

PENNYMAC FINANCIAL SERVICES, INC.

Form 10-Q

June 21, 2013

[Table of Contents](#)

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2013

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: 001-35916

PennyMac Financial Services, Inc.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

80-0882793
(IRS Employer
Identification No.)

6101 Condor Drive, Moorpark, California
(Address of principal executive offices)

93021
(Zip Code)

(818) 224-7442

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer
(Do not check if a smaller reporting company)

Smaller reporting company

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

Edgar Filing: PENNYMAC FINANCIAL SERVICES, INC. - Form 10-Q

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

Class	Outstanding at June 17, 2013
Class A Common Stock, \$0.0001 par value	12,777,777
Class B Common Stock, \$0.0001 par value	60

Table of Contents

PENNYMAC FINANCIAL SERVICES, INC.

FORM 10-Q

March 31, 2013

TABLE OF CONTENTS

	Page
<u>PART I. FINANCIAL INFORMATION</u>	1
<u>Item 1.</u>	1
<u>PennyMac Financial Services, Inc.</u>	1
<u>Financial Statements (Unaudited)</u>	1
<u>Balance Sheets as of March 31, 2013 and December 31, 2012</u>	1
<u>Notes to Balance Sheets</u>	2
<u>Private National Mortgage Acceptance Company, LLC</u>	3
Financial Statements (Unaudited):	
<u>Consolidated Balance Sheets as of March 31, 2013 and December 31, 2012</u>	3
<u>Consolidated Statements of Income as of March 31, 2013 and December 31, 2012</u>	4
<u>Consolidated Statements of Changes in Members' Equity</u>	5
<u>Consolidated Statements of Cash Flows as of March 31, 2013 and December 31, 2012</u>	6
<u>Notes to Consolidated Financial Statements</u>	7
<u>Item 2.</u>	44
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	44
<u>Item 3.</u>	59
<u>Quantitative and Qualitative Disclosures About Market Risk</u>	59
<u>Item 4.</u>	59
<u>Controls and Procedures</u>	59
<u>PART II. OTHER INFORMATION</u>	59
<u>Item 1.</u>	59
<u>Legal Proceedings</u>	59
<u>Item 1A.</u>	59
<u>Risk Factors</u>	59
<u>Item 2.</u>	59
<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	59
<u>Item 3.</u>	60
<u>Defaults Upon Senior Securities</u>	60
<u>Item 4.</u>	60
<u>Mine Safety Disclosures</u>	60
<u>Item 5.</u>	60
<u>Other Information</u>	60
<u>Item 6.</u>	61
<u>Exhibits</u>	61

Table of Contents

EXPLANATORY NOTE

The financial statements and other disclosures contained in this report include those of PennyMac Financial Services, Inc. (PFSI), which is the registrant, and those of Private National Mortgage Acceptance Company, LLC (PennyMac), in which PFSI acquired an ownership interest in a reorganization transaction that was completed after March 31, 2013 in connection with the initial public offering of PFSI (which was completed on May 14, 2013). Accordingly, because PFSI had no substantial assets or activities (except for activities relating to its initial public offering) as of March 31, 2013 and because the reorganization transactions had not been completed as of such date, PFSI believes it is informative to provide the financial statements and various other disclosures of PennyMac as of March 31, 2013 and for the quarters ended March 31, 2013 and 2012. For more information regarding the transactions described above, see Note 22, *Subsequent Events*, to the financial statements of PennyMac contained in this report.

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****PENNYMAC FINANCIAL SERVICES, INC.****BALANCE SHEETS (UNAUDITED)**

	March 31, 2013	December 31, 2012
(in thousands except share data)		
ASSETS		
Cash	\$ 50	\$
Total assets	\$ 50	\$
LIABILITIES		
Payable to Private National Mortgage Acceptance Company, LLC	\$ 50	\$
Total liabilities	50	
Commitments and contingencies		
STOCKHOLDERS EQUITY		
Class A Common Stock, par value \$0.0001 per share, 9,000 shares authorized, none issued and outstanding	\$	\$
Class B Common Stock, par value \$0.0001 per share, 1,000 shares authorized, none issued and outstanding		
Total stockholders equity		
Total liabilities and stockholders equity	\$ 50	\$

Table of Contents

PENNYMAC FINANCIAL SERVICES, INC.

NOTES TO BALANCE SHEET (UNAUDITED)

Note 1 Organization

PennyMac Financial Services, Inc. (the Company) was formed as a Delaware corporation on December 31, 2012. Pursuant to a reorganization, the Company became a holding corporation and its sole asset is an equity interest in Private National Mortgage Acceptance Company, LLC (PennyMac). The Company is the managing member of PennyMac and operates and controls all of the businesses and affairs of PennyMac subject to the consent rights of other members under certain circumstances and, through PennyMac and its subsidiaries, continues to conduct the business now conducted by these subsidiaries.

Note 2 Summary of Significant Accounting Policies

Basis of Accounting The balance sheet has been prepared in accordance with accounting principles generally accepted in the United States of America. Separate statements of income, changes in stockholders' equity and cash flows have not been presented in the financial statements because this entity has had no activities.

Underwriting Commissions and Offering Costs Underwriting commissions and offering costs to be incurred by the Company in connection with its common share offerings will be reflected as a reduction of additional paid-in capital. Underwriting commissions and offering costs are not recorded in the Company's consolidated balance sheet because such costs are not the Company's liability until the Company completes a successful initial public offering.

Organizational Costs Organizational costs are not recorded in the Company's consolidated balance sheet because such costs are not the Company's liability until the Company completes a successful initial public offering. Thereafter, costs incurred to organize the Company will be expensed as incurred.

Note 3 Liabilities

In March 2013, the Company borrowed \$50,000 from PennyMac to fund its operating cash account.

Note 4 Stockholders' Equity

Edgar Filing: PENNYMAC FINANCIAL SERVICES, INC. - Form 10-Q

Under the Company's certificate of incorporation as in effect as of March 31, 2013 and December 31, 2012, the Company is authorized to issue 9,000 shares of Class A Common Stock, par value \$0.0001 per share (Class A Common Stock), and 1,000 shares of Class B Common Stock, par value \$0.0001 per share (Class B Common Stock), and all shares of Class A common stock and Class B Common Stock are identical.

Note 5 Subsequent Events

Management has evaluated all events and transactions through the date the Company issued these financial statements. During this period:

- In connection with the initial public offering (IPO) by the Company of its Class A Common Stock, par value \$0.0001 per share, covered by the final prospectus, dated May 8, 2013 and included as part of the Registration Statement on Form S-1, as amended (File No. 333-186495) (the Registration Statement), the Company and PennyMac consummated a recapitalization (Recapitalization). Under the terms of the Recapitalization, the Company, PennyMac and the existing unitholders of PennyMac entered into that certain Fourth Amended and Restated Limited Liability Company Agreement of PennyMac, dated May 8, 2013 (the LLC Agreement), pursuant to which, among other things, the Company became the sole managing member of PennyMac and the capital structure of PennyMac was modified by converting all existing classes of units into new Class A units, with the allocation of Class A units among PennyMac's existing owners determined pursuant to the distribution provisions of its former limited liability company agreement based upon the liquidation value of PennyMac, assuming it was liquidated at the time of the IPO of Class A Common Stock with a value implied by the IPO of the shares of Class A Common Stock sold in the IPO.

Also in connection with the Recapitalization, on May 8, 2013, the Company entered into: (i) an exchange agreement with PennyMac and the then-existing unitholders of PennyMac; (ii) a tax receivable agreement with PennyMac and the then-existing unitholders of PennyMac; (iii) a registration rights agreement with the then-existing unitholders of PennyMac and (iv) separate stockholder agreements with each of BlackRock Mortgage Ventures, LLC and HC Partners LLP, formerly known as Highfields Capital Investments LLC.

- On May 8, 2013, the Company's Amended and Restated Certificate of Incorporation and the Company's Amended and Restated Bylaws became effective. The Company is authorized to issue 210.0 million shares consisting of 10.0 million shares of Preferred Stock, par value \$0.0001 per share, 200.0 million shares of Class A Common Stock, and 1,000 shares of Class B Common Stock.

- On May 14, 2013, the Company completed its IPO by issuing approximately 12.8 million shares of Class A Common Stock for cash consideration of \$16.875 per share (net of underwriting discounts) to a syndicate of underwriters led by Citigroup Global Markets, Inc., BofA Merrill Lynch, Credit Suisse Securities (USA) LLC and Goldman, Sachs & Co., as joint book-running managers for the offering. Barclays Capital Inc., J.P. Morgan Securities LLC, Morgan Stanley & Co. LLC, and Wells Fargo Securities, LLC acted as co-managers. The Company's net proceeds from the offering were approximately \$215.6 million, after deducting underwriting discounts and commissions. As contemplated in the Registration Statement, the Company used the net proceeds from the offering to purchase approximately 12.8 million newly issued Class A units of PennyMac at a price per Class A unit of \$16.875.

- On June 13, 2013, the Sub-Committee of the Compensation Committee of PFSI authorized the grant of (a) nonstatutory stock options (each a Stock Option) to purchase a total of 259,565 shares of PFSI's Class A Common Stock (the Optioned Shares), and (b) 324,460 performance-based restricted stock units (RSUs), pursuant to PFSI's 2013 Equity Incentive Plan, to its executive officers, including those equity awards granted to the named executive officers and principal financial officer of PFSI as previously disclosed in a Current Report on Form 8-K filed with the SEC on June 17, 2013. Also on June 13, 2013 and as disclosed in the aforementioned Current Report on Form 8-K, the Compensation Committee authorized the grant of (a) Stock Options to purchase a total of 164,112 Optioned Shares, (b) 177,007 performance-based RSUs, and (c) 69,127 time-based RSUs to other eligible participants pursuant to the Company's 2013 Equity Incentive Plan.

Table of Contents**PRIVATE NATIONAL MORTGAGE ACCEPTANCE COMPANY, LLC****CONSOLIDATED BALANCE SHEETS (UNAUDITED)**

	March 31, 2013	December 31, 2012
	(in thousands except unit data)	
ASSETS		
Cash	\$ 56,135	\$ 12,323
Short-term investments, at fair value	72,664	53,164
Mortgage loans held for sale at fair value	203,661	448,384
Servicing advances	96,587	93,152
Receivable from Investment Funds	3,169	3,672
Receivable from PennyMac Mortgage Investment Trust	14,748	16,691
Derivative assets	27,481	27,290
Carried Interest due from Investment Funds	52,460	47,723
Investment in PennyMac Mortgage Investment Trust at fair value	1,942	1,897
Mortgage servicing rights at fair value	18,622	19,798
Mortgage servicing rights at lower of amortized cost or fair value	128,370	89,177
Furniture, fixtures, equipment and building improvements, net	6,253	5,065
Capitalized software, net	866	795
Other	10,019	13,032
Total assets	\$ 692,977	\$ 832,163
LIABILITIES		
Mortgage loans sold under agreements to repurchase	\$ 180,049	\$ 393,534
Note payable	63,437	53,013
Payable to Investment Funds	37,766	36,795
Payable to PennyMac Mortgage Investment Trust	53,909	46,779
Accounts payable and accrued expenses	42,966	36,279
Derivative liabilities	2,359	509
Liability for losses under representations and warranties	4,748	3,504
Total liabilities	385,234	570,413
Commitments and contingencies		
MEMBERS EQUITY		
Preferred units, 96,682 units authorized and subscribed, 96,682 units issued and outstanding as of March 31, 2013 and December 31, 2012	\$ 97,148	\$ 97,148
Common units, 20,556 units authorized; 15,890 and 13,552 units issued and outstanding as of March 31, 2013 and December 31, 2012, respectively		
Class C units, 3,738 units authorized; 440 and 367 units issued and outstanding as of March 31, 2013 and December 31, 2012, respectively		
Members' equity attributable to common and Class C units from equity compensation plan	22,446	22,270
Subscriptions receivable	(729)	(4,842)
Retained earnings	188,878	147,174
Total members' equity	307,743	261,750
Total liabilities and members' equity	\$ 692,977	\$ 832,163

The accompanying notes are an integral part of these financial statements.

Table of Contents

PRIVATE NATIONAL MORTGAGE ACCEPTANCE COMPANY, LLC

CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

	Quarter ended March 31,	
	2013	2012
	(in thousands except unit data)	
Revenue		
Net gains on mortgage loans held for sale at fair value	\$ 39,957	\$ 13,937
Loan origination fees	5,668	235
Fulfillment fees from PennyMac Mortgage Investment Trust	28,244	6,124
Net servicing income:		
Loan servicing fees		
From non-affiliates	9,057	2,845
From PennyMac Mortgage Investment Trust	7,722	4,206
From Investment Funds	2,147	3,623
Mortgage servicing rebate to Investment Funds	(139)	(246)
Ancillary and other fees	2,265	1,390
	21,052	11,818
Amortization, impairment and change in estimated fair value of mortgage servicing rights	(5,010)	(242)
Net servicing income	16,042	11,576
Management fees:		
From PennyMac Mortgage Investment Trust	6,492	1,804
From Investment Funds	1,914	2,389
	8,406	4,193
Carried Interest from Investment Funds	4,737	1,789
Interest	1,742	431
Change in fair value of investment in and dividends received from PennyMac Mortgage Investment Trust	88	195
Other	814	470
Total net revenue	105,698	38,950
Expenses		
Compensation	35,681	18,739
Interest	3,330	1,062
Loan origination	2,507	171
Professional services	2,288	1,244
Technology	1,586	982
Servicing	1,531	978
Occupancy	491	383
Other	2,991	160
Total expenses	50,405	23,719
Net income	\$ 55,293	\$ 15,231
Net income attributable to preferred units	\$ 46,014	\$ 13,308
Net income attributable to non-vested Class C unit awards outstanding	\$ 1,332	\$
Net income attributable to Class C units	\$ 190	\$
Net income attributable to non-vested common unit awards outstanding	\$ 534	\$ 1,157
Net income attributable to common units	\$ 7,223	\$ 766
Earnings per unit		
Preferred units	\$ 475.92	\$ 137.64
Class C units	\$ 432.71	\$
Common units		

Edgar Filing: PENNYMAC FINANCIAL SERVICES, INC. - Form 10-Q

Basic	\$	456.19	\$	112.73
Diluted	\$	429.83	\$	54.37
Weighted average units outstanding				
Preferred units		96,682		96,682
Class C units		439		
Common units				
Basic		15,833		6,792
Diluted		16,804		14,082

The accompanying notes are an integral part of these financial statements.

Table of Contents

PRIVATE NATIONAL MORTGAGE ACCEPTANCE COMPANY, LLC

CONSOLIDATED STATEMENTS OF CHANGES IN MEMBERS' EQUITY

	Preferred units		Common units		Class C common units		Subscriptions receivable	Retained earnings	Total
	Units	Amounts	Units	Amounts	Units	Amounts			
	(in thousands except unit data)								
Balance at December 31, 2011	96,682	\$ 96,374	4,564	\$ 2,737			\$ (19,918)	\$ 44,722	\$ 123,915
Capital:									
Contributions							15,058		15,058
Distributions								(18)	(18)
Unit-based compensation expense			2,228	2,736					2,736
Net income								15,231	15,231
Balance at March 31, 2012	96,682	\$ 96,374	6,792	\$ 5,473			\$ (4,860)	\$ 59,935	\$ 156,922
Balance at December 31, 2012	96,682	97,148	13,552	21,895	367	375	(4,842)	147,174	261,750
Capital:									
Distributions							4,113	(13,589)	(9,476)
Unit-based compensation expense			2,338	52	73	124			176
Net income								55,293	55,293
Balance at March 31, 2013	96,682	\$ 97,148	15,890	\$ 21,947	440	\$ 499	\$ (729)	\$ 188,878	\$ 307,743

The accompanying notes are an integral part of these financial statements.

Table of Contents

PRIVATE NATIONAL MORTGAGE ACCEPTANCE COMPANY, LLC

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	Quarter ended March 31,	
	2013	2012
	(in thousands)	
Cash flow from operating activities:		
Net income	\$ 55,293	\$ 15,231
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Net gain on mortgage loans held for sale at fair value	(39,957)	(13,937)
Accrual of servicing rebate to Investment Funds	139	246
Amortization, impairment and change in fair value of mortgage servicing rights	5,010	242
Carried Interest from Investment Funds	(4,737)	(1,789)
Change in fair value of investment in common shares of PennyMac Mortgage Investment Trust	(45)	(154)
Unit-based compensation expense	176	2,736
Amortization of debt issuance costs and commitment fees relating to financing facilities	1,145	549
Depreciation and amortization	137	132
Purchase from affiliate of mortgage loans held for sale	(3,548,397)	(838,120)
Originations of mortgage loans held for sale	(268,125)	(61,891)
Sale and principal payments of mortgage loans held for sale	4,061,097	813,128
Increase in servicing advances	(3,435)	(9,567)
Decrease in receivable from Investment Funds	364	3,660
Decrease (increase) in receivable from PennyMac Mortgage Investment Trust	2,427	(5,129)
Increase in other assets	(3,507)	(1,946)
Increase in accounts payable and accrued expenses	6,685	4,645
Increase in payable to Investment Funds	971	2,226
Increase in payable to PennyMac Mortgage Investment Trust	6,997	8,340
Net cash provided (used in) by operating activities	272,238	(81,398)
Cash flow from investing activities:		
Net increase in short-term investment	(19,500)	(18,209)
Purchase of furniture, fixtures, equipment and building improvements	(1,531)	(721)
Acquisition of capitalized software	(151)	(14)
Decrease in margin deposits and restricted cash	5,293	769
Net cash used in investing activities	(15,889)	(18,175)
Cash flow from financing activities:		
Sale of loans under agreements to repurchase	3,485,093	824,458
Repurchase of loans sold under agreements to repurchase	(3,698,578)	(742,611)
Increase (decrease) in notes payable	10,424	(1,018)
Collection of subscriptions receivable		15,058
Distributions	(9,476)	(18)
Net cash (used in) provided by financing activities	(212,537)	95,869
Net increase (decrease) in cash	43,812	(3,704)
Cash at beginning of period	12,323	16,465
Cash at end of period	\$ 56,135	\$ 12,761

The accompanying notes are an integral part of these financial statements.

Table of Contents

PRIVATE NATIONAL MORTGAGE ACCEPTANCE COMPANY, LLC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1 Organization and Basis of Presentation

Private National Mortgage Acceptance Company, LLC (PennyMac) is a Delaware limited liability company which, through its subsidiaries (collectively, the Company), engages in mortgage banking and investment management activities. PennyMac 's mortgage banking activities consist of residential mortgage lending (including correspondent lending and retail lending) and loan servicing. The investment management activities and a portion of the loan servicing activities are conducted on behalf of investment vehicles that invest in residential mortgage loans and related assets. PennyMac 's primary wholly-owned subsidiaries are:

- *PNMAC Capital Management, LLC* (PCM) a Delaware limited liability company registered with the Securities and Exchange Commission (SEC) as an investment advisor under the Investment Advisers Act of 1940, as amended. PCM enters into investment management agreements with entities that invest in residential mortgage loans and related assets.

Presently, PCM has management agreements with PennyMac Mortgage Investment Trust, a publicly held real estate investment trust (PMT), and three investment funds: PNMAC Mortgage Opportunity Fund, LLC and PNMAC Mortgage Opportunity Fund, L.P., (the Master Fund), both registered under the Investment Company Act of 1940, as amended; and PNMAC Mortgage Opportunity Fund Investors, LLC (collectively, Investment Funds). Together, the Investment Funds and PMT are referred to as the Advised Entities.

- *PennyMac Loan Services, LLC* (PLS) a Delaware limited liability company that services portfolios of residential mortgage loans on behalf of third parties or entities managed by the Company, originates new prime credit quality residential mortgage loans, and generally engages in mortgage banking activities for its own account and the account of PMT.

PLS is approved as a seller/servicer of mortgage loans by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) and as an issuer of securities guaranteed by the Government National Mortgage Association (Ginnie Mae). PLS is a licensed Federal Housing Administration Nonsupervised Title II Lender with the U.S. Department of Housing and Urban Development (HUD) and a lender/servicer with the Veterans Administration (VA) (each an Agency and collectively the Agencies).

- *PNMAC Opportunity Fund Associates, LLC* (PMOFA) a Delaware limited liability company and the general partner of the Master Fund. PMOFA is entitled to incentive fees representing allocations of profits (the Carried Interest) from the Master Fund.

Initial Public Offering and Recapitalization

Edgar Filing: PENNYMAC FINANCIAL SERVICES, INC. - Form 10-Q

PennyMac Financial Services, Inc. (PFSI) is a Delaware corporation that has not engaged in any business or other activities except in connection with its formation and initial public offering of shares.

On May 14, 2013, PFSI completed an initial public offering (IPO) in which it sold approximately 12.8 million shares of its common stock, which includes approximately 1.7 million shares sold pursuant to the exercise by the underwriters of an over-allotment option, at a public offering price of \$18.00 per share. PFSI received net proceeds of \$215.6 million, after deducting underwriting discounts and commissions, from sales of its shares in the IPO. PFSI used these net proceeds to purchase approximately 12.8 million Class A Units of PennyMac. PFSI operates and controls all of the business and affairs and consolidates the financial results of PennyMac and its subsidiaries.

Prior to the IPO, PennyMac completed a recapitalization by amending its limited liability company agreement to convert all classes of ownership interests held by its existing owners to a single class of common units. The conversion of existing interests was based on the various interests' liquidation priorities as specified in PennyMac's prior limited liability company agreement. In connection with that recapitalization, PFSI became the sole managing member of PennyMac.

As part of the IPO, PFSI entered into a tax receivable agreement with the Company's existing owners whereby PFSI will pay to such owners of PennyMac 85% of the tax benefits, if any, that PFSI is deemed to realize under certain circumstances as a result of (i) increases in tax basis resulting from exchanges of the then-existing unitholders and (ii) certain other tax benefits related to PFSI entering into the tax receivable agreement, including tax benefits attributable to payments under the tax receivable agreement.

The accompanying consolidated financial statements of the Company do not reflect the effect of the recapitalization described above which took effect on May 8, 2013, or the IPO completed on May 14, 2013.

Table of Contents

Basis of presentation

The Company's unaudited consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP) and applicable rules and regulations of the SEC regarding interim financial reporting. The information included in this quarterly report on Form 10-Q should be read with the financial statements and accompanying notes included in the Company's final prospectus dated May 8, 2013 as part of its Registration Statement on Form S-1, as amended (SEC File No. 333-186495) (the Registration Statement).

The accompanying unaudited consolidated financial statements reflect all normal recurring adjustments necessary to present fairly the financial position, results of operations, and cash flows for the interim periods, but are not necessarily indicative of the results of operations to be anticipated for the full year ending December 31, 2013.

Note 2 Concentration of Risk

A substantial portion of the Company's activities relate to the Advised Entities. Fees charged to these entities (comprised of management fees, loan servicing fees and loan servicing rebates, Carried Interest income and fulfillment fees from PMT) totaled 49% and 52% of total revenues for the quarters ended March 31, 2013 and 2012, respectively.

Note 3 Transactions with Affiliates

PennyMac Mortgage Investment Trust

Management Fees

Before February 1, 2013, under a management agreement, the Company received from PMT a base management fee. The base management fee was calculated at 1.5% per year of PMT's shareholders' equity. The management agreement also provided for a performance incentive fee, which was calculated at 20% per year of the amount by which PMT's core earnings, on a rolling four-quarter basis and before the incentive fee, exceeded an 8% hurdle rate as defined in the management agreement. The Company did not earn a performance incentive fee prior to February 1, 2013.

Effective February 1, 2013, the management agreement was amended to provide that:

Edgar Filing: PENNYMAC FINANCIAL SERVICES, INC. - Form 10-Q

- The base management fee is calculated quarterly and is equal to the sum of (i) 1.5% per year of PMT's shareholders' equity up to \$2 billion, (ii) 1.375% per year of shareholders' equity in excess of \$2 billion and up to \$5 billion, and (iii) 1.25% per year of PMT's shareholders' equity in excess of \$5 billion.
- The performance incentive fee is calculated at a defined annualized percentage of the amount by which PMT's net income, on a rolling four-quarter basis and before deducting the incentive fee, exceeds certain levels of return on equity.

The performance incentive fee is calculated quarterly and is equal to the sum of: (a) 10% of the amount by which PMT's net income for the quarter exceeds (i) an 8% return on equity plus the high watermark, up to (ii) a 12% return on PMT's equity; plus (b) 15% of the amount by which PMT's net income for the quarter exceeds (i) a 12% return on PMT's equity plus the high watermark, up to (ii) a 16% return on PMT's equity; plus (c) 20% of the amount by which PMT's net income for the quarter exceeds a 16% return on equity plus the high watermark.

For the purpose of determining the amount of the performance incentive fee:

Net income is defined as net income or loss computed in accordance with U.S. GAAP and certain other non-cash charges determined after discussions between the Company and PMT's independent trustees and approval by a majority of PMT's independent trustees.

Equity is the weighted average of the issue price per common share of all of PMT's public offerings, multiplied by the weighted average number of common shares outstanding (including restricted share units) in the four-quarter period.

The high watermark starts at zero and is adjusted quarterly. The quarterly adjustment reflects the amount by which the net income (stated as a percentage of return on equity) in that quarter exceeds or falls short of the lesser of 8% and the Fannie Mae Mortgage-Backed Security (MBS) yield (the target yield) for such quarter. If the net income is lower than the target yield, the high watermark is increased by the difference. If the net income is higher than the target yield, the high watermark is reduced by the difference. Each time a performance incentive fee is earned, the high watermark returns to zero. As a result, the threshold amounts required for the Company to earn a performance incentive fee are adjusted cumulatively based on the performance of PMT's net income over (or under) the target yield, until the net income in excess of the target yield exceeds the then-current cumulative high watermark amount, and a performance incentive fee is earned.

Table of Contents

The base management fee and the performance incentive fee are both receivable quarterly in arrears. The performance incentive fee may be paid in cash or in PMT's common shares (subject to a limit of no more than 50% paid in common shares), at PMT's option.

Following is a summary of the base management and performance incentive fees earned from PMT for the periods presented:

	Quarter ended March 31,	
	2013	2012
	(in thousands)	
Base management fee	\$ 4,364	\$ 1,804
Performance incentive fee	2,128	
	\$ 6,492	\$ 1,804

The term of the management agreement, as amended, expires on February 1, 2017, subject to automatic renewal for additional 18-month periods, unless terminated earlier in accordance with the terms of the management agreement.

In the event of termination by PMT, the Company may be entitled to a termination fee in certain circumstances. The termination fee is equal to three times the sum of (a) the average annual base management fee, and (b) the average annual (or, if the period is than 24 months, annualized) performance incentive fee earned by the Company, in each case during the 24-month period before termination.

Mortgage Loan Servicing

The Company has a loan servicing agreement with PMT. Before February 1, 2013, the servicing fee rates were based on the risk characteristics of the mortgage loans serviced and total servicing compensation was established at levels that management believed were competitive with those charged by other servicers or specialty servicers, as applicable.

- Servicing fee rates for nonperforming loans ranged between 50 and 100 basis points per year on the unpaid principal balance of the mortgage loans serviced on PMT's behalf. The Company was also entitled to certain customary market-based fees and charges, including boarding and deboarding fees, liquidation and disposition fees, assumption, modification and origination fees and late charges, as well as interest on funds on deposit in custodial accounts. In the event the Company either effected a refinancing of a loan on PMT's behalf and not through a third party lender and the resulting loan was readily saleable, or originated a loan to facilitate the disposition of real estate that PMT had acquired in settlement of a loan, the Company was entitled to receive from PMT market-based fees and compensation.

- For mortgage loans serviced by PMT as a result of acquisitions and sales with servicing rights retained in connection with PMT's correspondent lending business, the Company was entitled to base subservicing fees and other customary market-based fees and charges as described above.

Edgar Filing: PENNYMAC FINANCIAL SERVICES, INC. - Form 10-Q

Effective February 1, 2013, the servicing agreement was amended to provide for servicing fees payable to the Company that changed from being based on a percentage of the loan's unpaid principal balance to fixed per-loan monthly amounts based on the delinquency, bankruptcy and/or foreclosure status of the serviced loan or the REO. The Company also remains entitled to market-based fees and charges including boarding and deboarding fees, liquidation and disposition fees, assumption, modification and origination fees and late charges relating to loans it services for PMT.

- The base servicing fees for distressed whole loans are calculated based on a monthly per-loan dollar amount, with the actual dollar amount for each loan based on the delinquency, bankruptcy and/or foreclosure status of such loan or the related underlying real estate. Presently, the base servicing fees for distressed whole loans range from \$30 per month for current loans up to \$125 per month for loans that are severely delinquent and in foreclosure.
- The base servicing fees for loans subserviced by the Company on PMT's behalf are also calculated through a monthly per-loan dollar amount, with the actual dollar amount for each loan based on whether the mortgage loan is a fixed-rate or adjustable-rate loan. The base servicing fees for loans subserviced on PMT's behalf are \$7.50 per month for fixed-rate loans and \$8.50 per month for adjustable rate mortgage loans. To the extent that these loans become delinquent, the Company is entitled to an additional servicing fee per loan falling within a range of \$10 to \$75 per month based on the delinquency, bankruptcy and foreclosure status of the loan or the related underlying real estate. The Company is also entitled to customary ancillary income and certain market-based fees and charges, including boarding and deboarding fees, liquidation and disposition fees, assumption, modification and origination fees.

Table of Contents

- The Company is required to provide a range of services and activities significantly greater in scope than the services provided in connection with a customary servicing arrangement because PMT does not have any employees or infrastructure. For these services, the Company receives a supplemental fee of \$25 per month for each distressed whole loan and \$3.25 per month for each subserviced loan. The Company is entitled to reimbursement for all customary, good faith reasonable and necessary out-of-pocket expenses incurred in performance of its servicing obligations.

- The Company, on behalf of PMT, currently participates in the U.S. Department of the Treasury and HUD's Home Affordable Modification Program (HAMP) (and other similar mortgage loan modification programs), which establishes standard loan modification guidelines for at risk homeowners and provides incentive payments to certain participants, including loan servicers, for achieving modifications and successfully remaining in the program. The loan servicing agreement entitles the Company to retain any incentive payments made to it and to which it is entitled under HAMP; provided, however, that with respect to any such incentive payments paid to the Company under HAMP in connection with a mortgage loan modification for which PMT previously paid the Company a modification fee, the Company shall reimburse PMT an amount equal to the incentive payments.

Following is a summary of mortgage loan servicing fees earned for the periods presented:

	Quarter ended March 31,			
	2013		2012	
	(in thousands)			
Loan servicing fees:				
Base	\$	4,361	\$	3,028
Activity-based		3,361		1,178
	\$	7,722	\$	4,206

The term of the servicing agreement, as amended, expires on February 1, 2017, subject to automatic renewal for additional 18-month periods, unless terminated earlier in accordance with the terms of the servicing agreement.

Correspondent Lending

Before February 1, 2013, PMT paid the Company a fulfillment fee of 50 basis points of the unpaid principal balance of mortgage loans sold to non-affiliates where PMT is approved or licensed to sell to such non-affiliate. Effective February 1, 2013, the mortgage banking and warehouse services agreement provides for a fulfillment fee paid to the Company based on the type of mortgage loan that PMT acquires. The fulfillment fee is equal to a percentage of the unpaid principal balance of mortgage loans purchased by PMT, with the addition of potential fee rate discounts applicable to PMT's monthly purchase volume in excess of designated thresholds. The Company has also agreed to provide such services exclusively for PMT's benefit, and the Company and its affiliates are prohibited from providing such services for any other third party.

The Company is entitled to a fulfillment fee based on the type of mortgage loan that PMT acquires and equal to a percentage of the unpaid principal balance of such mortgage loan. Presently, the applicable percentages are (i) 0.50% for conventional mortgage loans, (ii) 0.88% for loans underwritten in accordance with the Ginnie Mae Mortgage-Backed Securities Guide, (iii) 0.80% for the U.S. Department of the Treasury and HUD's Home Affordable Refinance Program (HARP) mortgage loans with a loan-to-value ratio of 105% or less, (iv) 1.20% for HARP

Edgar Filing: PENNYMAC FINANCIAL SERVICES, INC. - Form 10-Q

mortgage loans with a loan-to-value ratio of greater than 105%, and (v) 0.50% for all other mortgage loans not contemplated above.

In the event that PMT purchases mortgage loans with an aggregate unpaid principal balance in any month greater than \$2.5 billion and less than \$5 billion, the Company has agreed to discount the amount of such fulfillment fees by reimbursing PMT an amount equal to the product of (i) 0.025%, (ii) the amount of unpaid principal balance in excess of \$2.5 billion and (iii) the percentage of the aggregate unpaid principal balance relating to mortgage loans for which the Company collected fulfillment fees in such month. In the event PMT purchases mortgage loans with an aggregate unpaid principal balance in any month greater than \$5 billion, the Company has agreed to discount the amount of such fulfillment fees by reimbursing PMT an amount equal to the product of (i) 0.05%, (ii) the amount of unpaid principal balance in excess of \$5 billion and (iii) the percentage of the aggregate unpaid principal balance relating to mortgage loans for which the Company collected fulfillment fees in such month.

PMT does not hold the Ginnie Mae approval required to issue securities guaranteed by Ginnie Mae MBS and act as a servicer. Accordingly, under the mortgage banking and warehouse services agreement, the Company currently purchases loans underwritten in accordance with the Ginnie Mae Mortgage-Backed Securities Guide as is and without recourse of any kind from PMT at its cost less fees collected by PMT from the seller, plus accrued interest and a sourcing fee of three basis points.

Table of Contents

In consideration for the mortgage banking services provided by the Company with respect to PMT's acquisition of mortgage loans under PennyMac Loan Services, LLC early purchase program, the Company is entitled to fees (i) accruing at a rate equal to \$25,000 per year, and (ii) in the amount of \$50 for each mortgage loan PMT acquires. In consideration for the warehouse services provided by the Company with respect to mortgage loans that PMT finances for its warehouse lending clients, with respect to each facility, the Company is entitled to fees (i) accruing at a rate equal to \$25,000 per year, and (ii) in the amount of \$50 for each mortgage loan that PMT finances thereunder. Where PMT has entered into both an early purchase agreement and a warehouse lending agreement with the same client, the Company shall only be entitled to one \$25,000 per annum fee and, with respect to any mortgage loan that becomes subject to both such agreements, only one \$50 per loan fee.

The term of the mortgage banking and warehouse services agreement expires on February 1, 2017, subject to automatic renewal for additional 18-month periods, unless terminated earlier in accordance with the terms of the agreement.

Following is a summary of correspondent lending activity between the Company and PMT for the periods presented:

	Quarter ended March 31,	
	2013	2012
	(in thousands)	
Sourcing fees paid	\$ 1,010	\$ 244
Fulfillment fee revenue	\$ 28,244	\$ 6,124
Unpaid principal balance of loans fulfilled	\$ 3,366,770	\$ 799,207

Investment Activities

Pursuant to the terms of a mortgage servicing rights (MSR) recapture agreement, effective February 1, 2013, if the Company refinances through its retail lending business loans for which PMT previously held the MSR, the Company is generally required to transfer and convey to one of PMT's wholly-owned subsidiaries, without cost to PMT, the MSR with respect to new mortgage loans originated in those refinancings (or, under certain circumstances, other mortgage loans) that have an aggregate unpaid principal balance that is not less than 30% of the aggregate unpaid principal balance of all the loans so originated. The MSR recapture agreement expires, unless terminated earlier in accordance with the agreement, on February 1, 2017, subject to automatic renewal for additional 18-month periods.

Pursuant to the terms of a spread acquisition and MSR servicing agreement, PMT may acquire from the Company the rights to receive certain excess servicing spread arising from MSRs acquired by the Company, in which case the Company generally would be required to service or subservice the related mortgage loans. The terms of each transaction under the spread acquisition and MSR servicing agreement will be subject to the terms of such agreement as modified and supplemented by the terms of a confirmation executed in connection with such transaction.

Other Transactions

Edgar Filing: PENNYMAC FINANCIAL SERVICES, INC. - Form 10-Q

In connection with the IPO of PMT's common shares on August 4, 2009, the Company entered into an agreement with PMT pursuant to which PMT agreed to reimburse the Company for the \$2.9 million payment that it made to the underwriters in such offering (the "Conditional Reimbursement") if PMT satisfied certain performance measures over a specified period of time. Effective February 1, 2013, PMT amended the terms of the reimbursement agreement to provide for the reimbursement to the Company of the Conditional Reimbursement if PMT is required to pay the Company performance incentive fees under the management agreement at a rate of \$10 in reimbursement for every \$100 of performance incentive fees earned. The reimbursement of the Conditional Reimbursement is subject to a maximum reimbursement in any particular 12-month period of \$1.0 million and the maximum amount that may be reimbursed under the agreement is \$2.9 million. The reimbursement agreement also provides for the payment to the underwriters in such offering of the payment that PMT agreed to make to them at the time of the offering if PMT satisfied certain performance measures over a specified period of time. As the Company earns performance incentive fees under the management agreement, such underwriters will be paid by PMT at a rate of \$20 of payments for every \$100 of performance incentive fees earned by the Company. The payment to the underwriters is subject to a maximum reimbursement in any particular 12-month period of \$2.0 million and the maximum amount that may be paid under the agreement is \$5.9 million.

In the event the termination fee is payable to the Company under the management agreement and the Company and the underwriters have not received the full amount of the reimbursements and payments under the reimbursement agreement, such amount will be paid in full. The term of the reimbursement agreement expires on February 1, 2019.

Table of Contents

PMT reimburses the Company for other expenses, including common overhead expenses incurred on its behalf by the Company, in accordance with the terms of its management agreement. Such amounts are summarized below:

	Quarter ended March 31,	
	2013	2012
	(in thousands)	
Reimbursement of expenses incurred on PMT's behalf	\$ 1,358	\$ 2,410
Reimbursement of common overhead incurred by PCM and its affiliates	2,606	386
	\$ 3,964	\$ 2,796
Payments and settlements during the period (1)	\$ 33,362	\$ 5,485

(1) Payments and settlements include payments for management fees and correspondent lending activities itemized in the preceding tables and netting settlements made pursuant to master netting agreements between the Company and PMT.

Amounts due from PMT are summarized below as of the dates presented:

	March 31, 2013	December 31, 2012
	(in thousands)	
Management fees	\$ 6,518	\$ 4,473
Servicing fees	3,191	3,670
Contingent underwriting fees	2,941	2,941
Allocated expenses	2,098	1,132
Loan purchases	4,475	4,475
	\$ 14,748	\$ 16,691

The Company also holds an investment in PMT in the form of 75,000 common shares of beneficial interest as of March 31, 2013 and December 31, 2012. The shares had fair values of \$1,942,000 and \$1,897,000 as of March 31, 2013 and December 31, 2012, respectively.

Investment Funds

Amounts due from the Investment Funds are summarized below for the dates presented:

Edgar Filing: PENNYMAC FINANCIAL SERVICES, INC. - Form 10-Q

	March 31, 2013	December 31, 2012
(in thousands)		
Receivable from Investment Funds:		
Management fees	\$ 1,913	\$ 2,164
Loan servicing fees	853	1,052
Expense reimbursements	245	695
Loan servicing rebate	158	(239)
	\$ 3,169	\$ 3,672
Carried interest due from Investment Funds:		
PNMAC Mortgage Opportunity Fund, LLC	\$ 32,707	\$ 29,785
PNMAC Mortgage Opportunity Fund Investors, LLC	19,753	17,938
	\$ 52,460	\$ 47,723

Amounts due to the Investment Funds totaling \$37,766,000 and \$36,795,000 represent amounts advanced by the Investment Funds to fund servicing advances made by the Company as of March 31, 2013 and December 31, 2012, respectively.

Table of Contents

Note 4 Earnings Per Unit

The following reflects the earnings per unit calculation of the Company and is not attributable to the calculation of PFSI's earnings per common share following the IPO and recapitalization, as discussed in Note 22 *Subsequent Events*.

Earnings per unit is calculated using the two-class method. The Company allocates net income or loss to each class of participating unitholders as specified in the Company's limited liability company agreement, which requires the allocation of distributions among the units under the assumption of a hypothetical liquidation of the Company as follows:

- First, to the preferred member units until the aggregate unpaid preferred distributions (the 8% annual compounded preferred return) have been paid.

- Second, to the preferred member units until all of the initial paid-in capital has been returned.

- Third, distributions will be made to the extent that prior period undistributed net income has not been distributed to any member (preferred, common or Class C). This represents previous undistributed amounts applicable to the remaining tiers (i.e. tier four, five and six that follow).

- Fourth, distributions will be made to the preferred and common units on a pro-rata basis to each outstanding unit. This distribution is referred to as the priority operating profit allocation to preferred and common units receiving an 8% compounded annual priority return beginning June 1, 2011. The aggregate amount distributable under this tier can range between \$435,246,000 and \$135,246,000 depending on the thresholds for newly originated loan acquisitions achieved by the correspondent lending group after June 1, 2011. Before June 1, 2011 there were no allocations of income required for this fourth tier distribution. If unpaid amounts exist at a period end, they are paid out of the following year or in a liquidation event under tier three above.

- Fifth, distributions will be made under the priority capital appreciation allocation to preferred and common units on a pro-rata basis to each unit outstanding. The priority capital appreciation would require total distributions in this tier of up to \$300,000,000 before June 1, 2011. After June 1, 2011, the amount distributable under this tier can range between \$300,000,000 and \$0 depending on the thresholds for newly originated loan acquisitions achieved by the correspondent lending group. If unpaid amounts exist at a period end they are paid out of the following year or in a liquidation event under tier three above.

- Sixth, and finally, a sharing of the remaining distributions among all members (including the preferred, common, and Class C unitholders on a pro-rata basis) to each unit outstanding with allocations up to the strike price of vested and unvested unit awards being paid back first, as a priority allocation, to the preferred and common unitholders that did not receive such units as stock based compensation awards. If unpaid amounts exist at a period end they are paid out of the following year or in a liquidation event under tier three above.

Table of Contents

The following is a reconciliation of net income to net income attributable to common unitholders and a table summarizing the basic and diluted earnings per unit calculations for the periods presented:

	Quarter ended March 31,	
	2013	2012
	(in thousands except unit data)	
Earnings per preferred unit:		
Net income	\$ 55,293	\$ 15,231
Net income attributable to preferred units		
Distributed priority return	\$ 13,589	\$ 1,426
Undistributed priority return	29,519	
Undistributed earnings	2,906	11,882
Net income attributable to preferred units	\$ 46,014	\$ 13,308
Preferred units outstanding	96,682	96,682
Earnings per preferred unit	\$ 475.92	\$ 137.64
Earnings per common unit:		
Net income attributable to common members	\$ 7,757	\$ 1,923
Less: Distributions to non-vested common unit awards outstanding		
Undistributed earnings attributable to non-vested common unit awards outstanding	534	1,157
Net income attributable to common units	\$ 7,223	\$ 766
Basic earnings per common unit:		
Weighted-average common units outstanding	15,833	6,792
Basic earnings per common unit	\$ 456.19	\$ 112.73
Diluted earnings per common unit:		
Net income attributable to common units	\$ 7,223	\$ 766
Weighted-average common units outstanding	15,833	6,792
Dilutive potential common units units issuable under equity-based compensation plan	971	7,290
Diluted weighted-average number of common units outstanding	16,804	14,082
Diluted earnings per common units	\$ 429.83	\$ 54.37
Earnings per Class C unit:		
Net income attributable to Class C	\$ 1,522	\$
Less: Undistributed income attributable to non-vested Class C units	1,332	
Net income available to Class C units	\$ 190	\$
Weighted-average Class C units outstanding	439	
Earnings per Class C unit	\$ 432.71	\$

Table of Contents**Note 5 Loan Sales and Servicing Activities**

The Company purchases and sells mortgage loans to the secondary mortgage market without recourse for credit losses. However, the Company maintains continuing involvement with the loans in the form of servicing arrangements and the liability under representations and warranties it makes to purchasers and insurers of the loans.

The following table summarizes cash flows between the Company and transferees upon sale of mortgage loans in transactions where the Company maintains continuing involvement with the mortgage loans (primarily the obligation to service the loans on behalf of the loans owners or owners agents):

	Quarter ended March 31,	
	2013	2012
	(in thousands)	
Cash flows:		
Proceeds from sales	\$ 4,061,097	\$ 813,128
Servicing fees received	\$ 9,299	\$ 1,846
Net servicing advances	\$ (3,736)	\$ 609
Quarter-end information:		
Unpaid principal balance of loans outstanding at period-end	\$ 12,485,598	\$ 1,499,970
Loans delinquent 30-89 days	\$ 119,433	\$ 9,650
Loans delinquent 90 or more days or in foreclosure or bankruptcy	\$ 36,566	\$ 3,450

The Company's mortgage servicing portfolio is summarized as follows:

	March 31, 2013		
	Servicing rights owned	Subservicing (in thousands)	Total loans serviced
Affiliated entities	\$	\$ 21,384,109	\$ 21,384,109
Agencies	13,328,541		13,328,541
Private investors	1,260,086		1,260,086
Mortgage loans held for sale	193,894		193,894
	\$ 14,782,521	\$ 21,384,109	\$ 36,166,630
Amount subserviced for the Company	\$ 43,546	\$ 285,243	\$ 328,789
Delinquent mortgage loans:			
30 days	\$ 187,015	\$ 175,071	\$ 362,086
60 days	67,328	96,266	163,594
90 days or more	129,865	1,083,921	1,213,786
	384,208	1,355,258	1,739,466
Loans pending foreclosure	69,559	1,211,596	1,281,155
	\$ 453,767	\$ 2,566,854	\$ 3,020,621
Custodial funds managed by the Company(1)	\$ 200,611	\$ 224,176	\$ 424,787

Table of Contents

	December 31, 2012		
	Servicing rights owned	Subservicing (in thousands)	Total loans serviced
Affiliated entities	\$	\$ 16,552,939	\$ 16,552,939
Agencies	9,860,284		9,860,284
Private investors	1,321,584		1,321,584
Mortgage loans held for sale	417,742		417,742
	\$ 11,599,610	\$ 16,552,939	\$ 28,152,549
Amount subserviced for the Company	\$ 45,562	\$ 375,818	\$ 421,380
Delinquent mortgage loans:			
30 days	\$ 191,884	\$ 187,653	\$ 379,537
60 days	60,886	122,564	183,450
90 days or more	112,847	851,851	964,698
	365,617	1,162,068	1,527,685
Loans pending foreclosure	75,329	1,290,687	1,366,016
	\$ 440,946	\$ 2,452,755	\$ 2,893,701
Custodial funds managed by the Company(1)	\$ 263,562	\$ 150,080	\$ 413,642

(1) Borrower and investor custodial cash accounts relate to loans serviced under the servicing agreements and are not recorded on the Company's consolidated balance sheets. The Company earns interest on custodial funds it manages on behalf of the loans' investors, which is recorded as part of the interest income in the Company's consolidated statements of income.

Following is a summary of the geographical distribution of loans included in the Company's servicing portfolio for the top five states as measured by the total unpaid principal balance:

State	(in thousands)	
	March 31, 2013	December 31, 2012
California	\$ 13,710,964	\$ 10,696,508
Virginia	1,698,397	*
Texas	1,677,184	1,223,382
Florida	1,668,887	1,385,286
Colorado	1,602,650	1,299,295
Washington	*	1,143,849
All other states	15,808,548	12,404,229
	\$ 36,166,630	\$ 28,152,549

* State did not represent a top five state as of the respective date.

Certain of the loans serviced by the Company are subserviced on the Company's behalf by other mortgage loan servicers. Loans are subserviced for the Company when the loans are secured by property in the State of Massachusetts where the Company is not licensed and a license is required to perform such services, or on a transitional basis for loans where the Company has obtained the rights to service the loans but servicing of the loans has not yet transferred to the Company's servicing system.

Table of Contents**Note 6 Netting of Financial Instruments**

The Company uses derivative instruments to manage exposure to interest rate risk for the commitments it makes to purchase or originate mortgage loans at specified interest rates (interest rate lock commitments or IRLCs), its inventory of mortgage loans held for sale and MSRs. All derivative financial instruments are recorded on the balance sheet at fair value with changes in fair value recognized in current period income. The Company has elected to net derivative asset and liability positions, and cash collateral obtained (or posted) by (or for) its counterparties when subject to an enforceable master netting arrangement. In the event of default, all counterparties are subject to legally enforceable master netting agreements. The derivatives that are not subject to a master netting arrangement are IRLCs.

As of March 31, 2013 and December 31, 2012, the Company was not party to reverse repurchase agreements or securities lending transactions that are required to be disclosed in the following table.

Offsetting of Derivative Assets

	March 31, 2013			December 31, 2012		
	Gross amounts of recognized assets	Gross amounts offset in the balance sheet	Net amounts of assets presented in the balance sheet	Gross amounts of recognized assets	Gross amounts offset in the balance sheet	Net amounts of assets presented in the balance sheet
	(in thousands)					
Derivatives subject to master netting arrangements:						
MBS put options	\$ 431	\$	\$ 431	\$ 967	\$	\$ 967
MBS call options	755		755			
Forward purchase contracts	4,544		4,544	1,645		1,645
Forward sale contracts	553		553	1,818		1,818
Netting		(4,239)	(4,239)		(1,091)	(1,091)
	6,283	(4,239)	2,044	4,430	(1,091)	3,339
Derivatives not subject to master netting arrangements -						
IRLCs	25,437		25,437	23,951		23,951
Total	\$ 31,720	\$ (4,239)	\$ 27,481	\$ 28,381	\$ (1,091)	\$ 27,290

Derivative Assets, Financial Assets, and Collateral Held by Counterparty

The following table summarizes by significant counterparty the amount of derivative asset positions after considering master netting arrangements and financial instruments or cash pledged that does not meet the accounting guidance qualifying for setoff accounting.

Edgar Filing: PENNYMAC FINANCIAL SERVICES, INC. - Form 10-Q

	March 31, 2013			December 31, 2012			
	Gross amounts not offset in the consolidated balance sheet			Gross amounts not offset in the consolidated balance sheet			
Net amount of assets in the balance sheet	Financial instruments	Cash collateral received	Net amount	Net amount of assets in the balance sheet	Financial instruments	Cash collateral received	Net amount
(in thousands)							
Interest rate lock commitments	\$ 25,437	\$	\$ 25,437	\$ 23,951	\$	\$	\$ 23,951
Barclays Capital	747		747				
Bank of America, N.A.	297		297	1,782			1,782
Citibank	190		190	522			522
Bank of NY Mellon	47		47	311			311
Other	763		763	724			724
Total	\$ 27,481	\$	\$ 27,481	\$ 27,290	\$	\$	\$ 27,290

Table of Contents

Offsetting of Derivative Liabilities and Financial Liabilities

Following is a summary of net derivative liabilities and assets sold under agreements to repurchase. As discussed above, all derivatives with the exception of IRLCs are subject to master netting arrangements. The assets sold under agreements to repurchase do not qualify for setoff accounting.

	March 31, 2013			December 31, 2012		
	Gross amounts of recognized liabilities	Gross amounts offset in the consolidated balance sheet	Net amounts of liabilities presented in the consolidated balance sheet	Gross amounts of recognized liabilities	Gross amounts offset in the consolidated balance sheet	Net amounts of liabilities presented in the consolidated balance sheet
(in thousands)						
Derivatives:						
Subject to a master netting arrangement:						
Forward purchase contracts	\$ 59	\$	\$ 59	\$ 389	\$	\$ 389
Forward sale contracts	9,411		9,411	1,894		1,894
Netting		(7,111)	(7,111)		(1,785)	(1,785)
	9,470	(7,111)	2,359	2,283	(1,785)	498
Derivatives not subject to a master netting arrangement - IRLCs						
				11		11
Total derivatives	9,470	(7,111)	2,359	2,294	(1,785)	509
Mortgage loans sold under agreements to repurchase						
	180,049		180,049	393,534		393,534
Total	\$ 189,519	\$ (7,111)	\$ 182,408	\$ 395,828	\$ (1,785)	\$ 394,043

Derivative Liabilities, Financial Liabilities, and Collateral Held by Counterparty

The following table summarizes by significant counterparty the amount of derivative liabilities and assets sold under agreements to repurchase after considering master netting arrangements and financial instruments or cash pledged that does not meet the accounting guidance qualifying for setoff accounting. All assets sold under agreements to repurchase are secured by sufficient collateral or exceed the liability amount recorded on the consolidated balance sheet.

Net amount of liabilities in the	March 31, 2013			Net amount	December 31, 2012		
	Financial instruments	Cash collateral	Gross amounts not offset in the balance sheet		Financial instruments	Cash collateral	Gross amounts not offset in the balance sheet

Edgar Filing: PENNYMAC FINANCIAL SERVICES, INC. - Form 10-Q

	balance sheet		pledged		(in thousands)		balance sheet		pledged			
Citibank, N.A.	\$	61,419	\$	(61,092)	\$	327	\$	121,200	\$	(121,200)	\$	\$
Bank of America, N.A.		92,910		(92,910)				150,082		(150,082)		
Credit Suisse First Boston Mortgage Capital LLC		26,399		(26,047)		352		122,443		(122,252)		191
Morgan Stanley Bank, N.A.		216				216		53				53
Goldman Sachs		668				668						
Other		796				796		265				265
Total	\$	182,408	\$	(180,049)	\$	2,359	\$	394,043	\$	(393,534)	\$	\$ 509

Table of Contents

Note 7 Fair Value

The Company's consolidated financial statements include assets and liabilities that are measured based on their estimated fair values. The application of fair value estimates may be on a recurring or nonrecurring basis depending on the accounting principles applicable to the specific asset or liability and whether management has elected to carry the item at its estimated fair value as discussed in the following paragraphs.

Fair Value Accounting Elections

Management identified all of its non-cash financial assets and its originated MSR's relating to loans with initial interest rates of more than 4.5% to be accounted for at estimated fair value so changes in fair value will be reflected in results of operations as they occur and more timely reflect the results of the Company's performance. The Company's financial assets subject to this election include the short-term investments and mortgage loans held for sale.

For originated MSR's relating to mortgage loans with initial interest rates of less than or equal to 4.5%, management has concluded that such assets present different risks to the Company than originated MSR's relating to mortgage loans with initial interest rates of more than 4.5% and therefore require a different risk management approach. Management's risk management efforts relating to these assets are aimed at mainly moderating the effects of non-interest rate risks on fair value, such as the effect of changes in home prices on the assets' values. Management has identified these assets for accounting using the amortization method. Management's risk management efforts in connection with MSR's relating to mortgage loans with initial interest rates of more than 4.5% are aimed at mainly moderating the effects of changes in interest rates on the assets' values. During the period, a portion of the IRLC's, the fair value of which typically increases when prepayment speeds increase, were used to mitigate the effect of changes in fair value of the servicing assets, which typically decreases as prepayment speeds increase.

Table of Contents**Financial Statement Items Measured at Fair Value on a Recurring Basis**

Following is a summary of financial statement items that are measured at estimated fair value on a recurring basis:

Assets:					
Short-term investment	\$	72,664	\$	72,664	\$
Mortgage loans held for sale at fair value		203,661		199,174	4,487
Investment in PMT		1,942		1,942	
Mortgage servicing rights at fair value		18,622			18,622
Derivative assets:					
Interest rate lock commitments		25,437			25,437
Forward purchase contracts		4,544		4,544	
Forward sales contracts		553		553	
MBS put options		431		431	
MBS call options		755		755	
Total derivative assets before netting		31,720		6,283	25,437
Netting (1)		(4,239)			
Total derivative assets		27,481		6,283	25,437
	\$	324,370	\$	74,606	\$ 205,457 \$ 48,546
Liabilities:					
Derivative liabilities:					
Forward purchase contracts	\$	59	\$	59	\$
Forward sales contracts		9,411		9,411	
Total derivative liabilities before netting		9,470		9,470	
Netting (1)		(7,111)			
Total derivative liabilities	\$	2,359	\$	9,470	\$

(1) Derivatives are reported net of cash collateral received and paid and, to the extent that the criteria of the accounting guidance covering the offsetting of amounts related to certain contracts are met, positions with the same counterparty are netted as part of a legally enforceable master netting agreement.

Table of Contents

	Total	December 31, 2012		Level 3
		Level 1	Level 2	
(in thousands)				
Assets:				
Short-term investment	\$ 53,164	\$ 53,164	\$	\$
Mortgage loans held for sale at fair value	448,384		448,384	
Investment in PMT	1,897	1,897		
Mortgage servicing rights at fair value	19,798			19,798
Derivative assets:				
Interest rate lock commitments	23,951			23,951
Forward purchase contracts	1,645		1,645	
Forward sales contracts	1,818		1,818	
MBS put options	967		967	
Total derivative assets before netting	28,381		4,430	23,951
Netting (1)	(1,091)			
Total derivative assets	27,290		4,430	23,951
	\$ 550,533	\$ 55,061	\$ 452,814	\$ 43,749
Liabilities:				
Derivative liabilities:				
Interest rate lock commitments	\$ 11	\$	\$	\$ 11
Forward purchase contracts	389		389	
Forward sales contracts	1,894		1,894	
Total derivative liabilities before netting	2,294		2,283	11
Netting (1)	(1,785)			
Net derivative liabilities	\$ 509	\$	\$ 2,283	\$ 11

(1) Derivatives are reported net of cash collateral received and paid and, to the extent that the criteria of the accounting guidance covering the setoff of amounts related to certain contracts are met, positions with the same counterparty are netted as part of a legally enforceable master netting agreement.

Table of Contents

As shown above, certain of the Company's mortgage loans held for sale, MSR's at fair value, and IRLCs, are measured using Level 3 inputs. Following is a roll forward of these items for the quarters ended March 31, 2013 and 2012 where Level 3 inputs were used on a recurring basis:

	Mortgage loans held for sale	Quarter ended March 31, 2013		Total
		Mortgage servicing rights (in thousands)	Interest rate lock commitments	
Balance, December 31, 2012	\$	\$ 19,798	\$ 23,951	\$ 43,749
Repurchases	4,612			4,612
Repayments	(13)			(13)
Interest rate lock commitments issued, net			33,649	33,649
Servicing received as proceeds from sales of mortgage loans		3		3
Changes in fair value included in income	(112)	(1,179)	(107)	(1,398)
Transfers to mortgage loans held for sale			(32,056)	(32,056)
Balance, March 31, 2013	\$ 4,487	\$ 18,622	\$ 25,437	\$ 48,546
Changes in fair value recognized during the period relating to assets still held at March 31, 2013	\$ (112)	\$ (1,179)	\$ 25,437	
Accumulated changes in fair value relating to assets still held at March 31, 2013	\$ (112)		\$ 25,437	

	Mortgage servicing rights	Quarter ended March 31, 2012		Total
		Mortgage servicing rights (in thousands)	Interest rate lock commitments (in thousands)	
Balance, December 31, 2011	\$ 25,698	\$ 7,905	\$	\$ 33,603
Interest rate lock commitments issued, net			14,444	14,444
Servicing received as proceeds from sales of mortgage loans	680			680
Changes in fair value included in income	(34)		8	(26)
Transfers to mortgage loans held for sale			(14,269)	(14,269)
Balance, March 31, 2012	\$ 26,344	\$ 8,088	\$	\$ 34,432
Changes in fair value recognized during the period relating to assets still held at March 31, 2012	\$ (34)	\$ 8,088		
Accumulated changes in fair value relating to assets still held at March 31, 2012		\$ 8,088		

The information used in the preceding roll forwards represents activity for any financial statement items identified as using Level 3 inputs at either the beginning or the end of the periods presented. The Company had no transfers in or out between the levels.

Table of Contents

Gains (losses) from changes in estimated fair values included in earnings for financial statement items carried at estimated fair value as a result of management's election of the fair value option are summarized below:

	Quarter ended March 31, 2013			Quarter ended March 31, 2012		
	Change in fair value of mortgage loans held for sale at fair value	Net servicing income	Total	Change in fair value of mortgage loans held for sale at fair value	Net servicing income	Total
	(in thousands)					
Short-term investments	\$	\$	\$	\$	\$	\$
Mortgage loans held for sale at fair value	26,161		26,161	16,186		16,186
Mortgage servicing rights at fair value		(1,179)	(1,179)		(34)	(34)
	\$ 26,161	\$ (1,179)	\$ 24,982	\$ 16,186	\$ (34)	\$ 16,152

Following are the fair value and related principal amounts due upon maturity of assets and liabilities accounted for under the fair value option as of the dates presented:

	Fair value	March 31, 2013 Principal amount due upon maturity (in thousands)	Difference
Mortgage loans held for sale:			
Current through 89 days delinquent	\$ 203,030	\$ 193,108	\$ 9,922
90 or more days delinquent	631	786	(155)
	\$ 203,661	\$ 193,894	\$ 9,767

	Fair value	December 31, 2012 Principal amount due upon maturity (in thousands)	Difference
Mortgage loans held for sale:			
Current through 89 days delinquent	\$ 447,889	\$ 418,650	\$ 29,239
90 or more days delinquent	495	623	(128)
	\$ 448,384	\$ 419,273	\$ 29,111

Financial Statement Items Measured at Fair Value on a Nonrecurring Basis

Following is a summary of financial statement items that are measured at estimated fair value on a nonrecurring basis as of the dates presented:

Total	March 31, 2013		
	Level 1	Level 2	Level 3

Edgar Filing: PENNYMAC FINANCIAL SERVICES, INC. - Form 10-Q

(in thousands)

Mortgage servicing rights at lower of amortized cost or fair value	\$	56,090	\$	\$	\$	56,090
	\$	56,090	\$	\$	\$	56,090

Table of Contents

	Total	December 31, 2012		Level 3
		Level 1	Level 2	
(in thousands)				
Mortgage servicing rights at lower of amortized cost or fair value	\$ 51,180	\$	\$	\$ 51,180
	\$ 51,180	\$	\$	\$ 51,180

The following table summarizes the total gains on assets measured at estimated fair values on a nonrecurring basis:

	Quarter ended March 31,	
	2013	2012
(in thousands)		
Mortgage servicing rights at lower of amortized cost or fair value	\$ 555	\$ 57

The Company evaluates its MSR at lower of amortized cost or fair value for impairment with reference to the assets' fair values. For purposes of performing its MSR impairment evaluation, the Company stratifies its MSR at lower of amortized cost or fair value based on the interest rates borne by the mortgage loans underlying the MSR. Mortgage loans are grouped into note rate pools of 50 basis points for fixed-rate mortgage loans with note rates between 3% and 4.5% and a single pool for mortgage loans with note rates below 3%. MSR relating to adjustable rate mortgage loans with initial interest rates of 4.5% or less are evaluated in a single pool. If the fair value of MSR in any of the note rate pools is below the carrying value of the MSR for that pool reduced by any existing valuation allowance, those MSR are impaired.

When MSR are impaired, the impairment is recognized in current period income and the carrying value of the MSR is adjusted using a valuation allowance. If the value of the MSR subsequently increases, the increase in value is recognized in current period income only to the extent of the valuation allowance.

Management periodically reviews the various impairment strata to determine whether the value of the impaired MSR in a given stratum is likely to recover. When management concludes that recovery of the value is unlikely in the foreseeable future, a write-down of the cost of the MSR for that note rate pool to its estimated fair value is charged to the valuation allowance.

Fair Value of Financial Instruments Carried at Amortized Cost

The Company's Cash as well as its Mortgage loans sold under agreements to repurchase, Note payable, Carried Interest due from Investment Funds, and amounts receivable from and payable to the Advised Entities are carried at cost.

Cash is measured using Level 1 inputs. The Company's borrowings carried at amortized cost do not have active markets or observable inputs and the fair value is measured using management's best estimate of fair value, where the inputs into the determination of fair value require significant management judgment or estimation. The Company has classified these financial instruments as Level 3 financial statement items as of March 31, 2013 and December 31, 2012 due to the lack of current market activity and the Company's reliance on unobservable inputs to estimate the fair value.

Management has concluded that the carrying value of the *Carried Interest due from Investment Funds* approximates its fair value as the balance represents the amount distributable to the Company at the balance sheet date assuming liquidation of the Investment Funds. Management has concluded that the estimated fair value of the *Note payable* approximates the agreements' carrying value due to the agreements' short terms and variable interest rates.

The Company also carries the receivable from and payable to the Advised Entities at cost. Management has concluded that the estimated fair value of such balances approximates the carrying value due to the short terms of such balances.

Table of Contents

Valuation Techniques and Assumptions

Most of the Company's financial assets are carried at fair value with changes in fair value recognized in current period income. A substantial portion of the Company's financial assets are Level 3 financial statement items which require the use of significant unobservable inputs in the estimation of the assets' values. Unobservable inputs reflect the Company's own assumptions about the factors that market participants use in pricing an asset or liability, and are based on the best information available under the circumstances.

The Company has assigned the responsibility for estimating the fair values of Level 3 financial statement items to a valuation group and has developed procedures and controls governing the valuation process relating to these assets. The estimation of fair values of the Company's financial assets are assigned to its Financial Analysis and Valuation group (the FAV group), which is responsible for valuing and monitoring the Company's investment portfolios and maintenance of its valuation policies and procedures.

The FAV group reports to the Company's senior management valuation committee, which oversees and approves the valuations. The valuation committee includes the Company's chief executive, financial, investment and credit officers. The FAV group monitors the models used for valuation of the Company's Level 3 financial statement items, including the models' performance versus actual results and reports those results to the valuation committee. The results developed in the FAV group's monitoring activities are used to calibrate subsequent projections used for valuation.

The FAV group is responsible for reporting to the Company's senior management valuation committee on a monthly basis on the changes in the valuation of the portfolio, including major factors affecting the valuation and any changes in model methods and assumptions. To assess the reasonableness of its valuations, the FAV group presents an analysis of the effect on the valuation of each of the changes to the significant inputs to the models.

The following describes the methods used in estimating the fair values of Level 2 and Level 3 fair value financial statement items:

Mortgage Loans Held for Sale

Most of the Company's mortgage loans held for sale at fair value are saleable into active markets and are therefore categorized as Level 2 fair value financial statement items and their fair values are estimated using their quoted market or contracted price or market price equivalent.

Certain of the Company's mortgage loans may become non-saleable due to identification of a defect by the Company or to the repurchase of a mortgage loan with an identified defect. Such loans are generally not saleable into active mortgage markets and are therefore classified as Level 3 financial statement items. The significant unobservable inputs used in the fair value measurement of the Company's non-saleable mortgage loans held for sale at fair value are discount rate, home price projections, voluntary prepayment speeds and default speeds. Significant changes in any of those inputs in isolation could result in a significant change to the loans' fair value measurement. Increases in home price projections are generally accompanied by an increase in voluntary prepayment speeds.

Edgar Filing: PENNYMAC FINANCIAL SERVICES, INC. - Form 10-Q

The Company did not hold Level 3 Mortgage loans held for sale before the quarter ended March 31, 2013. Following is a quantitative summary of key inputs used in the valuation of Level 3 mortgage loans held for sale at fair value:

Key Inputs	March 31, 2013 Range (Weighted average)
Twelve-month projected housing price index change	5.4% - 6.6% (5.6%)
Prepayment speed(1)	1.2% - 9.0%
Total prepayment speed(2)	3.3% - 9.0% (8.2%)

(1) Prepayment speed is measured using life voluntary Conditional Prepayment Rate (CPR). CPR represents the percentage of the remaining unpaid principal balance (UPB) that is expected to be prepaid in excess of the scheduled amortization of principal.

(2) Total prepayment speed is measured using life total CPR.

Changes in fair value attributable to changes in instrument-specific credit risk are measured by the change in the respective loan s delinquency status at period-end from the later of the beginning of the period or acquisition date.

Table of Contents*Derivative Financial Instruments*

The Company estimates the fair value of an IRLC based on quoted Agency MBS prices, its estimate of the fair value of the MSR it expects to receive in the sale of the loans and the probability that the mortgage loan will fund or be purchased as a percentage of the commitment it has made (the pull-through rate).

The significant unobservable inputs used in the fair value measurement of the Company's IRLCs are the pull-through rate and the MSR component of the Company's estimate of the value of the mortgage loans it has committed to purchase. Significant changes in the pull-through rate and the MSR component of the IRLCs, in isolation, could result in a significant change in fair value measurement. The financial effects of changes in these assumptions are generally inversely correlated as increasing interest rates have a positive effect on the fair value of the MSR component of IRLC value, but increase the pull-through rate for loans that have decreased in fair value in comparison to the agreed-upon purchase price.

Following is a quantitative summary of key unobservable inputs used in the valuation of IRLCs:

Key Inputs			
Pull-through rate	57.6% - 98.0%	61.6% - 98.1%	
	(77.8%)	(79.1%)	
MSR value expressed as:			
Servicing fee multiple	1.7 - 5.2	3.2 - 4.2	
	(4.5)	(4.0)	
Percentage of unpaid principal balance	0.4% - 2.2%	0.6% - 2.2%	
	(1.1%)	(0.9%)	

The Company estimates the fair value of commitments to sell loans based on quoted MBS prices. The Company estimates the fair value of the MBS options and futures it purchases and sells based on observed interest rate volatilities in the MBS market. The Company estimates the fair value of its MBS interest rate swaptions based on quoted market prices.

Mortgage Servicing Rights

MSRs are categorized as Level 3 fair value financial statement items. The Company uses a discounted cash flow approach to estimate the fair value of MSRs. This approach consists of projecting servicing cash flows discounted at a rate that management believes market participants would use in their determinations of value. The key assumptions used in the estimation of the fair value of MSRs include prepayment and default rates of the underlying loans, the applicable discount rate, and cost to service loans. The results of the estimates of fair value of MSRs are reported to the Company's senior management valuation committee as part of their review and approval of monthly valuation results. Changes in the fair value of MSRs are included in the consolidated statements of income under the caption *Net servicing income*, *Amortization, impairment and change in estimated fair value of mortgage servicing rights*.

Table of Contents

Key assumptions used in determining the fair value of MSRs at the time of initial recognition are as follows:

	2013		Quarter ended March 31,		2012	
	Amortized cost	Fair value	Range (Weighted average)	Amortized cost	Fair value	
Pricing spread (1)	5.4% - 12.5% (8.5%)	8.6% (8.7%)	8.9%	7.5% - 10.5% (9.8%)	7.5% - 9.9% (8.9%)	
Annual total prepayment speed (2)	8.5% - 16.5% (8.8%)	11.3% (12.4%)	12.7%	6.7% - 13.6% (7.8%)	7.8% - 12.9% (8.5%)	
Life (in years)	2.9 6.9 (6.7)	6.5 6.7 (6.5)		3.0 7.0 (6.8)	3.6 7.0 (6.9)	
Cost of servicing	\$68 \$120 (\$100)	\$68 \$68 (\$68)		\$68 \$100 (\$99)	\$68 \$100 (\$85)	

(1) Pricing spread represents a margin that is applied to a reference interest rate s forward rate curve to develop periodic discount rates. The Company applies a pricing spread to the United States Dollar London Inter Bank Offered Rate (LIBOR) curve for purposes of discounting cash flows relating to MSRs acquired as proceeds from the sale of mortgage loans.

(2) Annual total prepayment speed is measured using life total CPR.

Table of Contents

Following is a quantitative summary of key inputs used in the valuation of the Company's MSR's at period end and the effect on the estimated fair value from adverse changes in those assumptions (weighted averages are based upon unpaid principal balance):

Purchased MSR's backed by distressed mortgage loans

	March 31, 2013		December 31, 2012	
	Fair value	Amortized cost	Fair value	Amortized cost
	Range			
	(Weighted average)			
	(Unpaid principal balance of underlying loans and effect on value amounts in thousands)			
Unpaid principal balance of underlying loans	\$1,211,047		\$1,271,478	
Discount rate	15.3%	15.3%	15.3%	15.3%
		(15.3%)		(15.3%)
Effect on value of 5% adverse change		(\$282)		(\$302)
Effect on value of 10% adverse change		(\$552)		(\$590)
Effect on value of 20% adverse change		(\$1,057)		(\$1,130)
Average life (in years)	4.9		5.0	
Prepayment speed(1)	11.0% - 11.0%		10.7% - 10.7%	
		(11.0%)		(10.7%)
Effect on value of 5% adverse change		(\$265)		(\$273)
Effect on value of 10% adverse change		(\$519)		(\$529)
Effect on value of 20% adverse change		(\$994)		(\$1,040)
Per-loan cost of servicing	\$271	\$271	\$270	\$270
		(\$271)		(\$270)
Effect on value of 5% adverse change		(\$274)		(\$290)
Effect on value of 10% adverse change		(\$549)		(\$580)
Effect on value of 20% adverse change		(\$1,098)		(\$1,159)

(1) Prepayment speed is measured using CPR.

Table of Contents*All other MSR*s

Unpaid principal balance of underlying loans	\$1,058,987	\$12,316,588	\$1,166,765	\$8,730,686
Pricing spread (1)	8.6% - 18.5%	5.4% - 18.5%	7.5% 19.5%	7.5% 16.5%
	(10.6%)	(8.2%)	(10.6%)	(9.8%)
Effect on value of 5% adverse change	(\$112)	(\$2,690)	(\$113)	(\$1,814)
Effect on value of 10% adverse change	(\$220)	(\$5,284)	(\$222)	(\$3,562)
Effect on value of 20% adverse change	(\$426)	(\$10,203)	(\$430)	(\$6,870)
Average life (in years)	0.1 14.4	2.5 6.9	0.2 14.4	2.5 6.9
	(5.4)	(6.7)	(5.0)	(6.6)
Prepayment speed (2)	9.0% - 81.2%	8.5% - 26.9%	9.0% 84.2%	8.7% 28.3%
	(17.4%)	(9.0%)	(19.2%)	(9.2%)
Effect on value of 5% adverse change	(\$218)	(\$2,732)	(\$238)	(\$1,751)
Effect on value of 10% adverse change	(\$425)	(\$5,373)	(\$462)	(\$3,446)
Effect on value of 20% adverse change	(\$807)	(\$10,402)	(\$877)	(\$6,674)
Per-loan cost of servicing	\$68 \$115	\$68 \$120	\$68 \$140	\$68 \$140
	(\$75)	(\$100)	(\$76)	(\$99)
Effect on value of 5% adverse change	(\$74)	(\$1,459)	(\$77)	(\$963)
Effect on value of 10% adverse change	(\$147)	(\$2,919)	(\$153)	(\$1,926)
Effect on value of 20% adverse change	(\$295)	(\$5,837)	(\$307)	(\$3,852)

(1) Pricing spread represents a margin that is applied to a reference interest rate's forward curve to develop periodic discount rates. The Company applies a pricing spread to the United States Dollar LIBOR curve for purposes of discounting cash flows relating to MSR's acquired as proceeds from the sale of loans and purchased MSR's not backed by pools of distressed mortgage loans.

(2) Prepayment speed is measured using CPR.

The preceding sensitivity analyses are limited in that they were performed at a particular point in time; only contemplate the movements in the indicated variables; do not incorporate changes in the variables in relation to other variables; are subject to the accuracy of various models and assumptions used; and do not incorporate other factors that would affect the Company's overall financial performance in such scenarios, including operational adjustments made by management to account for changing circumstances. For these reasons, the preceding estimates should not be viewed as an earnings forecast.

Table of Contents**Note 8 Mortgage Loans Held for Sale at Fair Value**

Mortgage loans held for sale at fair value include the following:

	March 31, 2013		December 31, 2012	
	(in thousands)			
Conforming	\$	60,038	\$	50,003
Government-insured or guaranteed		139,136		398,381
Repurchased mortgage loans		4,487		
	\$	203,661	\$	448,384
Fair value of mortgage loans pledged to secure mortgage loans sold under agreements to repurchase				
	\$	197,693	\$	438,850

Note 9 Derivative Instruments

The Company is exposed to price risk relative to its mortgage loans held for sale as well as to its IRLCs. The Company bears price risk from the time a commitment to purchase or originate a loan is made to PMT or a loan applicant to the time the mortgage loan is sold. The Company is exposed to loss in value of its commitments to originate or purchase mortgage loans held for sale when mortgage rates increase. The Company is exposed to risk relative to the fair value of its MSR's. The Company is exposed to loss in value of its MSR's when interest rates decrease.

The Company engages in interest rate risk management activities in an effort to reduce the variability of earnings caused by changes in market interest rates. To manage this price risk resulting from interest rate risk, the Company uses derivative financial instruments acquired with the intention of moderating the risk that changes in market interest rates will result in unfavorable changes in the value of the Company's IRLCs, inventory of mortgage loans held for sale and MSR's. The Company does not use derivative financial instruments for purposes other than in support of its risk management activities.

The Company had the following derivative financial instruments recorded on its consolidated balance sheets:

Instrument	Notional amount	March 31, 2013		December 31, 2012		
		Fair Value		Fair Value		
		Derivative assets	Derivative liabilities	Notional amount	Derivative assets	Derivative liabilities
(in thousands)						
Derivatives not designated as hedging instruments						
Free-standing derivatives:						
Interest rate lock commitments	1,701,082	\$ 25,437	\$	1,576,174	\$ 23,951	\$ 11
Forward purchase contracts	1,349,300	4,544	59	1,021,981	1,645	389
Forward sales contracts	3,022,710	553	9,411	2,621,948	1,818	1,894

Edgar Filing: PENNYMAC FINANCIAL SERVICES, INC. - Form 10-Q

MBS put options	325,000	431		500,000	967		
MBS call options	300,000	755					
Total derivatives before netting		31,720	9,470		28,381	2,294	
Netting		(4,239)	(7,111)		(1,091)	(1,785)	
Total		\$ 27,481	\$ 2,359		\$ 27,290	\$ 509	

Table of Contents

The following table summarizes the activity for derivative contracts used to hedge the Company's IRLCs and inventory of mortgage loans held for sale at notional value:

	Balance beginning of period	Additions (in thousands)	Dispositions/ expirations	Balance end of period
Quarter ended March 31, 2013				
Forward purchase contracts	1,021,981	10,195,550	(9,868,231)	1,349,300
Forward sales contracts	2,621,948	14,677,256	(14,276,494)	3,022,710
MBS call options		850,000	(550,000)	300,000
MBS put options	500,000	965,000	(1,140,000)	325,000

Quarter ended March 31, 2012				
Forward sales contracts	510,569	2,883,711	(2,115,999)	1,278,281
MBS put options	29,000	68,000	(47,000)	50,000

The Company recorded net gains (losses) on derivative financial instruments used to hedge the Company's IRLCs and inventory of mortgage loans totaling \$11,025,000 and \$(1,962,000) for the quarters ending March 31, 2013 and March 31, 2012, respectively. Derivative gains and losses are included in *Net gains on mortgage loans held for sale at fair value* in the Company's consolidated statements of income.

The Company recorded a net loss on derivative financial instruments used as economic hedges of MSRs totaling \$1,291,000 for the quarter ended March 31, 2013. The Company had no similar economic hedges in place for the quarter ended March 31, 2012. The derivative loss is included in *Amortization, impairment and changes in estimated fair value of mortgage servicing rights* in the Company's consolidated statements of income.

Note 10 Mortgage Servicing Rights***Carried at Fair Value:***

The activity in MSRs carried at fair value is as follows:

Edgar Filing: PENNYMAC FINANCIAL SERVICES, INC. - Form 10-Q

	Quarter ended March 31,	
	2013	2012
	(in thousands)	
Balance at beginning of period	\$ 19,798	\$ 25,698
Additions - servicing resulting from loan sales	3	680
Change in fair value:		
Due to changes in valuation inputs or assumptions used in valuation model	(90)	1,315
Other changes in fair value(1)	(1,089)	(1,349)
Total change in fair value	(1,179)	(34)
Balance at end of period	\$ 18,622	\$ 26,344

(1) Represents changes due to realization of cash flows.

Table of Contents**Carried at Amortized Cost:**

The activity in MSRs carried at amortized cost is summarized below:

	Quarter ended March 31,	
	2013	2012
	(in thousands)	
Amortized cost:		
Balance at beginning of period	\$ 92,155	\$ 6,496
Additions	41,733	9,621
Amortization	(3,095)	(264)
Application of valuation allowance to write down MSRs with other-than temporary impairment		
Balance at end of period	130,793	15,853
Valuation allowance for impairment of MSRs:		
Balance at beginning of period	(2,978)	(70)
Reversal	555	57
Application of valuation allowance to write down MSRs with other-than temporary impairment		
Balance at end of period	(2,423)	(13)
MSRs, net	\$ 128,370	\$ 15,840
Estimated fair value of MSRs at end of period	\$ 137,553	\$ 16,437

The following table summarizes the Company's estimate of future amortization of its existing MSRs. This projection was developed using the assumptions made by management in its March 31, 2013 valuation of MSRs. The assumptions underlying the following estimate will change as market conditions and portfolio composition and behavior change, causing both actual and projected amortization levels to change over time.

Twelve month period ending March 31,	Estimated amortization (in thousands)
2014	\$ 13,972
2015	13,050
2016	12,020
2017	11,146
2018	10,478
Thereafter	70,127
Total	\$ 130,793

Servicing fees relating to MSRs are recorded in *Net servicing income - Loan servicing fees - From non-affiliates* on the consolidated statements of income; late fees, ancillary and other fees are recorded in *Net servicing income - Loan servicing fees - Ancillary and other fees* on the consolidated statements of income and are summarized below:

Quarter ended March 31,	
2013	2012

Edgar Filing: PENNYMAC FINANCIAL SERVICES, INC. - Form 10-Q

	(in thousands)			
Contractual servicing fees	\$	9,057	\$	2,845
Late charges		413		267
Ancillary and other fees		102		58
	\$	9,572	\$	3,170

Table of Contents**Note 11 Carried Interest Due from Investment Funds**

The activity in the Company's Carried Interest due from Investment Funds is summarized as follows:

	Quarter ended March 31,	
	2013	2012
	(in thousands)	
Balance at beginning of period	\$ 47,723	\$ 37,250
Carried Interest recognized during the period	4,737	1,789
Proceeds received during the period		
Balance at end of period	\$ 52,460	\$ 39,039

The amount of the Carried Interest received by the Company depends on the Investment Funds' future performance. As a result, the amount of Carried Interest recorded by the Company at period end is subject to adjustment based on future results of the Investment Funds and may be reduced in future periods. However, the Company is not required to pay guaranteed returns to the Investment Funds and the amount of Carried Interest will only be reduced to the extent of amounts previously recognized.

Management expects the Carried Interest to be collected by the Company when the Investment Funds liquidate. The investment period for the Investment Funds ended on December 31, 2011. The Investment Funds will continue in existence through December 31, 2016, subject to three one-year extensions by PCM at its discretion as specified in the limited liability company and limited partnership agreements that govern the Investment Funds.

Note 12 Investment in PennyMac Mortgage Investment Trust at Fair Value

Following is a summary of *Change in fair value and dividends received from PennyMac Mortgage Investment Trust*:

	Quarter ended March 31,	
	2013	2012
	(in thousands)	
Dividends	\$ 43	\$ 41
Change in fair value	45	154
	\$ 88	\$ 195

Note 13 Borrowings

Edgar Filing: PENNYMAC FINANCIAL SERVICES, INC. - Form 10-Q

The Company maintains four borrowing facilities: three facilities that provide for sales of mortgage loans under agreements to repurchase; and one note payable secured by MSRs and servicing advances made on loans in the Company's loan servicing portfolio.

Mortgage Loans Sold Under Agreement to Repurchase

The borrowing facilities secured by mortgage loans held for sale are in the form of loan sale and repurchase agreements. Eligible loans are sold under advance rates based on the loan type. Interest is charged at a rate based on the buyer's overnight cost-of funds rate for one agreement and based on the LIBOR for the other two agreements. Loans sold under these agreements may be re-pledged by the lenders.

Table of Contents

Financial data pertaining to mortgage loans sold under agreements to repurchase are as follows:

	Quarter ended March 31,	
	2013	2012
(dollar amounts in thousands)		
Period end:		
Balance	\$ 180,049	\$ 159,547
Unused amount(1)	\$ 319,951	\$ 90,453
Weighted-average interest rate	2.21%	2.19%
Fair value of mortgage loans securing agreements to repurchase	\$ 197,693	\$ 175,173
During the period:		
Average balance of mortgage loans sold under agreements to repurchase	\$ 275,061	\$ 64,956
Weighted-average interest rate(2)	2.26%	2.30%
Total interest expense	\$ 2,375	\$ 865
Maximum daily amount outstanding	\$ 479,860	\$ 159,547

(1) The amount the Company is able to borrow under loan repurchase agreements is tied to the fair value of unencumbered mortgage loans eligible to secure those agreements and the Company's ability to fund the agreements' margin requirements relating to the mortgage loans sold.

(2) Excludes the effect of amortization of commitment fees totaling \$819,000 and \$488,000 for the quarters ended March 31, 2013 and 2012, respectively.

Following is a summary of maturities of outstanding advances under repurchase agreements by maturity date:

Remaining maturity at March 31, 2013	Balance (in thousands)
Within 30 days	\$ 58,953
Over 30 to 90 days	119,109
Over 90 days to 180 days	1,987
Over 180 days to 1 year	\$ 180,049
Weighted-average maturity (in months)	2.0

The amount at risk (the fair value of the assets pledged plus the related margin deposit, less the amount advanced by the counterparty and accrued interest) relating to the Company's mortgage loans held for sale sold under agreements to repurchase is summarized by counterparty below as of March 31, 2013:

Counterparty	Amount at risk	Weighted-average maturity of
--------------	----------------	---------------------------------

Edgar Filing: PENNYMAC FINANCIAL SERVICES, INC. - Form 10-Q

			advances under repurchase agreement
	(in thousands)		
Bank of America, N.A.	\$	9,151	June 20, 2013
Citibank, N.A.	\$	6,415	April 24, 2013
Credit Suisse First Boston Mortgage Capital LLC	\$	3,416	June 11, 2013

The Company is subject to margin calls during the period the agreements are outstanding and therefore may be required to repay a portion of the borrowings before the respective agreements mature if the value (as determined by the applicable lender) of the mortgage loans securing those agreements decreases. As of March 31, 2013, the Company had \$1.6 million on deposit with its mortgage loan repurchase agreement counterparties.

Table of Contents**Note Payable**

The note payable is summarized below:

	March 31, 2013		December 31, 2012
	(in thousands)		
Note payable secured by:			
Servicing advances	\$ 5,155	\$	4,905
MSRs	58,282		48,108
	\$ 63,437	\$	53,013
Servicing advances pledged to secure note payable	\$ 7,544	\$	7,430
MSRs pledged to secure note payable	\$ 144,932	\$	100,957

The note payable matures on the earlier to occur of October 31, 2014 or the rolling maturity date that is 364 days from any particular date of determination. Interest is charged at a rate based on the lender's overnight cost of funds. The note payable is secured by servicing advances and MSRs relating to certain loans in the Company's servicing portfolio, and provides for advance rates ranging from 50% to 85% of the amount of the servicing advances or the carrying value of the MSR pledged, up to a maximum of \$17 million in the case of servicing advances and \$100 million in the case of MSRs.

The borrowing facilities contain various covenants, including financial covenants governing the Company's net worth, debt-to-equity ratio, profitability and liquidity. Management believes the Company was in compliance with these requirements as of March 31, 2013.

Note 14 Liability for Representations and Warranties

The Company's agreements with the Agencies include representations and warranties related to the loans the Company sells to those Agencies. The representations and warranties require adherence to Agency origination and underwriting guidelines, including but not limited to the validity of the lien securing the loan, property eligibility, borrower credit, income and asset requirements, and compliance with applicable federal, state and local law.

In the event of a breach of its representations and warranties, the Company may be required to either repurchase the mortgage loans with the identified defects or indemnify the investor or insurer. In such cases, the Company bears any subsequent credit loss on the mortgage loans. The Company's credit loss may be reduced by any recourse it has to correspondent lenders that, in turn, had sold such mortgage loans to the Company and breached similar or other representations and warranties. In such event, the Company has the right to seek a recovery of related credit losses from that correspondent lender.

The Company records a provision for losses relating to the representations and warranties it makes as part of its loan sale transactions. The method used to estimate the liability for representations and warranties is a function of the representations and warranties given and considers a

Edgar Filing: PENNYMAC FINANCIAL SERVICES, INC. - Form 10-Q

combination of factors, including, but not limited to, estimated future defaults and loan repurchase rates and the potential severity of loss in the event of defaults and the probability of reimbursement by the correspondent loan seller.

The Company establishes a liability at the time loans are sold and continually updates its liability estimate.

Table of Contents

Following is a summary of the Company's liability for representations and warranties:

	Quarter ended March 31,	
	2013	2012
	(in thousands)	
Balance at beginning of period	\$ 3,504	\$ 449
Provisions for losses on loans sold	1,244	311
Incurring losses		
Balance at end of period	\$ 4,748	\$ 760
Unpaid principal balance of mortgage loans subject to representations and warranties	\$ 14,586,623	\$ 4,244,275

Following is a summary of the Company's repurchase activity:

	Quarter ended March 31,	
	2013	2012
	(in thousands)	
During the period:		
Unpaid balance of mortgage loans repurchased	\$	\$
Incurring losses on repurchased loans	\$	\$
At period end:		
Unpaid balance of mortgage loans subject to pending claims for repurchase	\$ 1,038	\$ 5,492

The level of the liability for representations and warranties requires considerable management judgment. The level of mortgage loan repurchase losses is dependent on economic factors (including unemployment levels and trends, and housing price levels and trends), investor reviews of recently sold mortgage loans and repurchase demand strategies relating to defaulted mortgage loans, and other external conditions that will change over the lives of the underlying loans. The Company's representations and warranties are generally not subject to stated limits of exposure. However, management believes that the current unpaid principal balance of loans sold by the Company to date represents the maximum exposure to repurchases related to representations and warranties. Management believes the amount and range of reasonably possible losses in relation to the recorded liability is not material to the Company's financial condition or results of operations.

Note 15 Members Equity

Subscriptions receivable are amounts due from certain members who are holders of preferred units, and earn interest at rates of either 4% or 8% annually.

The Company made tax distributions of \$9,476,000 to its unitholders relating to the Company's taxable income allocated to the respective unitholders for the quarter ended March 31, 2013.

Table of Contents**Note 16 Net Gain on Mortgage Loans Held for Sale**

Net gain on mortgage loans held for sale at fair value is summarized below:

	Quarter ended March 31,	
	2013	2012
	(in thousands)	
Cash gain (loss) on sale:		
Loan proceeds	\$ (11,823)	\$ 5,700
Hedging activities	17,621	(6,032)
	5,798	(332)
Non-cash gain on sale:		
Change in fair value of IRLCs	1,497	183
MSRs received as proceeds on sale	41,736	10,301
MSR recapture payable to affiliate	(133)	
Provision for representations and warranties on loans sold	(1,244)	(311)
Change in fair value relating to loans and hedging instruments held for sale at period end:		
Loans	(2,392)	26
Hedging instruments	(5,305)	4,070
Total non-cash (loss) gain relating to loans and hedging instruments held at period end	(7,697)	4,096
Total non-cash gain on sale	34,159	14,269