

MFA FINANCIAL, INC.  
Form 10-Q  
August 04, 2014  
Table of Contents

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 June 30, 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

367,873,219 shares of the registrant’s common stock, \$0.01 par value, were outstanding as of July 30, 2014.

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Table of Contents

## TABLE OF CONTENTS

	Page
PART I	
FINANCIAL INFORMATION	
Item 1.	Financial Statements
	<u>Consolidated Balance Sheets as of June 30, 2014 (Unaudited) and December 31, 2013</u>
	<u>1</u>
	<u>Consolidated Statements of Operations (Unaudited) for the Three and Six Months Ended June 30, 2014 and June 30, 2013</u>
	<u>2</u>
	<u>Consolidated Statements of Comprehensive Income/(Loss) (Unaudited) for the Three and Six Months Ended June 30, 2014 and June 30, 2013</u>
	<u>3</u>
	<u>Consolidated Statement of Changes in Stockholders' Equity (Unaudited) for the Six Months Ended June 30, 2014</u>
	<u>4</u>
	<u>Consolidated Statements of Cash Flows (Unaudited) for the Six Months Ended June 30, 2014 and June 30, 2013</u>
	<u>5</u>
	<u>Notes to the Unaudited Consolidated Financial Statements</u>
	<u>6</u>
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>
	<u>43</u>
Item 3.	<u>Quantitative and Qualitative Disclosures about Market Risk</u>
	<u>78</u>
Item 4.	<u>Controls and Procedures</u>
	<u>84</u>
PART II	
OTHER INFORMATION	
Item 1.	<u>Legal Proceedings</u>
	<u>85</u>
Item 1A.	<u>Risk Factors</u>
	<u>85</u>
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>
	<u>85</u>
Item 6.	<u>Exhibits</u>
	<u>86</u>
	<u>Signatures</u>
	<u>87</u>

Table of Contents

## MFA FINANCIAL, INC.

## CONSOLIDATED BALANCE SHEETS

(In Thousands Except Per Share Amounts)	June 30, 2014 (Unaudited)	December 31, 2013
Assets:		
Mortgage-backed securities ("MBS"):		
Agency MBS, at fair value (\$6,150,048 and \$6,142,306 pledged as collateral, respectively)	\$6,549,451	\$6,519,221
Non-Agency MBS, at fair value (\$1,743,605 and \$1,778,067 pledged as collateral, respectively)	2,801,049	2,569,766
Non-Agency MBS transferred to consolidated variable interest entities ("VIEs") (1)	2,200,288	2,282,371
Securities obtained and pledged as collateral, at fair value	446,375	383,743
Cash and cash equivalents	343,719	565,370
Restricted cash	54,430	37,520
Interest receivable	34,673	35,828
Derivative instruments:		
MBS linked transactions, net ("Linked Transactions"), at fair value	106,859	28,181
Interest rate swap agreements ("Swaps"), at fair value	2,755	13,000
Goodwill	7,189	7,189
Prepaid and other assets (See Notes 2(d) and 15)	104,073	29,719
Total Assets	\$12,650,861	\$12,471,908
Liabilities:		
Repurchase agreements	\$8,384,101	\$8,339,297
Securitized debt (2)	214,048	366,205
Obligation to return securities obtained as collateral, at fair value	446,375	383,743
8% Senior Notes due 2042 ("Senior Notes")	100,000	100,000
Accrued interest payable	10,915	14,726
Swaps, at fair value	57,426	28,217
Dividends and dividend equivalents rights ("DERs") payable	74,104	73,643
Accrued expenses and other liabilities	88,598	23,826
Total Liabilities	\$9,375,567	\$9,329,657
Commitments and contingencies (See Note 10)		
Stockholders' Equity:		
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; 367,475 and 365,125 shares issued and outstanding, respectively	3,675	3,651
Additional paid-in capital, in excess of par	2,991,927	2,972,369
Accumulated deficit	(571,421)	(571,544)
Accumulated other comprehensive income	851,033	737,695
Total Stockholders' Equity	\$3,275,294	\$3,142,251
Total Liabilities and Stockholders' Equity	\$12,650,861	\$12,471,908

(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.

1

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Table of ContentsMFA FINANCIAL, INC.  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(UNAUDITED)

(In Thousands, Except Per Share Amounts)	Three Months Ended		Six Months Ended	
	June 30, 2014	2013	June 30, 2014	2013
Interest Income:				
Agency MBS	\$37,609	\$38,037	\$76,938	\$80,824
Non-Agency MBS	43,473	43,997	86,628	85,044
Non-Agency MBS transferred to consolidated VIEs	37,543	38,601	76,207	77,469
Cash and cash equivalent investments	17	36	43	72
Interest Income	\$118,642	\$120,671	\$239,816	\$243,409
Interest Expense:				
Repurchase agreements	\$36,690	\$33,397	\$73,419	\$68,072
Securitized debt	1,871	3,075	4,056	6,551
Senior Notes	2,008	2,006	4,015	4,013
Total Interest Expense	\$40,569	\$38,478	\$81,490	\$78,636
Net Interest Income	\$78,073	\$82,193	\$158,326	\$164,773
Other Income, net:				
Unrealized net gains/(losses) and net interest income from Linked Transactions	\$3,776	\$(295)	\$7,027	\$1,241
Gain on sales of MBS and U.S. Treasury securities, net	7,852	4,365	11,423	5,998
Other, net	708	55	292	110
Other Income, net	\$12,336	\$4,125	\$18,742	\$7,349
Operating and Other Expense:				
Compensation and benefits	\$5,901	\$5,284	\$12,408	\$10,557
Other general and administrative expense	4,546	3,561	8,510	6,741
Excise tax and interest	1,175	2,000	1,175	2,000
Other investment related operating expenses	61	—	61	—
Operating and Other Expense	\$11,683	\$10,845	\$22,154	\$19,298
Net Income	\$78,726	\$75,473	\$154,914	\$152,824
Less Preferred Stock Dividends	3,750	4,210	7,500	6,250
Less Issuance Costs of Redeemed Preferred Stock	—	3,947	—	3,947
Net Income Available to Common Stock and Participating Securities	\$74,976	\$67,316	\$147,414	\$142,627
Earnings per Common Share - Basic and Diluted	\$0.20	\$0.19	\$0.40	\$0.39
Dividends Declared per Share of Common Stock	\$0.20	\$0.22	\$0.40	\$0.94

(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.



Table of Contents

MFA FINANCIAL, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME/(LOSS)  
(UNAUDITED)

(In Thousands)	Three Months Ended		Six Months Ended	
	June 30,	June 30,	June 30,	June 30,
	2014	2013	2014	2013
Net income	\$78,726	\$75,473	\$154,914	\$152,824
Other Comprehensive Income/(Loss):				
Unrealized gain/(loss) on Agency MBS, net	43,094	(140,480 )	60,937	(167,771 )
Unrealized gain/(loss) on Non-Agency MBS, net	50,136	(98,282 )	101,554	48,388
Reclassification adjustment for MBS sales included in net income	(6,748 )	(3,254 )	(9,699 )	(4,554 )
Unrealized (loss)/gain on derivative hedging instruments, net	(27,634 )	18,548	(39,901 )	30,864
Reclassification of unrealized loss on de-designated derivative hedging instruments	—	—	447	—
Other Comprehensive Income/(Loss)	58,848	(223,468 )	113,338	(93,073 )
Comprehensive income/(loss) before preferred stock dividends and issuance costs of redeemed preferred stock	\$137,574	\$(147,995 )	\$268,252	\$59,751
Dividends declared on preferred stock	(3,750 )	(4,210 )	(7,500 )	(6,250 )
Issuance costs of redeemed preferred stock	—	(3,947 )	—	(3,947 )
Comprehensive Income/(Loss) Available to Common Stock and Participating Securities	\$133,824	\$(156,152 )	\$260,752	\$49,554

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



Table of Contents

MFA FINANCIAL, INC.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY  
(UNAUDITED)

(In Thousands, Except Per Share Amounts)	Six Months Ended June 30, 2014	
	Dollars	Shares
Preferred Stock, 7.50% Series B Cumulative Redeemable - Liquidation Preference \$25.00 per Share:		
Balance at June 30, 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)	24	2,414
Repurchase of shares of common stock (1)	—	(64
Balance at June 30, 2014	\$3,675	367,475
Additional Paid-in Capital, in excess of Par:		
Balance at December 31, 2013	\$2,972,369	
Issuance of common stock, net of expenses (1)	16,822	
Equity-based compensation expense	3,086	
Accrued dividends attributable to stock-based awards	(109	)
Repurchase of shares of common stock (1)	(241	)
Balance at June 30, 2014	\$2,991,927	
Accumulated Deficit:		
Balance at December 31, 2013	\$(571,544	)
Net income	154,914	
Dividends declared on common stock	(146,907	)
Dividends declared on preferred stock	(7,500	)
Dividends attributable to DERs	(384	)
Balance at June 30, 2014	\$(571,421	)
Accumulated Other Comprehensive Income:		
Balance at December 31, 2013	\$737,695	
Change in unrealized gains on MBS, net	152,792	
Change in unrealized losses on derivative hedging instruments, net	(39,454	)
Balance at June 30, 2014	\$851,033	
Total Stockholders' Equity at June 30, 2014	\$3,275,294	

(1) For the six months ended June 30, 2014, includes approximately \$480,000 (64,012 shares) surrendered for tax purposes related to equity-based compensation awards.

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

Table of Contents

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

(In Thousands)	Six Months Ended	
	June 30, 2014	2013
Cash Flows From Operating Activities:		
Net income	\$154,914	\$152,824
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sales of MBS and U.S. Treasury securities	(11,423	) (5,998
Accretion of purchase discounts on MBS and other investments	(48,433	) (28,762
Amortization of purchase premiums on MBS	17,678	31,301
Depreciation and amortization on fixed assets and other assets	657	2,160
Equity-based compensation expense	3,086	2,186
Unrealized gains on derivative instruments	(4,094	) (466
Decrease in interest receivable	1,144	3,142
Increase in prepaid and other assets	(15,935	) (12,088
(Decrease)/increase in accrued expenses and other liabilities, and excise tax and interest	(1,185	) 1,720
Increase/(decrease) in accrued interest payable on financial instruments	18,553	(4,773
Net cash provided by operating activities	\$114,962	\$141,246
Cash Flows From Investing Activities:		
Principal payments on MBS and other investments	\$935,415	\$1,483,476
Proceeds from sale of MBS and U.S. Treasury securities	42,029	216,079
Purchases of MBS and other investments	(955,975	) (1,251,726
Additions to leasehold improvements, furniture and fixtures	(221	) (135
Net cash provided by investing activities	\$21,248	\$447,694
Cash Flows From Financing Activities:		
Principal payments on repurchase agreements	\$(41,172,586)	\$(39,284,004)
Proceeds from borrowings under repurchase agreements	41,217,390	39,440,815
Principal payments on securitized debt	(151,296	) (203,068
Payments made on obligation to return securities obtained as collateral	—	(300,119
Cash disbursements on financial instruments underlying Linked Transactions	(1,139,692	) (114,903
Cash received from financial instruments underlying Linked Transactions	1,065,107	117,554
Payments made for margin calls on repurchase agreements and Swaps	(87,700	) (3
Proceeds from reverse margin calls on repurchase agreements and Swaps	48,400	2,000
Proceeds from issuances of common stock	16,846	40,398
Payments made for redemption of Series A Preferred Stock	—	(96,000
Proceeds from issuance of Series B Preferred Stock	—	200,000
Payments made for preferred stock offering costs	—	(6,684
Dividends paid on preferred stock	(7,500	) (6,250
Dividends paid on common stock and DERs	(146,830	) (331,687
Net cash used in financing activities	\$(357,861	) \$(541,951
Net (decrease)/increase in cash and cash equivalents	\$(221,651	) \$46,989
Cash and cash equivalents at beginning of period	\$565,370	\$401,293
Cash and cash equivalents at end of period	\$343,719	\$448,282

Non-cash Investing and Financing Activities:

Net increase in securities obtained as collateral/obligation to return securities obtained as collateral	\$50,375	\$200,098
Dividends and DERs declared and unpaid	\$74,104	\$80,440

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

Table of Contents

MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 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 Notes 2(n) and 11)

2. Summary of Significant Accounting Policies

(a) Basis of Presentation and Consolidation

The interim unaudited consolidated 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 consolidated financial statements should be read in conjunction with the consolidated 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 June 30, 2014 and results of operations for all periods presented have been made. The results of operations for the six months ended June 30, 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(n)). 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.

Table of Contents

MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 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 assessed as high credit quality 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 which is the security's internal rate of return ("IRR"). The IRR is determined using 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 IRR/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)

Table of Contents

MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014

Non-Agency MBS that are assessed to be of less than high credit quality and 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 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 IRR.

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(o) 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(j) for Repurchase Agreements and Reverse Repurchase Agreements)

(d) Residential Whole Loans

Residential whole loans included in the Company's consolidated balance sheets are comprised of pools of fixed and adjustable rate residential mortgage loans. The Company has acquired these loans through a consolidated trust at discounted purchase prices that reflect, in part, the credit quality of the borrowers. While the majority of such loans are currently performing in accordance with their current contractual terms, for accounting purposes the loans are considered by the Company to be credit impaired at purchase as the borrowers have previously experienced payment delinquencies and the amount owed on the mortgage loan may exceed the value of the property pledged as collateral.



Consequently, the Company has assessed that these loans have a higher likelihood of default than newly originated mortgage loans. The Company believes that amounts paid to acquire residential whole loans represent fair market value at the date of acquisition. Residential whole loans are initially recorded at fair value with no allowance for loan losses. Subsequent to acquisition, the recorded amount reflects the original investment amount, plus accretion of interest income, less principal and interest cash flows received and principal amounts forgiven or otherwise charged off as they are considered not recoverable. Residential whole loans are presented in Prepaid and other assets in the Company's consolidated balance sheets at carrying value, which reflects the recorded amount net of any allowance for loan losses established subsequent to acquisition.

The Company may aggregate into pools loans acquired in the same fiscal quarter that are assessed as having similar risk characteristics. For each pool established, or on an individual loans basis for loans not aggregated into pools, the Company estimates at acquisition and periodically on at least a quarterly basis, the principal and interest cash flows expected to be collected. The difference between the cash flows expected to be collected and the carrying amount of the loans is referred to as the "accretable yield". This amount is accreted as interest income over the life of the loans using an effective interest rate (level yield) methodology.

Table of Contents

MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014

Interest income recorded each period reflects the amount of accretable yield recognized and not the coupon interest payments received on the underlying loans. The difference between contractually required principal and interest payments and the cash flows expected to be collected, referred to as the “nonaccretable difference,” includes estimates of both the impact of prepayments and expected credit losses over the life of the underlying loans.

A decrease in expected cash flows in subsequent periods may indicate impairment at the pool and/or individual loan level thus requiring the establishment of an allowance for loan losses by a charge to the provision for loan losses. The allowance for loan losses represents the present value of cash flows expected at acquisition that are no longer expected to be received at the relevant measurement date. An increase in expected cash flows in subsequent periods initially reduces any previously established allowance for loan losses by the increase in the present value of cash flows expected to be collected, and results in a recalculation of the amount of accretable yield. The adjustment of accretable yield due to an increase in expected cash flows is accounted for prospectively as a change in estimate and results in reclassification from nonaccretable difference to accretable yield. (See Note 15)

(e) 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 June 30, 2014 or December 31, 2013. At June 30, 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)

(f) 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 and repurchase agreements of \$54.4 million at June 30, 2014 and \$37.5 million held as collateral against its Swaps at December 31, 2013. (See Notes 5, 6, 7 and 14)

(g) Goodwill

At June 30, 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 June 30, 2014, the Company had not recognized any impairment against its goodwill.

(h) 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.

(i) 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 resecuritization 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

Table of Contents

MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014

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.

(j) 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(o) 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(o), 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 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))

(k) 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

Table of Contents

MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014

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 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(1) and 13)

(l) 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)

(m) 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.

Table of Contents

MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014

(n) 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 June 30, 2014, December 31, 2013, or June 30, 2013. The Company expects to file its 2013 tax return prior to September 15, 2014. The Company’s tax returns for tax years 2009 through 2012 are open to examination.

(o) 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.

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)



Table of Contents

MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014

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 June 30, 2014 and December 31, 2013.

(p) 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.

Table of Contents

MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014

(q) Variable Interest Entities and Other Consolidated Special Purpose 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)

The Company also includes in its consolidated balance sheets certain financial assets and liabilities that are acquired/issued by trusts and/or other special purpose entities that have been evaluated as being required to be consolidated by the Company under the applicable accounting guidance.

(r) 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 Notes 11 and 12)

(s) New 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.

Table of Contents

MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014

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.

Table of Contents

MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014

The following tables present certain information about the Company's MBS at June 30, 2014 and December 31, 2013:

June 30, 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	\$5,128,686	\$195,467	\$(74)	\$—	\$5,324,079	\$5,403,241	\$106,337	\$(27,175)	\$79,162
Freddie Mac	1,094,460	42,075	—	—	1,137,853	1,133,670	11,652	(15,835)	(4,183)
Ginnie Mae	12,001	206	—	—	12,207	12,540	333	—	333
Total Agency MBS	6,235,147	237,748	(74)	—	6,474,139	6,549,451	118,322	(43,010)	75,312
Non-Agency MBS:									
Expected to Recover Par (3)	313,136	524	(29,593)	—	284,067	310,586	27,653	(1,134)	26,519
Expected to Recover Less Than Par (3)(4)	5,280,238	—	(406,518)	(986,842)	3,886,878	4,690,751	804,953	(1,080)	803,873
Total Non-Agency MBS	5,593,374	524	(436,111)	(986,842)	4,170,945	5,001,337	832,606	(2,214)	830,392
Total MBS	\$11,828,521	\$238,272	\$(436,185)	\$(986,842)	\$10,645,084	\$11,550,788	\$950,928	\$(45,224)	\$905,704

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 June 30, 2014 reflect Credit Reserve of \$942.7 million and OTTI of \$44.1 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 \$1.3 million and \$1.1 million at June 30, 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 June 30, 2014 and December 31, 2013, the Company expected to recover approximately 82% and 81%, respectively, of the then-current face amount of Non-Agency MBS.

Table of Contents

MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014

## Unrealized Losses on MBS and Impairments

The following table presents information about the Company's MBS that were in an unrealized loss position at June 30, 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	\$407,252	\$ 2,013	35	\$1,383,328	\$ 25,162	147	\$1,790,580	\$ 27,175
Freddie Mac	9,980	34	2	733,159	15,801	103	743,139	15,835
Total Agency MBS	417,232	2,047	37	2,116,487	40,963	250	2,533,719	43,010
Non-Agency MBS:								
Expected to Recover Par (1)	1,357	10	1	23,335	1,124	8	24,692	1,134
Expected to Recover Less Than Par (1)	17,668	118	3	29,241	962	8	46,909	1,080
Total Non-Agency MBS	19,025	128	4	52,576	2,086	16	71,601	2,214
Total MBS	\$436,257	\$ 2,175	41	\$2,169,063	\$ 43,049	266	\$2,605,320	\$ 45,224

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

At June 30, 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 \$43.0 million at June 30, 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 June 30, 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 \$2.2 million at June 30, 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 and six months ended June 30, 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 of expected future cash flows, prepayment rates, default rates, loss severities, delinquency rates, percentage of non-performing

Table of Contents

MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014

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.

	Three Months Ended June 30, 2014	Six Months Ended June 30, 2014
(In Thousands)		
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

Table of Contents

MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014

## 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 and six months ended June 30, 2014 and 2013:

(In Thousands)	Three Months Ended June 30, 2014		Three Months Ended June 30, 2013	
	Discount Designated as Credit Reserve and OTTI (1)	Accretable Discount (1)(2)	Discount Designated as Credit Reserve and OTTI (1)	Accretable Discount (1)(2)
Balance at beginning of period	\$(1,041,933 )	\$(442,156 )	\$(1,312,952 )	\$(381,913 )
Accretion of discount	—	25,766	—	16,698
Realized credit losses	23,359	—	38,375	—
Purchases	(3,018 )	1,636	(49,852 )	18,425
Sales	10,269	3,124	4,689	4,978
Transfers/release of credit reserve	24,481	(24,481 )	54,769	(54,769 )
Balance at end of period	\$(986,842 )	\$(436,111 )	\$(1,264,971 )	\$(396,581 )

(In Thousands)	Six Months Ended June 30, 2014		Six Months Ended June 30, 2013	
	Discount Designated as Credit Reserve and OTTI (3)	Accretable Discount (2)(3)	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	—	53,197	—	28,749
Realized credit losses	48,396	—	88,682	—
Purchases	(66,335 )	25,042	(73,387 )	29,654
Sales	13,756	6,067	10,972	5,910
Transfers/release of credit reserve	60,378	(60,378 )	89,268	(89,268 )
Balance at end of period	\$(986,842 )	\$(436,111 )	\$(1,264,971 )	\$(396,581 )

The Company did not reallocate any purchase discount designated as Credit Reserve to accretable purchase

discount on Non-Agency MBS underlying Linked Transactions during the three months ended June 30, 2014. The

(1) Company reallocated \$116,000 of purchase discount designated as Credit Reserve to accretable purchase discount on Non-Agency MBS underlying Linked Transactions during the three months ended June 30, 2013.

(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 \$115,000 and \$129,000 of purchase discount designated as Credit Reserve to accretable purchase discount on Non-Agency MBS underlying Linked Transactions during the six months ended June 30, 2014 and 2013, respectively.



Table of Contents

MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014

## Impact of MBS on AOCI

The following table presents the impact of the Company's MBS on its AOCI for the three and six months ended June 30, 2014 and 2013:

(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
AOCI from MBS:				
Unrealized gain on MBS at beginning of period	\$819,222	\$942,887	\$752,912	\$824,808
Unrealized gain/(loss) on Agency MBS, net	43,094	(140,480 )	60,937	(167,771 )
Unrealized gain/(loss) on Non-Agency MBS, net	50,136	(98,282 )	101,554	48,388
Reclassification adjustment for MBS sales included in net income	(6,748 )	(3,254 )	(9,699 )	(4,554 )
Change in AOCI from MBS	86,482	(242,016 )	152,792	\$(123,937 )
Balance at end of period	\$905,704	\$700,871	\$905,704	\$700,871

## Sales of MBS

During the three and six months ended June 30, 2014, the Company sold certain Non-Agency MBS for \$26.5 million and \$42.0 million, realizing gross gains of \$7.9 million and \$11.4 million, respectively. During the three and six months ended June 30, 2013, the Company sold certain Non-Agency MBS for \$9.9 million and \$16.0 million, realizing gross gains of \$4.4 million and \$6.0 million, respectively. 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 and six months ended June 30, 2014 and 2013:

(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Coupon interest	\$49,836	\$54,485	\$99,335	\$111,989
Effective yield adjustment (1)	(12,227 )	(16,448 )	(22,397 )	(31,165 )
Agency MBS interest income	\$37,609	\$38,037	\$76,938	\$80,824

(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 and six months ended June 30, 2014 and 2013:

(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Coupon interest	\$55,322	\$65,954	\$109,752	\$133,887
Effective yield adjustment (1)	25,694	16,644	53,083	28,626

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Non-Agency MBS interest income	\$81,016	\$82,598	\$162,835	\$162,513
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(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.

20

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Table of Contents

MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014

## 4. Interest Receivable

The following table presents the Company's interest receivable by investment category at June 30, 2014 and December 31, 2013:

(In Thousands)	June 30, 2014	December 31, 2013
MBS interest receivable:		
Fannie Mae	\$ 13,638	\$ 13,760
Freddie Mac	2,872	3,110
Ginnie Mae	19	19
Non-Agency MBS	18,069	18,917
Total MBS interest receivable	34,598	35,806
Money market and other investments	75	22
Total interest receivable	\$ 34,673	\$ 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 June 30, 2014 and December 31, 2013:

Derivative Instrument	Designation	Balance Sheet Location	June 30, 2014 Notional Amount	June 30, 2014 Fair Value	December 31, 2013
(In Thousands)					
Linked Transactions	Non-Hedging	Assets	N/A	\$ 106,859	\$ 28,181
Non-cleared legacy Swaps (1)	Hedging	Assets	\$ 450,000	\$ 2,755	\$ 4,925
Cleared Swaps (2)	Hedging	Assets	\$ —	\$ —	\$ 8,075
Non-cleared legacy Swaps (1)	Hedging	Liabilities	\$ 927,214	\$(12,856)	\$(24,437)
Cleared Swaps (2)	Hedging	Liabilities	\$ 2,550,000	\$(44,570)	\$(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.



Table of Contents

MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014

The following tables present certain information about the Non-Agency MBS and repurchase agreements underlying the Company's Linked Transactions at June 30, 2014 and December 31, 2013:

## Linked Transactions at June 30, 2014

Linked Repurchase Agreements	Linked MBS							
	Balance	Weighted Average Interest Rate	Non-Agency MBS	Fair Value	Amortized Cost	Par/Current Face	Average Coupon Rate	
Maturity or Repricing								
(Dollars in Thousands)			(Dollars in Thousands)					
Within 30 days	\$ 183,790	1.76 %	Total	\$ 494,047	\$ 486,220	\$ 499,034	3.55 %	
>30 days to 90 days	203,739	1.54						
Total	\$ 387,529	1.64 %						

## 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	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 June 30, 2014, Linked Transactions also included approximately \$481,000 of associated accrued interest receivable and \$141,000 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/(losses) and net interest income from Linked Transactions included in the Company's consolidated statements of operations for the three and six months ended June 30, 2014 and 2013:

Components of Unrealized Net Gains and Net Interest Income from Linked Transactions (In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Interest income attributable to MBS underlying Linked Transactions	\$ 2,925	\$ 654	\$ 4,966	\$ 1,322
Interest expense attributable to linked repurchase agreement borrowings underlying Linked Transactions	(921)	(137)	(1,472)	(277)
Change in fair value of Linked Transactions included in earnings	1,772	(812)	3,533	196
Unrealized net gains/(losses) and net interest income from Linked Transactions	\$ 3,776	\$ (295)	\$ 7,027	\$ 1,241



Table of Contents

MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014

## 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 June 30, 2014. At June 30, 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 \$59.7 million, including accrued interest payable of approximately \$2.3 million.

The following table presents the assets pledged as collateral against the Company's Swap contracts at June 30, 2014 and December 31, 2013:

(In Thousands)	June 30, 2014	December 31, 2013
Agency MBS, at fair value	\$75,061	\$73,859
Restricted cash	52,630	37,520
Total assets pledged against Swaps	\$127,691	\$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 and six months ended June 30, 2014 and 2013.

At June 30, 2014, the Company had Swaps designated in hedging relationships with an aggregate notional amount of \$3.927 billion, which had net unrealized losses of \$54.7 million, and extended 51 months on average with a maximum term of approximately 110 months.

Table of Contents

MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014

The following table presents certain information with respect to the Company's Swap activity during the three and six months ended June 30, 2014:

(Dollars in Thousands)	Three Months Ended June 30, 2014		Six Months Ended June 30, 2014	
New Swaps:				
Aggregate notional amount	\$200,000		\$400,000	
Weighted average fixed-pay rate	1.96	%	1.95	%
Initial maturity date	5 years to 7 years		5 years to 7 years	
Number of new Swaps	Two		Four	
Swaps amortized/expired:				
Aggregate notional amount	\$476,147		\$517,998	
Weighted average fixed-pay rate	1.80	%	1.97	%

The following table presents information about the Company's Swaps at June 30, 2014 and December 31, 2013: