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Armour Residential REIT, Inc.

Form 10-Q

April 24, 2019

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

FORM 10-Q

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

For the Quarterly Period Ended March 31, 2019

OR

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

For the transition period from _____ to _____

ARMOUR RESIDENTIAL REIT, INC.

(Exact name of registrant as specified in its charter)

Maryland

(State or other jurisdiction of incorporation or organization)

001-34766

(Commission File Number)

26-1908763

(I.R.S. Employer Identification No.)

3001 Ocean Drive, Suite 201, Vero Beach, FL 32963

(Address of principal executive offices)(zip code)

(772) 617-4340

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). YES NO

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

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Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company Emerging growth company

If an emerging growth company, indicate by a check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act

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

The number of outstanding shares of the Registrant's common stock as of April 23, 2019 was 59,791,877.

ARMOUR Residential REIT, Inc.
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1

PART I. FINANCIAL INFORMATION**Item 1. Financial Statements**

ARMOUR Residential REIT, Inc.
CONSOLIDATED BALANCE SHEETS (UNAUDITED)
(in thousands, except per share)

	March 31, 2019	December 31, 2018
Assets		
Cash	\$167,372	\$221,668
Cash collateral posted to counterparties	58,996	10,531
Investments in securities, at fair value		
Agency Securities (including pledged securities of \$12,306,464 at March 31, 2019 and \$6,743,689 at December 31, 2018)	12,707,442	7,051,954
Credit Risk and Non-Agency Securities (including pledged securities of \$489,995 at March 31, 2019 and \$698,255 at December 31, 2018)	815,008	819,915
Interest-Only Securities	19,319	20,623
U.S. Treasury Securities (including pledged securities of \$0 at March 31, 2019 and \$20,748 at December 31, 2018)	—	98,646
Derivatives, at fair value	58,677	111,913
Accrued interest receivable	39,609	22,505
Prepaid and other	1,396	1,855
Subordinated loan to BUCKLER	105,000	105,000
Total Assets	\$13,972,819	\$8,464,610
Liabilities and Stockholders' Equity		
Liabilities:		
Repurchase agreements	\$12,143,274	\$7,037,651
Cash collateral posted by counterparties	49,826	97,213
Payable for unsettled purchases	198,172	166,052
Derivatives, at fair value	67,065	24,505
Accrued interest payable- repurchase agreements	21,790	10,268
Accounts payable and other accrued expenses	6,039	3,608
Total Liabilities	\$12,486,166	\$7,339,297
Commitments and contingencies (Note 11)		
Stockholders' Equity:		
Preferred stock, \$0.001 par value, 50,000 shares authorized; 8.250% Series A Cumulative Preferred Stock; 2,181 shares issued and outstanding (\$54,514 aggregate liquidation preference)	2	2
7.875% Series B Cumulative Preferred Stock; 6,369 shares issued and outstanding (\$159,232 aggregate liquidation preference)	6	6
Common stock, \$0.001 par value, 125,000 shares authorized, 59,791 and 43,702 shares issued and outstanding at March 31, 2019 and December 31, 2018	60	44
Additional paid-in capital	3,075,172	2,752,376

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Accumulated deficit	(1,731,875)	(1,583,245)
Accumulated other comprehensive income (loss)	143,288	(43,870)
Total Stockholders' Equity	\$1,486,653	\$1,125,313
Total Liabilities and Stockholders' Equity	\$13,972,819	\$8,464,610

See financial statement notes (unaudited).

2

ARMOUR Residential REIT, Inc.
CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(in thousands, except per share)

	For the Three Months Ended March 31,	
	2019	2018
Interest Income:		
Agency Securities, net of amortization of premium and fees	\$ 79,832	\$ 52,253
Credit Risk and Non-Agency Securities, including discount accretion	13,592	14,006
Interest-Only Securities	345	442
U.S. Treasury Securities	482	844
BUCKLER Subordinated loan	539	624
Total Interest Income	\$ 94,790	\$ 68,169
Interest expense- repurchase agreements	(60,978)	(32,018)
Net Interest Income	\$ 33,812	\$ 36,151
Other Income (Loss):		
Realized loss on sale of Agency Securities (reclassified from Other comprehensive income (loss))	(2,910)	(32,603)
Other than temporary impairment of Agency Securities (reclassified from Other comprehensive income (loss))	—	(12,090)
Gain on Credit Risk and Non-Agency Securities	496	1,283
Gain (loss) on Interest-Only Securities	(368)	298
Gain (loss) on U.S. Treasury Securities	(693)	2,576
Subtotal	\$(3,475)	\$(40,536)
Realized loss on derivatives ⁽¹⁾	(22,131)	(38,604)
Unrealized gain (loss) on derivatives	(113,067)	97,201
Subtotal	\$(135,198)	\$ 58,597
Total Other Income (Loss)	\$(138,673)	\$ 18,061
Expenses:		
Management fees	7,258	6,801
Professional fees	1,035	1,172
Insurance	165	165
Compensation	787	977
Other	275	350
Total Expenses	\$ 9,520	\$ 9,465
Net Income (Loss)	\$(114,381)	\$ 44,747
Dividends on preferred stock	(4,259)	(4,253)
Net Income (Loss) available (related) to common stockholders	\$(118,640)	\$ 40,494
Net Income (Loss) per share available (related) to common stockholders (Note 14):		
Basic	\$(2.21)	\$ 0.97
Diluted	\$(2.21)	\$ 0.96
Dividends declared per common share	\$ 0.57	\$ 0.57
Weighted average common shares outstanding:		

Basic	53,630	41,887
Diluted	53,630	42,331

(1) Interest expense related to our interest rate swap contracts is recorded in realized loss on derivatives on the consolidated statements of operations. For additional information, see financial statement Note 10.

See financial statement notes (unaudited).

3

ARMOUR Residential REIT, Inc.**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (UNAUDITED)**
(in thousands)

	For the Three Months Ended March 31,	
	2019	2018
Net Income (Loss)	\$(114,381)	\$44,747
Other comprehensive income (loss):		
Reclassification adjustment for realized loss on sale of available for sale Agency Securities	2,910	32,603
Reclassification adjustment for other than temporary impairment of available for sale Agency Securities	—	12,090
Net unrealized gain (loss) on available for sale Agency Securities	184,248	(145,410)
Other comprehensive income (loss)	\$187,158	\$(100,717)
Comprehensive Income (Loss)	\$72,777	\$(55,970)

See financial statement notes (unaudited).

4

ARMOUR Residential REIT, Inc.
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (UNAUDITED)
(in thousands)

	Preferred Stock						Common Stock				Total Additional Paid-in Capital	Accumulated Deficit	Accumulate Other Comprehen Income (Loss)	
	8.25% Series A			7.875% Series B			Shares	Par Amount	Additional Paid-in Capital	Shares				Par Amount
	Shares	Par Amount	Additional Paid-in Capital	Shares	Par Amount	Additional Paid-in Capital	Shares	Par Amount	Additional Paid-in Capital	Shares	Par Amount	Additional Paid-in Capital	Accumulated Deficit	Accumulate Other Comprehen Income (Loss)
Balance, December 31, 2018	2,181	\$ 2	\$ 53,172	6,369	\$ 6	\$ 154,147	43,702	\$ 44	\$ 2,545,057			\$ 2,752,376	\$(1,583,245)	\$(43,870)
Cumulative impact of adopting accounting standard ASU 2018-07	—	—	—	—	—	—	—	—	176			176	(176)	—
Adjusted Balance, January 1, 2019	2,181	\$ 2	\$ 53,172	6,369	\$ 6	\$ 154,147	43,702	\$ 44	\$ 2,545,233			\$ 2,752,552	\$(1,583,421)	\$(43,870)
Series A Preferred dividends	—	—	—	—	—	—	—	—	—			—	(1,124)	—
Series B Preferred dividends	—	—	—	—	—	—	—	—	—			—	(3,135)	—
Common stock dividends	—	—	—	—	—	—	—	—	—			—	(29,814)	—
Issuance of common stock, net	—	—	—	—	—	—	16,064	16	321,976			321,976	—	—
Stock based compensation, net of withholding requirements	—	—	—	—	—	—	25	—	644			644	—	—
Net Loss	—	—	—	—	—	—	—	—	—			—	(114,381)	—
Other comprehensive income	—	—	—	—	—	—	—	—	—			—	—	187,158
Balance, March 31, 2019	2,181	\$ 2	\$ 53,172	6,369	\$ 6	\$ 154,147	59,791	\$ 60	\$ 2,867,853			\$ 3,075,172	\$(1,731,875)	\$ 143,288

See financial statement notes (unaudited).

5

ARMOUR Residential REIT, Inc.
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(in thousands)

	For the Three Months Ended March 31,	
	2019	2018
Cash Flows From Operating Activities:		
Net Income (Loss)	\$(114,381)	\$ 44,747
Adjustments to reconcile net income (loss) to net cash and cash collateral posted to counterparties provided by (used in) operating activities:		
Net amortization of premium on Agency Securities	6,347	9,794
Accretion of net discount on Credit Risk and Non-Agency Securities	(932)	(1,006)
Net amortization of Interest-Only Securities	936	1,117
Net amortization of U.S. Treasury Securities	(453)	—
Realized loss on sale of Agency Securities	2,910	32,603
Other than temporary impairment of Agency Securities	—	12,090
Gain on Credit Risk and Non-Agency Securities	(496)	(1,283)
(Gain) loss on Interest-Only Securities	368	(298)
(Gain) loss on U.S. Treasury Securities	693	(2,576)
Stock based compensation	644	644
Changes in operating assets and liabilities:		
(Increase) decrease in accrued interest receivable	(17,178)	1,971
Decrease in prepaid and other assets	459	56
Change in derivatives, at fair value	95,796	(99,558)
Increase (decrease) in accrued interest payable- repurchase agreements	11,522	(1,178)
Increase in accounts payable and other accrued expenses	2,431	2,270
Net cash and cash collateral posted to counterparties used in operating activities	\$(11,334)	\$(607)
Cash Flows From Investing Activities:		
Purchases of Agency Securities	(6,608,566)	—
Purchases of U.S. Treasury Securities	(101,039)	(668,120)
Principal repayments of Agency Securities	145,777	167,649
Principal repayments of Credit Risk and Non-Agency Securities	6,335	9,168
Proceeds from sales of Agency Securities	1,017,396	1,068,996
Proceeds from sales of U.S. Treasury Securities	199,445	—
(Decrease) increase in cash collateral posted by counterparties	(47,387)	98,128
Net cash and cash collateral posted to counterparties provided by (used in) investing activities	\$(5,388,039)	\$ 675,821
Cash Flows From Financing Activities:		
Issuance of Series B Preferred stock, net of expenses	—	2,632
Issuance of common stock, net of expenses	321,992	—
Proceeds from repurchase agreements	50,656,945	35,593,550
Principal repayments on repurchase agreements	(45,551,322)	(36,295,752)
Series A Preferred stock dividends paid	(1,124)	(1,124)
Series B Preferred stock dividends paid	(3,135)	(3,129)

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Common stock dividends paid	(29,814) (24,138)
Net cash and cash collateral posted to counterparties provided by (used in) financing activities	\$5,393,542	\$ (727,961)

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ARMOUR Residential REIT, Inc.
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(in thousands)

Net Increase (decrease) in cash and cash collateral posted to counterparties	(5,831)	152,747
Cash and cash collateral posted to counterparties - beginning of period	232,199		282,394
Cash and cash collateral posted to counterparties - end of period	\$226,368		229,647
Supplemental Disclosure:			
Cash paid during the period for interest	\$98,627		53,651
Non-Cash Investing Activities:			
Receivable for unsettled sales	\$—		68,796
Payable for unsettled purchases	\$198,172		227,409
Net unrealized gain (loss) on available for sale Agency Securities	\$184,248		1145,410

See financial statement notes (unaudited).

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ARMOUR Residential REIT, Inc.
FINANCIAL STATEMENT NOTES (UNAUDITED)
(in thousands, except per share)

Note 1 - Organization and Nature of Business Operations

References to “we,” “us,” “our,” or the “Company” are to ARMOUR Residential REIT, Inc. (“ARMOUR”) and its subsidiaries. References to “ACM” are to ARMOUR Capital Management LP, a Delaware limited partnership. References to “BUCKLER” are to BUCKLER Securities, LLC, a Delaware limited liability company and a FINRA-regulated broker-dealer, controlled by ACM and certain executive officers of ARMOUR. Refer to the Glossary of Terms for definitions of capitalized terms and abbreviations used in this report.

ARMOUR is an externally managed Maryland corporation incorporated in 2008. The Company is managed by ACM, an investment advisor registered with the Securities and Exchange Commission (the “SEC”), (see *Note 11 - Commitments and Contingencies* and *Note 16 - Related Party Transactions* for additional discussion). We have elected to be taxed as a real estate investment trust (“REIT”) under the Internal Revenue Code of 1986, as amended (the “Code”). Our qualification as a REIT depends on our ability to meet, on a continuing basis, various complex requirements under the Code relating to, among other things, the sources of our gross income, the composition and values of our assets, our distribution levels and the concentration of ownership of our capital stock. We believe that we are organized in conformity with the requirements for qualification as a REIT under the Code and our manner of operations enables us to meet the requirements for taxation as a REIT for federal income tax purposes. As a REIT, we will generally not be subject to federal income tax on the REIT taxable income that we currently distribute to our stockholders. If we fail to qualify as a REIT in any taxable year and do not qualify for certain statutory relief provisions, we will be subject to federal income tax at regular corporate rates. Even if we qualify as a REIT for U.S. federal income tax purposes, we may still be subject to some federal, state and local taxes on our income.

We invest in residential mortgage backed securities issued or guaranteed by a United States (“U.S.”) Government-sponsored entity (“GSE”), such as the Federal National Mortgage Association (“Fannie Mae”), the Federal Home Loan Mortgage Corporation (“Freddie Mac”), or a government agency such as Government National Mortgage Administration (“Ginnie Mae”) (collectively, “Agency Securities”). The Agency securities in our securities portfolio consist primarily of fixed rate home loans, the remaining are either backed by hybrid adjustable rate or adjustable rate home loans. Other securities backed by residential mortgages in which we invest, for which the payment of principal and interest is not guaranteed by a GSE or government agency may benefit from credit enhancement derived from structural elements such as subordination, over collateralization or insurance (collectively, “Credit Risk and Non-Agency Securities”). We also invest in Interest-Only Securities, which are the interest portion of Agency Securities, that is separated and sold individually from the principal portion of the same payment (“Interest-Only Agency Securities”). (“Agency Securities” together with “Credit Risk and Non-Agency Securities” and “Interest-Only Securities”, collectively, “MBS”). From time to time we may also invest in U.S. Treasury Securities and money market

instruments.

Note 2 - Basis of Presentation and Consolidation

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X promulgated by the SEC. Accordingly, the condensed financial statements do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2019 are not necessarily indicative of the results that may be expected for the calendar year ending December 31, 2019. These unaudited consolidated financial statements should be read in conjunction with the audited financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2018.

The unaudited consolidated financial statements include the accounts of ARMOUR Residential REIT, Inc. and its subsidiaries. All intercompany accounts and transactions have been eliminated. The preparation of the consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates affecting the accompanying condensed consolidated financial statements include the valuation of MBS

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ARMOUR Residential REIT, Inc.
FINANCIAL STATEMENT NOTES (UNAUDITED)
(in thousands, except per share)

(as defined below), including an assessment of whether other-than-temporary impairment (“OTTI”) exists, and derivative instruments.

Note 3 - Summary of Significant Accounting Policies

Cash

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

Cash Collateral Posted To/By Counterparties

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

Investments in Securities, at Fair Value

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

Agency Securities - At March 31, 2019 and December 31, 2018, all of our Agency Securities were classified as available for sale securities. Agency Securities classified as available for sale are reported at their estimated fair values with unrealized gains and losses excluded from earnings and reported as part of the consolidated statements of comprehensive income (loss).

Credit Risk and Non-Agency Securities - At March 31, 2019 and December 31, 2018, all of our Credit Risk and Non-Agency Securities were classified as trading securities. Credit Risk and Non-Agency Securities classified as trading are reported at their estimated fair values with unrealized gains and losses included in Other Income (Loss) as a component of the consolidated statements of operations.

Interest-Only Securities - At March 31, 2019 and December 31, 2018, all of our Interest-Only Securities were classified as trading securities. Interest-Only Securities represent the right to receive a specified proportion of the contractual interest flows of specific Agency MBS. Interest-Only Securities classified as trading are reported at their estimated fair values with

unrealized gains and losses included in Other Income (Loss) as a component of the consolidated statements of operations.

U.S. Treasury Securities - At December 31, 2018, all of our U.S. Treasury Securities were classified as trading securities and are reported at their estimated fair values with unrealized gains and losses included in Other Income (Loss) as a component of the consolidated statements of operations. We did not have any U.S. Treasury Securities at March 31, 2019.

Receivables and Payables for Unsettled Sales and Purchases

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

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ARMOUR Residential REIT, Inc.
FINANCIAL STATEMENT NOTES (UNAUDITED)
(in thousands, except per share)

Accrued Interest Receivable and Payable

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

Repurchase Agreements

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

In addition to the repurchase agreement financing discussed above, at certain times we have entered into reverse repurchase agreements with certain of our repurchase agreement counterparties. Under a typical reverse repurchase agreement, we purchase U.S. Treasury Securities from a borrower in exchange for cash and agree to sell the same securities in the future in exchange for a price that is higher than the original purchase price. The difference between the purchase price originally paid and the sale price represents interest received from the borrower. Reverse repurchase agreement receivables and repurchase agreement liabilities are presented net when they meet certain criteria, including being with the same counterparty, being governed by the same master repurchase agreement ("MRA"), settlement through the same brokerage or clearing account and maturing on the same day. We did not have any reverse repurchase agreements outstanding at March 31, 2019 and December 31, 2018.

Derivatives, at Fair Value

We recognize all derivatives as either assets or liabilities at fair value on our consolidated balance sheets. All changes in the fair values of our derivatives are reflected in our consolidated statements of operations. We designate derivatives as hedges for tax purposes and any unrealized derivative gains or losses would not affect our distributable net taxable

income. These transactions include interest rate swap contracts, interest rate swaptions and basis swap contracts. We also may utilize forward contracts for the purchase or sale of TBA Agency Securities. We account for TBA Agency Securities as derivative instruments if it is reasonably possible that we will not take or make physical delivery of the Agency Security upon settlement of the contract. We account for TBA dollar roll transactions as a series of derivative transactions.

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

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ARMOUR Residential REIT, Inc.
FINANCIAL STATEMENT NOTES (UNAUDITED)
(in thousands, except per share)

Revenue Recognition

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

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

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

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

Credit Risk and Non-Agency Securities and Interest-Only Securities - Interest income on Credit Risk and Non-Agency Securities and Interest-Only Securities is recognized using the effective yield method over the life of the securities based on the future cash flows expected to be received. Future cash flow projections and related effective yields are determined for each security and updated quarterly. Other than temporary impairments, which establish a new cost basis in the security for purposes of calculating effective yields, are recognized when the

fair value of a security is less than its cost basis and there has been an adverse change in the future cash flows expected to be received. Other changes in future cash flows expected to be received are recognized prospectively over the remaining life of the security.

U.S. Treasury Securities - Interest income on U.S. Treasury Securities is recognized based on their unpaid principal amounts and their contractual terms. Recognition of interest income commences on the settlement date of the purchase transaction and continues through the settlement date of the sale transaction.

Comprehensive Income (Loss)

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

Note 4 - Recent Accounting Pronouncements

We consider the applicability and impact of all Accounting Standards Updates issued by the Financial Accounting Standards Board. Those not listed below were deemed to be either not applicable, are not expected to have a significant impact

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ARMOUR Residential REIT, Inc.
FINANCIAL STATEMENT NOTES (UNAUDITED)
(in thousands, except per share)

on our consolidated financial statements when adopted, or did not have a significant impact on our consolidated financial statements upon adoption.

In the current year we have adopted Accounting Standard ASU 2018-07/*Improvements to Nonemployee Share-Based Payment Accounting (Topic 718)*. The standard is effective for fiscal years beginning after December 15, 2018, including interim periods within that fiscal year. The standard largely aligns the accounting for share-based payment awards issued to employees and nonemployees. Equity-classified share-based payment awards issued to nonemployees are measured on the grant date, instead of being remeasured through the performance completion date (generally the vesting date). The standard was applied on a modified retrospective basis through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year when adopted. The cumulative effective adjustment was recorded in our consolidated statement of stockholders' equity as of January 1, 2019, and did not have a material to the Company's financial condition or the results of operations. In 2018, we adopted Accounting Standards ASU 2016-18, *Statement of Cash Flows (Topic 230) - Restricted Cash* which resulted in the presentation of cash collateral posted to counterparties with cash on the consolidated statements of cash flows when reconciling the total beginning and ending amounts. Prior period results have been revised to conform to the current presentation.

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

Note 5 - Fair Value of Financial Instruments

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

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

Level 2 Inputs - Quoted prices for similar instruments in active markets; quoted prices for

identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.

Level 3 Inputs - Prices determined using significant unobservable inputs. Unobservable inputs may be used in situations where quoted prices or observable inputs are unavailable (for example, when there is little or no market activity for an investment at the end of the period). Unobservable inputs reflect management's assumptions about the factors that market participants would use in pricing an asset or liability, and would be based on the best information available.

At the beginning of each quarter, we assess the assets and liabilities that are measured at fair value on a recurring basis to determine if any transfers between levels in the fair value hierarchy are needed.

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

Cash and Cash Collateral - Cash includes cash on deposit with financial institutions. The carrying amount of cash is deemed to be its fair value and is classified as Level 1. Cash balances posted by us to counterparties or posted by counterparties

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ARMOUR Residential REIT, Inc.
FINANCIAL STATEMENT NOTES (UNAUDITED)
(in thousands, except per share)

to us as collateral are classified as Level 2 because they are integrally related to the Company's repurchase financing and interest rate swap agreements, which are classified as Level 2.

Agency Securities - Fair value for the Agency Securities in our securities portfolio is based on obtaining a valuation for each Agency Security from third party pricing services and/or dealer quotes. The third party pricing services use common market pricing methods that may include pricing models that may incorporate such factors as coupons, prepayment speeds, spread to the Treasury curves and interest rate swap curves, duration, periodic and life caps and credit enhancement. If the fair value of an Agency Security is not available from the third party pricing services or such data appears unreliable, we obtain pricing indications from up to three dealers who make markets in similar Agency Securities. Management reviews pricing used to ensure that current market conditions are properly reflected. This review includes, but is not limited to, comparisons of similar market transactions or alternative third party pricing services, dealer pricing indications and comparisons to a third party pricing model. Fair values obtained from the third party pricing services for similar instruments are classified as Level 2 securities if the inputs to the pricing models used are consistent with the Level 2 definition. If quoted prices for a security are not reasonably available from the third party pricing service, but dealer pricing indications are, the security will be classified as a Level 2 security. If neither is available, management will determine the fair value based on characteristics of the security that we receive from the issuer and based on available market information and classify it as a Level 3 security. At March 31, 2019 and December 31, 2018, all of our Agency Security fair values are classified as Level 2 based on the inputs used by our third party pricing services and dealer quotes.

Credit Risk and Non-Agency Securities - The fair value for the Credit Risk and Non-Agency Securities in our securities portfolio is based on obtaining a valuation for each Credit Risk and Non-Agency Security from third party pricing services and/or dealer quotes. The third party pricing services incorporate such factors as collateral type, bond structure and priority of payments, coupons, prepayment speeds, defaults, delinquencies and severities. If the fair value of a Credit Risk and Non-Agency Security is not available from the third party pricing services or such data appears unreliable, we obtain pricing indications from up to three dealers who make markets in similar Credit Risk and Non-Agency Securities. Management reviews pricing used to ensure that current market conditions are properly reflected. This review includes, but is not limited to, comparisons of similar market transactions or alternative third party pricing services, dealer pricing indications and comparisons to fair value determined using a third party pricing model. Fair values obtained from the third party pricing services for similar instruments are classified as Level 2 securities if the inputs to the pricing models used are consistent with the Level 2 definition. If quoted prices for a security are not reasonably available from the third party pricing service, but dealer pricing indications are, the security will be classified as a Level 2 security. If neither is available, management will determine the fair value based on characteristics of the security that we receive from the issuer and based on available market information and classify it as a Level 3 security. At

March 31, 2019 and December 31, 2018, all of our Credit Risk and Non-Agency Securities are classified as Level 2 based on the inputs used by our third party pricing services and dealer quotes.

Interest-Only Securities - The fair value for the Interest-Only Securities in our securities portfolio is based on obtaining a valuation for each Interest-Only Security from third party pricing services and/or dealer quotes. The third party pricing services use common market pricing methods that may include pricing models consistent with those models used to price Agency Securities underlying the Interest-Only Securities that may incorporate such factors as coupons, prepayment speeds, spread to the Treasury curves and interest rate swap curves, duration, periodic and life caps and credit enhancement. If the fair value of an Interest-Only Security is not available from the third party pricing services or such data appears unreliable, we obtain pricing indications from up to three dealers who make markets in similar Interest-Only Securities. Management reviews pricing used to ensure that current market conditions are properly reflected. This review includes, but is not limited to, comparisons of similar market transactions or alternative third party pricing services, dealer pricing indications and comparisons to a third party pricing model. Fair values obtained from the third party pricing services for similar instruments are classified as Level 2 securities if the inputs to the pricing models used are consistent with the Level 2 definition. If quoted prices for a security are not reasonably available from the third party pricing service, but dealer pricing indications are, the security will be classified as a Level 2 security. If neither is available, management will determine the fair value based on characteristics of the security that we receive from the issuer and based on available market information and classify it as a Level 3 security. At March 31, 2019 and December 31, 2018, all of our Interest-Only Security fair values are classified as Level 2 based on the inputs used by our third party pricing services and dealer quotes.

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ARMOUR Residential REIT, Inc.
FINANCIAL STATEMENT NOTES (UNAUDITED)
(in thousands, except per share)

U.S. Treasury Securities- Fair value for the U.S. Treasury Securities in our securities portfolio is based on obtaining a valuation for each U.S. Treasury Securities from third party pricing services and/or dealer quotes. At December 31, 2018, all of our U.S. Treasury Securities are classified as Level 1, as quoted unadjusted prices are available in active markets for identical assets. We did not have any U.S. Treasury Securities at March 31, 2019.

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

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

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

The following tables provide a summary of our assets and liabilities that are measured at fair value on a recurring basis at March 31, 2019 and December 31, 2018.

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance, March 31, 2019
Assets at Fair Value:				
Agency Securities	\$	—\$12,707,442	\$	—\$12,707,442

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Credit Risk and Non-Agency Securities	\$	—\$815,008	\$	—\$815,008
Interest-Only Securities	\$	—\$19,319	\$	—\$19,319
Derivatives	\$	—\$58,677	\$	—\$58,677
Liabilities at Fair Value:				
Derivatives	\$	—\$67,065	\$	—\$67,065

There were no transfers of assets or liabilities between the levels of the fair value hierarchy during the three months ended March 31, 2019.

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ARMOUR Residential REIT, Inc.
FINANCIAL STATEMENT NOTES (UNAUDITED)
(in thousands, except per share)

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at December 31, 2018
Assets at Fair Value:				
Agency Securities	\$ —	\$ 7,051,954	\$ —	\$ 7,051,954
Credit Risk and Non-Agency Securities	\$ —	\$ 819,915	\$ —	\$ 819,915
Interest-Only Securities	\$ —	\$ 20,623	\$ —	\$ 20,623
U.S. Treasury Securities	\$ 98,646	\$ —	\$ —	\$ 98,646
Derivatives	\$ —	\$ 111,913	\$ —	\$ 111,913
Liabilities at Fair Value:				
Derivatives	\$ —	\$ 24,505	\$ —	\$ 24,505

There were no transfers of assets or liabilities between the levels of the fair value hierarchy during the year ended December 31, 2018.

The following tables provide a summary of the carrying values and fair values of our financial assets and liabilities not carried at fair value but for which fair value is required to be disclosed at March 31, 2019 and December 31, 2018.

March 31, 2019		Fair Value Measurements using: Quoted Prices in Active Markets for Identical Assets (Level 1)	
Carrying Value	Fair Value	Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)