents certain information about the components of the unrealized net gains and net interest income from Linked Transactions included in the Company's consolidated statements of operations for the three months ended March 31, 2014 and 2013:

Components of Unrealized Net Gains and Net Interest Income from Linked Transactions (In Thousands)	Three Months Ended	
	March 31, 2014	2013
Interest income attributable to MBS underlying Linked Transactions	\$2,041	\$668
Interest expense attributable to linked repurchase agreement borrowings underlying Linked Transactions	(551	) (140
Change in fair value of Linked Transactions included in earnings	1,761	1,008
Unrealized net gains and net interest income from Linked Transactions	\$3,251	\$1,536



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## Swaps

Consistent with market practice, the Company has agreements with its Swap counterparties that provide for the posting of collateral based on the fair values of its derivative contracts. Through this margining process, either the Company or its derivative counterparty may be required to pledge cash or securities as collateral. In addition, Swaps novated to and cleared by a central clearing house are subject to initial margin requirements. Certain derivative contracts provide for cross collateralization with repurchase agreements with the same counterparty.

A number of the Company's Swap contracts include financial covenants, which, if breached, could cause an event of default or early termination event to occur under such agreements. Such financial covenants include minimum net worth requirements and maximum debt-to-equity ratios. If the Company were to cause an event of default or trigger an early termination event pursuant to one of its Swap contracts, the counterparty to such agreement may have the option to terminate all of its outstanding Swap contracts with the Company and, if applicable, any close-out amount due to the counterparty upon termination of the Swap contracts would be immediately payable by the Company. The Company was in compliance with all of its financial covenants through March 31, 2014. At March 31, 2014, the aggregate fair value of assets needed to immediately settle Swap contracts that were in a liability position to the Company, if so required, was approximately \$35.5 million, including accrued interest payable of approximately \$2.7 million.

The following table presents the assets pledged as collateral against the Company's Swap contracts at March 31, 2014 and December 31, 2013:

(In Thousands)	March 31, 2014	December 31, 2013
Agency MBS, at fair value	\$76,968	\$73,859
Restricted cash	26,139	37,520
Total assets pledged against Swaps	\$103,107	\$111,379

The use of derivative hedging instruments exposes the Company to counterparty credit risk. In the event of a default by a derivative counterparty, the Company may not receive payments to which it is entitled under its derivative agreements, and may have difficulty recovering its assets pledged as collateral against such agreements. If, during the term of a derivative contract, a counterparty should file for bankruptcy, the Company may experience difficulty recovering its assets pledged as collateral which could result in the Company having an unsecured claim against such counterparty's assets for the difference between the fair value of the derivative and the fair value of the collateral pledged to such counterparty.

The Company's derivative hedging instruments, or a portion thereof, could become ineffective in the future if the associated repurchase agreements that such derivatives hedge fail to exist or fail to have terms that match those of the derivatives that hedge such borrowings.

The Company's Swaps designated as hedging transactions have the effect of modifying the repricing characteristics of the Company's repurchase agreements and cash flows for such liabilities. To date, no cost has been incurred at the inception of a Swap (except for certain transaction fees related to entering in to Swaps cleared through a central clearing house), pursuant to which the Company agrees to pay a fixed rate of interest and receive a variable interest rate, generally based on one-month or three-month London Interbank Offered Rate ("LIBOR"), on the notional amount of the Swap. The Company did not recognize any change in the value of its existing Swaps designated as hedges



through earnings as a result of hedge ineffectiveness during the three months ended March 31, 2014 and 2013.

At March 31, 2014, the Company had Swaps designated in hedging relationships with an aggregate notional amount of \$4.078 billion, which had net unrealized losses of \$27.0 million, and extended 49 months on average with a maximum term of approximately 113 months. In addition, at March 31, 2014, the Company had a Swap with a notional amount of \$125.0 million, which had an unrealized loss of approximately \$233,000, maturing on June 27, 2014 that was not designated in a hedge relationship.

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The following table presents certain information with respect to the Company's Swap activity during the three months ended March 31, 2014:

(Dollars in Thousands)	Three Months Ended March 31, 2014	
New Swaps:		
Aggregate notional amount	\$200,000	
Weighted average fixed-pay rate	1.95	%
Initial maturity date	Five years to seven years	
Number of new Swaps	Two	
Swaps amortized/expired:		
Aggregate notional amount	\$41,851	
Weighted average fixed-pay rate	3.92	%

The following table presents information about the Company's Swaps at March 31, 2014 and December 31, 2013:

Maturity (1)	March 31, 2014			December 31, 2013		
	Notional Amount	Weighted Average Fixed-Pay Interest Rate	Weighted Average Variable Interest Rate (2)	Notional Amount	Weighted Average Fixed-Pay Interest Rate	Weighted Average Variable Interest Rate (2)
(Dollars in Thousands)						
Within 30 days	\$160,413	1.54	% 0.16	% \$17,635	3.90	% 0.21
Over 30 days to 3 months	315,734	1.94	0.16	24,216	3.93	0.21
Over 3 months to 6 months	46,322	2.84	0.17	476,147	1.80	0.17
Over 6 months to 12 months	530,892	2.23	0.16	167,043	3.22	0.18
Over 12 months to 24 months	350,000	2.07	0.16	710,171	1.97	0.17
Over 24 months to 36 months	150,000	0.54	0.16	150,000	1.03	0.17
Over 36 months to 48 months	300,000	0.57	0.16	350,000	0.58	0.17
Over 48 months to 60 months	650,000	1.53	0.16	550,000	1.49	0.17
Over 72 months to 84 months	1,600,000	2.22	0.16	1,500,000	2.22	0.17
Over 84 months (3)	100,000	2.75	0.16	100,000	2.75	0.17
Total Swaps	\$4,203,361	1.89	% 0.16	% \$4,045,212	1.91	% 0.17

(1) Each maturity category reflects contractual amortization and/or maturity of notional amounts.

(2) Reflects the benchmark variable rate due from the counterparty at the date presented, which rate adjusts monthly or quarterly based on one-month or three-month LIBOR, respectively.

(3) Reflects one Swap with a maturity date of July 2023.

The following table presents the net impact of the Company's derivative hedging instruments on its interest expense and the weighted average interest rate paid and received for such Swaps for the three months ended March 31, 2014 and 2013:

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(Dollars in Thousands)	Three Months Ended			
	March 31,	2013		
Interest expense attributable to Swaps	2014	2013		
	\$17,563	\$12,969		
Weighted average Swap rate paid	1.92	% 2.27		%
Weighted average Swap rate received	0.16	% 0.21		%

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## Impact of Derivative Hedging Instruments on AOCI

The following table presents the impact of the Company's derivative hedging instruments on its AOCI for the three months ended March 31, 2014 and 2013:

(In Thousands)	Three Months Ended	
	March 31, 2014	2013
AOCI from derivative hedging instruments:		
Balance at beginning of period	\$(15,217	) \$(62,831
Unrealized (loss)/gain on Swaps, net	(12,267	) 12,316
Reclassification of unrealized loss on de-designated Swaps	447	—
Balance at end of period	\$(27,037	) \$(50,515

## Counterparty Credit Risk from Use of Swaps

By using Swaps, the Company is exposed to counterparty credit risk if counterparties to the derivative contracts do not perform as expected. If a counterparty fails to perform, the Company's counterparty credit risk is equal to the amount reported as a derivative asset on its consolidated balance sheets to the extent that amount exceeds collateral obtained from the counterparty or, if in a net liability position, the extent to which collateral posted exceeds the liability to the counterparty. The amounts reported as a derivative asset/(liability) are derivative contracts in a gain/(loss) position, and to the extent subject to master netting arrangements, net of derivatives in a loss/(gain) position with the same counterparty and collateral received/(pledged). The Company attempts to minimize counterparty credit risk through credit approvals, limits, monitoring procedures, executing master netting arrangements and obtaining collateral, where appropriate. Counterparty credit risk related to the Company's Swaps is considered in determining fair value of such derivatives and its assessment of hedge effectiveness.

## 6. Repurchase Agreements

The Company's repurchase agreements are collateralized by the Company's MBS and U.S. Treasury securities (obtained as part of a reverse repurchase agreement) and cash, and bear interest that is generally LIBOR-based. (See Note 7) At March 31, 2014, the Company's borrowings under repurchase agreements had a weighted average remaining term-to-interest rate reset of 29 days and an effective repricing period of 23 months, including the impact of related Swaps. At December 31, 2013, the Company's borrowings under repurchase agreements had a weighted average remaining term-to-interest rate reset of 25 days and an effective repricing period of 24 months, including the impact of related Swaps.

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The following table presents information with respect to the Company's borrowings under repurchase agreements and associated assets pledged as collateral at March 31, 2014 and December 31, 2013:

(Dollars in Thousands)	March 31, 2014	December 31, 2013		
Repurchase agreement borrowings secured by Agency MBS	\$6,018,689	\$5,750,053		
Fair Value of Agency MBS pledged as collateral under repurchase agreements	\$6,327,835	\$6,068,447		
Weighted average haircut on Agency MBS (1)	4.69	% 4.89		%
Repurchase agreement borrowings secured by Non-Agency MBS (2)	\$2,155,402	\$2,206,586		
Fair Value of Non-Agency MBS pledged as collateral under repurchase agreements (2)(3)	\$3,711,997	\$3,663,523		
Weighted average haircut on Non-Agency MBS (1)	32.74	% 32.48		%
Repurchase agreements secured by U.S. Treasuries	\$432,038	\$382,658		
Fair value of U.S. Treasuries pledged as collateral under repurchase agreements	\$435,888	\$383,743		
Weighted average haircut on U.S. Treasuries (1)	1.69	% 1.65		%

(1) Haircut represents the percentage amount by which the collateral value is contractually required to exceed the loan amount on the Company's repurchase agreements borrowings.

(2) Does not reflect Non-Agency MBS and repurchase agreement borrowings that are components of Linked Transactions.

(3) Includes \$1.936 billion and \$1.885 billion of Non-Agency MBS acquired from consolidated VIEs at March 31, 2014, and December 31, 2013, respectively, that are eliminated from the Company's consolidated balance sheets.

The following table presents repricing information about the Company's borrowings under repurchase agreements, which does not reflect the impact of associated derivative hedging instruments, at March 31, 2014 and December 31, 2013:

Time Until Interest Rate Reset	March 31, 2014		December 31, 2013		
	Balance (1)	Weighted Average Interest Rate	Balance (1)	Weighted Average Interest Rate	
(Dollars in Thousands)					
Within 30 days	\$7,456,229	0.62	% \$7,064,598	0.68	%
Over 30 days to 3 months	933,479	1.13	1,274,699	1.31	
Over 3 months to 12 months	216,421	1.84	—	—	
Total	\$8,606,129	0.70	% \$8,339,297	0.77	%

(1) At March 31, 2014 and December 31, 2013, the Company had repurchase agreements of \$206.0 million and \$102.7 million, respectively, that were linked to Non-Agency MBS purchases and accounted for as Linked Transactions, and as such, the linked repurchase agreements are not included in the above table. (See Note 5)

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The following table presents contractual maturity information about the Company's borrowings under repurchase agreements at March 31, 2014 and does not reflect the impact of derivative contracts that hedge such repurchase agreements:

Contractual Maturity (Dollars in Thousands)	March 31, 2014	
	Balance (1)	Weighted Average Interest Rate
Overnight	\$—	— %
Within 30 days	7,039,400	0.54
Over 30 days to 90 days	1,036,048	1.20
Over 90 days to 12 months	216,421	1.84
Over 12 months	314,260	1.92
Total	\$8,606,129	0.70 %

At March 31, 2014, the Company had repurchase agreements of \$206.0 million that were linked to Non-Agency (1)MBS purchases and were accounted for as Linked Transactions, and as such, the linked repurchase agreements are not included in the above table. (See Note 5)

The Company had repurchase agreements with 26 counterparties at both March 31, 2014 and December 31, 2013. The following table presents information with respect to any counterparty for repurchase agreements and/or Linked Transactions for which the Company had greater than 5% of stockholders' equity at risk in the aggregate at March 31, 2014:

Counterparty	Counterparty Rating (1)	Amount at Risk (2)	Weighted Average Months to Maturity for Repurchase Agreements	Percent of Stockholders' Equity
(Dollars in Thousands)				
Alpine Securitization Corporation/Credit Suisse (3)	A-1/P-1/F1	\$776,757	1	24.2 %
Wells Fargo (4)	A+/A2/AA-	416,723	5	13.0
RBS	BBB+/Baa2/A	256,852	1	8.0
UBS (5)	A/A2/A	250,924	22	7.8

(1) As rated at March 31, 2014 by S&P, Moody's and Fitch, Inc., respectively. The counterparty rating presented is the lowest published for these entities.

(2) The amount at risk reflects the difference between (a) the amount loaned to the Company through repurchase agreements and repurchase agreements underlying Linked Transactions, including interest payable, and (b) the cash and the fair value of the securities pledged by the Company as collateral and MBS underlying Linked Transaction, including accrued interest receivable on such securities.

(3) Includes \$747.3 million at risk with Alpine Securitization Corporation and \$29.5 million at risk with Credit Suisse Securities (USA) LLC. Alpine Securitization Corporation is a special purpose funding vehicle that is a consolidated affiliate of Credit Suisse Group. Counterparty rating shown is the asset backed short term rating for Alpine Securitization Corporation.

- (4) Includes \$279.5 million at risk with Wells Fargo Bank, NA and \$137.2 million at risk with Wells Fargo Securities LLC.
- (5) Includes Non-Agency MBS pledged as collateral with contemporaneous repurchase and reverse repurchase agreements.

## 7. Collateral Positions

The Company pledges securities or cash as collateral to its counterparties pursuant to its borrowings under repurchase agreements and its derivative contracts that are in an unrealized loss position, and it receives securities or cash as collateral pursuant to financing provided under reverse repurchase agreements and certain of its derivative contracts in an unrealized gain position. The Company exchanges collateral with its counterparties based on changes in the fair value, notional amount and term of the associated repurchase and reverse repurchase agreements and derivative contracts, as applicable. Through this margining process, either the Company or its counterparty may be required to pledge cash or securities as collateral. In addition, Swaps novated to and cleared by a central clearing house are subject to initial margin requirements. When the Company's pledged collateral exceeds the required margin, the Company may initiate a reverse margin call, at which time the counterparty may either return the excess collateral, or provide collateral to the Company in the form of cash or high-quality securities.

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The following table summarizes the fair value of the Company's collateral positions, which includes collateral pledged and collateral held, with respect to its borrowings under repurchase agreements, reverse repurchase agreements and derivative hedging instruments at March 31, 2014 and December 31, 2013:

(In Thousands)	March 31, 2014		December 31, 2013	
	Assets Pledged	Collateral Held	Assets Pledged	Collateral Held
<b>Derivative Hedging Instruments:</b>				
Agency MBS	\$76,968	\$—	\$73,859	\$—
Cash (1)	26,139	—	37,520	—
	103,107	—	111,379	—
<b>Repurchase Agreement Borrowings:</b>				
Agency MBS	\$6,327,835	\$—	\$6,068,447	\$—
Non-Agency MBS (2)(3)	3,711,997	—	3,663,523	—
U.S. Treasury securities	435,888	—	383,743	—
	10,475,720	—	10,115,713	—
<b>Reverse Repurchase Agreements:</b>				
U.S. Treasury securities	\$—	\$435,888	\$—	\$383,743
	—	435,888	—	383,743
<b>Total</b>	<b>\$10,578,827</b>	<b>\$435,888</b>	<b>\$10,227,092</b>	<b>\$383,743</b>

(1) Cash pledged as collateral is reported as "restricted cash" on the Company's consolidated balance sheets.

(2) Includes \$1.936 billion and \$1.885 billion of Non-Agency MBS acquired in connection with securitization transactions from consolidated VIEs at March 31, 2014 and December 31, 2013, respectively, that are eliminated from the Company's consolidated balance sheets.

(3) In addition, \$751.1 million and \$738.3 million of Non-Agency MBS are pledged as collateral in connection with contemporaneous repurchase and reverse repurchase agreements entered into with a single counterparty at March 31, 2014 and December 31, 2013, respectively.

The following table presents detailed information about the Company's assets pledged as collateral pursuant to its borrowings under repurchase agreements and derivative hedging instruments at March 31, 2014:

(In Thousands)	Assets Pledged Under Repurchase Agreements			Assets Pledged Against Derivative Hedging Instruments			Total Fair Value of Assets Pledged and Accrued Interest
	Fair Value/Carrying Value	Amortized Cost	Accrued Interest on Pledged MBS	Fair Value/Carrying Value	Amortized Cost	Accrued Interest on Pledged MBS	
U.S. Treasuries	\$435,888	\$435,888	\$—	\$—	\$—	\$—	\$435,888
Fannie Mae	\$5,328,922	\$5,281,673	\$13,620	\$7,360	\$7,086	\$15	\$5,349,917
Freddie Mac	998,913	1,014,954	2,542	59,289	60,642	143	1,060,887
Ginnie Mae	—	—	—	10,319	10,124	14	10,333
Agency MBS	\$6,327,835	\$6,296,627	\$16,162	\$76,968	\$77,852	\$172	\$6,421,137
Non-Agency MBS (1)(2)	\$3,711,997	\$2,824,533	\$13,803	\$—	\$—	\$—	\$3,725,800
<b>Total</b>	<b>\$10,475,720</b>	<b>\$9,557,048</b>	<b>\$29,965</b>	<b>\$76,968</b>	<b>\$77,852</b>	<b>\$172</b>	<b>\$10,582,825</b>



- (1) Includes \$1.936 billion of Non-Agency MBS acquired in connection with resecuritization transactions from consolidated VIEs at March 31, 2014, that are eliminated from the Company's consolidated balance sheets.
- (2) In addition, \$751.1 million of Non-Agency MBS are pledged as collateral in connection with contemporaneous repurchase and reverse repurchase agreements entered into with a single counterparty at March 31, 2014.

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## 8. Offsetting Assets and Liabilities

The following tables present information about certain assets and liabilities that are subject to master netting arrangements (or similar agreements) and can potentially be offset on the Company's consolidated balance sheets at March 31, 2014 and December 31, 2013:

## Offsetting of Financial Assets and Derivative Assets

(In Thousands)	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Consolidated Balance Sheets	Net Amounts of Gross Amounts Not Offset in the Consolidated Balance Sheets			Net Amount
			Assets Presented in the Consolidated Balance Sheets	Financial Instruments	Cash Collateral Received	
March 31, 2014						
Swaps, at fair value	\$5,485	\$ —	\$ 5,485	\$ (5,485 )	\$ —	\$ —
Total	\$5,485	\$ —	\$ 5,485	\$ (5,485 )	\$ —	\$ —
December 31, 2013						
Swaps, at fair value	\$13,000	\$ —	\$ 13,000	\$ (13,000 )	\$ —	\$ —
Total	\$13,000	\$ —	\$ 13,000	\$ (13,000 )	\$ —	\$ —

## Offsetting of Financial Liabilities and Derivative Liabilities

(In Thousands)	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Consolidated Balance Sheets	Net Amounts of Gross Amounts Not Offset in the Consolidated Balance Sheets			Net Amount
			Liabilities Presented in the Consolidated Balance Sheets	Financial Instruments (1)	Cash Collateral Pledged (1)	
March 31, 2014						
Swaps, at fair value (2)	\$32,755	\$ —	\$ 32,755	\$ (6,616 )	\$ (26,139 )	\$ —
Repurchase agreements (3)	8,606,129	—	8,606,129	(8,606,129 )	—	—
Total	\$8,638,884	\$ —	\$ 8,638,884	\$ (8,612,745 )	\$ (26,139 )	\$ —
December 31, 2013						
Swaps, at fair value (2)	\$28,217	\$ —	\$ 28,217	\$ —	\$ (28,217 )	\$ —
Repurchase agreements (3)	8,339,297	—	8,339,297	(8,339,297 )	—	—
Total	\$8,367,514	\$ —	\$ 8,367,514	\$ (8,339,297 )	\$ (28,217 )	\$ —

(1) Amounts disclosed in the Financial Instruments column of the table above represents collateral pledged that is available to be offset against liability balances associated with repurchase agreement and derivative transactions. Amounts disclosed in the Cash Collateral Pledged column of the table above represents amounts pledged as collateral against derivative transactions and excludes excess collateral of \$9.3 million at December 31, 2013.

(2) The fair value of securities pledged against the Company's Swaps was \$77.0 million and \$73.9 million at March 31, 2014 and December 31, 2013, respectively.

(3) The fair value of securities pledged against the Company's repurchase agreements was \$10.476 billion and \$10.116 billion at March 31, 2014 and December 31, 2013, respectively.

#### Nature of Setoff Rights

In the Company's consolidated balance sheets, all balances associated with the repurchase agreement and derivatives transactions are presented on a gross basis.

Certain of the Company's repurchase agreement and derivative transactions are governed by underlying agreements that generally provide for a right of setoff in the event of default or in the event of a bankruptcy of either party to the transaction. For one repurchase agreement counterparty, the underlying agreements provide for an unconditional right of setoff.

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9. Senior Notes

On April 11, 2012 the Company issued \$100.0 million in aggregate principal amount of its Senior Notes in an underwritten public offering. The total net proceeds to the Company from the offering of the Senior Notes were approximately \$96.6 million, after deducting offering expenses and the underwriting discount. The Senior Notes bear interest at a fixed rate of 8.00% per year, paid quarterly in arrears on January 15, April 15, July 15 and October 15 of each year and will mature on April 15, 2042. The Company may redeem the Senior Notes, in whole or in part, at any time on or after April 15, 2017 at a redemption price equal to 100% of the principal amount redeemed plus accrued and unpaid interest to, but not excluding, the redemption date.

The Senior Notes are the Company's senior unsecured obligations and are subordinate to all of the Company's secured indebtedness, which includes the Company's repurchase agreements, securitized debt, obligation to return securities obtained as collateral, and other financing arrangements, to the extent of the value of the collateral securing such indebtedness.

10. Commitments and Contingencies

(a) Lease Commitments

The Company pays monthly rent pursuant to two operating leases. The lease term for the Company's headquarters in New York, New York extends through May 31, 2020. The lease provides for aggregate cash payments ranging over time from approximately \$2.4 million to \$2.5 million per year, paid on a monthly basis, exclusive of escalation charges. In addition, as part of this lease agreement, the Company has provided the landlord a \$785,000 irrevocable standby letter of credit fully collateralized by cash. The letter of credit may be drawn upon by the landlord in the event that the Company defaults under certain terms of the lease. In addition, the Company has a lease through December 31, 2016 for its off-site back-up facility located in Rockville Centre, New York, which provides for, among other things, cash payments ranging over time from \$28,000 to \$30,000 per year, paid on a monthly basis.

(b) Representations and Warranties in Connection with Resecuritization Transactions

In connection with the resecuritization transactions engaged in by the Company (See Note 15 for further discussion), the Company has the obligation under certain circumstances to repurchase assets from its VIEs upon breach of certain representations and warranties.

11. Stockholders' Equity

(a) Preferred Stock

Redemption of 8.50% Series A Cumulative Redeemable Preferred Stock ("Series A Preferred Stock")

On May 16, 2013 (the "Redemption Date"), the Company redeemed all 3,840,000 outstanding shares of its Series A Preferred Stock at an aggregate redemption price of approximately \$97.0 million, or \$25.27153 per share, including all accrued and unpaid dividends to the Redemption Date. The redemption value of the Series A Preferred Stock exceeded its carrying value by \$3.9 million, which represents the original offering costs for the Series A Preferred Stock. This amount was included in the determination of net income available to common stock and participating securities from the Redemption Date through the year ended December 31, 2013. In addition, as part of the redemption price on its Series A Preferred Stock (discussed above), the Company paid a dividend of \$0.27153 per

share, which reflected accrued and unpaid dividends for the period from April 1, 2013, through and including the Redemption Date.

**Issuance of 7.50% Series B Cumulative Redeemable Preferred Stock (“Series B Preferred Stock”)**

On April 15, 2013, the Company amended its charter through the filing of articles supplementary to its charter to reclassify 8,050,000 shares of the Company’s authorized but unissued common stock as shares of the Company’s Series B Preferred Stock. On April 15, 2013, the Company completed the issuance of 8.0 million shares of its Series B Preferred Stock, with a par value of \$0.01 per share and a liquidation preference \$25.00 per share, plus accrued and unpaid dividends, in an underwritten public offering. The aggregate net proceeds to the Company from the offering of the Series B Preferred Stock were approximately \$193.3 million, after deducting the underwriting discount and related offering expenses. The Company used a portion of such net proceeds to redeem all of its outstanding Series A Preferred Stock (as discussed above), and used the remaining net proceeds of the offering for general corporate purposes, including, without limitation, to acquire additional MBS consistent with its investment policy, and for working capital, which may include, among other things, the repayment of its repurchase agreements.

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The Company's Series B Preferred Stock, which is redeemable at \$25.00 per share plus accrued and unpaid dividends (whether or not authorized or declared) exclusively at the Company's option commencing on April 15, 2018 (subject to the Company's right under limited circumstances to redeem the Series B Preferred Stock prior to that date in order to preserve its qualification as a REIT and upon certain specified change in control transactions in which the Company's common stock and the acquiring or surviving entity common securities would not be listed on the New York Stock Exchange (the "NYSE"), the NYSE MKT or NASDAQ, or any successor exchanges), is entitled to receive a dividend at a rate of 7.50% per year on the \$25.00 liquidation preference before the Company's common stock is paid any dividends and is senior to the Company's common stock with respect to distributions upon liquidation, dissolution or winding up.

Dividends on the Series B Preferred Stock are payable quarterly in arrears on or about March 31, June 30, September 30 and December 31 of each year. On May 20, 2013, the Company declared the first dividend payable on the Series B Preferred Stock, which was paid on July 1, 2013 to preferred stockholders of record as of June 3, 2013. The amount of such dividend payable was \$0.39583 per share, and was paid in respect of the partial period commencing on April 15, 2013, the date of original issue of the Series B Preferred Stock, and ending on, and including, June 30, 2013.

The Series B Preferred Stock generally does not have any voting rights, subject to an exception in the event the Company fails to pay dividends on such stock for six or more quarterly periods (whether or not consecutive). Under such circumstances, the Series B Preferred Stock will be entitled to vote to elect two additional directors to the Company's Board of Directors (the "Board"), until all unpaid dividends have been paid or declared and set apart for payment. In addition, certain material and adverse changes to the terms of the Series B Preferred Stock cannot be made without the affirmative vote of holders of at least 66 2/3% of the outstanding shares of Series B Preferred Stock. The following table presents cash dividends declared by the Company on its Series B Preferred Stock from January 1, 2014 through March 31, 2014:

Declaration Date	Record Date	Payment Date	Dividend Per Share
February 14, 2014	February 28, 2014	March 31, 2014	\$ 0.46875

## (b) Dividends on Common Stock

The following table presents cash dividends declared by the Company on its common stock from January 1, 2014 through March 31, 2014:

Declaration Date (1)	Record Date	Payment Date	Dividend Per Share
March 10, 2014	March 28, 2014	April 30, 2014	\$ 0.20 (1)

(1) At March 31, 2014, the Company had accrued dividends and DERs payable of \$73.9 million related to the common stock dividend declared on March 10, 2014.

## (c) Discount Waiver, Direct Stock Purchase and Dividend Reinvestment Plan ("DRSPP")

On August 8, 2013, the Company filed a shelf registration statement on Form S-3 with the SEC under the Securities Act of 1933, as amended (the "1933 Act"), for the purpose of registering additional common stock for sale through its DRSPP. Pursuant to Rule 462(e) of the 1933 Act, this shelf registration statement became effective automatically upon filing with the SEC and, when combined with the unused portion of the Company's previous DRSPP shelf registration statements, registered an aggregate of 15 million shares of common stock. The Company's DRSPP is designed to provide existing stockholders and new investors with a convenient and economical way to purchase shares of common stock through the automatic reinvestment of dividends and/or optional cash investments. At March 31,

2014, 10.5 million shares of common stock remained available for issuance pursuant to the DRSPS shelf registration statement.

During the three months ended March 31, 2014, the Company issued 1,053,785 shares of common stock through the DRSPS, raising net proceeds of approximately \$7.6 million. From the inception of the DRSPS in September 2003 through March 31, 2014, the Company issued 27,093,549 shares pursuant to the DRSPS, raising net proceeds of \$229.0 million.

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## (d) Stock Repurchase Program

As previously disclosed, in August 2005, the Company's Board authorized a stock repurchase program (the "Repurchase Program"), to repurchase up to 4.0 million shares of its outstanding common stock under the Repurchase Program. The Board reaffirmed such authorization in May 2010. In December 2013, the Board increased the number of shares authorized for repurchase to an aggregate of 10.0 million. Such authorization does not have an expiration date and, at present, there is no intention to modify or otherwise rescind such authorization. Subject to applicable securities laws, repurchases of common stock under the Repurchase Program are made at times and in amounts as the Company deems appropriate, (including, in our discretion, through the use of one or more plans adopted under Rule 10b5-1 promulgated under the Securities Exchange Act of 1934, as amended (the "1934 Act")) using available cash resources. Shares of common stock repurchased by the Company under the Repurchase Program are cancelled and, until reissued by the Company, are deemed to be authorized but unissued shares of the Company's common stock. The Repurchase Program may be suspended or discontinued by the Company at any time and without prior notice. The Company did not repurchase any shares of its common stock during the three months ended March 31, 2014. At March 31, 2014, 6,616,355 shares remained authorized for repurchase under the Repurchase Program.

## (e) Accumulated Other Comprehensive Income/(Loss)

The following table presents changes in the balances of each component of the Company's AOCI for the three months ended March 31, 2014:

(In Thousands)	Three Months Ended March 31, 2014		Total AOCI
	Net Unrealized Gain/(Loss) on Available-for-Sale MBS	Net Unrealized Gain/(Loss) on Swaps	
Balance at the beginning of the period	\$752,912	\$(15,217)	) \$737,695
OCI before reclassifications	69,260	(12,267)	) 56,993
Amounts reclassified from AOCI (1)	(2,950)	) 447	(2,503)
Net OCI during the period (2)	66,310	(11,820)	) 54,490
Balance at end of period	\$819,222	\$(27,037)	) \$792,185

The following table presents changes in the balances of each component of the Company's AOCI for the three months ended March 31, 2013:

(In Thousands)	Three Months Ended March 31, 2013		Total AOCI
	Net Unrealized Gain/(Loss) on Available-for-Sale MBS	Net Unrealized Gain/(Loss) on Swaps	
Balance at the beginning of the period	\$824,808	\$(62,831)	) \$761,977
OCI before reclassifications	119,439	12,316	) 131,755
Amounts reclassified from AOCI (1)	(1,360)	) —	(1,360)
Net OCI during the period (2)	118,079	12,316	) 130,395



Balance at end of period	\$942,887	\$(50,515	) \$892,372
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(1) See separate table below for details about these reclassifications.

(2) For further information regarding changes in OCI, see the Company's consolidated statement of comprehensive income/(loss).

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The following table presents information about the significant amounts reclassified out of the Company's AOCI for the three months ended March 31, 2014:

Details about AOCI Components	Amounts Reclassified from AOCI	Affected Line Item in the Statement Where Net Income is Presented
(In Thousands)		
Available-for-sale MBS:		
Realized gain on sale of securities	\$ (2,950)	) Gain on sales of MBS and U.S. Treasury securities, net
Swaps designated as cash flow hedges:		
De-designated Swaps	\$ 447	) Other, net
Total reclassifications for period	\$ (2,503)	)

The following table presents information about the significant amounts reclassified out of the Company's AOCI for the three months ended March 31, 2013:

Details about AOCI Components	Amounts Reclassified from AOCI	Affected Line Item in the Statement Where Net Income is Presented
(In Thousands)		
Available-for-sale MBS:		
Realized gain on sale of securities	\$ (1,360)	) Gain on sales of MBS and U.S. Treasury securities, net
Total reclassifications for period	\$ (1,360)	)

At March 31, 2014 and December 31, 2013, the Company had OTTI recognized in AOCI of \$591,000 and \$609,000, respectively.

## 12. EPS Calculation

The following table presents a reconciliation of the earnings and shares used in calculating basic and diluted EPS for the three months ended March 31, 2014 and 2013:

(In Thousands, Except Per Share Amounts)	Three Months Ended	
	March 31, 2014	2013
Numerator:		
Net income	\$ 76,188	\$ 77,351
Dividends declared on preferred stock	(3,750)	) (2,040)
Dividends, DERs and undistributed earnings allocated to participating securities	(278)	) (321)
Net income to common stockholders - basic and diluted	\$ 72,160	\$ 74,990
Denominator:		
	365,848	358,110

Weighted average common shares for basic and diluted earnings per share

(1)		
Basic and diluted earnings per share	\$0.20	\$0.21

(1) At March 31, 2014, the Company had an aggregate of 1.6 million equity instruments outstanding that were not included in the calculation of diluted EPS for the three months ended March 31, 2014, as their inclusion would have been anti-dilutive. These equity instruments were comprised of 5,000 stock options with a weighted average exercise price of \$8.40 and a weighted average remaining contractual life of 0.36 years, approximately 415,000 shares of restricted common stock with a weighted average grant date fair value of \$7.49 and approximately 1.2 million RSUs with a weighted average grant date fair value of \$6.81. These equity instruments may have a dilutive impact on future EPS.

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13. Equity Compensation, Employment Agreements and Other Benefit Plans

(a) 2010 Equity Compensation Plan

In accordance with the terms of the Company's Amended and Restated 2010 Equity Compensation Plan (the "2010 Plan"), directors, officers and employees of the Company and any of its subsidiaries and other persons expected to provide significant services for the Company and any of its subsidiaries are eligible to receive grants of stock options ("Options"), restricted stock, RSUs, DERs and other stock-based awards under the 2010 Plan.

Subject to certain exceptions, stock-based awards relating to a maximum of 13.5 million shares of common stock may be granted under the 2010 Plan; forfeitures and/or awards that expire unexercised do not count towards such limit. At March 31, 2014, approximately 9.2 million shares of common stock remained available for grant in connection with stock-based awards under the 2010 Plan. A participant may generally not receive stock-based awards in excess of 1,500,000 shares of common stock in any one year and no award may be granted to any person who, assuming exercise of all Options and payment of all awards held by such person, would own or be deemed to own more than 9.8% of the outstanding shares of the Company's common stock. Unless previously terminated by the Board, awards may be granted under the 2010 Plan until May 20, 2020.

DERs

A DER is a right to receive a distribution equal to the dividend distributions that would be paid on a share of the Company's common stock. DERs may be granted separately or together with other awards and are paid in cash or other consideration at such times and in accordance with such rules, as the Compensation Committee of the Board (the "Compensation Committee") shall determine at its discretion. Payments made on the Company's existing DERs are charged to stockholders' equity when the common stock dividends are declared to the extent that such DERs are expected to vest. The Company made DER payments of approximately \$169,000 and \$313,000 during the three months ended March 31, 2014 and 2013. At March 31, 2014, the Company had 1,234,373 DERs outstanding, of which 1,233,123 were awarded in connection with, or attached to, RSUs and 1,250 were attached to common stock options. A 0% forfeiture rate was assumed with respect to DERs outstanding at March 31, 2014. The DERs were scheduled to elapse over a weighted average period of 2.3 years.

Options

Pursuant to Section 422(b) of the Code, in order for Options granted under the 2010 Plan and vesting in any one calendar year to qualify as an incentive stock option ("ISO") for tax purposes, the market value of the common stock to be received upon exercise of such Options as determined on the date of grant shall not exceed \$100,000 during such calendar year. The exercise price of an ISO may not be lower than 100% (110% in the case of an ISO granted to a 10% stockholder) of the fair market value of the Company's common stock on the date of grant. The exercise price for any other type of Option issued under the 2010 Plan may not be less than the fair market value on the date of grant. Each Option is exercisable after the period or periods specified in the award agreement, which will generally not exceed ten years from the date of grant.

The Company did not grant any stock options during the three months ended March 31, 2014 and 2013. There were no stock options exercised and no stock options cancelled during the three months ended March 31, 2014 and 2013. At March 31, 2014, 5,000 stock options were outstanding, all of which were vested and exercisable, with a weighted average exercise price of \$8.40. As of March 31, 2014, the aggregate intrinsic value of total Options outstanding was

zero.

#### Restricted Stock

The Company did not award any shares of restricted common stock during the three months ended March 31, 2014 and awarded 12,331 shares of restricted common stock during the three months ended March 31, 2013. At March 31, 2014 and December 31, 2013, the Company had unrecognized compensation expense of \$2.9 million and \$3.3 million, respectively, related to the unvested shares of restricted common stock. The Company had accrued dividends payable of approximately \$410,000 and \$413,000 on unvested shares of restricted stock at March 31, 2014 and December 31, 2013, respectively. The unrecognized compensation expense at March 31, 2014 is expected to be recognized over a weighted average period of 2.5 years.

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## Restricted Stock Units and Associated DERs

Under the terms of the 2010 Plan, RSUs are instruments that provide the holder with the right to receive, subject to the satisfaction of conditions set by the Compensation Committee at the time of grant, a payment of a specified value, which may be a share of the Company's common stock, the fair market value of a share of the Company's common stock, or such fair market value to the extent in excess of an established base value, on the applicable settlement date. Although the 2010 Plan permits the Company to issue RSUs that can settle in cash, all of the Company's outstanding RSUs as of March 31, 2014 are designated to be settled in shares of the Company's common stock. The Company granted 610,621 RSUs during the three months ended March 31, 2014, and did not grant any RSUs during the three months ended March 31, 2013. In addition, an aggregate of 97,164 previously awarded RSUs were forfeited by the holders' thereof during the three months ended March 31, 2014 in connection with the negotiation of such holders' respective new employment agreements. All RSUs outstanding at March 31, 2014 had DERs attached or issued as separate associated instruments in connection with RSUs. At March 31, 2014 and December 31, 2013, the Company had unrecognized compensation expense of \$4.6 million and \$1.6 million, respectively, related to RSUs and DERs. The unrecognized compensation expense at March 31, 2014 is expected to be recognized over a weighted average period of 2.4 years. A 0% forfeiture rate was assumed with respect to unvested RSUs at March 31, 2014.

## Expense Recognized for Equity-Based Compensation Instruments

The following table presents the Company's expenses related to its equity-based compensation instruments for the three months ended March 31, 2014 and 2013:

(In Thousands)	Three Months Ended	
	March 31,	
	2014	2013
Restricted shares of common stock	\$367	\$544
RSUs	1,080	(1) 290
DERs	37	51
Total	\$1,484	\$885

(1) RSU expense for the three months ended March 31, 2014 includes approximately \$500,000 for a one-time grant to the Company's chief executive officer.

## (b) Employment Agreements

At March 31, 2014, the Company had employment agreements with five of its officers, with varying terms that provide for, among other things, base salary, bonus and change-in-control payments upon the occurrence of certain triggering events.

## (c) Deferred Compensation Plans

The Company administers deferred compensation plans for its senior officers and non-employee directors (collectively, the "Deferred Plans"), pursuant to which participants may elect to defer up to 100% of certain cash compensation. The Deferred Plans are designed to align participants' interests with those of the Company's stockholders.

Amounts deferred under the Deferred Plans are considered to be converted into “stock units” of the Company. Stock units do not represent stock of the Company, but rather are a liability of the Company that changes in value as would equivalent shares of the Company’s common stock. Deferred compensation liabilities are settled in cash at the termination of the deferral period, based on the value of the stock units at that time. The Deferred Plans are non-qualified plans under the Employee Retirement Income Security Act of 1974 and, as such, are not funded. Prior to the time that the deferred accounts are settled, participants are unsecured creditors of the Company.

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The Company's liability for stock units in the Deferred Plans is based on the market price of the Company's common stock at the measurement date. The following table presents the Company's expenses related to its Deferred Plans for its non-employee directors and senior officers for the three months ended March 31, 2014 and 2013:

(In Thousands)	Three Months Ended	
	March 31,	
	2014	2013
Non-employee directors	\$36	\$52
Total	\$36	\$52

The following table presents the aggregate amount of income deferred by participants of the Deferred Plans through March 31, 2014 and December 31, 2013 that had not been distributed and the Company's associated liability for such deferrals at March 31, 2014 and December 31, 2013:

(In Thousands)	March 31, 2014		December 31, 2013	
	Undistributed Income Deferred (1)	Liability Under Deferred Plans	Undistributed Income Deferred (1)	Liability Under Deferred Plans
Non-employee directors	\$210	\$299	\$270	\$382
Total	\$210	\$299	\$270	\$382

(1) Represents the cumulative amounts that were deferred by participants through March 31, 2014 and December 31, 2013, which had not been distributed through such date.

## (d) Savings Plan

The Company sponsors a tax-qualified employee savings plan (the "Savings Plan"), in accordance with Section 401(k) of the Code. Subject to certain restrictions, all of the Company's employees are eligible to make tax deferred contributions to the Savings Plan subject to limitations under applicable law. Participant's accounts are self-directed and the Company bears the costs of administering the Savings Plan. The Company matches 100% of the first 3% of eligible compensation deferred by employees and 50% of the next 2%, subject to a maximum as provided by the Code. The Company has elected to operate the Savings Plan under the applicable safe harbor provisions of the Code, whereby among other things, the Company must make contributions for all participating employees and all matches contributed by the Company immediately vest 100%. For the three months ended March 31, 2014 and 2013, the Company recognized expenses for matching contributions of \$65,000 and \$62,000.

## 14. Fair Value of Financial Instruments

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The three levels of valuation hierarchy are defined as follows:

Level 1 — inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 — inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the



financial instrument.

Level 3 — inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The following describes the valuation methodologies used for the Company's financial instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy.

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Securities Obtained and Pledged as Collateral/Obligation to Return Securities Obtained as Collateral

The fair value of U.S. Treasury securities obtained as collateral and the associated obligation to return securities obtained as collateral are based upon prices obtained from a third-party pricing service, which are indicative of market activity. Securities obtained as collateral are classified as Level 1 in the fair value hierarchy.

Agency MBS, Non-Agency MBS and Securitized Debt

The Company determines the fair value of its Agency MBS, based upon prices obtained from third-party pricing services, which are indicative of market activity and repurchase agreement counterparties.

For Agency MBS, the valuation methodology of the Company's third-party pricing services incorporate commonly used market pricing methods, trading activity observed in the marketplace and other data inputs. The methodology also considers the underlying characteristics of each security, which are also observable inputs, including: collateral vintage; coupon; maturity date; loan age; reset date; collateral type; periodic and life cap; geography; and prepayment speeds. Management analyzes pricing data received from third-party pricing services and compares it to other indications of fair value including data received from repurchase agreement counterparties and its own observations of trading activity observed in the marketplace.

In determining the fair value of its Non-Agency MBS and securitized debt, management considers a number of observable market data points, including prices obtained from pricing services and brokers as well as dialogue with market participants. In valuing Non-Agency MBS, the Company understands that pricing services use observable inputs that include, in addition to trading activity observed in the marketplace, loan delinquency data, credit enhancement levels and vintage, which are taken into account to assign pricing factors such as spread and prepayment assumptions. For tranches that are cross-collateralized, performance of all collateral groups involved in the tranche are considered. The Company collects and considers current market intelligence on all major markets, including benchmark security evaluations and bid-lists throughout the day from various sources, when available.

The Company's MBS and securitized debt are valued using various market data points as described above, which management considers directly or indirectly observable parameters. Accordingly, the Company's MBS and securitized debt are classified as Level 2 in the fair value hierarchy.

Derivative Instruments

Linked Transactions

The Non-Agency MBS underlying the Company's Linked Transactions are valued using similar techniques to those used for the Company's other Non-Agency MBS. The value of the underlying MBS is then netted against the carrying amount (which approximates fair value) of the repurchase agreement borrowing at the valuation date. The fair value of Linked Transactions also includes accrued interest receivable on the MBS and accrued interest payable on the underlying repurchase agreement borrowings. The Company's Linked Transactions are classified as Level 2 in the fair value hierarchy.

Swaps

The Company determines the fair value of non-centrally cleared Swaps considering valuations obtained from a third-party pricing service. For Swaps that are cleared by a central clearing house valuations provided by the clearing house are used. All valuations obtained are tested with internally developed models that apply readily observable market parameters. The Company considers the creditworthiness of both the Company and its counterparties, along with collateral provisions contained in each derivative agreement, from the perspective of both the Company and its counterparties. All of the Company's Swaps are subject either to bilateral collateral arrangements, or for cleared Swaps, to the clearing house's margin requirements. Consequently, no credit valuation adjustment was made in determining the fair value of such instruments. Swaps are classified as Level 2 in the fair value hierarchy.

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MFA FINANCIAL, INC.

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The following table presents the Company's financial instruments carried at fair value as of March 31, 2014, on the consolidated balance sheet by the valuation hierarchy, as previously described:

## Fair Value at March 31, 2014

(In Thousands)	Level 1	Level 2	Level 3	Total
Assets:				
Agency MBS	\$—	\$6,841,033	\$—	\$6,841,033
Non-Agency MBS, including MBS transferred to consolidated VIEs	—	5,045,155	—	5,045,155
Securities obtained and pledged as collateral	435,888	—	—	435,888
Linked Transactions	—	59,826	—	59,826
Swaps	—	5,485	—	5,485
Total assets carried at fair value	\$435,888	\$11,951,499	\$—	\$12,387,387
Liabilities:				
Swaps	\$—	\$32,755	\$—	\$32,755
Obligation to return securities obtained as collateral	435,888	—	—	435,888
Total liabilities carried at fair value	\$435,888	\$32,755	\$—	\$468,643

Changes to the valuation methodologies used with respect to the Company's financial instruments are reviewed by management to ensure any such changes result in appropriate exit price valuations. As markets and products develop and the pricing for certain products becomes more transparent, the Company continues to refine its valuation methodologies. The methods described above may produce fair value estimates that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Company believes its valuation methods are appropriate and consistent with those used by market participants, the use of different methodologies, or assumptions, to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. The Company uses inputs that are current as of the measurement date, which may include periods of market dislocation, during which price transparency may be reduced. The Company reviews the classification of its financial instruments within the fair value hierarchy on a quarterly basis, and management may conclude that its financial instruments should be reclassified to a different level in the future.

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The following table presents the carrying value and estimated fair value of the Company's financial instruments, at March 31, 2014 and December 31, 2013:

(In Thousands)	March 31, 2014		December 31, 2013	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
<b>Financial Assets:</b>				
Agency MBS	\$6,841,033	\$6,841,033	\$6,519,221	\$6,519,221
Non-Agency MBS, including MBS transferred to consolidated VIEs	5,045,155	5,045,155	4,852,137	4,852,137
Securities obtained and pledged as collateral	435,888	435,888	383,743	383,743
Cash and cash equivalents	274,672	274,672	565,370	565,370
Restricted cash	26,139	26,139	37,520	37,520
Linked Transactions	59,826	59,826	28,181	28,181
Swaps	5,485	5,485	13,000	13,000
<b>Financial Liabilities:</b>				
Repurchase agreements	8,606,129	8,605,609	8,339,297	8,339,071
Securitized debt	292,526	293,017	366,205	366,767
Obligation to return securities obtained as collateral	435,888	435,888	383,743	383,743
Senior Notes	100,000	103,640	100,000	98,000
Swaps	32,755	32,755	28,217	28,217

In addition to the methodologies used to determine the fair value of the Company's financial assets and liabilities reported at fair value, as previously described, the following methods and assumptions were used by the Company in arriving at the fair value of the Company's other financial instruments presented in the above table:

**Cash and Cash Equivalents and Restricted Cash:** Cash and cash equivalents and restricted cash are comprised of cash held in overnight money market investments and demand deposit accounts. At March 31, 2014 and December 31, 2013, the Company's money market funds were invested in securities issued by the U.S. Government, or its agencies, instrumentalities, and sponsored entities, and repurchase agreements involving the securities described above. Given the overnight term and assessed credit risk, the Company's investments in money market funds are determined to have a fair value equal to their carrying value.

**Repurchase Agreements:** The fair value of repurchase agreements reflects the present value of the contractual cash flows discounted at market interest rates at the valuation date for repurchase agreements with a term equivalent to the remaining term to interest rate repricing, which may be at maturity. Such interest rates are estimated based on LIBOR rates observed in the market. The Company's repurchase agreements are classified as Level 2 in the fair value hierarchy.

**Senior Notes:** The fair value of Senior Notes is determined using the end of day market price quoted on the NYSE at the reporting date. The Company's Senior Notes are classified as Level 1 in the fair value hierarchy.

#### 15. Use of Special Purpose Entities and Variable Interest Entities

A Special Purpose Entity ("SPE") is an entity designed to fulfill a specific limited need of the company that organized it. SPEs are often used to facilitate transactions that involve securitizing financial assets or resecuritizing previously

securitized financial assets. The objective of such transactions may include obtaining non-recourse financing, obtaining liquidity or refinancing the underlying securitized financial assets on improved terms. Securitization involves transferring assets to a SPE to convert all or a portion of those assets into cash before they would have been realized in the normal course of business, through the SPE's issuance of debt or equity instruments. Investors in an SPE usually have recourse only to the assets in the SPE and depending on the overall structure of the transaction, may benefit from various forms of credit enhancement, such as over-collateralization in the form of excess assets in the SPE, priority with respect to receipt of cash flows relative to holders of other debt or equity instruments issued by the SPE, or a line of credit or other form of liquidity agreement that is designed with the objective of ensuring that investors receive principal and/or interest cash flow on the investment in accordance with the terms of their investment agreement.

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## Resecuritization transactions

Since October 2010, the Company has entered into several resecuritization transactions that resulted in the Company consolidating as VIEs the SPEs that were created to facilitate the transactions and to which the underlying assets in connection with the resecuritizations were transferred. See Note 2(p) for a discussion of the accounting policies applied to the consolidation of VIEs and transfers of financial assets in connection with resecuritization transactions.

The following table summarizes the key details of the resecuritization transactions the Company has been involved in to date:

(Dollars in Thousands)	February 2012 WFMLT Series 2012-RR1	June 2011 CSMC Series 2011-7R	February 2011 CSMC Series 2011-1R	October 2010 DMSI 2010-RS2
Name of Trust (Consolidated as a VIE)				
Principal value of Non-Agency MBS sold	\$433,347	\$1,283,422	\$1,319,969	\$985,228
Face amount of Bonds issued by the VIE and purchased by 3rd party investors (1)	\$186,691	\$474,866	\$488,389	\$373,577
Outstanding amount of Senior Bonds at March 31, 2014	\$85,250	\$34,410	\$74,890	\$97,976
Pass-through rate for Senior Bonds issued	2.85	% One-month LIBOR plus 125 basis points	One-month LIBOR plus 100 basis points	Weighted Average Coupon Rate
Face amount of Senior Support Certificates received by the Company (2)	\$221,321	\$765,908	\$784,187	\$490,428
Cash received	\$186,691	\$474,866	\$488,389	\$375,621
Notional amount acquired of non-rated, interest only senior certificates (1)	\$186,691	\$474,866	\$488,389	\$—
Unamortized deferred costs	\$734	\$239	\$700	\$282

(1) Amount disclosed reflects principal balance on the DMSI 2010-RS A1, A2 and A3 bonds. The DMSI 2010-RS2 A2 and A3 bond was sold to third party investors during 2013. The principal balance for the DMSI 2010-RS2 A1 Bond and associated interest only Senior certificate was paid off during the three months ended June 30, 2013.

(2) Provides credit support for the sequential Senior Non-Agency MBS sold to third-party investors in resecuritization transactions (“Senior Bonds”).

The Company engaged in these transactions primarily for the purpose of obtaining non-recourse financing on a portion of its Non-Agency MBS portfolio, as well as refinancing a portion of its Non-Agency MBS portfolio on improved terms. As a result of engaging in these transactions, the risks facing the Company are largely unchanged as the Company remains economically exposed to the first loss position on the underlying MBS transferred to the VIEs.

The activities that can be performed by an entity created to facilitate a resecuritization transaction are predominantly specified in the entity’s formation documents. Those documents do not permit the entity, any beneficial interest holder in the entity, or any other party associated with the entity to cause the entity to sell or replace the assets held by the entity, or to limit such ability to specific events of default.





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The Company concluded that the entities created to facilitate these resecuritization transactions are VIEs. The Company then completed an analysis of whether each VIE created to facilitate the resecuritization transaction should be consolidated by the Company, based on consideration of its involvement in each VIE, including the design and purpose of the SPE, and whether its involvement reflected a controlling financial interest that resulted in the Company being deemed the primary beneficiary of each VIE. In determining whether the Company would be considered the primary beneficiary, the following factors were assessed:

- Whether the Company has both the power to direct the activities that most significantly impact the economic performance of the VIE; and
- Whether the Company has a right to receive benefits or absorb losses of the entity that could be potentially significant to the VIE.

Based on its evaluation of the factors discussed above, including its involvement in the purpose and design of the entity, the Company determined that it was required to consolidate each VIE created to facilitate these transactions.

As of March 31, 2014 and December 31, 2013, the aggregate fair value of the Non-Agency MBS that were resecuritized as described above was \$2.244 billion and \$2.282 billion, respectively. These assets are included in the Company's consolidated balance sheets and disclosed as "Non-Agency MBS transferred to consolidated VIEs". As of March 31, 2014 and December 31, 2013, the aggregate outstanding balance of Senior Bonds issued by consolidated VIEs was \$292.5 million and \$366.2 million, respectively. These Senior Bonds are included in the Company's consolidated balance sheets and disclosed as "Securitized debt". The holders of the Senior Bonds have no recourse to the general credit of the Company, but the Company does have the obligation, under certain circumstances to repurchase assets from the VIE upon the breach of certain representations and warranties in relation to the Non-Agency MBS sold to the VIE. In the absence of such a breach, the Company has no obligation to provide any other explicit or implicit support to any VIE.

Prior to the completion of the Company's first resecuritization transaction in October 2010, the Company had not transferred assets to VIEs or QSPEs and other than acquiring MBS issued by such entities, had no other involvement with VIEs or QSPEs.

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

In this Quarterly Report on Form 10-Q, we refer to MFA Financial, Inc. and its subsidiaries as "the Company," "MFA," "we," "us," or "our," unless we specifically state otherwise or the context otherwise indicates.

The following discussion should be read in conjunction with our financial statements and accompanying notes included in Item 1 of this Quarterly Report on Form 10-Q as well as our Annual Report on Form 10-K for the year ended December 31, 2013.

Forward Looking Statements

When used in this Quarterly Report on Form 10-Q, in future filings with the SEC or in press releases or other written or oral communications, statements which are not historical in nature, including those containing words such as "will," "believe," "expect," "anticipate," "estimate," "plan," "continue," "intend," "should," "could," "would," "may" or similar expressions, are intended to identify "forward-looking statements" within the meaning of Section 27A of the 1933 Act and Section 21E of the 1934 Act, and, as such, may involve known and unknown risks, uncertainties and assumptions.

These forward-looking statements include information about possible or assumed future results with respect to our business, financial condition, liquidity, results of operations, plans and objectives. Statements regarding the following subjects, among others, may be forward-looking: changes in interest rates and the market value of our MBS; changes in the prepayment rates on the mortgage loans securing our MBS, an increase of which could result in a reduction of the yield on MBS in our portfolio and an increase of which could require us to reinvest the proceeds received by us as a result of such prepayments in MBS with lower coupons; changes in the default rates and management's assumptions regarding default rates on the mortgage loans securing our Non-Agency MBS; our ability to borrow to finance our assets and the terms, including the cost, maturity and other terms, of any such borrowings; implementation of or changes in government regulations or programs affecting our business; our estimates regarding taxable income the actual amount of which is dependent on a number of factors, including, but not limited to, changes in the amount of interest income and financing costs, the method elected by us to accrete the market discount on Non-Agency MBS and the extent of prepayments, realized losses and changes in the composition of our Agency MBS and Non-Agency MBS portfolios that may occur during the applicable tax period, including gain or loss on any MBS disposals; the timing and amount of distributions to stockholders, which are declared and paid at the discretion of our Board of Directors and will depend on, among other things, our taxable income, our financial results and overall financial condition and liquidity, maintenance of our REIT qualification and such other factors as the Board deems relevant; our ability to maintain our qualification as a REIT for federal income tax purposes; our ability to maintain our exemption from registration under the Investment Company Act of 1940, as amended (or the Investment Company Act), including statements regarding the concept release issued by the SEC relating to interpretive issues under the Investment Company Act with respect to the status under the Investment Company Act of certain companies that are engaged in the business of acquiring mortgages and mortgage-related interests; and risks associated with investing in real estate assets, including changes in business conditions and the general economy. These and other risks, uncertainties and factors, including those described in the annual, quarterly and current reports that we file with the SEC, could cause our actual results to differ materially from those projected in any forward-looking statements we make. All forward-looking statements are based on beliefs, assumptions and expectations of our future performance, taking into account all information currently available. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date they are made. New risks and uncertainties arise over time and it is not possible to predict those events or how they may affect us. Except as required by law, we are not obligated to, and do not intend to, update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Business/General

We are a REIT primarily engaged in the business of investing, on a leveraged basis, in residential Agency MBS and Non-Agency MBS. Our principal business objective is to generate net income for distribution to our stockholders resulting from the difference between the interest and other income we earn on our investments and the interest expense we pay on the borrowings that we use to finance our leveraged investments and our operating costs.

At March 31, 2014, we had total assets of approximately \$12.793 billion, of which \$11.886 billion, or 92.9%, represented our MBS portfolio. At such date, our MBS portfolio was comprised of \$6.841 billion of Agency MBS and \$5.045 billion of Non-Agency MBS. Our remaining investment-related assets were primarily comprised of cash and cash equivalents, restricted cash, collateral obtained in connection with reverse repurchase agreements, derivative instruments and MBS-related receivables.

The results of our business operations are affected by a number of factors, many of which are beyond our control, and primarily depend on, among other things, the level of our net interest income, the market value of our assets, the supply and demand for

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MBS in the marketplace, the terms and availability of adequate financing, general economic and real estate conditions (both on national and local level), the impact of government actions in the real estate and mortgage sector, and the credit performance of our Non-Agency MBS. Our net interest income varies primarily as a result of changes in interest rates, the slope of the yield curve (i.e., the differential between long-term and short-term interest rates), borrowing costs (i.e., our interest expense) and prepayment speeds on our MBS, the behavior of which involves various risks and uncertainties. Interest rates and conditional prepayment rates (or CPRs) (which measure the amount of unscheduled principal prepayment on a bond as a percentage of the bond balance), vary according to the type of investment, conditions in the financial markets, competition and other factors, none of which can be predicted with any certainty.

With respect to our business operations, increases in interest rates, in general, may over time cause: (i) the interest expense associated with our borrowings to increase; (ii) the value of our MBS portfolio and, correspondingly, our stockholders' equity to decline; (iii) coupons on our ARM-MBS to reset, on a delayed basis, to higher interest rates; (iv) prepayments on our MBS to decline, thereby slowing the amortization of our MBS purchase premiums and the accretion of our purchase discounts; and (v) the value of our derivative instruments and, correspondingly, our stockholders' equity to increase. Conversely, decreases in interest rates, in general, may over time cause: (i) the interest expense associated with our borrowings to decrease; (ii) the value of our MBS portfolio and, correspondingly, our stockholders' equity to increase; (iii) coupons on our ARM-MBS to reset, on a delayed basis, to lower interest rates; (iv) prepayments on our MBS to increase, thereby accelerating the amortization of our MBS purchase premiums and the accretion of our purchase discounts; and (v) the value of our derivative instruments and, correspondingly, our stockholders' equity to decrease. In addition, our borrowing costs and credit lines are further affected by the type of collateral we pledge and general conditions in the credit market.

We are exposed to credit risk in our Non-Agency MBS portfolio, generally meaning that we are subject to credit losses in our Non-Agency MBS portfolio that correspond to the risk of delinquency, default and foreclosure on the real estate collateralizing our Non-Agency MBS. In particular we have significantly higher exposure in our Non-Agency MBS portfolio in California, Florida, New York, Virginia and Maryland. We believe the discounted purchase prices paid on certain of our Non-Agency MBS effectively mitigates our risk of loss in the event, as we expect on most, that we receive less than 100% of the par value of these securities. Our Non-Agency MBS investment process involves analysis focused primarily on quantifying and pricing credit risk. Interest income on Non-Agency MBS purchased at a significant discount is recorded at an effective yield, based on management's estimate of expected cash flows from each security, which estimate is based on our observation of current information and events and include assumptions related to fluctuations in interest rates, prepayment speeds and the timing and amount of credit losses.

As of March 31, 2014, approximately \$8.126 billion, or 68.4%, of our MBS portfolio was in its contractual fixed-rate period or were fixed-rate MBS and approximately \$3.759 billion, or 31.6%, was in its contractual adjustable-rate period, or were floating rate MBS. Our ARM-MBS in their contractual adjustable-rate period primarily include MBS collateralized by Hybrids for which the initial fixed-rate period has elapsed, such that the interest rate will typically adjust on an annual or semiannual basis. In addition, at March 31, 2014, we had \$180.5 million, or 1.5%, of MBS with interest rates that reset monthly.

Premiums arise when we acquire MBS at a price in excess of the principal balance of the mortgages securing such MBS (i.e., par value). Conversely, discounts arise when we acquire MBS at a price below the principal balance of the mortgages securing such MBS. Premiums paid on our MBS are amortized against interest income and accretable purchase discounts on our MBS are accreted to interest income. Purchase premiums on our MBS, which are primarily carried on our Agency MBS, are amortized against interest income over the life of each security using the effective yield method, adjusted for actual prepayment activity. An increase in the prepayment rate, as measured by the CPR, will typically accelerate the amortization of purchase premiums, thereby reducing the yield/interest income earned on

such assets. Generally, if prepayments on our Non-Agency MBS are less than anticipated, we expect that the income recognized on such assets would be reduced and impairments could result.

CPR levels are impacted by, among other things, conditions in the housing market, new regulations, government and private sector initiatives, interest rates, availability of credit to home borrowers, underwriting standards and the economy in general. In particular, CPR reflects the conditional repayment rate (or CRR), which measures voluntary prepayments of mortgages collateralizing a particular MBS, and the conditional default rate (or CDR), which measures involuntary prepayments resulting from defaults. CPRs on Agency MBS and Non-Agency MBS may differ significantly. For the three months ended March 31, 2014, our Agency MBS portfolio experienced a weighted average CPR of 11.5%, and our Non-Agency MBS portfolio (including Non-Agency MBS underlying our Linked Transactions) experienced a weighted average CPR of 11.9%. Over the last consecutive eight quarters, ending with March 31, 2014, the monthly fair value weighted average CPR on our MBS portfolio ranged from a high of 19.7% experienced during the month ended August 31, 2013 to a low of 10.3%, experienced during the month ended March 31, 2014, with an average CPR over such quarters of 16.8%.

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When we purchase Non-Agency MBS at significant discounts to par value, we make certain assumptions with respect to each security. These assumptions include, but are not limited to, future interest rates, voluntary prepayment rates, default rates, mortgage modifications and loss severities. As part of our Non-Agency MBS surveillance process, we track and compare each security's actual performance over time to the performance expected at the time of purchase or, if we have modified our original purchase assumptions, to our revised performance expectations. To the extent that actual performance or our expectation of future performance of our Non-Agency MBS deviates materially from our expected performance parameters, we may revise our performance expectations, such that the amount of purchase discount designated as credit discount may be increased or decreased over time. Nevertheless, credit losses greater than those anticipated or in excess of the recorded purchase discount could occur, which could materially adversely impact our operating results.

It is our business strategy to hold our MBS as long-term investments. On at least a quarterly basis, we assess our ability and intent to continue to hold each security and, as part of this process, we monitor our securities for other-than-temporary impairment. A change in our ability and/or intent to continue to hold any of our securities that are in an unrealized loss position, or a deterioration in the underlying characteristics of these securities, could result in our recognizing future impairment charges or a loss upon the sale of any such security. At March 31, 2014, we had net unrealized gains of \$32.2 million on our Agency MBS, comprised of gross unrealized gains of \$107.9 million and gross unrealized losses of \$75.6 million, and had net unrealized gains on our Non-Agency MBS of \$787.0 million, comprised of gross unrealized gains of \$789.8 million and gross unrealized losses of \$2.8 million. At March 31, 2014, we did not intend to sell any of our MBS that were in an unrealized loss position, and we believe it is more likely than not that we will not be required to sell those MBS before recovery of their amortized cost basis, which may be at their maturity.

We rely primarily on borrowings under repurchase agreements to finance our Agency MBS and Non-Agency MBS. Our MBS have longer-term contractual maturities than our borrowings under repurchase agreements. We have also engaged in resecuritization transactions with respect to our Non-Agency MBS, which provide access to non-recourse financing. Even though the majority of our MBS have interest rates that adjust over time based on short-term changes in corresponding interest rate indices (typically following an initial fixed-rate period for our Hybrids), the interest rates we pay on our borrowings and securitized debt will typically change at a faster pace than the interest rates we earn on our MBS. In order to reduce this interest rate risk exposure, we may enter into derivative instruments, which at March 31, 2014 were comprised of Swaps.

Our Swap derivative instruments are typically designated as cash-flow hedges against a portion of our current and forecasted LIBOR-based repurchase agreements. Our Swaps do not extend the maturities of our repurchase agreements; they do, however, lock in a fixed rate of interest over their term for the notional amount of the Swap corresponding to the hedged item. During the three months ended March 31, 2014, we entered into two new Swaps with an aggregate notional amount of \$200.0 million, a weighted average fixed-pay rate of 1.95% and initial maturities ranging from five to seven years, and had Swaps with an aggregate notional amount of \$41.9 million and a weighted average fixed-pay rate of 3.92% amortize and/or expire. At March 31, 2014, we had Swaps designated in hedging relationships with an aggregate notional amount of \$4.078 billion with a weighted average fixed-pay rate of 1.92% and a weighted average variable interest rate received of 0.16%. In addition at March 31, 2014, the Company had a Swap with a notional amount of \$125.0 million, maturing on June 27, 2014 that was not designated in a hedge relationship.

## Recent Market Conditions and Our Strategy

During the first quarter of 2014, we continued to invest in both Agency and Non-Agency MBS. During the three months ended March 31, 2014, we acquired approximately (i) \$599.3 million of Agency MBS at a weighted average purchase price of 105.9% of par value and (ii) \$282.1 million of Non-Agency MBS, at a weighted average purchase

price of 87.6% of par value. In addition, we purchased MBS which are reported as a component of Linked Transactions, consisting of \$111.5 million of Non-Agency MBS purchased at par value in which the underlying collateral consists of re-performing/non-performing loans (or RPL/NPL MBS) and \$30.2 million of Non-Agency MBS with a weighted average purchase price of 84.9%. At March 31, 2014, our combined MBS portfolio was approximately \$12.152 billion (including \$265.5 million MBS reported as components of Linked Transactions) compared to \$11.502 billion (including \$130.8 million MBS reported as components of Linked Transactions) at December 31, 2013. During the three months ended March 31, 2014, we experienced an increase in our MBS portfolio primarily due to the addition of newly acquired assets exceeding principal payments and portfolio price appreciation.

At March 31, 2014, \$6.841 billion, or 57.6% of our MBS portfolio, was invested in Agency MBS. During the three months ended March 31, 2014, the fair value of our Agency MBS increased by \$321.8 million. This was due to the addition of \$599.3 million of newly acquired assets and a \$17.8 million increase in net unrealized gains which was partially offset by \$285.1 million of principal repayments and \$10.2 million of premium amortization.

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At March 31, 2014, \$5.045 billion, or 42.4% of our MBS portfolio, was invested in Non-Agency MBS. During the three months ended March 31, 2014, the fair value of our Non-Agency MBS holdings increased by \$193.0 million. The primary components of the change during the quarter in the Non-Agency balances include purchases of \$282.1 million, portfolio appreciation reflecting Non-Agency MBS price changes of \$80.3 million, partially offset by \$153.9 million of principal reductions, and the sale of Non-Agency MBS with a fair value of \$15.5 million.

Our book value per common share was \$8.20 as of March 31, 2014. Book value increased from \$8.06 as of December 31, 2013 due primarily to price appreciation within the Non-Agency MBS portfolio.

Due to the interest rate environment in 2013 and the first three months of 2014, yields on acquired assets were lower than in prior periods. At the end of the first quarter of 2014, the average coupon on mortgages underlying our Agency MBS was lower compared to the end of the first quarter of 2013, due to acquisition of assets in the marketplace at generally lower coupons reflecting current market conditions and as a result of prepayments on higher yielding assets and downward resets on Hybrid and ARM-MBS within the portfolio. As a result, the coupon yield on our Agency MBS portfolio declined 24 basis points to 3.01% for the three months ended March 31, 2014 from 3.25% for the three months ended March 31, 2013. In addition, the net Agency MBS yield decreased to 2.39% for the three months ended March 31, 2014, from 2.42% for the three months ended March 31, 2013. The overall yield for our Non-Agency MBS portfolio was 7.80% for the three months ended March 31, 2014 compared to 6.80% for the three months ended March 31, 2013. The increase in the yield on our Non-Agency MBS portfolio is primarily due to increases in accretable discount due to the impact of improving credit quality on our cash flow estimates.

We continue to believe that loss-adjusted returns on Non-Agency MBS represent attractive investment opportunities. We believe that our \$1.042 billion Credit Reserve and OTTI appropriately factors in remaining uncertainties regarding underlying mortgage performance and the potential impact on future cash flows. Home price appreciation and underlying mortgage loan amortization further decreased the average loan-to-value ratio (or LTV) for many of the mortgages underlying our Non-Agency portfolio. Home price appreciation is generally due to a combination of limited housing supply, low mortgage rates, capital flows into own-to-rent foreclosure purchases and demographic-driven U.S. household formation. We estimate that the LTV of mortgage loans underlying our Non-Agency MBS has declined from approximately 105% as of January 2012 to less than 85% as of March 31, 2014. In addition, we estimate that the percentage of current loans underlying our Non-Agency MBS that are underwater (with LTVs greater than 100%), has declined from approximately 52% as of January 2012 to 16% at March 31, 2014. Lower LTVs lessen the likelihood of defaults and simultaneously decrease loss severities. Additionally, current to 60-days delinquent transition rates continue to decline from their 2009 peak. Further, during 2013 and the first three months of 2014, we have also observed faster voluntary prepayment (i.e. prepayment of loans in full with no loss) speeds than originally projected. The yields on our Non-Agency MBS that were purchased at a discount are generally positively impacted if prepayment rates on these securities exceed our prepayment assumptions. Based on these current conditions, we have reduced estimated future losses within our Non-Agency portfolio. As a result, during the three months ended March 31, 2014 \$35.9 million was transferred from Credit Reserve to accretable discount. This increase in accretable discount is expected to increase the interest income realized over the remaining life of our Non-Agency MBS. The remaining average contractual life of such assets is approximately 22 years, but based on scheduled loan amortization and prepayments (both voluntary and involuntary), loan balances will decline substantially over time. Consequently, we believe that the majority of the impact on interest income from the reduction in Credit Reserve will occur over the next ten years.

With \$274.7 million of cash and cash equivalents and \$434.7 million of unpledged Agency MBS at March 31, 2014, we believe that we are positioned to continue to take advantage of investment opportunities within the residential mortgage marketplace. During the remainder of 2014 we intend to continue to selectively acquire Agency MBS and Non-Agency MBS. We believe that our Non-Agency assets will benefit going forward as the existing private label MBS universe continues to decline in size due to prepayments, defaults and limited issuance. In addition, while most



Non-Agency MBS in our portfolio will not return their full face value due to loan defaults, we believe that they will deliver attractive loss adjusted yields due to our discounted average amortized cost of 74% of face value at March 31, 2014.

We believe the financial environment continues to be favorably impacted by accommodative U.S. monetary policy. Repurchase agreement funding for both Agency MBS and Non-Agency MBS continues to be available to us from multiple counterparties. Typically, repurchase agreement funding involving Non-Agency MBS is available from fewer counterparties, at terms requiring higher collateralization and higher interest rates, than for repurchase agreement funding involving Agency MBS. At March 31, 2014, our debt consisted of borrowings under repurchase agreements with 26 counterparties, securitized debt, and Senior Notes outstanding, and obligation to return securities obtained as collateral, resulting in a debt-to-equity multiple of 2.9 times. (See table on page 59 under Results of Operations that presents our quarterly leverage multiples since March 31, 2013.)

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## Information About Our Assets

The tables below present certain information about our asset allocation at March 31, 2014:

## ASSET ALLOCATION

GAAP Basis	Agency MBS	Non-Agency MBS	RPL/NPL MBS (1)	MBS Portfolio	Cash (2)	Other, net (3)	Total
(Dollars in Thousands)							
Amortized Cost	\$6,808,815	\$4,254,450	\$3,701	\$11,066,966	\$300,811	\$43,513	\$11,411,290
Market Value	\$6,841,033	\$5,041,417	\$3,738	\$11,886,188	\$300,811	\$43,513	\$12,230,512
Less Repurchase Agreements	(6,018,689 )	(2,587,440 )	—	(8,606,129 )	—	—	(8,606,129 )
Less Securitized Debt	—	(292,526 )	—	(292,526 )	—	—	(292,526 )
Less Senior Notes	—	—	—	—	—	(100,000 )	(100,000 )
Equity Allocated	\$822,344	\$2,161,451	\$3,738	\$2,987,533	\$300,811	\$(56,487 )	\$3,231,857
Less Swaps at Market Value	—	—	—	—	—	(27,270 )	(27,270 )
Net Equity Allocated	\$822,344	\$2,161,451	\$3,738	\$2,987,533	\$300,811	\$(83,757 )	\$3,204,587
Debt/Net Equity Ratio (4)	7.32	x 1.33	x —				2.94 x
Non-GAAP Adjustments	Agency MBS	Non-Agency MBS (5)	RPL/NPL MBS (1)(5)	MBS Portfolio	Cash (2)	Other, net (5)	Total
(Dollars in Thousands)							
Amortized Cost	\$—	\$64,074	\$195,419	\$259,493	\$—	\$(55,712 )	\$203,781
Market Value	\$—	\$68,652	\$196,896	\$265,548	\$—	\$(55,712 )	\$209,836
Repurchase Agreements	—	381,374	(155,322 )	226,052	—	—	226,052
Multi-year Collateralized Financing	—	(435,888 )	—	(435,888 )	—	—	(435,888 )
Arrangements							
Equity Allocated	\$—	\$14,138	\$41,574	\$55,712	\$—	\$(55,712 )	\$—
Less Swaps at Market Value	—	—	—	—	—	—	—
Net Equity Allocated	\$—	\$14,138	\$41,574	\$55,712	\$—	\$(55,712 )	\$—
Non-GAAP Basis	Agency MBS	Non-Agency MBS (5)	RPL/NPL MBS (1)(5)	MBS Portfolio	Cash (2)	Other, net (6)	Total
(Dollars in Thousands)							
Amortized Cost	\$6,808,815	\$4,318,524	\$199,120	\$11,326,459	\$300,811	\$(12,199 )	\$11,615,071
Market Value	\$6,841,033	\$5,110,069	\$200,634	\$12,151,736	\$300,811	\$(12,199 )	\$12,440,348
Less Repurchase Agreements	(6,018,689 )	(2,206,066 )	(155,322 )	(8,380,077 )	—	—	(8,380,077 )
Less Multi-year Collateralized Financing	—	(435,888 )	—	(435,888 )	—	—	(435,888 )
Arrangements							
Less Securitized Debt	—	(292,526 )	—	(292,526 )	—	—	(292,526 )
Less Senior Notes	—	—	—	—	—	(100,000 )	(100,000 )
Equity Allocated	\$822,344	\$2,175,589	\$45,312	\$3,043,245	\$300,811	\$(112,199 )	\$3,231,857

Less Swaps at Market Value	—	—	—	—	—	(27,270 )	(27,270 )
Net Equity Allocated	\$822,344	\$2,175,589	\$45,312	\$3,043,245	\$300,811	\$(139,469)	\$3,204,587
Debt/Net Equity Ratio	7.32	x 1.35	x 3.43	x			3.01
(4) (7)							x

Represents private-label MBS issued in 2013 and 2014 in which the underlying collateral consists of (1) re-performing/non-performing loans that were originated in prior years. Included with the balance of Non-Agency MBS reported in the Company's consolidated balance sheets.

(2) Includes cash, cash equivalents and restricted cash.

(3) Includes securities obtained and pledged as collateral, Linked Transactions, interest receivable, goodwill, prepaid and other assets, obligation to return securities obtained as collateral, interest payable, dividends payable, excise tax and interest payable and accrued expenses and other liabilities.

(4) For the Agency, Non-Agency and RPL/NPL MBS portfolios, represents the sum of borrowings under repurchase agreements, payable for unsettled MBS purchases and securitized debt as a multiple of net equity allocated. The numerator of our Total Debt/Net Equity ratio also includes the obligation to return securities obtained as collateral of \$435.9 million and Senior Notes.

(5) Includes Non-Agency and RPL/NPL MBS and repurchase agreements underlying Linked Transactions. The purchase of a Non-Agency or RPL/NPL MBS and contemporaneous repurchase borrowing of this MBS with the same counterparty are accounted for under GAAP as a "linked transaction." The two components of a linked transaction (MBS and associated borrowings under a repurchase agreement) are evaluated on a combined basis and are presented net as "Linked Transactions" on our consolidated balance sheets. Also includes the adjustment to reflect Non-Agency financing under multi-year collateralized financing arrangements of \$435.9 million, while borrowings under repurchase agreements of \$432.0 million for which U.S. Treasury securities are pledged as collateral is reclassified to other, net.

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(6) Includes securities obtained and pledged as collateral, interest receivable, goodwill, prepaid and other assets, borrowings under repurchase agreements of \$432.0 million for which U.S. Treasury securities are pledged as collateral, interest payable, dividends payable, excise tax and interest payable and accrued expenses and other liabilities.

(7) For the Agency, Non-Agency and RPL/NPL MBS portfolios, represents the sum of borrowings under repurchase agreements (including an aggregate of \$206.0 million repurchase agreements underlying linked transactions), payable for unsettled MBS purchases, multi-year collateralized financing arrangements of \$435.9 million and securitized debt as a multiple of net equity allocated. The numerator of our Total Debt/Net Equity ratio also includes borrowings under repurchase agreements of \$432.0 million for which U.S. Treasury securities are pledged as collateral and Senior Notes.

## Agency MBS

The following table presents certain information regarding the composition of our Agency MBS portfolio as of March 31, 2014 and December 31, 2013:

## March 31, 2014

(Dollars in Thousands)	Current Face	Weighted Average Purchase Price	Weighted Average Market Price	Fair Value (1)	Weighted Average Loan Age (Months) (2)	Weighted Average Coupon (2)	Weighted Average 3 Month CPR
15-Year Fixed Rate:							
Low Loan Balance (3)	\$1,916,726	104.3	% 102.5	% \$1,964,910	23	3.03	% 6.0
HARP (4)	198,741	104.7	102.6	203,867	22	3.00	6.3
Other (Post June 2009) (5)	231,209	103.9	106.4	245,903	42	4.15	11.2
Other (Pre June 2009) (6)	1,230	104.9	106.7	1,313	58	4.50	0.7
Total 15-Year Fixed Rate	\$2,347,906	104.3	% 102.9	% \$2,415,993	25	3.14	% 6.6
Hybrid:							
Other (Post June 2009) (5)	\$2,850,522	104.4	% 104.6	% \$2,982,794	35	3.22	% 16.1
Other (Pre June 2009) (6)	1,199,471	101.7	106.3	1,274,514	87	3.16	12.4
Total Hybrid	\$4,049,993	103.6	% 105.1	% \$4,257,308	51	3.20	% 14.9
CMO/Other	\$159,473	102.5	% 104.2	% \$166,190	156	2.43	% 6.4
Total Portfolio	\$6,557,372	103.8	% 104.3	% \$6,839,491	44	3.16	% 11.5

## December 31, 2013

(Dollars in Thousands)	Current Face	Weighted Average Purchase Price	Weighted Average Market Price	Fair Value (1)	Weighted Average Loan Age (Months) (2)	Weighted Average Coupon (2)	Weighted Average 3 Month CPR
15-Year Fixed Rate:							
Low Loan Balance (3)	\$1,977,798	104.3	% 101.8	% \$2,012,876	20	3.04	% 7.2
HARP (4)	205,895	104.7	101.8	209,597	19	3.01	6.3
Other (Post June 2009) (5)	222,691	103.7	106.1	236,253	40	4.16	17.0
Other (Pre June 2009) (6)	1,256	104.9	106.7	1,340	55	4.50	0.5

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Total 15-Year Fixed Rate	\$2,407,640	104.3	% 102.2	% \$2,460,066	22	3.14	% 8.0	%
Hybrid:								
Other (Post June 2009) (5)	\$2,502,413	104.1	% 104.4	% \$2,612,108	32	3.22	% 17.7	%
Other (Pre June 2009) (6)	1,202,227	101.4	106.0	1,274,745	84	3.28	13.2	
Total Hybrid	\$3,704,640	103.2	% 104.9	% \$3,886,853	49	3.24	% 16.2	%
CMO/Other	\$164,639	102.5	% 104.0	% \$171,182	154	2.44	% 8.7	%
Total Portfolio	\$6,276,919	103.6	% 103.8	% \$6,518,101	41	3.18	% 12.9	%

(1) Does not include principal payments receivable of \$1.5 million and \$1.1 million at March 31, 2014 and December 31, 2013, respectively.

(2) Weighted average is based on MBS current face at March 31, 2014 and December 31, 2013, respectively.

(3) Low loan balance represents MBS collateralized by mortgages with original loan balance of less than or equal to \$175,000.

(4) Home Affordable Refinance Program (or HARP) MBS are backed by refinanced loans with LTVs greater than or equal to 80% at origination.

(5) MBS issued in June 2009 or later. Majority of underlying loans are ineligible to refinance through the HARP program.

(6) MBS issued before June 2009.

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The following table presents certain information regarding our 15-year fixed-rate Agency MBS as of March 31, 2014 and December 31, 2013:

March 31, 2014

Coupon	Current Face	Weighted Average Purchase Price	Weighted Average Market Price	Fair Value (1)	Weighted Average Loan Age (Months) (2)	Weighted Average Loan Rate	Low Loan Balance and/or HARP (3)	Weighted Average 3 Month CPR
(Dollars in Thousands)								
15-Year Fixed Rate:								
2.5%	\$1,067,409	104.0 %	100.2 %	\$1,069,562	15	3.04 %	100 %	4.3 %
3.0%	467,595	105.9	102.9	481,055	21	3.49	100	4.8
3.5%	14,380	103.5	105.0	15,097	41	4.16	100	18.7
4.0%	678,427	103.5	106.4	722,148	40	4.40	78	10.0
4.5%	120,095	105.2	106.7	128,131	44	4.87	32	12.5
Total 15-Year Fixed Rate	\$2,347,906	104.3 %	102.9 %	\$2,415,993	25	3.62 %	90 %	6.6 %

December 31, 2013

Coupon	Current Face	Weighted Average Purchase Price	Weighted Average Market Price	Fair Value (1)	Weighted Average Loan Age (Months) (2)	Weighted Average Loan Rate	Low Loan Balance and/or HARP (3)	Weighted Average 3 Month CPR
(Dollars in Thousands)								
15-Year Fixed Rate:								
2.5%	\$1,096,097	104.0 %	99.2 %	\$1,086,853	12	3.04 %	100 %	4.0 %
3.0%	481,174	105.9	102.1	491,212	18	3.49	100	5.5
3.5%	15,429	103.5	104.8	16,162	38	4.16	100	24.1
4.0%	688,213	103.4	106.2	730,542	37	4.40	80	13.8
4.5%	126,727	105.2	106.8	135,297	41	4.87	32	15.8
Total 15-Year Fixed Rate	\$2,407,640	104.3 %	102.2 %	\$2,460,066	22	3.62 %	91 %	8.0 %

(1) Does not include principal payments receivable of \$1.5 million and \$1.1 million at March 31, 2014 and December 31, 2013, respectively.

(2) Weighted average is based on MBS current face at March 31, 2014 and December 31, 2013, respectively.

(3) Low Loan Balance represents MBS collateralized by mortgages with original loan balance less than or equal to \$175,000. HARP MBS are backed by refinanced loans with LTVs greater than or equal to 80% at origination.

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The following table presents certain information regarding our Hybrid Agency MBS as of March 31, 2014 and December 31, 2013:

March 31, 2014

(Dollars in Thousands)	Current Face	Weighted Average Purchase Price	Weighted Average Market Price	Fair Value (1)	Weighted Average Coupon (2)	Weighted Average Loan Age (Months) (2)	Weighted Average Months to Reset (3)	Weighted Interest Only (4)	Weighted Average Month CPR
Hybrid Post June 2009:									
Agency 5/1	\$1,223,136	104.2 %	105.8 %	\$1,293,606	3.35 %	42	17	21 %	20.2 %
Agency 7/1	1,290,349	104.5	104.1	1,343,223	3.09	31	52	20	15.2
Agency 10/1	337,037	104.8	102.6	345,965	3.25	27	92	58	8.2
Total Hybrids Post June 2009	\$2,850,522	104.4 %	104.6 %	\$2,982,794	3.22 %	35	42	25 %	16.1 %
Hybrid Pre June 2009:									
Coupon < 4.5% (5)	\$891,774	101.8 %	106.1 %	\$946,264	2.40 %	91	5	56 %	8.9 %
Coupon >= 4.5% (6)	307,697	101.2	106.7	328,250	5.38	76	17	77	21.9
Total Hybrids Pre June 2009	\$1,199,471	101.7 %	106.3 %	\$1,274,514	3.16 %	87	8	61 %	12.4 %
Total Hybrids	\$4,049,993	103.6 %	105.1 %	\$4,257,308	3.20 %	51	32	36 %	14.9 %

December 31, 2013

(Dollars in Thousands)	Current Face	Weighted Average Purchase Price	Weighted Average Market Price	Fair Value (1)	Weighted Average Coupon (2)	Weighted Average Loan Age (Months) (2)	Weighted Average Months to Reset (3)	Weighted Interest Only (4)	Weighted Average Month CPR
Hybrid Post June 2009:									
Agency 5/1	\$921,849	103.5 %	105.5 %	\$972,201	3.37 %	39	20	24 %	23.8 %
Agency 7/1	1,233,187	104.4	104.2	1,284,739	3.09	28	55	21	15.1
Agency 10/1	347,377	104.8	102.2	355,168	3.27	24	95	57	10.9
Total Hybrids Post June 2009	\$2,502,413	104.1 %	104.4 %	\$2,612,108	3.22 %	32	48	27 %	17.7 %
Hybrid Pre June 2009:									
Coupon < 4.5% (5)	\$860,491	101.5 %	105.9 %	\$910,849	2.44 %	88	6	56 %	8.8 %
Coupon >= 4.5% (6)	341,736	101.2	106.5	363,896	5.40	73	20	77	23.5
Total Hybrids Pre June 2009	\$1,202,227	101.4 %	106.0 %	\$1,274,745	3.28 %	84	10	62 %	13.2 %
Total Hybrids	\$3,704,640	103.2 %	104.9 %	\$3,886,853	3.24 %	49	35	38 %	16.2 %

(1) Does not include principal payments receivable of \$1.5 million and \$1.1 million at March 31, 2014 and December 31, 2013, respectively.

(2) Weighted average is based on MBS current face at March 31, 2014 and December 31, 2013, respectively.

(3) Weighted average months to reset is the number of months remaining before the coupon interest rate resets. At reset, the MBS coupon will adjust based upon the underlying benchmark interest rate index, margin and periodic or

lifetime caps. The months to reset do not reflect scheduled amortization or prepayments.

(4) Interest only represents MBS backed by mortgages currently in their interest only period. Percentage is based on MBS current face at March 31, 2014 and December 31, 2013, respectively.

(5) Agency 3/1, 5/1, 7/1 and 10/1 Hybrid ARM-MBS with coupon less than 4.5%.

(6) Agency 3/1, 5/1, 7/1 and 10/1 Hybrid ARM-MBS with coupon greater than or equal to 4.5%.



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## Non-Agency MBS

The following table presents information with respect to our Non-Agency MBS: (i) excluding Linked Transactions and reported in accordance with GAAP; (ii) underlying our Linked Transactions and reflected consistent with GAAP reporting requirements; and (iii) on a combined basis (Non-GAAP) as of March 31, 2014 and December 31, 2013:

(In Thousands)	March 31, 2014	December 31, 2013
(i) Non-Agency MBS (GAAP - excluding Linked Transactions)		
Face/Par	\$5,741,643	\$5,616,038
Fair Value	5,045,155	4,852,137
Amortized Cost	4,258,151	4,113,600
Purchase Discount Designated as Credit Reserve and OTTI	(1,041,933 )	(1,043,037 )
Purchase Discount Designated as Accretable	(442,156 )	(460,039 )
Purchase Premiums	597	638
(ii) Non-Agency MBS Underlying Linked Transactions		
Face/Par	\$272,375	\$134,430
Fair Value	265,548	130,790
Amortized Cost	259,493	126,497
Purchase Discount Designated as Credit Reserve	(10,705 )	(4,721 )
Purchase Discount Designated as Accretable	(2,177 )	(3,212 )
(iii) Combined Non-Agency MBS and MBS Underlying Linked Transactions (Non-GAAP)		
Face/Par	\$6,014,018	\$5,750,468
Fair Value	5,310,703	4,982,927
Amortized Cost	4,517,644	4,240,097
Purchase Discount Designated as Credit Reserve and OTTI	(1,052,638 )	(1,047,758 )
Purchase Discount Designated as Accretable	(444,333 )	(463,251 )
Purchase Premiums	597	638

(1) Includes discount designated as Credit Reserve of \$997.6 million and OTTI of \$44.4 million.

(2) Includes discount designated as Credit Reserve of \$998.5 million and OTTI of \$44.5 million.

(3) Includes discount designated as Credit Reserve of \$1.008 billion and OTTI of \$44.4 million.

(4) Includes discount designated as Credit Reserve of \$1.003 billion and OTTI of \$44.5 million.

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## Purchase Discounts on Non-Agency MBS and Securities Underlying Linked Transactions

The following table presents the changes in the components of purchase discount on Non-Agency MBS with respect to purchase discount designated as Credit Reserve and OTTI, and accretable purchase discount, including securities underlying Linked Transactions, for the three months ended March 31, 2014 and March 31, 2013 on both a GAAP and Non-GAAP basis:

GAAP Basis	Three Months Ended March 31, 2014		Three Months Ended March 31, 2013	
	Discount Designated as Credit Reserve and OTTI	Accretable Discount (1)	Discount Designated as Credit Reserve and OTTI	Accretable Discount (1)
(In Thousands)				
Balance at beginning of period	\$(1,043,037	) \$(460,039	) \$(1,380,506	) \$(371,626
Accretion of discount	—	27,431	—	12,051
Realized credit losses	25,037	—	50,307	—
Purchases	(63,317	) 23,406	(23,535	) 11,229
Sales	3,487	2,943	6,283	932
Transfers/release of credit reserve	35,897	(35,897	) 34,499	(34,499
Balance at the end of period	\$(1,041,933	) \$(442,156	) \$(1,312,952	) \$(381,913
Non-GAAP Adjustments				
(In Thousands)				
Balance at beginning of period	\$(4,721	) \$(3,212	) \$(6,051	) \$(2,409
Accretion of discount	—	315	—	129
Realized credit losses	120	—	260	—
Purchases	(6,219	) 835	—	—
Transfers/release of credit reserve	115	(115	) 13	(13
Balance at the end of period	\$(10,705	) \$(2,177	) \$(5,778	) \$(2,293
Non-GAAP Basis				
(In Thousands)				
Balance at beginning of period	\$(1,047,758	) \$(463,251	) \$(1,386,557	) \$(374,035
Accretion of discount	—	27,746	—	12,180
Realized credit losses	25,157	—	50,567	—
Purchases	(69,536	) 24,241	(23,535	) 11,229
Sales	3,487	2,943	6,283	932
Transfers/release of credit reserve	36,012	(36,012	) 34,512	(34,512
Balance at the end of period	\$(1,052,638	) \$(444,333	) \$(1,318,730	) \$(384,206

(1) Together with coupon interest, accretable purchase discount is recognized as interest income over the life of the security.



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The following table presents information with respect to the yield components of our Non-Agency MBS for the three months ended March 31, 2014 and March 31, 2013:

Non-Agency MBS	Three Months Ended			
	March 31, 2014		March 31, 2013	
Coupon Yield (1)	5.19	%	5.78	%
Effective Yield Adjustment (2)	2.61		1.02	
Net Yield	7.80	%	6.80	%

(1) Reflects the annualized coupon interest income divided by the average amortized cost. The discounted purchase price on Non-Agency MBS causes the coupon yield to be higher than the pass-through coupon interest rate.

(2) The effective yield adjustment is the difference between the net yield, calculated utilizing management's estimates of future cash flows for Non-Agency MBS, less the current coupon yield.

The information in the above tables, on pages 48-49, includes certain underlying Non-Agency MBS and the associated repurchase agreement borrowings that are disclosed both separately and/or on a combined basis with our Non-Agency MBS portfolio. However, for GAAP financial reporting purposes, these items are required to be accounted for by us as Linked Transactions. Consequently, the presentation of this information in the above tables constitutes Non-GAAP financial measures within the meaning of Regulation G, as promulgated by the SEC.

In assessing the performance of the Non-Agency MBS portfolio, we do not view these transactions as linked, but rather view the performance of the linked Non-Agency MBS and the related repurchase agreement borrowings as we would any other Non-Agency MBS that is not part of a linked transaction. Accordingly, we consider that the Non-GAAP information disclosed in the above tables enhances the ability of investors to analyze the performance of our Non-Agency MBS in the same way that we assess such assets.

In addition, in connection with our financing strategy for Non-Agency MBS, we have entered into contemporaneous repurchase agreement and reverse repurchase agreement transactions with a single counterparty. The transactions effectively result in us pledging Non-Agency MBS as collateral to the counterparty in connection with the repurchase agreement financing and obtaining U.S. Treasury securities as collateral in connection with the reverse repurchase agreement. Both the repurchase agreement and the reverse repurchase agreement have a contractual maturity of January 2016 with no net exchange of cash at inception. The U.S. Treasury collateral obtained is pledged as collateral in a subsequent repurchase agreement transaction with a different counterparty for cash. This subsequent repurchase transaction has a term of 90 days at inception. For purposes of presentation of its repurchase agreement financing liabilities in the Non-GAAP Asset Allocation table on page 44, the obligation to return the \$436 million of U.S. Treasury collateral, is separately presented as "Multi-year collateralized financing arrangements" and is included in the numerator of the Debt/Net Equity Ratio for the Non-Agency MBS portfolio. In addition, the asset balance for U.S. Treasury securities obtained as collateral and the repurchase agreement liability to the second counterparty to which we pledged those U.S Treasury securities as collateral are included in the "Other, net" column as we believe net presentation is consistent with the economic substance of the transactions. However, GAAP prohibits offsetting of this asset and liability for a number of reasons, including the fact that the counterparties to these transactions are different, and there is no legal right of offset. For GAAP presentation purposes, the repurchase agreement liability against which we have pledged U.S. Treasuries is disclosed as "Repurchase Agreements" and is included in the numerator of the Debt/Net Equity Ratio for the Non-Agency MBS portfolio. In addition, the asset balance for the U.S. Treasury securities obtained as collateral and the liability balance for the obligation to return this collateral are included in the "Other, net" column. However, management considers that the Non-GAAP Asset Allocation table presented on page 44 more appropriately reflects the economic substance of the transactions. Consequently, this presentation constitutes a Non-GAAP financial measure within the meaning of Regulation G, as promulgated by the SEC. The Non-GAAP presentation of liabilities associated with the Company's collateralized financing arrangements does not impact the

overall calculation of Debt/Net Equity for the Company as a whole.

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Actual maturities of MBS are generally shorter than stated contractual maturities because actual maturities of MBS are affected by the contractual lives of the underlying mortgages, periodic payments of principal, and prepayments of principal. The following table presents certain information regarding the amortized costs, weighted average yields and contractual maturities of our MBS at March 31, 2014 and does not reflect the effect of prepayments or scheduled principal amortization on our MBS:

(Dollars in Thousands)	One to Five Years		Five to Ten Years		Over Ten Years		Total MBS (1)		
	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Total Amortized Cost	Total Fair Value	Weighted Average Yield
Agency MBS:									
Fannie Mae	\$317	3.74 %	\$16,930	2.65 %	\$5,599,854	2.39 %	\$5,617,101	\$5,666,693	2.39 %
Freddie Mac	—	—	—	—	1,179,123	2.29	1,179,123	1,161,428	2.29
Ginnie Mae	—	—	—	—	12,591	1.65	12,591	12,912	1.65
Total Agency MBS	\$317	3.74 %	\$16,930	2.65 %	\$6,791,568	2.37 %	\$6,808,815	\$6,841,033	2.37 %
Non-Agency MBS	\$3,700	4.30 %	\$12,225	6.68 %	\$4,242,226	7.78 %	\$4,258,151	\$5,045,155	7.78 %
Total MBS	\$4,017	4.26 %	\$29,155	4.34 %	\$11,033,794	4.45 %	\$11,066,966	\$11,886,188	4.47 %

(1) We did not have any MBS with contractual maturities of less than one year at March 31, 2014.

## Exposure to Financial Counterparties

We finance the acquisition of a significant portion of our MBS with repurchase agreements. In connection with these financing arrangements, we pledge our securities as collateral to secure the borrowing. The amount of collateral pledged will typically exceed the amount of the financing with the extent of over-collateralization ranging from 1% - 6% of the amount borrowed (U.S. Treasury and Agency MBS collateral) to up to 63% (Non-Agency MBS collateral). Consequently, while repurchase agreement financing results in us recording a liability to the counterparty in our consolidated balance sheets, we are exposed to the counterparty, if during the term of the repurchase agreement financing, a lender should default on its obligation and we are not able to recover our pledged assets. The amount of this exposure is the difference between the amount loaned to us plus interest due to the counterparty and the fair value of the collateral pledged by us to the lender including accrued interest receivable on such collateral.

In addition, we use interest rate Swaps to manage interest rate risk exposure in connection with our repurchase agreement financings. We will make cash payments or pledge securities as collateral as part of a margin arrangement in connection with interest rate Swaps that are in an unrealized loss position. In the event that a counterparty for a Swap that is not subject to central clearing were to default on its obligation, we would be exposed to a loss to a Swap counterparty to the extent that the amount of cash or securities pledged exceeded the unrealized loss on the associated Swaps and we were not able to recover the excess collateral.

During the past several years, certain of our repurchase agreement counterparties in the United States and Europe have experienced financial difficulty and have been either rescued by government assistance or otherwise benefited from accommodative monetary policy of central banks.

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The table below summarizes our exposure to our counterparties at March 31, 2014, by country of domicile:

Country	Number of Counterparties	Repurchase Agreement Financing	Swaps at Fair Value	Exposure (1)	Exposure as a Percentage of MFA Total Assets
(Dollars in Thousands)					
European Countries: (2)					
Switzerland	3	\$1,428,704	\$—	\$1,027,681	8.03 %
United Kingdom	2	1,091,857	(8,687	) 289,887	2.27
France	1	513,179	—	30,476	0.24
Holland	1	434,557	1,827	16,348	0.13
Germany	1	—	(1,444	) 2,640	0.02
Total	8	3,468,297	(8,304	) 1,367,032	10.69 %
Other Countries:					
United States (3)	13	\$4,523,645	\$(18,966	) \$803,811	6.28 %
Japan	4	626,516	—	35,402	0.28
Other	3	693,656	—	159,723	1.25
Total	20	5,843,817	(18,966	) 998,936	7.81 %
Total Counterparty Exposure	28	\$9,312,114	(4)(5) \$(27,270	) \$2,365,968	18.50 %

(1) Represents for each counterparty the amount of cash and/or securities pledged as collateral less the aggregate of repurchase agreement financing, Swaps at fair value, and net interest receivable/payable on all such instruments.

(2) Includes European-based counterparties as well as U.S.-domiciled subsidiaries of the European parent entity.

(3) Includes one counterparty that is a central clearing house for our Swaps.

(4) Includes \$500.0 million of repurchase agreements entered into in connection with contemporaneous repurchase and reverse repurchase agreements with a single counterparty.

(5) Includes \$206.0 million of repurchase agreements which are a component of our Linked Transactions.

At March 31, 2014, we did not use credit default Swaps or other forms of credit protection to hedge the exposures summarized in the table above.

If the weak European conditions continue to impact our major European financial counterparties, there is the possibility that it will also impact the operations of their U.S. domiciled subsidiaries. This could adversely affect our financing and operations as well as those of the entire mortgage sector in general. Management monitors our exposure to our repurchase agreement and Swap counterparties on a regular basis, using various methods, including review of recent rating agency actions or other developments and by monitoring the amount of cash and securities collateral pledged and the associated loan amount under repurchase agreements and/or the fair value of Swaps with our counterparties. We intend to make reverse margin calls on our counterparties to recover excess collateral as permitted by the agreements governing our financing arrangements, or take other necessary actions to reduce the amount of our exposure to a counterparty when such actions are considered necessary.

#### Tax Considerations

##### Key differences between GAAP net income and REIT Taxable Income for Non-Agency MBS

Our total Non-Agency MBS portfolio for tax differs from our portfolio reported for GAAP primarily due to the fact that for tax purposes; (i) certain of the MBS contributed to the VIEs used to facilitate resecuritization transactions were deemed to be sold; (ii) the tax portfolio includes certain securities issued by these VIEs; and (iii) Non-Agency

MBS underlying linked transactions are included in our tax portfolio. In addition, for our Non-Agency MBS tax portfolio, potential timing differences arise with respect to the accretion of market discount into income and recognition of realized losses for tax purposes as compared to GAAP. Consequently, our REIT taxable income calculated in a given period may differ significantly from our GAAP net income.

The determination of taxable income attributable to Non-Agency MBS is dependent on a number of factors, including principal payments, defaults and loss severities. In projecting taxable income for Non-Agency MBS during the year, management considers estimates of the amount of discount expected to be accreted. Such estimates require significant judgment and actual results may differ from these estimates. Moreover, the deductibility of realized losses from Non-Agency MBS and their effect on market



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discount accretion is analyzed on an asset-by-asset basis and while they will result in a reduction of taxable income, this reduction tends to occur gradually and primarily in periods after the realized losses are reported.

Resecuritization transactions result in differences between GAAP net income and REIT Taxable Income

For tax purposes, depending on the transaction structure, a resecuritization transaction may be treated either as a sale or a financing of the underlying MBS. Income recognized from resecuritization transactions will differ for tax and GAAP. For tax purposes, we own and may in the future acquire interests in resecuritization trusts, in which several of the classes of securities are or will be issued with Original Issue Discount (or OID). As the holder of the retained interests in the trust, we generally will be required to include OID in our current gross interest income over the term of the applicable securities as the OID accrues. The rate at which the OID is recognized into taxable income is calculated using a constant rate of yield to maturity, with realized losses impacting the amount of OID recognized in REIT taxable income once they are actually incurred. For tax purposes, REIT taxable income may be recognized in excess of economic income (i.e., OID) or in advance of the corresponding cash flow from these assets, thereby effecting our dividend distribution requirement to stockholders.

We estimate that for the three months ended March 31, 2014, our taxable income was approximately \$66 million. Based on dividends paid or declared during the three months ended March 31, 2014, we have undistributed taxable income of approximately \$50 million, or \$0.14 per share. We have until the filing of our 2014 tax return (due not later than September 15, 2015) to declare the distribution of any 2014 REIT taxable income not previously distributed.

## Regulatory Developments

The U.S. Congress, Board of Governors of the Federal Reserve System, U.S. Treasury, Federal Deposit Insurance Corporation, SEC and other governmental and regulatory bodies have taken and continue to consider additional actions in response to the financial crisis. In particular, the Dodd-Frank Wall Street Reform and Consumer Protection Act (or the Dodd-Frank Act) created a new regulator housed within the Federal Reserve System, an independent bureau known as the Consumer Financial Protection Bureau (or the CFPB), which has broad authority over a wide range of consumer financial products and services, including mortgage lending. Another section of the Dodd-Frank Act, the Mortgage Reform and Anti-Predatory Lending Act (or the Mortgage Reform Act), contains new underwriting and servicing standards for the mortgage industry, as well as restrictions on compensation for mortgage originators. In addition, the Mortgage Reform Act grants broad discretionary regulatory authority to the CFPB to prohibit or condition terms, acts or practices relating to residential mortgage loans that the CFPB finds abusive, unfair, deceptive or predatory, as well as to take other actions that the CFPB finds are necessary or proper to ensure responsible affordable mortgage credit remains available to consumers. The Dodd-Frank Act also affects the securitization of mortgages (and other assets) with requirements for risk retention by securitizers and requirements for regulating credit rating agencies.

The Dodd-Frank Act requires numerous regulations, many of which (including those mentioned above regarding underwriting and mortgage originator compensation) have only recently been finalized and are only now becoming effective and implemented and operationalized. As a result, we are unable to fully predict at this time how the Dodd-Frank Act, as well as other laws that may be adopted in the future, will impact our business, results of operations and financial condition, or the environment for repurchase financing and other forms of borrowing, the investing environment for Agency MBS, Non-Agency MBS and/or residential mortgage loans, the securitization industry, Swaps and other derivatives. However, at a minimum, we believe that the Dodd-Frank Act and the regulations promulgated and made effective thereunder are likely to increase the economic and compliance costs for participants in the mortgage and securitization industries, including us.

In addition to the regulatory actions being implemented under the Dodd-Frank Act, on August 31, 2011, the SEC issued a concept release under which it is reviewing interpretive issues related to Section 3(c)(5)(C) of the Investment Company Act. Section 3(c)(5)(C) excludes from the definition of “investment company” entities that are primarily engaged in, among other things, “purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.” Many companies that engage in the business of acquiring mortgages and mortgage-related instruments seek to rely on existing interpretations of the SEC Staff with respect to Section 3(c)(5)(C) so as not to become an investment company for the purpose of regulation under the Investment Company Act. In connection with the concept release, the SEC requested comments on, among other things, whether it should reconsider its existing interpretation of Section 3(c)(5)(C). To date the SEC has not taken or otherwise announced any further action in connection with the concept release.

In the first quarter of 2014 Senators Tim Johnson (D-SD) and Mike Crapo (R-ID), the two most senior members of the Senate Banking Committee, released a proposed bill (or Johnson-Crapo Bill), which is generally based on earlier legislation proposed by Senators Bob Corker (R-TN) and Mark Warner (D-VA). The Johnson-Crapo Bill, among other things, would eliminate Freddie Mac and Fannie Mae and replace them with a new agency. The final outcome of the Johnson-Crapo Bill remains uncertain, as

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reports indicate that the House Republican leadership continues to favor a very different approach. However, it is possible that the adoption of the Johnson-Crapo Bill or other similar legislation could adversely effect the types of assets we can buy and our business operations. As the Federal Housing Finance Agency and both houses of Congress are each working on separate measures intended to dramatically restructure the U.S. housing finance system and the operations of Fannie Mae and Freddie Mac, we expect debate and discussion on the topic to continue throughout 2014.

Results of Operations

Quarter Ended March 31, 2014 Compared to the Quarter Ended March 31, 2013

General

For the first quarter of 2014, we had net income available to common stock and participating securities of \$72.4 million, or \$0.20 per basic and diluted common share, compared to net income available to common stock and participating securities of \$75.3 million, or \$0.21 per basic and diluted common share, for the first quarter of 2013. The decrease in net income available to our common stock and participating securities, and the decrease of this item on a per share basis reflects lower interest income, driven by lower average balances of Agency and Non-Agency MBS, and higher interest expense due primarily to higher Non-Agency financing costs partially offset by higher yields on Non-Agency MBS. Since the third quarter of 2013, the Company has taken steps to reduce interest rate risk by using derivatives to reduce the duration of our investment portfolio which resulted in an increase in Non-Agency borrowing costs. Yields on Agency MBS were marginally lower compared to the prior year period and were impacted by the lower interest rate environment, while yields on Non-Agency MBS were higher compared to the prior period due primarily to the impact of credit reserve releases. In addition, we had an increase in preferred stock dividends resulting from the issuance of the Series B Preferred Stock in 2013. (See Note 11 to the accompanying consolidated financial statements, included under Item 1 of this Quarterly Report on Form 10-Q).

Net Interest Income

Net interest income represents the difference between income on interest-earning assets and expense on interest-bearing liabilities. Net interest income depends primarily upon the volume of interest-earning assets and interest-bearing liabilities and the corresponding interest rates earned or paid. Our net interest income varies primarily as a result of changes in interest rates, the slope of the yield curve (i.e., the differential between long-term and short-term interest rates), borrowing costs (i.e., our interest expense) and prepayment speeds on our MBS. Interest rates and CPRs (which measure the amount of unscheduled principal prepayment on a bond as a percentage of the bond balance), vary according to the type of investment, conditions in the financial markets, and other factors, none of which can be predicted with any certainty.

The changes in average interest-earning assets and average interest-bearing liabilities and their related yields and costs are discussed in greater detail below under “Interest Income” and “Interest Expense.”

For the first quarter of 2014, our net interest spread and margin were 2.44% and 2.84%, respectively, compared to a net interest spread and margin of 2.32% and 2.69%, respectively, for the first quarter of 2013. Although our net interest spread and margin increased, our net interest income decreased by \$2.3 million, or 2.82% to \$80.3 million from \$82.6 million for the first quarter of 2013. This decrease primarily reflects the impact of the lower average balance of our MBS portfolio as measured by amortized cost, increased Non-Agency MBS borrowing costs (including the impact of allocated Swap expense), partially offset by higher yielding Non-Agency MBS due to strong credit performance. The net interest spread on our Agency MBS portfolio remained unchanged at 1.18% for the first quarters of 2014 and 2013. The net interest spread on our Non-Agency MBS portfolio increased to 4.81% for the first quarter

of 2014 compared to 4.35% for the first quarter of 2013.

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## Analysis of Net Interest Income

The following table sets forth certain information about the average balances of our assets and liabilities and their related yields and costs for the three months ended March 31, 2014 and 2013. Average yields are derived by dividing annualized interest income by the average amortized cost of the related assets and average costs are derived by dividing annualized interest expense by the daily average balance of the related liabilities, for the periods shown. The yields and costs include premium amortization and purchase discount accretion which are considered adjustments to interest rates.

(Dollars in Thousands)	Three Months Ended March 31,			2013		
	Average Balance	Interest	Average Yield/Cost	Average Balance	Interest	Average Yield/Cost
Assets:						
Interest-earning assets:						
Agency MBS (1)	\$6,582,184	\$39,329	2.39 %	\$7,068,326	\$42,787	2.42 %
Non-Agency MBS (1)	4,198,327	81,819	7.80	4,701,813	79,915	6.80
Total MBS	10,780,511	121,148	4.50	11,770,139	122,702	4.17
Cash and cash equivalents (2)	443,086	26	0.02	436,223	36	0.03
Total interest-earning assets	11,223,597	121,174	4.32	12,206,362	122,738	4.02
Total non-interest-earning assets	1,377,740			1,504,221		
Total assets	\$12,601,337			\$13,710,583		
Liabilities and stockholders' equity:						
Interest-bearing liabilities:						
Agency repurchase agreements (3)	\$5,823,463	\$17,328	1.21	\$6,413,742	\$19,640	1.24
Non-Agency repurchase agreements (3)	2,588,582	19,401	3.04	2,460,110	15,035	2.47
Total repurchase agreements	8,412,045	36,729	1.77	8,873,852	34,675	1.58
Securitized debt	336,893	2,185	2.63	606,858	3,476	2.32
Senior Notes	100,000	2,007	8.03	100,000	2,007	8.03
Total interest-bearing liabilities	8,848,938	40,921	1.88	9,580,710	40,158	1.70
Total non-interest-bearing liabilities	568,592			752,442		
Total liabilities	9,417,530			10,333,152		
Stockholders' equity	3,183,807			3,377,431		
Total liabilities and stockholders' equity	\$12,601,337			\$13,710,583		
Net interest income/ net interest rate spread (4)		\$80,253	2.44 %		\$82,580	2.32 %
Net interest-earning assets/ net interest margin (5)	\$2,374,659		2.84 %	\$2,625,652		2.69 %
Ratio of interest-earning assets to interest-bearing liabilities	1.27	x		1.27	x	

- (1) Yields presented throughout this Quarterly Report on Form 10-Q are calculated using average amortized cost data which excludes unrealized gains and losses and includes principal payments receivable on such MBS. For GAAP reporting purposes, MBS purchases and sales are reported on the trade date. Average

amortized cost data used to determine yields is calculated based on the settlement date of the associated purchase or sale as interest income is not earned on purchased bonds and continues to be earned on sold bonds until settlement date. Includes Non-Agency MBS transferred to consolidated VIEs.

(2) Includes average interest-earning cash, cash equivalents and restricted cash.

(3) Average cost of repurchase agreements includes the cost of Swaps allocated based on the proportionate share of the overall estimated weighted average portfolio duration.

(4) Net interest rate spread reflects the difference between the yield on average interest-earning assets and average cost of funds.

(5) Net interest margin reflects annualized net interest income divided by average interest-earning assets.

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## Rate/Volume Analysis

The following table presents the extent to which changes in interest rates (yield/cost) and changes in the volume (average balance) of interest-earning assets and interest-bearing liabilities have affected our interest income and interest expense during the periods indicated. Information is provided in each category with respect to: (i) the changes attributable to changes in volume (changes in average balance multiplied by prior rate); (ii) the changes attributable to changes in rate (changes in rate multiplied by prior average balance); and (iii) the net change. The changes attributable to the combined impact of volume and rate have been allocated proportionately, based on absolute values, to the changes due to rate and volume.

(In Thousands)	Three Months Ended March 31, 2014 Compared to Three Months Ended March 31, 2013		
	Increase/(Decrease) due to		Total Net Change in Interest Income/Expense
	Volume	Rate	
Interest-earning assets:			
Agency MBS	\$ (2,911	) \$ (547	) \$ (3,458 )
Non-Agency MBS	(9,088	) 10,992	1,904
Cash and cash equivalents	1	(11	) (10 )
Total net change in income from interest-earning assets	\$ (11,998	) \$ 10,434	\$ (1,564 )
Interest-bearing liabilities:			
Agency repurchase agreements	\$ (1,790	) \$ (522	) \$ (2,312 )
Non-Agency repurchase agreements	818	3,548	4,366
Securitized debt	(1,706	) 415	(1,291 )
Total net change in expense of interest-bearing liabilities	\$ (2,678	) \$ 3,441	\$ 763
Net change in net interest income	\$ (9,320	) \$ 6,993	\$ (2,327 )

The following table presents certain quarterly information regarding our net interest spread and net interest margin for the quarterly periods presented:

Quarter Ended	Total Interest-Earning Assets and Interest-Bearing Liabilities	
	Net Interest Spread (1)	Net Interest Margin (2)
March 31, 2014	2.44	% 2.84 %
December 31, 2013	2.34	2.75
September 30, 2013	2.24	2.63
June 30, 2013	2.38	2.73
March 31, 2013	2.32	2.69

(1) Reflects the difference between the yield on average interest-earning assets and average cost of funds.

(2) Reflects annualized net interest income divided by average interest-earning assets.

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The following table presents the components of the net interest spread earned on our Agency and Non-Agency MBS for the quarterly periods presented:

Quarter Ended	Agency MBS			Non-Agency MBS			Total MBS		
	Net Yield (1)	Cost of Funding (2)	Net Interest Spread (3)	Net Yield (1)	Cost of Funding (2)	Net Interest Spread (3)	Net Yield (1)	Cost of Funding (2)	Net Interest Spread (3)
March 31, 2014	2.39 %	1.21 %	1.18 %	7.80 %	2.99 %	4.81 %	4.50 %	1.80 %	2.70 %
December 31, 2013	2.37	1.26	1.11	7.77	3.01	4.76	4.48	1.85	2.63
September 30, 2013	2.13	1.12	1.01	7.33	2.91	4.42	4.20	1.74	2.46
June 30, 2013	2.19	1.15	1.04	7.15	2.41	4.74	4.18	1.56	2.62
March 31, 2013	2.42	1.24	1.18	6.80	2.45	4.35	4.17	1.63	2.54

(1) Reflects annualized interest income on MBS divided by average amortized cost of MBS.

Reflects annualized interest expense divided by average balance of repurchase agreements, including the cost of swaps allocated based on the proportionate share of the overall estimated weighted average portfolio duration and securitized debt. Agency cost of funding includes 85, 86 and 74 basis points and Non-Agency cost of funding

(2) includes 74, 72 and 57 basis points associated with Swaps to hedge interest rate sensitivity on these assets for the quarters ended March 31, 2014, December 31, 2013 and September 30, 2013, respectively. Agency cost of funding includes 100 and 88 basis points associated with Swaps to hedge interest rate sensitivity on these assets for the quarters ended June 30, 2013 and March 31, 2013 respectively.

(3) Reflects the difference between the net yield on average MBS and average cost of funds on MBS.

## Interest Income

Interest income on our Agency MBS for the first quarter of 2014 decreased by \$3.5 million, or 8.1% to \$39.3 million from \$42.8 million for the first quarter of 2013. This change primarily reflects a \$486.1 million decrease in the average amortized cost of our Agency MBS portfolio to \$6.582 billion for the first quarter of 2014 from \$7.068 billion for the first quarter of 2013 and a decrease in the net yield on our Agency MBS to 2.39% for the first quarter of 2014 from 2.42% for the first quarter of 2013. At the end of the first quarter of 2014, the average coupon on mortgages underlying our Agency MBS was lower compared to the end of the first quarter of 2013, due to acquisition of assets in the marketplace at generally lower coupons reflecting current market conditions and as a result of prepayments on higher yielding assets and downward resets on Hybrid and ARM-MBS within the portfolio. As a result, the coupon yield on our Agency MBS portfolio declined 24 basis points to 3.01% for the first quarter of 2014 from 3.25% for the first quarter of 2013. During the first quarter of 2014, our Agency MBS portfolio experienced an 11.5% CPR and we recognized \$10.2 million of net premium amortization compared to a CPR of 19.1% and \$14.7 million of net premium amortization for the first quarter of 2013. At March 31, 2014, we had net purchase premiums on our Agency MBS of \$249.9 million, or 3.8% of current par value, compared to net purchase premiums of \$226.8 million and 3.6% of par value at December 31, 2013.

Interest income on our Non-Agency MBS (which includes Non-Agency MBS transferred to consolidated VIEs) increased \$1.9 million, or 2.4%, for the first quarter of 2014 to \$81.8 million compared to \$79.9 million for the first quarter of 2013, primarily due to the increase in the net yield on our Non-Agency MBS portfolio, partially offset by the decrease in the amortized cost of our Non-Agency MBS portfolio. Our Non-Agency MBS portfolio yielded 7.80% for the first quarter of 2014 compared to 6.80% for the first quarter of 2013. For the first quarter of 2014, the average amortized cost of our Non-Agency MBS decreased by \$503.5 million or 10.7%, to \$4.198 billion, from \$4.702 billion for the first quarter of 2013. The increase in the yield on our Non-Agency MBS is primarily due to increases in



accretable discount and changes in the forward yield curve, partially offset by the addition of newly acquired assets at yields less than our overall portfolio yield. During the first quarter of 2014, we recognized net purchase discount accretion of \$27.4 million on our Non-Agency MBS, compared to \$12.0 million for the first quarter of 2013. At March 31, 2014, we had net purchase discounts of \$1.483 billion, including Credit Reserve and previously recognized OTTI of \$1.042 billion, on our Non-Agency MBS, or 25.8% of par value. During the first quarter of 2014 we reallocated \$35.9 million of purchased discount designated as Credit Reserve to accretable purchase discount.

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The following table presents the components of the coupon yield and net yields earned on our Agency MBS and Non-Agency MBS and weighted average CPRs experienced for such MBS for the quarterly periods presented:

Quarter Ended	Agency MBS			Non-Agency MBS			Total MBS		
	Coupon Yield (1)	Net Yield (2)	Weighted Average CPR	Coupon Yield (1)	Net Yield (2)	Weighted Average CPR	Coupon Yield (1)	Net Yield (2)	Weighted Average CPR
March 31, 2014	3.01 %	2.39 %	11.54 %	5.19 %	7.80 %	11.90 %	3.86 %	4.50 %	11.71 %
December 31, 2013	3.04	2.37	12.87	5.40	7.77	14.16	3.96	4.48	13.42
September 30, 2013	3.07	2.13	19.25	5.59	7.33	18.15	4.07	4.20	18.77
June 30, 2013	3.14	2.19	20.19	5.71	7.15	16.37	4.17	4.18	18.53
March 31, 2013	3.25	2.42	19.08	5.78	6.80	15.06	4.26	4.17	17.34

Reflects the annualized coupon interest income divided by the average amortized cost. The discounted purchase price on Non-Agency MBS causes the coupon yield to be higher than the pass-through coupon interest rate. (Does not include MBS underlying our Linked Transactions. See Note 5 to the accompanying consolidated financial statements, included under Item 1 of this Quarterly Report on Form 10-Q.)

(2) Reflects annualized interest income on MBS divided by average amortized cost of MBS.

## Interest Expense

Our interest expense for the first quarter of 2014 increased by \$763,000, or 1.9% to \$40.9 million, from \$40.2 million for the first quarter of 2013. This increase primarily reflects higher effective funding costs associated with Non-Agency MBS, including allocated Swap financing costs. In addition, the average balance of Non-Agency MBS financing increased, which was partially offset by a decrease in our average borrowings to finance Agency MBS, the lower effective interest rate paid on borrowings to finance Agency MBS and a decrease in the average balance of securitized debt.

At March 31, 2014, we had repurchase agreement borrowings of \$8.606 billion of which \$4.078 billion was hedged with Swaps, and securitized debt of \$292.5 million. At March 31, 2014, our Swaps designated in hedging relationships had a weighted average fixed-pay rate of 1.92% and extended 49 months on average with a maximum remaining term of approximately 113 months.

The following table presents information about our securitized debt at March 31, 2014:

Benchmark Interest Rate (Dollars in Thousands)	At March 31, 2014 Securitized Debt Interest Rate		
30 Day LIBOR + 100 basis points	\$74,890	1.02	%
30 Day LIBOR + 125 basis points	34,410	1.27	
Fixed Rate	85,250	2.85	
Weighted Average Coupon Rate	97,976	3.89	
Total	\$292,526	2.54	%

The effective interest rate paid on our borrowings increased to 1.88% for the quarter ended March 31, 2014 from 1.70% for the quarter ended March 31, 2013. This increase reflects additional higher cost financing (including the allocation of Swap expense) associated with our Non-Agency MBS portfolio partially offset by the lower average balance of Agency repurchase agreements and securitized debt and the maturity of Swaps with higher fixed-pay rates. Payments made and/or received on our Swaps are a component of our borrowing costs and accounted for interest

expense of \$17.6 million or 80 basis points, for the quarter ended March 31, 2014, compared to interest expense of \$13.0 million, or 55 basis points, for the first quarter of 2013. Certain of our Swaps have fixed interest rates that are significantly higher than current market interest rates. The weighted average fixed-pay rate on our Swaps designated as hedges decreased to 1.92% for the quarter ended March 31, 2014 from 2.27% for the quarter ended March 31, 2013. The weighted average variable interest rate received on our Swaps designated as hedges decreased to 0.16% for the quarter ended March 31, 2014 from 0.21% for the quarter ended March 31, 2013. During the quarter ended March 31, 2014, we entered into two new Swaps with an aggregate notional amount of \$200.0 million, a weighted average fixed-pay rate of 1.95% with initial maturities ranging from five to seven years, and had Swaps with an aggregate notional amount of \$41.9 million and a weighted average fixed-pay rate of 3.92% amortize and/or expire.

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We expect that our interest expense and funding costs for the remainder of 2014 will be impacted by market interest rates, the amount of our borrowings and incremental hedging activity, our existing and future interest rates on our hedging instruments and the extent to which we execute additional longer-term structured financing transactions. As a result of these variables, our borrowing costs cannot be predicted with any certainty. (See Notes 5, 6 and 14 to the accompanying consolidated financial statements, included under Item 1 of this Quarterly Report on Form 10-Q.)

The following table presents our leverage multiples, as measured by debt-to-equity, at the dates presented:

At the Period Ended	GAAP Leverage Multiple (1)	Non-GAAP Leverage Multiple (2)
March 31, 2014	2.9	3.0
December 31, 2013	2.9	3.0
September 30, 2013	3.0	3.1
June 30, 2013	3.1	3.1
March 31, 2013	3.1	3.1

Represents the sum of borrowings under repurchase agreements, securitized debt, payable for unsettled MBS (1)purchases, and obligations to return securities obtained as collateral and Senior Notes divided by stockholders' equity.

The Non-GAAP Leverage Multiple reflects the sum of our borrowings under repurchase agreements, securitized debt, payable for unsettled MBS purchases, obligations to return securities obtained as collateral, Senior Notes and borrowings that are reported on our consolidated balance sheets as a component of Linked Transactions of \$206.0 million, \$102.7 million, \$82.4 million, \$33.2 million and \$34.1 million at March 31, 2014, December 31, 2013, (2)September 30, 2013, June 30, 2013 and March 31, 2013, respectively. We present a Non-GAAP leverage multiple since repurchase agreement borrowings that are a component of Linked Transactions may not be linked in the future and, if no longer linked, will be reported as repurchase agreement borrowings, which will increase our leverage multiple. (See Note 5 to the accompanying consolidated financial statements, included under Item 1 of this Quarterly Report on Form 10-Q.)

**OTTI**

During the first quarters of 2014 and 2013, we did not recognize any OTTI charges through earnings against our Non-Agency MBS. At March 31, 2014, we had 336 Agency MBS with a gross unrealized loss of \$75.6 million and 27 Non-Agency MBS with a gross unrealized loss of \$2.8 million. Impairments on Agency MBS in an unrealized loss position at March 31, 2014 are considered temporary and not credit related. Unrealized losses on Non-Agency MBS for which no OTTI was recorded during the quarter are considered temporary based on an assessment of changes in the expected cash flows for such MBS, which considers recent bond performance and expected future performance of the underlying collateral. Significant judgment is used both in the Company's analysis of expected cash flows for its Non-Agency MBS and any determination of the credit component of OTTI.

**Other Income, net**

For the first quarter of 2014, other income, net increased by \$3.2 million to \$6.4 million from \$3.2 million for the first quarter of 2013. Other income, net for the first quarter of 2014 primarily reflects \$3.6 million of net gains realized on the sale of certain Non-Agency MBS and unrealized net gains and net interest income of \$3.3 million on our Linked Transactions. During the three months ended March 31, 2014, we sold Non-Agency MBS for \$15.5 million, realizing gross gains of \$3.6 million. During the three months ended March 31, 2013, we sold certain Non-Agency MBS for \$6.1 million, realizing gross gains of \$1.7 million and sold U.S. Treasury securities for \$200.1 million, realizing gross

losses of approximately \$27,000. The unrealized net gains and net interest income from Linked Transactions of \$3.3 million for the three months ended March 31, 2014 included interest income of \$2.0 million on the underlying Non-Agency MBS, interest expense of \$551,000 on the borrowings under repurchase agreements and an increase of \$1.8 million in the fair value of the underlying securities. The unrealized net gains and net interest income on Linked Transactions of \$1.5 million for the three months ended March 31, 2013 included interest income of \$668,000 on the underlying Non-Agency MBS, interest expense of \$140,000 on borrowings under repurchase agreements and an increase of \$1.0 million in the fair value of the underlying securities. Changes in the market value of the securities underlying our Linked Transactions, the amount of bond purchases recorded as Linked Transactions in the future and the amount of Linked Transactions that become unlinked in the future, none of which can be predicted with any certainty, will impact future gains/(losses) on our Linked Transactions.

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## Operating and Other Expense

For the first quarter of 2014, we had compensation and benefits and other general and administrative expense of \$10.5 million, or 1.32% of average equity, compared to \$8.5 million, or 1.00% of average equity, for the first quarter of 2013. The \$1.2 million increase in our compensation and benefits expense to \$6.5 million for the first quarter of 2014, compared to \$5.3 million for the first quarter of 2013, primarily reflects an increase in equity-based compensation expense for RSUs awarded during 2014 as well as increases in salary and bonus expense and payroll taxes. Our other general and administrative expenses increased by \$784,000 to \$4.0 million for the quarter ended March 31, 2014 compared to \$3.2 million for the quarter ended March 31, 2013. The increase was primarily due to higher personnel related and business development expense in support of our residential asset investment strategy.

## Selected Financial Ratios

The following table presents information regarding certain of our financial ratios at or for the dates presented:

At or for the Quarter Ended	Return on Average Total Assets (1)	Return on Average Total Stockholders' Equity (2)	Total Average Stockholders' Equity to Total Average Assets (3)	Dividend Payout Ratio (4)	Book Value per Share of Common Stock (5)
March 31, 2014	2.30	% 9.10	% 25.27	% 1.00	% \$8.20
December 31, 2013	2.37	9.55	24.80	0.98	8.06
September 30, 2013	2.10	8.71	24.12	1.18	(6) 7.85
June 30, 2013	2.10	8.29	25.35	1.16	8.19
March 31, 2013	2.20	8.92	24.63	1.05	(7) 8.84

(1) Reflects annualized net income divided by average total assets.

(2) Reflects annualized net income divided by average total stockholders' equity.

(3) Reflects total average stockholders' equity divided by total average assets.

(4) Reflects dividends declared per share of common stock divided by earnings per share.

(5) Reflects total stockholders' equity less the preferred stock liquidation preference divided by total shares of common stock outstanding.

(6) Excludes the special common stock dividend declared on August 1, 2013.

(7) Excludes the special common stock dividend declared on March 4, 2013.

## Proposed Accounting Standards

The FASB has recently issued or discussed a number of proposed standards on such topics as repurchase agreements and similar transactions, measurement of credit impairment, financial instrument measurement and classification, revenue recognition, leases, hedging, disclosures about liquidity risk and interest rate risk, and disclosures of uncertainties about an Entity's going concern presumption. Some of the proposed changes are potentially significant and could have a material impact on the Company's reporting. The Company has not yet fully evaluated the potential impact of these proposals but will make such an evaluation as the standards are finalized.

## Liquidity and Capital Resources

## General

Our principal sources of cash generally consist of borrowings under repurchase agreements, payments of principal and interest we receive on our MBS portfolio, cash generated from our operating results and, depending on market

conditions, proceeds from capital market and resecuritization transactions. Our most significant uses of cash are generally to pay principal and interest on our borrowings under repurchase agreements and securitized debt, to purchase MBS, to make dividend payments on our capital stock, to fund our operations and to make other investments that we consider appropriate.

We seek to employ a diverse capital raising strategy under which we may issue capital stock and other types of securities. To the extent we raise additional funds through capital market transactions, we currently anticipate using the net proceeds from such transactions to acquire additional MBS, consistent with our investment policy, and for working capital which may include, among other things, the repayment of our repurchase agreements. There can be no assurance, however, that we will be able to access the capital markets at any particular time or on any particular terms. We have available for issuance an unlimited amount (subject to the terms and limitations of our charter) of common stock, preferred stock, depositary shares representing preferred

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stock, warrants, debt securities, rights and/or units pursuant to our automatic shelf registration statement and, at March 31, 2014, we had 10.5 million shares of common stock available for issuance pursuant to our DRSPS shelf registration statement. During the three months ended March 31, 2014, we issued 1,053,785 shares of common stock through our DRSPS, raising net proceeds of approximately \$7.6 million.

On April 15, 2013, we completed the issuance of 8.0 million shares of our Series B Preferred Stock, liquidation preference \$25.00 per share, in an underwritten public offering. The aggregate net proceeds to us from the offering of the Series B Preferred Stock were approximately \$193.3 million, after deducting the underwriting discount and related offering expenses. We used a portion of the net proceeds to redeem all of our outstanding Series A Preferred Stock (as discussed below), and used the remaining net proceeds of the offering for general corporate purposes, including, without limitation, to acquire additional MBS consistent with our investment policy, and for working capital, which may include, among other things, the repayment of our repurchase agreements.

On May 16, 2013, we redeemed all 3,840,000 outstanding shares of our Series A Preferred Stock, at an aggregate redemption price of approximately \$97.0 million, or \$25.27153 per share, including all accrued and unpaid dividends to the redemption date. The redemption value of the Series A Preferred Stock exceeded its carrying value by \$3.9 million, which represents the original offering costs for the Series A Preferred Stock.

Our borrowings under repurchase agreements are uncommitted and renewable at the discretion of our lenders and, as such, our lenders could determine to reduce or terminate our access to future borrowings at virtually any time. The terms of the repurchase transaction borrowings under our master repurchase agreements as such terms relate to repayment, margin requirements and the segregation of all securities that are the subject of repurchase transactions generally conform to the terms in the standard master repurchase agreement as published by SIFMA or the global master repurchase agreement published by SIFMA and the International Capital Market Association. In addition, each lender typically requires that we include supplemental terms and conditions to the standard master repurchase agreement. Typical supplemental terms and conditions, which differ by lender, may include changes to the margin maintenance requirements, required haircuts (as defined below), purchase price maintenance requirements, requirements that all controversies related to the repurchase agreement be litigated in a particular jurisdiction and cross default and setoff provisions.

With respect to margin maintenance requirements for repurchase agreements with Non-Agency MBS as collateral, margin calls are typically determined by our counterparties based on their assessment of changes in the fair value of the underlying collateral and in accordance with the agreed upon haircuts specified in the transaction confirmation with the counterparty. We address margin call requests in accordance with the required terms specified in the applicable repurchase agreement and such requests are typically satisfied by posting additional cash or collateral on the same business day. We review margin calls made by counterparties and assess them for reasonableness by comparing the counterparty valuation against our valuation determination. When we believe that a margin call is unnecessary because our assessment of collateral value differs from the counterparty valuation, we typically hold discussions with the counterparty and are able to resolve the matter. In the unlikely event that resolution cannot be reached, we will look to resolve the dispute based on the remedies available to us under the terms of the repurchase agreement, which in some instances may include the engagement of a third party to review collateral valuations. For other agreements that do not include such provisions, we could resolve the matter by substituting collateral as permitted in accordance with the agreement or otherwise request the counterparty to return the collateral in exchange for cash to unwind the financing.



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The following table presents information regarding the margin requirements, or the percentage amount by which the collateral value is contractually required to exceed the loan amount (this difference is referred to as the “haircut”), on our repurchase agreements at March 31, 2014 and December 31, 2013:

At March 31, 2014	Weighted Average Haircut	Low	High	
Repurchase agreement borrowings secured by:				
Agency MBS	4.69	% 3.00	% 6.00	%
Non-Agency MBS	32.74	10.00	63.00	
U.S. Treasury securities	1.69	1.00	2.00	
At December 31, 2013	Weighted Average Haircut	Low	High	
Repurchase agreement borrowings secured by:				
Agency MBS	4.89	% 3.00	% 6.00	%
Non-Agency MBS	32.48	10.00	63.00	
U.S. Treasury securities	1.65	1.00	2.00	

The weighted average haircut requirements for the respective underlying collateral types for our repurchase agreements have not significantly changed since December 31, 2013.

During the first three months of 2014, the financial market environment was impacted by continued accommodative monetary policy. Repurchase agreement funding for both Agency MBS and Non-Agency MBS has been available to us at generally attractive market terms from multiple counterparties. Typically, due to the credit risk inherent to Non-Agency MBS, repurchase agreement funding involving Non-Agency MBS is available from fewer counterparties, at terms requiring higher collateralization and higher interest rates, than repurchase agreement funding secured by Agency MBS and U.S. Treasury securities. Therefore, we generally expect to be able to finance our acquisitions of Agency MBS (which we expect will continue to comprise the majority of our assets) on more favorable terms than financing for Non-Agency MBS.

We maintain cash and cash equivalents, unpledged Agency MBS and collateral in excess of margin requirements held by our counterparties (or collectively, our Cushion) to meet routine margin calls and protect against unforeseen reductions in our borrowing capabilities. Our ability to meet future margin calls will be impacted by the amount of our Cushion, which varies based on the market value of our securities, our cash position and margin requirements. Our cash position fluctuates based on the timing of our operating, investing and financing activities and is managed based on our anticipated cash needs. (See our consolidated statements of cash flows, included under Item 1 of this Quarterly Report on Form 10-Q and “Interest Rate Risk” included under Item 3 of this Quarterly Report on Form 10-Q.)

At March 31, 2014, we had a total of \$10.553 billion of MBS and U.S. Treasury securities and \$26.1 million of restricted cash pledged against our repurchase agreements and Swaps. At March 31, 2014, we had a Cushion of \$737.0 million available to meet potential margin calls, comprised of cash and cash equivalents of \$274.7 million, unpledged Agency MBS of \$434.7 million, and excess Agency MBS collateral of \$27.6 million. In addition, at March 31, 2014, we had unpledged Non-Agency MBS with a fair value of \$273.9 million and Non-Agency MBS with a fair value of \$290.9 million pledged in excess of contractual requirements.

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The table below presents certain information about our borrowings under repurchase agreements and securitized debt:

Quarter Ended (1)	Repurchase Agreements			Securitized Debt		
	Quarterly Average Balance	End of Period Balance	Maximum Balance at Any Month-End	Quarterly Average Balance	End of Period Balance	Maximum Balance at Any Month-End
(In Thousands)						
March 31, 2014	\$8,412,045	\$8,606,129	\$8,606,129	\$336,893	\$292,526	\$338,965
December 31, 2013	8,462,138	8,339,297	8,504,593	399,762	366,205	398,384
September 30, 2013	8,679,410	8,568,171	8,721,573	440,665	419,693	462,207
June 30, 2013	8,842,018	8,909,283	8,909,283	505,409	443,748	508,893
March 31, 2013	8,873,852	8,902,827	8,956,951	606,858	542,014	609,707

(1) The information presented in the table above excludes Senior Notes issued in April 2012. The outstanding balance of Senior Notes has been unchanged at \$100.0 million since issuance.

#### Cash Flows and Liquidity For the Three Months Ended March 31, 2014

Our cash and cash equivalents decreased by \$290.7 million during the three months ended March 31, 2014, reflecting: \$434.5 million used in our investing activities, primarily from purchases of MBS; \$95.6 million provided by our financing activities; and \$48.3 million provided by our operating activities.

At both March 31, 2014 and December 31, 2013, our debt-to-equity multiple was 2.9 times. At March 31, 2014, we had borrowings under repurchase agreements of \$8.606 billion with 26 counterparties, of which \$6.019 billion was secured by Agency MBS, \$2.155 billion was secured by Non-Agency MBS and \$432.0 million was secured by U.S. Treasuries. In addition, at such date, we had \$206.0 million of borrowings under repurchase agreements that were a component of our Linked Transactions. (See Note 5 to the consolidated financial statements, included under Item 1 of this Quarterly Report on Form 10-Q.) We continue to have available capacity under our repurchase agreement credit lines. At December 31, 2013, we had borrowings under repurchase agreements of \$8.339 billion with 26 counterparties and had borrowings under repurchase agreements of \$102.7 million that were a component of our Linked Transactions.

At March 31, 2014, outstanding securitized debt was \$292.5 million, which had a weighted average expected remaining term of 0.69 years. During the three months ended March 31, 2014, securitized debt was reduced by principal payments of \$73.3 million.

During the three months ended March 31, 2014 we used \$434.5 million through our investing activities. We received cash of \$438.1 million from prepayments and scheduled amortization on our MBS portfolio, of which \$285.1 million was attributable to Agency MBS and \$153.1 million was from Non-Agency MBS. We purchased \$606.0 million of Agency MBS and \$282.1 million of Non-Agency MBS funded with cash and repurchase agreement borrowings. While we generally intend to hold our MBS as long-term investments, we may sell certain MBS in order to manage our interest rate risk and liquidity needs, meet other operating objectives and adapt to market conditions. In addition, during the three months ended March 31, 2014 we sold certain of our Non-Agency MBS for \$15.5 million, realizing gross gains of \$3.6 million.

In connection with our repurchase agreement borrowings and Swaps, we routinely receive margin calls/reverse margin calls from our counterparties and make margin calls to our counterparties. Margin calls and reverse margin calls, which requirements vary over time, may occur daily between us and any of our counterparties when the value of

collateral pledged changes from the amount contractually required. The value of securities pledged as collateral fluctuates reflecting changes in: (i) the face (or par) value of our MBS; (ii) market interest rates and/or other market conditions; and (iii) the market value of our Swaps. Margin calls/reverse margin calls are satisfied when we pledge/receive additional collateral in the form of additional securities and/or cash.

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The table below summarizes our margin activity with respect to our repurchase agreement financings (including underlying Linked Transactions) and derivative hedging instruments for the quarterly periods presented:

For the Quarter Ended	Collateral Pledged to Meet Margin Calls		Aggregate Assets Pledged For Margin Calls	Cash and Securities Received for Reverse Margin Calls	Net Assets Received/(Pledged) for Margin Activity
	Fair Value of Securities Pledged	Cash Pledged			
(In Thousands)					
March 31, 2014	\$238,306	\$29,000	\$267,306	\$285,544	\$18,238
December 31, 2013	282,521	8,500	291,021	242,652	(48,369)
September 30, 2013	395,970	61,400	457,370	506,703	49,333
June 30, 2013	421,744	2	421,746	294,067	(127,679)
March 31, 2013	631,265	—	631,265	575,083	(56,182)

We are subject to various financial covenants under our repurchase agreements and derivative contracts, which include minimum net worth and/or profitability requirements, maximum debt-to-equity ratios and minimum market capitalization requirements. We have maintained compliance with all of our financial covenants through March 31, 2014.

During the three months ended March 31, 2014, we paid \$73.3 million for cash dividends on our common stock and DERs and paid cash dividends of \$3.8 million on our preferred stock. On March 10, 2014, we declared our first quarter 2014 dividend on our common stock of \$0.20 per share; on April 30, 2014, we paid this dividend which totaled approximately \$73.5 million, including DERs of approximately \$193,000.

We believe that we have adequate financial resources to meet our current obligations, including margin calls, as they come due, to fund dividends we declare and to actively pursue our investment strategies. However, should the value of our MBS suddenly decrease, significant margin calls on our repurchase agreement borrowings could result and our liquidity position could be materially and adversely affected. Further, should market liquidity tighten, our repurchase agreement counterparties may increase our margin requirements on new financings, reducing our ability to use leverage. Access to financing may also be negatively impacted by the ongoing volatility in the world financial markets, potentially adversely impacting our current or potential lenders' ability or willingness to provide us with financing. In addition, there is no assurance that favorable market conditions will continue to permit us to consummate additional securitization transactions if we determine to seek that form of financing.

#### Off-Balance Sheet Arrangements

We do not have any material off-balance-sheet arrangements. Our Linked Transactions are comprised of MBS, associated repurchase agreements and interest receivable/payable on such accounts. The extent to which these transactions become unlinked in the future, the underlying MBS and the borrowings under repurchase agreements and associated interest income and expense will be presented on a gross basis on our consolidated balance sheets and statements of operations, prospectively. (See page 59 for information about our leverage multiple and Note 5 to the accompanying consolidated financial statements, included under Item 1 of this Quarterly Report on Form 10-Q.)

#### Inflation

Substantially all of our assets and liabilities are financial in nature. As a result, changes in interest rates and other factors impact our performance far more than does inflation. Our financial statements are prepared in accordance with GAAP and dividends declared are based upon net ordinary income as calculated for tax purposes. In each case, our

results of operations and reported assets, liabilities and equity are measured with reference to historical cost or fair value without considering inflation.

#### Other Matters

Commencing in the second quarter of 2014, we have organized ourselves as a holding company and conduct our real estate businesses primarily through wholly-owned subsidiaries. We conduct our real estate business so that we are not subject to regulation under the Investment Company Act by maintaining less than 40% of the value of our total assets, exclusive of U.S. Government securities and cash items (which we refer to as our adjusted total assets for Investment Company Act purposes), on an unconsolidated basis consist of “investment securities” as defined by the Investment Company Act. We refer to this test as the “40% Test”.

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Certain of the subsidiaries through which we operate our business rely upon the exclusion from the definition of investment company provided by Section 3(c)(5)(C) of the Investment Company Act. Section 3(c)(5)(C), as interpreted by the staff of the SEC, requires an entity to invest at least 55% of its assets in “mortgages and other liens on and interests in real estate,” which we refer to as “qualifying real estate assets,” and at least 80% of its assets in qualifying real estate assets plus “real estate-related assets.” In satisfying the 55% requirement, the entity may treat securities issued with respect to an underlying pool of mortgage loans in which it holds all of the certificates issued by the pool as qualifying real estate assets. We treat the whole pool Agency certificates in which we invest as qualifying real estate assets for purposes of the 55% requirement.

We also have formed, and may in the future form, certain other wholly-owned or majority-owned subsidiaries that rely upon the exclusion from the definition of investment company under the Investment Company Act provided by Section 3(c)(1) or 3(c)(7) of the Investment Company Act. The securities issued by any wholly-owned or majority-owned subsidiary that relies on the exclusion from the definition of investment company provided by Section 3(c)(1) or 3(c)(7), together with any other investment securities we may own, may not have a value in excess of 40% of the value of our adjusted total assets on an unconsolidated basis. We monitor our compliance with the 40% Test and the operations of our subsidiaries so that we and each of our subsidiaries may maintain compliance with an exclusion from registration as an investment company under the Investment Company Act.

On August 31, 2011, the SEC issued a “concept release” under which it announced that it is reviewing interpretive issues related to the Section 3(c)(5)(C) exclusion, including requesting comments on whether it should reconsider whether whole pool certificates may be treated as qualifying real estate assets and whether companies, such as certain of our subsidiaries, whose primary business consists of investing in whole pool certificates, are the type of entities that Congress intended to be covered by the exclusion provided by Section 3(c)(5)(C).

The potential timetable and outcome of the SEC’s review are unclear. However, if the SEC determines that whole pool certificates are not qualifying real estate assets, adopts an otherwise adverse interpretation with respect to whole pool certificates, issues different guidance regarding any of the matters bearing upon the exclusion under Section 3(c)(5)(C) or otherwise believes we do not satisfy an Investment Company Act exclusion, we would be required to significantly restructure our operations in order to maintain our investment company exclusion. Under these circumstances, our ability to use leverage and our access to more favorable methods of financing would be substantially reduced, and we would be unable to conduct our business as we currently conduct it. We may also be required to sell certain of our assets and/or limit the types of assets we acquire. Under the circumstances described above, it is likely that our net interest income would be significantly reduced, which would materially and adversely affect our business.

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## Item 3. Quantitative and Qualitative Disclosures About Market Risk.

We seek to manage our risks related to interest rates, liquidity, prepayment speeds, market value and the credit quality of our assets while, at the same time, seeking to provide an opportunity to stockholders to realize attractive total returns through ownership of our capital stock. While we do not seek to avoid risk, we seek, consistent with our investment policies, to: assume risk that can be quantified based on management's judgment and experience and actively manage such risk; earn sufficient returns to justify the taking of such risks; and maintain capital levels consistent with the risks that we undertake.

## Interest Rate Risk

We generally acquire interest-rate sensitive assets and fund them with interest-rate sensitive liabilities, a portion of which are hedged with Swaps. We are exposed to interest rate risk on our assets, both Agency and Non-Agency MBS, and our liabilities, repurchase agreements and securitized debt. Changes in interest rates can affect our net interest income and the fair value of our assets and liabilities.

We finance the majority of our investments in Agency and Non-Agency MBS with short-term repurchase agreements. In general, the borrowing cost of our repurchase agreements changes more quickly, including the impact of Swaps, than the yield on our assets when interest rates change. In a rising interest rate environment the borrowing cost of our repurchase agreements may increase faster than the interest income on our assets, lowering our net income. In order to mitigate compression in net income based on such interest rate movements, we use Swaps and other hedging instruments to lock in a portion of the net interest spread between assets and liabilities.

The fair value of our MBS assets could change at a different rate than the fair value of our liabilities when interest rates change. We measure the sensitivity of our portfolio to changes in interest rates by estimating the duration of our assets and liabilities. Duration is the approximate percentage change in fair value for a 100 basis point parallel shift in the yield curve. In general, our assets have higher duration than our liabilities and in order to reduce this exposure we use Swaps and other hedging instruments to reduce the gap in duration between our assets and liabilities.

In calculating the duration of our Agency MBS we take into account the characteristics of the underlying mortgage loans including whether the underlying loans are fixed rate, adjustable or hybrid; coupon, expected prepayment rates and lifetime and periodic caps. We use third-party financial models, combined with management's assumptions and observed empirical data when estimating the duration of our Agency MBS.

Over the past few years, as the expected yields on Non-Agency MBS were significantly greater than expected yields on non-credit sensitive assets, changes in Non-Agency MBS prices were generally not highly correlated to changes in market interest rates. We believe that this low sensitivity to increases in interest rates was due to the fact that periods of rising interest rates had been generally accompanied by an improvement in economic expectations and therefore, more positive scenarios for Non-Agency MBS. Also, wide risk premiums for Non-Agency MBS meant that spreads could tighten to allow Non-Agency MBS to retain value despite increases in interest rates.

Non-Agency prices have generally trended up during the last nine quarters. As with other financial assets, this has been driven by very accommodative Federal Reserve monetary policy. It has also been driven by strong mortgage credit fundamentals with increasing home prices, declining defaults, stable severities and higher voluntary prepayment rates.

At these higher prices and therefore lower yields, we believe that our Non-Agency MBS have become more interest rate sensitive and now exhibit positive duration. In analyzing the interest rate sensitivity of our Non-Agency MBS we take into account the characteristics of the underlying mortgage loans including credit quality and whether the underlying loans are fixed-rate, adjustable or hybrid. We estimate the duration of our Non-Agency MBS using management's assumptions.

We use Swaps as part of our overall interest rate risk management strategy. Such derivative financial instruments are intended to act as a hedge against future interest rate increases on our repurchase agreement financings, which rates are typically highly correlated with LIBOR. While our derivatives do not extend the maturities of our borrowings under repurchase agreements, they do, however, in effect, lock in a fixed rate of interest over their term for a

corresponding amount of our repurchase agreements that are hedged.



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At March 31, 2014, MFA's \$11.951 billion of Agency MBS and Non-Agency MBS, which includes \$68.6 million of MBS underlying Linked Transactions, were backed by Hybrid, adjustable and fixed-rate mortgages. Additional information about these MBS, including average months to reset and three-month average CPR, is presented below:

Time to Reset	Agency MBS			Non-Agency MBS			Total			
	Fair Value	Average Months to Reset (1)	Average CPR (2)	Fair Value	Average Months to Reset (1)	Average CPR (2)	Fair Value	Average Months to Reset (1)	Average CPR (2)	
(Dollars in Thousands)										
< 2 years (3)	\$2,324,385	8	14.1 %	\$2,967,167	5	10.7 %	\$5,291,552	6	12.0 %	
2-5 years	1,394,257	44	17.7	539,497	33	17.8	1,933,754	41	17.7	
> 5 years	706,398	77	10.2	—	—	—	706,398	77	10.2	
ARM-MBS Total	\$4,425,040	30	14.6 %	\$3,506,664	9	11.8 %	\$7,931,704	21	13.2 %	
15-year fixed (4)	\$2,415,993		6.6 %	\$12,737		21.6 %	\$2,428,730		6.6 %	
30-year fixed (4)	—		—	1,584,776		12.1	1,584,776		12.1	
40-year fixed (4)	—		—	5,892		3.4	5,892		3.4	
Fixed-Rate Total	\$2,415,993		6.6 %	\$1,603,405		12.2 %	\$4,019,398		8.9 %	
MBS Total	\$6,841,033		11.5 %	\$5,110,069		11.9 %	\$11,951,102		11.7 %	

Months to reset is the number of months remaining before the coupon interest rate resets. At reset, the MBS (1) coupon will adjust based upon the underlying benchmark interest rate index, margin and periodic or lifetime caps.

The months to reset do not reflect scheduled amortization or prepayments.

(2) Average CPR weighted by positions as of the beginning of each month in the quarter.

(3) Includes floating rate MBS that may be collateralized by fixed-rate mortgages.

(4) Information presented based on data available at time of loan origination.

The information presented in the following "Shock Table" projects the potential impact of sudden parallel changes in interest rates on our net interest income and portfolio value, including the impact of Swaps, over the next 12 months based on the assets in our investment portfolio at March 31, 2014. All changes in income and value are measured as the percentage change from the projected net interest income and portfolio value at the base interest rate scenario at March 31, 2014.

## Shock Table

Change in Interest Rates	Estimated Value of Assets (1)	Estimated Value of Swaps	Estimated Value of Financial Instruments Carried at Fair Value	Estimated Change in Fair Value	Percentage Change in Net Interest Income (2)	Percentage Change in Portfolio Value
(Dollars in Thousands)						
+100 Basis Point Increase	\$12,153,273	\$124,081	\$12,277,354	\$(121,784)	0.51 %	(0.98) %
+ 50 Basis Point Increase	\$12,294,372	\$48,405	\$12,342,777	\$(56,361)	0.31 %	(0.45) %
Actual at March 31, 2014	\$12,426,408	\$(27,270)	\$12,399,138	\$—	—	—
- 50 Basis Point Decrease	\$12,549,382	\$(102,945)	\$12,446,437	\$47,299	(3.08) %	0.38 %
-100 Basis Point Decrease	\$12,663,294	\$(178,620)	\$12,484,674	\$85,536	(9.65) %	0.69 %

- (1) Such assets include MBS, including linked MBS that are reported as a component of our Linked Transactions on our consolidated balance sheets, and cash and cash equivalents. Such linked MBS may not be linked in future periods.
- (2) Includes underlying interest income and interest expense associated with MBS and repurchase agreement borrowings underlying our Linked Transactions. Such MBS and repurchase agreements may not be linked in future periods.

Certain assumptions have been made in connection with the calculation of the information set forth in the Shock Table and, as such, there can be no assurance that assumed events will occur or that other events will not occur that would affect the outcomes. The base interest rate scenario assumes interest rates at March 31, 2014. The analysis presented utilizes assumptions and estimates based on management's judgment and experience. Furthermore, while we generally expect to retain the majority of such assets and the associated interest rate risk to maturity, future purchases and sales of assets could materially change our interest rate risk profile. It should be specifically noted that the information set forth in the above table and all related disclosure constitute forward-looking statements within the meaning of Section 27A of the 1933 Act and Section 21E of the 1934 Act. Actual results could differ significantly from those estimated in the Shock Table above.

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The Shock Table quantifies the potential changes in net interest income and portfolio value, which includes the value of our Swaps (which are carried at fair value), should interest rates immediately change (i.e., shocked). The Shock Table presents the estimated impact of interest rates instantaneously rising 50 and 100 basis points, and falling 50 and 100 basis points. The cash flows associated with our portfolio of MBS for each rate shock are calculated based on assumptions, including, but not limited to, prepayment speeds, yield on replacement assets, the slope of the yield curve and composition of our portfolio. Assumptions made on the interest rate sensitive liabilities, which are assumed to be repurchase financings and securitized debt, include anticipated interest rates, collateral requirements as a percent of the repurchase agreement, amount and term of borrowing. At March 31, 2014, we applied a floor of 0% for all anticipated interest rates included in our assumptions. Due to this floor, it is anticipated that any hypothetical interest rate shock decrease would have a limited positive impact on our funding costs; however, because prepayments speeds are unaffected by this floor, it is expected that any increase in our prepayment speeds (occurring as a result of any interest rate shock decrease or otherwise) could result in an acceleration of our premium amortization on our Agency MBS and discount accretion on our Non-Agency MBS and the reinvestment of principal repayments in lower yielding assets. As a result, because the presence of this floor limits the positive impact of interest rate decrease on our funding costs, hypothetical interest rate shock decreases could cause the fair value of our financial instruments and our net interest income to decline.

At March 31, 2014, the impact on portfolio value was approximated using estimated effective duration (i.e., the price sensitivity to changes in interest rates), including the effect of Swaps, of 0.83 which is the weighted average of 2.54 for our Agency MBS, 1.53 for our Non-Agency MBS, (3.62) for our Swaps and zero for our cash and cash equivalents. Estimated convexity (i.e., the approximate change in duration relative to the change in interest rates) of the portfolio was (0.29), which is the weighted average of (0.53) for our Agency MBS, zero for our Swaps, zero for our Non-Agency MBS and zero for our cash and cash equivalents. The impact on our net interest income is driven mainly by the difference between portfolio yield and cost of funding of our repurchase agreements (including those underlying our Linked Transactions), which includes the cost and/or benefit from Swaps. Our asset/liability structure is generally such that an increase in interest rates would be expected to result in a decrease in net interest income, as our borrowings are generally shorter in term than our interest-earning assets. When interest rates are shocked, prepayment assumptions are adjusted based on management's expectations along with the results from the prepayment model.

**Market Value Risk**

Our MBS are designated as "available-for-sale" and, as such, are reported at their fair value. The difference between amortized cost and fair value of our MBS is reflected in AOCI, a component of stockholders' equity, except that credit related impairments that are identified as other-than-temporary are recognized through earnings. Changes in the fair value of our Linked Transactions are reported in earnings. At March 31, 2014, our investment portfolio was comprised of Agency MBS and Non-Agency MBS. While changes in the fair value of our Agency MBS are generally not credit-related, changes in the fair value of our Non-Agency MBS and Linked Transactions may reflect both market and interest rate conditions as well as credit risk. At March 31, 2014, our Non-Agency MBS had a fair value of \$5.045 billion and an amortized cost of \$4.258 billion, comprised of gross unrealized gains of \$789.8 million and gross unrealized losses of \$2.8 million. At March 31, 2014, our Linked Transactions included MBS with a fair value of \$265.5 million, including net unrealized gains of \$6.1 million, which have been reflected through earnings to date as a component of unrealized net gains and net interest income from Linked Transactions.

Generally, in a rising interest rate environment, the fair value of our MBS would be expected to decrease; conversely, in a decreasing interest rate environment, the fair value of such MBS would be expected to increase. If the fair value of MBS collateralizing our repurchase agreements decreases, we may receive margin calls from our repurchase agreement counterparties for additional MBS collateral or cash due to such decline. If such margin calls are not met, our lender could liquidate the securities collateralizing our repurchase agreements with such lender, potentially

resulting in a loss to us. To avoid forced liquidations, we could apply a strategy of reducing borrowings and assets, by selling assets or not replacing securities as they amortize and/or prepay. Such an action would likely reduce our interest income, interest expense and net income, the extent of which would be dependent on the level of reduction in assets and liabilities as well as the price at which such assets are sold. Such a decrease in our net interest income could negatively impact cash available for dividend distributions, which in turn could reduce the market price of our issued and outstanding common stock and preferred stock.

In evaluating our asset/liability management and Non-Agency MBS credit performance, we consider the credit characteristics underlying our Non-Agency MBS, including those that are a component of our Linked Transactions. The following table presents certain information about our Non-Agency MBS portfolio and Non-Agency MBS underlying our Linked Transactions at March 31, 2014. Information presented with respect to the weighted average FICO scores and other information aggregated based on information reported at the time of mortgage origination are historical and, as such, does not reflect the impact of the general decline in home prices or changes in a borrower's credit score or the current use of the mortgaged property.

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The information in the table below is presented as of March 31, 2014:

Year of Securitization (2) (Dollars in Thousands)	Securities with Average Loan FICO of 715 or Higher (1)			Securities with Average Loan FICO Below 715 (1)			Total	
	2007	2006	2005 and Prior	2007	2006	2005 and Prior		
Number of securities	106	95	111	20	50	59	441	
MBS current face (3)	\$1,707,100	\$1,220,965	\$1,350,279	\$223,701	\$622,680	\$689,498	\$5,814,223	
Total purchase discounts, net (3)	\$(434,434 )	\$(349,636 )	\$(242,603 )	\$(79,342 )	\$(220,052)	\$(169,630)	\$(1,495,697)	
Purchase discount designated as Credit Reserve and OTTI (4)	\$(317,670 )	\$(203,604 )	\$(125,894 )	\$(62,344 )	\$(220,143)	\$(122,983)	\$(1,052,638)	
Purchase discount designated as Credit Reserve and OTTI as percentage of current face	18.6	% 16.7	% 9.3	% 27.9	% 35.4	% 17.8	% 18.1	%
MBS amortized cost (3)	\$1,272,665	\$871,329	\$1,107,676	\$144,359	\$402,628	\$519,867	\$4,318,524	
MBS fair value (3)	\$1,502,396	\$1,059,399	\$1,245,318	\$182,944	\$497,395	\$622,617	\$5,110,069	
Weighted average fair value to current face	88.0	% 86.8	% 92.2	% 81.8	% 79.9	% 90.3	% 87.9	%
Weighted average coupon (5)	4.35	% 3.64	% 3.27	% 4.28	% 4.61	% 4.35	% 3.98	%
Weighted average loan age (months) (5)(6)	84	93	107	88	95	108	96	
Weighted average current loan size (5)(6)	\$538	\$503	\$332	\$405	\$272	\$273	\$418	
Percentage amortizing (7)	37	% 57	% 64	% 46	% 57	% 63	% 53	%
Weighted average FICO score at origination (5)(8)	732	729	727	705	703	705	723	
Owner-occupied loans	90.1	% 89.3	% 85.5	% 80.3	% 85.1	% 83.8	% 87.2	%
Rate-term refinancings	27.8	% 18.8	% 15.2	% 20.1	% 15.9	% 14.0	% 19.8	%
Cash-out refinancings	32.7	% 33.7	% 25.9	% 44.9	% 41.9	% 37.4	% 33.3	%
3 Month CPR (6)	13.8	% 12.6	% 9.7	% 8.6	% 10.5	% 9.6	% 11.9	%
3 Month CRR (6)(9)	9.1	% 8.5	% 6.8	% 5.6	% 6.6	% 6.5	% 7.7	%
3 Month CDR (6)(9)	2.8	% 2.7	% 2.2	% 2.8	% 3.8	% 2.9	% 2.8	%
3 Month loss severity	54.4	% 46.0	% 45.6	% 60.6	% 60.5	% 44.8	% 51.0	%

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60+ days delinquent (8)	15.1	% 15.1	% 12.3	% 22.8	% 23.4	% 16.4	% 15.8	%
Percentage of always current borrowers (Lifetime) (10)	45.9	% 45.8	% 52.2	% 35.7	% 31.8	% 39.4	% 44.7	%
Percentage of always current borrowers (12M) (11)	71.1	% 71.8	% 75.2	% 61.1	% 60.3	% 65.9	% 70.0	%
Weighted average credit enhancement (8)(12)	0.2	% 0.8	% 4.3	% 0.1	% 0.9	% 5.9	% 2.0	%

(1) FICO score is used by major credit bureaus to indicate a borrower's creditworthiness at time of loan origination.

Information presented based on the initial year of securitization of the underlying collateral. Certain of our

(2) Non-Agency MBS have been resecuritized. The historical information presented in the table is based on the initial securitization date and data available at the time of original securitization (and not the date of resecuritized). No information has been updated with respect to any MBS that have been resecuritized.

(3) Excludes Non-Agency MBS issued in 2013 and 2014 in which the underlying collateral consists of re-performing loans that were originated in prior years. These Non-Agency MBS are a component of our re-performing deals and have a current face of \$199.8 million, amortized cost of \$199.1 million, fair value of \$200.6 million and purchase discounts of \$677,000 at March 31, 2014.

(4) Purchase discounts designated as Credit Reserve and OTTI are not expected to be accreted into interest income.

(5) Weighted average is based on MBS current face at March 31, 2014.

(6) Information provided is based on loans for individual groups owned by us.

(7) Percentage of face amount for which the original mortgage note contractually calls for principal amortization in the current period.

(8) Information provided is based on loans for all groups that provide credit enhancement for MBS with credit enhancement.

(9) CRR represents voluntary prepayments and CDR represents involuntary prepayments.

(10) Percentage of face amount of loans for which the borrower has not been delinquent since origination.

(11) Percentage of face amount of loans for which the borrower has not been delinquent in the last twelve months.

(12) Credit enhancement for a particular security is expressed as a percentage of all outstanding mortgage loan collateral. A particular security will not be subject to principal loss as long as its credit enhancement is greater than zero. As of March 31, 2014, a total of 284 Non-Agency MBS in our portfolio representing approximately \$3.527 billion or 61% of the current face amount of the portfolio had no credit enhancement.

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The mortgages securing our Non-Agency MBS are located in many geographic regions across the United States. The following table presents the six largest geographic concentrations of the mortgages collateralizing our Non-Agency MBS, including Non-Agency MBS underlying our Linked Transactions, at March 31, 2014:

Property Location	Percent
Southern California	27.6 %
Northern California	16.7 %
Florida	7.9 %
New York	5.4 %
Virginia	3.9 %
Maryland	3.5 %

## Liquidity Risk

The primary liquidity risk for us arises from financing long-maturity assets, with shorter-term borrowings primarily in the form of repurchase agreements. We pledge MBS and cash to secure our repurchase agreements, including repurchase agreements that are reported as a component to our Linked Transactions, and Swaps. At March 31, 2014, we had a Cushion of \$737.0 million available to meet potential margin calls, comprised of cash and cash equivalents of \$274.7 million, unpledged Agency MBS of \$434.7 million and Agency MBS with a fair value of \$27.6 million pledged in excess of contractual requirements. In addition, at March 31, 2014, we had unpledged Non-Agency MBS with a fair value of \$273.9 million and Non-Agency MBS with a fair value of \$290.9 million pledged in excess of contractual requirements. Should the value of our MBS pledged as collateral suddenly decrease, margin calls relating to our repurchase agreements could increase, causing an adverse change in our liquidity position. As such, we cannot be assured that we will always be able to roll over our repurchase agreements. Further, should market liquidity tighten, our repurchase agreement counterparties may increase our margin requirements on new financings, including repurchase agreement borrowings that we roll with the same counterparty, reducing our ability to use leverage.

## Credit Risk

Although we do not believe that we are exposed to credit risk in our Agency MBS portfolio, we are exposed to credit risk in our Non-Agency MBS portfolio. In the event of the return of less than 100% of par on our Non-Agency MBS, credit support contained in the MBS deal structures and the discount purchase prices we paid mitigate our risk of loss on these investments. Over time, we expect the level of credit support remaining in MBS deal structures to decrease, which will result in an increase in the amount of realized credit loss experienced by our Non-Agency MBS portfolio. Our Non-Agency investment process involves analysis focused primarily on quantifying and pricing credit risk. When we purchase Non-Agency MBS, we assign certain assumptions to each of the MBS, including but not limited to, future interest rates, voluntary prepayment rates, mortgage modifications, default rates and loss severities, and generally allocate a portion of the purchase discount as a Credit Reserve which provides credit protection for such securities. As part of our surveillance process, we review our Non-Agency MBS by tracking their actual performance compared to the security's expected performance at purchase or, if we have modified our original purchase assumptions, compared to our revised performance expectations. To the extent that actual performance of a Non-Agency MBS is less favorable than the expected performance of the security, we may revise our performance expectations. As a result, we could reduce the accretable discount on such security and/or recognize an other-than-temporary impairment through earnings, which could have a material adverse impact on our operating results. In addition, as discussed in Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations," of this Quarterly Report on Form 10-Q, we are potentially exposed to repurchase agreement counterparties should they default on their obligations, and we are unable to recover any excess collateral pledged to them.

## Prepayment and Reinvestment Risk

Premiums arise when we acquire MBS at a price in excess of the principal balance of the mortgages securing such MBS (i.e., par value). Conversely, discounts arise when we acquire MBS at a price below the principal balance of the mortgages securing such MBS. Premiums paid on our MBS are amortized against interest income and accretable purchase discounts on our MBS are accreted to interest income. Purchase premiums on our MBS, which are primarily carried on our Agency MBS, are amortized against interest income over the life of each security using the effective yield method, adjusted for actual prepayment activity. An increase in the prepayment rate, as measured by the CPR, will typically accelerate the amortization of purchase premiums, thereby reducing the yield/interest income earned on such assets. Generally, if prepayments on our Non-Agency MBS are less than anticipated, we expect that the income recognized on such assets would be reduced and impairments could result.



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Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

Management, under the direction of its Chief Executive Officer and Chief Financial Officer, is responsible for maintaining disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the 1934 Act, that are designed to ensure that information required to be disclosed in reports filed or submitted under the 1934 Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosures.

In connection with the preparation of this Quarterly Report on Form 10-Q, the Company's management reviewed and evaluated the Company's disclosure controls and procedures. The evaluation was performed under the direction of the Company's Chief Executive Officer and Chief Financial Officer to determine the effectiveness, as of March 31, 2014, of the design and operation of the Company's disclosure controls and procedures. Based on that review and evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures, as designed and implemented, were effective as of March 31, 2014. Notwithstanding the foregoing, a control system, no matter how well designed, implemented and operated, can provide only reasonable, not absolute, assurance that it will detect or uncover failures within the Company to disclose material information otherwise required to be set forth in our periodic reports.

(b) Changes in Internal Control Over Financial Reporting

There have been no changes in our internal control over financial reporting that occurred during the quarter ended March 31, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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## PART II. OTHER INFORMATION

## Item 1. Legal Proceedings

There are no material pending legal proceedings to which we are a party or any of our assets are subject.

## Item 1A. Risk Factors

For a discussion of the Company's risk factors, see Part I, Item 1A. "Risk Factors" of the Company's Annual Report on Form 10-K for the year ended December 31, 2013. There are no material changes from the risk factors set forth in such Annual Report on Form 10-K. However, the risks and uncertainties that the Company faces are not limited to those set forth in the Company's Annual Report on Form 10-K for the year ended December 31, 2013. Additional risks and uncertainties not presently known to the Company or that it currently believes to be immaterial may also adversely affect the Company's business and the trading price of its securities.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

## Purchases of Equity Securities

As previously disclosed, in August 2005, the Company's Board authorized a Repurchase Program, to repurchase up to 4.0 million shares of the Company's outstanding common stock. The Board reaffirmed such authorization in May 2010. In December 31, 2013, the Company's Board increased the number of shares authorized for repurchase to an aggregate of 10.0 million shares. Such authorization does not have an expiration date and, at present, there is no intention to modify or otherwise rescind such authorization. Subject to applicable securities laws, repurchases of common stock under the Repurchase Program may be made at times and in amounts as we deem appropriate (including, in our discretion, through the use of one or more plans adopted under Rule 10b-5-1 promulgated under the 1934 Act), using available cash resources. Shares of common stock repurchased by the Company under the Repurchase Program are cancelled and, until reissued by the Company, are deemed to be authorized but unissued shares of the Company's common stock. The Repurchase Program may be suspended or discontinued by the Company at any time and without prior notice.

The Company engaged in no share repurchase activity during the first quarter of 2014 pursuant to the Repurchase program. The Company did, however, withhold restricted shares (under the terms of grants under our 2010 Plan) to offset tax withholding obligations that occur upon the vesting and release of restricted stock awards and RSUs. The following table presents information with respect to (i) such withheld restricted shares, and (ii) eligible shares remaining for repurchase under the Repurchase Program:

Month	Total Number of Shares Purchased	Weighted Average Price Paid Per Share (1)	Total Number of Shares Repurchased as Part of Publicly Announced Repurchase Program or Employee Plan	Maximum Number of Shares that May Yet be Purchased Under the Repurchase Program or Employee Plan
January 1-31, 2014:				
Repurchase Program	(2) —	\$—	—	6,616,355
Employee Transactions	(3) 33,799	7.08	N/A	N/A
February 1-28, 2014:				
Repurchase Program	(2) —	—	—	6,616,355
Employee Transactions	(3) —	—	N/A	N/A
March 1-31, 2014:				

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Repurchase Program	(2)	—	—	—	6,616,355
Employee Transactions	(3)	15,105	7.75	N/A	N/A
Total Repurchase Program	(2)	—	\$—	—	6,616,355
Total Employee Transactions	(3)	48,904	\$7.29	N/A	N/A

(1) Includes brokerage commissions.

(2) As of March 31, 2014, the Company had repurchased an aggregate of 3,383,645 shares under the Repurchase Program.

(3) The Company's 2010 Plan provides that the value of the shares delivered or withheld be based on the price of our common stock on the date the relevant transaction occurs.

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Item 6. Exhibits

The list of exhibits required to be filed as exhibits to this report are listed on page E-1 hereof, under “Exhibit Index,” which is incorporated herein by reference.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: May 1, 2014

MFA FINANCIAL, INC.  
(Registrant)

By: /s/ William S. Gorin  
William S. Gorin  
Chief Executive Officer

By: /s/ Stephen D. Yarad  
Stephen D. Yarad  
Chief Financial Officer  
(Principal Financial Officer)

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EXHIBIT INDEX

The following exhibits are filed as part of this Quarterly Report:

Exhibit	Description
3.1	Amended and Restated Bylaws of MFA Financial, Inc. (the “Company”), effective January 1, 2014 (incorporated herein by reference to Exhibit 3.1 to the Company’s Form 8-K, dated December 18, 2013 (Commission File No. 1-13991)).
10.1	Employment Agreement, entered into as of January 21, 2014, by and between the Company and William S. Gorin (incorporated herein by reference to Exhibit 10.1 to the Company’s Form 8-K, dated January 24, 2014 (Commission File No. 1-13991)).
10.2	Employment Agreement, entered into as of January 21, 2014, by and between the Company and Craig L. Knutson (incorporated herein by reference to Exhibit 10.2 to the Company’s Form 8-K, dated January 24, 2014 (Commission File No. 1-13991)).
10.3	Employment Agreement, entered into as of January 24, 2014, by and between the Company and Ronald A. Freyberg (incorporated herein by reference to Exhibit 10.6 to the Company’s Form 8-K, dated January 24, 2014 (Commission File No. 1-13991)).
10.4	Consulting Services Agreement, entered into as of December 31, 2013, by the Company and Stewart Zimmerman (incorporated herein by reference to Exhibit 10.1 to the Company’s Form 8-K, dated January 2, 2014, as amended by the Company’s Form 8-K/A (Amendment No. 1), dated January 2, 2014 (Commission File No. 1-13991)).
10.5	Form of Phantom Share Award Agreement (Time-Based Vesting) (Gorin and Knutson) relating to the Company’s Amended and Restated 2010 Equity Compensation Plan (incorporated herein by reference to Exhibit 10.3 to the Company’s Form 8-K, dated January 24, 2014 (Commission File No. 1-13991)).
10.6	Form of Phantom Share Award Agreement (Performance-Based Vesting) (Gorin and Knutson) relating to the Company’s Amended and Restated 2010 Equity Compensation Plan (incorporated herein by reference to Exhibit 10.4 to the Company’s Form 8-K, dated January 24, 2014 (Commission File No. 1-13991)).
10.7	Form of Phantom Share Award Agreement (Vested Award) relating to the Company’s Amended and Restated 2010 Equity Compensation Plan (incorporated herein by reference to Exhibit 10.5 to the Company’s Form 8-K, dated January 24, 2014 (Commission File No. 1-13991)).
10.8	Form of Phantom Share Award Agreement (Time-Based Vesting) relating to the Company’s Amended and Restated 2010 Equity Compensation Plan (incorporated herein by reference to Exhibit 10.7 to the Company’s Form 8-K, dated January 24, 2014 (Commission File No. 1-13991)).
10.9	Form of Phantom Share Award Agreement (Performance-Based Vesting) relating to the Company’s Amended and Restated 2010 Equity Compensation Plan (incorporated herein by reference to Exhibit 10.8 to the Company’s Form 8-K, dated January 24, 2014 (Commission File No. 1-13991)).
31.1	

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Certification of the Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of the Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of the Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of the Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

101.INS\* XBRL Instance Document

101.SCH\* XBRL Taxonomy Extension Schema Document

101.CAL\* XBRL Taxonomy Extension Calculation Linkbase Document

101.DEF\* XBRL Taxonomy Extension Definition Linkbase Document

101.LAB\* XBRL Taxonomy Extension Label Linkbase Document

101.PRE\* XBRL Taxonomy Extension Presentation Linkbase Document

\*These interactive data files are furnished and deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.