ANNALY CAPITAL MANAGEMENT INC
Form 10-Q
May 03, 2019
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

[X] 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 _________________
COMMISSION FILE NUMBER: 1-13447

ANNALY CAPITAL MANAGEMENT, INC.
(Exact Name of Registrant as Specified in its Charter)

| | |
|---|---|
| MARYLAND | 22-3479661 |
| (State or other jurisdiction of incorporation or organization) | (IRS Employer Identification No.) |

| | |
|---|---|
| 1211 AVENUE OF THE AMERICAS | |
| NEW YORK, NEW YORK | 10036 |
| (Address of principal executive offices) | (Zip Code) |

(212) 696-0100
(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.

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

If an emerging growth company, indicate by 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 Act). Yes No

Securities registered pursuant to Section 12(b) of the Act:

| Title of Each Class | Trading Symbol(s) | Name of Each Exchange on Which Registered |
|---|---|---|
| Common Stock, par value $0.01 per share | NLY | New York Stock Exchange |
| 7.625% Series C Cumulative Redeemable Preferred Stock | NLY.C | New York Stock Exchange |
| 7.50% Series D Cumulative Redeemable Preferred Stock | NLY.D | New York Stock Exchange |
| 6.95% Series F Fixed-to-Floating Rate Cumulative Redeemable Preferred Stock | NLY.F | New York Stock Exchange |
| 6.50% Series G Fixed-to-Floating Rate Cumulative Redeemable Preferred Stock | NLY.G | New York Stock Exchange |
| 8.125% Series H Cumulative Redeemable Preferred Stock | NLY.H | New York Stock Exchange |

The number of shares of the registrant’s Common Stock outstanding on April 30, 2019 was 1,456,197,143.

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PART I - FINANCIAL INFORMATION
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ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
(dollars in thousands, except per share data)

| | March 31, 2019 (Unaudited) | December 31, 2018 [1] |
|---|---|---|
| Assets | | |
| Cash and cash equivalents (includes pledged assets of $1,338,507 and $1,581,775, respectively) [2] | $1,522,605 | $1,735,749 |
| Securities (includes pledged assets of $95,845,559 and $87,193,316, respectively) [3] | 104,993,271 | 92,623,788 |
| Loans, net (includes pledged assets of $2,243,369 and $2,997,051, respectively) [4] | 3,879,324 | 4,585,975 |
| Mortgage servicing rights (includes pledged assets of $3,260 and $3,616, respectively) | 500,745 | 557,813 |
| Assets transferred or pledged to securitization vehicles | 4,365,300 | 3,833,200 |
| Real estate, net | 734,239 | 739,473 |
| Derivative assets | 148,178 | 200,503 |
| Reverse repurchase agreements | 523,449 | 650,040 |
| Receivable for unsettled trades | 1,574,251 | 68,779 |
| Interest receivable | 390,930 | 357,365 |
| Goodwill and intangible assets, net | 98,551 | 100,854 |
| Other assets | 441,706 | 333,988 |
| Total assets | $119,172,549 | $105,787,527 |
| Liabilities and stockholders’ equity | | |
| Liabilities | | |
| Repurchase agreements | $88,554,170 | $81,115,874 |
| Other secured financing | 4,144,623 | 4,183,311 |
| Debt issued by securitization vehicles | 3,693,766 | 3,347,062 |
| Mortgages payable | 510,386 | 511,056 |
| Derivative liabilities | 775,980 | 889,750 |
| Payable for unsettled trades | 4,763,376 | 583,036 |
| Interest payable | 424,391 | 570,928 |
| Dividends payable | 434,431 | 394,129 |
| Other liabilities | 89,982 | 74,580 |
| Total liabilities | 103,391,105 | 91,669,726 |
| Stockholders’ equity | | |
| Preferred stock, par value $0.01 per share, 75,950,000 authorized, 73,400,00 issued and outstanding | 1,778,168 | 1,778,168 |
| Common stock, par value $0.01 per share, 1,924,050,000 authorized, 1,448,103,248 and 1,313,763,450 issued and outstanding, respectively | 14,481 | 13,138 |
| Additional paid-in capital | 20,112,875 | 18,794,331 |
| Accumulated other comprehensive income (loss) | (319,376) | (1,979,865) |
| Accumulated deficit | (5,809,931) | (4,493,660) |
| Total stockholders’ equity | 15,776,217 | 14,112,112 |
| Noncontrolling interests | 5,227 | 5,689 |
| Total equity | 15,781,444 | 14,117,801 |
| Total liabilities and equity | $119,172,549 | $105,787,527 |

(1) Derived from the audited consolidated financial statements at December 31, 2018.

(2) Includes cash of consolidated Variable Interest Entities ("VIEs") of $40.7 million and $30.4 million at March 31, 2019 and December 31, 2018, respectively.

(3) Excludes $273.4 million and $83.6 million at March 31, 2019 and December 31, 2018, respectively, of non-Agency mortgage-backed securities and $246.6 million and $224.3 million at March 31, 2019 and December 31, 2018, respectively, of commercial mortgage-backed securities in consolidated VIEs pledged as collateral and eliminated from the Company's Consolidated Statements of Financial Condition.

(4) Includes $101.3 million and $97.5 million of residential mortgage loans held for sale, $42.0 million and $42.2 million of commercial mortgage loans held for sale and $44.5 million and $0 of corporate loans held for sale at March 31, 2019 and December 31, 2018, respectively.

See notes to consolidated financial statements.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 1. Financial Statements

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(dollars in thousands, except per share data)
(Unaudited)

| | For The Three Months Ended March 31, | |
|---|---|---|
| | 2019 | 2018 |
| Net interest income | | |
| Interest income | $866,186 | $879,487 |
| Interest expense | 647,695 | 367,421 |
| Net interest income | 218,491 | 512,066 |
| Realized and unrealized gains (losses) | | |
| Net interest component of interest rate swaps | 134,035 | (48,160) |
| Realized gains (losses) on termination or maturity of interest rate swaps | (588,256) | 834 |
| Unrealized gains (losses) on interest rate swaps | (390,556) | 977,285 |
| Subtotal | (844,777) | 929,959 |
| Net gains (losses) on disposal of investments | (93,916) | 13,468 |
| Net gains (losses) on other derivatives | (115,159) | (47,145) |
| Net unrealized gains (losses) on instruments measured at fair value through earnings | 47,629 | (51,593) |
| Loan loss provision | (5,703) | — |
| Subtotal | (167,149) | (85,270) |
| Total realized and unrealized gains (losses) | (1,011,926) | 844,689 |
| Other income (loss) | 30,502 | 34,023 |
| General and administrative expenses | | |
| Compensation and management fee | 44,833 | 44,529 |
| Other general and administrative expenses | 38,904 | 17,981 |
| Total general and administrative expenses | 83,737 | 62,510 |
| Income (loss) before income taxes | (846,670) | 1,328,268 |
| Income taxes | 2,581 | 564 |
| Net income (loss) | (849,251) | 1,327,704 |
| Net income (loss) attributable to noncontrolling interests | (101) | (96) |
| Net income (loss) attributable to Annaly | (849,150) | 1,327,800 |
| Dividends on preferred stock | 32,494 | 33,766 |
| Net income (loss) available (related) to common stockholders | $(881,644) | $1,294,034 |
| Net income (loss) per share available (related) to common stockholders | | |
| Basic | $(0.63) | $1.12 |
| Diluted | $(0.63) | $1.12 |
| Weighted average number of common shares outstanding | | |
| Basic | 1,398,614,205 | 1,159,617,848 |
| Diluted | 1,398,614,205 | 1,160,103,185 |
| Other comprehensive income (loss) | | |
| Net income (loss) | $(849,251) | $1,327,704 |
| Unrealized gains (losses) on available-for-sale securities | 1,599,398 | (1,879,479) |
| Reclassification adjustment for net (gains) losses included in net income (loss) | 61,091 | 5,419 |
| Other comprehensive income (loss) | 1,660,489 | (1,874,060) |
| Comprehensive income (loss) | 811,238 | (546,356) |
| Comprehensive income (loss) attributable to noncontrolling interests | (101) | (96) |
| Comprehensive income (loss) attributable to Annaly | 811,339 | (546,260) |

| | | |
|---|---|---|
| Dividends on preferred stock | 32,494 | 33,766 |
| Comprehensive income (loss) attributable to common stockholders | $ 778,845 | $ (580,026 ) |

See notes to consolidated financial statements.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 1. Financial Statements

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(dollars in thousands)
(Unaudited)

| | For The Three Months Ended March 31, | |
|---|---|---|
| | 2019 | 2018 |
| Preferred stock | | |
| Beginning of period | $1,778,168 | $1,720,381 |
| Issuance | — | 411,335 |
| Redemption | — | (408,548) |
| End of period | $1,778,168 | $1,723,168 |
| Common stock | | |
| Beginning of period | $13,138 | $11,596 |
| Issuance | 1,342 | — |
| Direct purchase and dividend reinvestment | 1 | 1 |
| End of period | $14,481 | $11,597 |
| Additional paid-in capital | | |
| Beginning of period | $18,794,331 | $17,221,265 |
| Stock compensation expense | 178 | 133 |
| Issuance | 1,317,475 | — |
| Redemption of preferred stock | — | (3,952) |
| Direct purchase and dividend reinvestment | 891 | 745 |
| End of period | $20,112,875 | $17,218,191 |
| Accumulated other comprehensive income (loss) | | |
| Beginning of period | $(1,979,865) | $(1,126,020) |
| Unrealized gains (losses) on available-for-sale securities | 1,599,398 | (1,879,479) |
| Reclassification adjustment for net gains (losses) included in net income (loss) | 61,091 | 5,419 |
| End of period | $(319,376) | $(3,000,080) |
| Accumulated deficit | | |
| Beginning of period | $(4,493,660) | $(2,961,749) |
| Net income (loss) attributable to Annaly | (849,150) | 1,327,800 |
| Dividends declared on preferred stock [1] | (32,494) | (33,766) |
| Dividends and dividend equivalents declared on common stock and share-based awards [1] | (434,627) | (347,897) |
| End of period | $(5,809,931) | $(2,015,612) |
| Total stockholder’s equity | $15,776,217 | $13,937,264 |
| Noncontrolling interests | | |
| Beginning of period | $5,689 | $6,100 |
| Net income (loss) attributable to noncontrolling interests | (101) | (96) |
| Equity contributions from (distributions to) noncontrolling interests | (361) | (333) |
| End of period | $5,227 | $5,671 |
| Total equity | $15,781,444 | $13,942,935 |

(1) See Note titled “Capital Stock” for dividends per share for each class of shares.

See notes to consolidated financial statements.

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ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 1. Financial Statements

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(dollars in thousands)

| | For The Three Months Ended March 31, | |
|---|---|---|
| | 2019 | 2018 |
| Cash flows from operating activities | | |
| Net income (loss) | $(849,251) | $1,327,704 |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities | | |
| Amortization of premiums and discounts of investments, net | 246,150 | 92,976 |
| Amortization of securitized debt premiums and discounts and deferred financing costs | (3,627) | 408 |
| Depreciation, amortization and other noncash expenses | 7,072 | 5,822 |
| Net (gains) losses on disposals of investments | 93,916 | (13,468) |
| Net (gains) losses on investments and derivatives | 458,086 | (878,547) |
| Income from unconsolidated joint ventures | 1,960 | 618 |
| Loan loss provision | 5,703 | — |
| Payments on purchases of loans held for sale | (49,070) | (37,190) |
| Proceeds from sales and repayments of loans held for sale | 44,817 | 30,178 |
| Net receipts (payments) on derivatives | (633,221) | 951,021 |
| Net change in | | |
| Other assets | (107,040) | (42,361) |
| Interest receivable | (29,491) | (2,963) |
| Interest payable | (146,537) | 31,628 |
| Other liabilities | 18,436 | (132,910) |
| Net cash provided by (used in) operating activities | (942,097) | 1,332,916 |
| Cash flows from investing activities | | |
| Payments on purchases of residential securities | (18,374,100) | (3,718,947) |
| Proceeds from sales of residential securities | 7,822,334 | 463,214 |
| Principal payments on residential securities | 2,343,383 | 2,696,245 |
| Payments on purchases of MSRs | — | (249) |
| Payments on purchases of corporate debt | (125,351) | (230,103) |
| Proceeds from sales of corporate debt | 179,112 | — |
| Principal payments on corporate debt | 33,545 | 92,820 |
| Originations and purchases of commercial real estate investments | (269,489) | (91,647) |
| Proceeds from sales of commercial real estate investments | 41,013 | 9,556 |
| Principal repayments on commercial real estate investments | 578,031 | 130,555 |
| Proceeds from sales of real estate | 6,661 | — |
| Proceeds from reverse repurchase agreements | 28,107,306 | 20,050,112 |
| Payments on reverse repurchase agreements | (27,980,715) | (20,250,571) |
| Distributions in excess of cumulative earnings from unconsolidated joint ventures | 241 | 2,813 |
| Payments on purchases of residential mortgage loans held for investment | (373,745) | (167,124) |
| Proceeds from repayments of residential mortgage loans held for investment | 107,783 | 67,384 |
| Net cash provided by (used in) investing activities | (7,903,991) | (945,942) |
| Cash flows from financing activities | | |
| Proceeds from repurchase agreements and other secured financing | 1,411,469,975 | 1,299,589,620 |
| Principal payments on repurchase agreements and other secured financing | (1,404,070,367) | (1,299,277,944) |
| Proceeds from issuances of securitized debt | 905,265 | 279,203 |
| Principal repayments on securitized debt | (561,955) | (317,773) |

| | | |
|---|---|---|
| Payment of deferred financing cost | (1,781 ) | — |
| Net proceeds from stock offerings, direct purchases and dividend reinvestments | 1,319,709 | 412,081 |
| Redemptions of preferred stock | — | (412,500 ) |
| Principal payments on mortgages payable | (722 ) | — |
| Net contributions (distributions) from (to) noncontrolling interests | (361 ) | (333 ) |
| Dividends paid | (426,819 ) | (381,642 ) |
| Net cash provided by (used in) financing activities | 8,632,944 | (109,288 ) |
| Net (decrease) increase in cash and cash equivalents | $(213,144 ) | $ 277,686 |
| Cash and cash equivalents including cash pledged as collateral, beginning of period | 1,735,749 | 706,589 |
| Cash and cash equivalents including cash pledged as collateral, end of period | $1,522,605 | $ 984,275 |
| Supplemental disclosure of cash flow information | | |
| Interest received | $1,079,294 | $ 1,017,534 |
| Dividends received | $2,116 | $ 1,650 |
| Interest paid (excluding interest paid on interest rate swaps) | $633,805 | $ 320,988 |
| Net interest paid on interest rate swaps | $34,663 | $ 39,206 |
| Taxes received (paid) | $(30 ) | $ 2 |
| Noncash investing activities | | |
| Receivable for unsettled trades | $1,574,251 | $ 45,126 |
| Payable for unsettled trades | $4,763,376 | $ 91,327 |
| Net change in unrealized gains (losses) on available-for-sale securities, net of reclassification adjustment | $1,660,489 | $ (1,874,060 ) |
| Noncash financing activities | | |
| Dividends declared, not yet paid | $434,431 | $ 347,897 |

See notes to consolidated financial statements.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 1. Financial Statements

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## 1. DESCRIPTION OF BUSINESS

Annaly Capital Management, Inc. (the “Company” or “Annaly”) is a Maryland corporation that commenced operations on February 18, 1997. The Company is a leading diversified capital manager that invests in and finances residential and commercial assets. The Company owns a portfolio of real estate related investments, including mortgage pass-through certificates, collateralized mortgage obligations, credit risk transfer (“CRT”) securities, other securities representing interests in or obligations backed by pools of mortgage loans, residential mortgage loans, mortgage servicing rights (“MSRs”), commercial real estate assets and corporate debt. The Company’s principal business objective is to generate net income for distribution to its stockholders and to preserve capital through prudent selection of investments and continuous management of its portfolio. The Company is externally managed by Annaly Management Company LLC (the “Manager”).

The Company’s four investment groups are primarily comprised of the following:

| Investment Groups | Description |
|---|---|
| Annaly Agency Group | Invests in Agency mortgage-backed securities (“MBS”) collateralized by residential mortgages which are guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae. |
| Annaly Residential Credit Group | Invests primarily in non-Agency residential mortgage assets within securitized products and residential mortgage loan markets. |
| Annaly Commercial Real Estate Group | Originates and invests in commercial mortgage loans, securities, and other commercial real estate debt and equity investments. |
| Annaly Middle Market Lending Group | Provides financing to private equity-backed middle market businesses across the capital structure. |

The Company has elected to be taxed as a Real Estate Investment Trust (“REIT”) as defined under the Internal Revenue Code of 1986, as amended, and regulations promulgated thereunder (the “Code”).

## 2. BASIS OF PRESENTATION

The accompanying consolidated financial statements and related notes of the Company have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”).

The accompanying consolidated financial statements and related notes are unaudited and should be read in conjunction with the audited consolidated financial statements included in the Company’s most recent Annual Report on Form 10-K for the fiscal year ended December 31, 2018 (the “2018 Form 10-K”). The consolidated financial information as of December 31, 2018 has been derived from audited consolidated financial statements included in the Company’s 2018 Form 10-K.

The preparation of the consolidated financial statements requires management to make estimates and assumptions that affect the reported balance sheet amounts and/or disclosures at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates.

In the opinion of management, all normal, recurring adjustments have been included for a fair presentation of this interim financial information. Interim period operating results may not be indicative of the operating results for a full year.

## 3. SIGNIFICANT ACCOUNTING POLICIES

The Company’s significant accounting policies are described below or are included elsewhere in these notes to the Consolidated Financial Statements.

Principles of Consolidation – The consolidated financial statements include the accounts of the entities where the Company has a controlling financial interest. In order to determine whether the Company has a controlling financial interest, it first evaluates whether an entity is a voting interest entity ("VOE") or a variable interest entity ("VIE"). All intercompany balances and transactions have been eliminated in consolidation.

Voting Interest Entities – A VOE is an entity that has sufficient equity and in which equity investors have a controlling financial interest. The Company consolidates VOEs where it has a majority of the voting equity of such VOE.



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ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 1. Financial Statements

Variable Interest Entities – A VIE is defined as an entity in which equity investors (i) do not have the characteristics of a controlling financial interest, and/or (ii) do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. A VIE is required to be consolidated by its primary beneficiary, which is defined as the party that has both (i) the power to control the activities that most significantly impact the VIE’s economic performance and (ii) the obligation to absorb losses or the right to receive benefits from the VIE that could potentially be significant to the VIE.

The Company performs ongoing reassessments of whether changes in the facts and circumstances regarding the Company’s involvement with a VIE causes the Company’s consolidation conclusion to change. Refer to the “Variable Interest Entities” Note for further information.

Equity Method Investments - For entities that are not consolidated, but where the Company has significant influence over the operating or financial decisions of the entity, the Company accounts for the investment under the equity method of accounting. In accordance with the equity method of accounting, the Company will recognize its share of earnings or losses of the investee in the period in which they are reported by the investee. The Company also considers whether there are any indicators of other-than-temporary impairment of joint ventures accounted for under the equity method. These investments are included in Real estate, net and Other assets with income or loss included in Other income (loss).

Cash and Cash Equivalents – Cash and cash equivalents include cash on hand, cash held in money market funds on an overnight basis and cash pledged as collateral with counterparties. Cash deposited with clearing organizations is carried at cost, which approximates fair value. Cash and securities deposited with clearing organizations and collateral held in the form of cash on margin with counterparties to the Company’s interest rate swaps and other derivatives totaled $1.3 billion and $1.6 billion at March 31, 2019 and December 31, 2018.

Equity Securities – The Company may invest in equity securities that are not accounted for under the equity method or do not result in consolidation. These equity securities are required to be reported at fair value with unrealized gains and losses reported in the Consolidated Statements of Comprehensive Income (Loss) as Net unrealized gains (losses) on instruments measured at fair value through earnings, unless the securities do not have readily determinable fair values.  For such equity securities without readily determinable fair values, the Company has elected to carry the securities at cost less impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or similar investment of the same issuer. For equity securities carried at fair value through earnings, dividends are recorded in earnings on the declaration date. Dividends from equity securities without readily determinable fair values are recognized as income when received to the extent they are distributed from net accumulated earnings.

Fair Value Measurements and the Fair Value Option – The Company reports various investments at fair value, including certain eligible financial instruments elected to be accounted for under the fair value option (“FVO”). The Company chooses to elect the fair value option in order to simplify the accounting treatment for certain financial instruments. If an item is accounted for at fair value, including financial instruments elected under the FVO, it is presented at fair value in the Consolidated Statements of Financial Condition and any change in fair value is recorded in Net unrealized gains (losses) on instruments measured at fair value through earnings in the Consolidated Statements of Comprehensive Income (Loss). For additional information regarding financial instruments for which the Company has elected the fair value option see the table in the “Financial Instruments” Note.

Refer to the “Fair Value Measurements” Note for a complete discussion on the methodology utilized by the Company to estimate the fair value of certain financial instruments.

Offsetting Assets and Liabilities - The Company elected to present all derivative instruments on a gross basis as discussed in the “Derivative Instruments” Note. Reverse repurchase and repurchase agreements are presented net in the Consolidated Statements of Financial Condition if they are subject to netting agreements and they meet the offsetting criteria. Please see below and refer to the “Secured Financing” Note for further discussion on reverse repurchase and repurchase agreements.

Derivative Instruments – Derivatives are accounted for in accordance with the Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 815, Derivatives and Hedging, which requires recognition of all derivatives as either assets or liabilities at fair value in the Consolidated Statements of Financial Condition with changes in fair value recognized in the Consolidated Statements of Comprehensive Income (Loss). The changes in the estimated fair value are presented within Net gains (losses) on other derivatives with the exception of interest rate swaps which are separately presented. None of the Company's derivative transactions have been designated as hedging instruments for accounting purposes. Refer to the "Derivative Instruments" Note for further discussion.

Stock Based Compensation – The Company is required to measure and recognize in the consolidated financial statements the compensation cost relating to share-based payment transactions. The Company recognizes compensation expense ratably over the requisite service period for the entire award.

Interest Income - The Company recognizes coupon income, which is a component of interest income, based upon the outstanding principal amounts of the financial instruments and their contractual terms. In addition, the Company amortizes or accretes premiums or discounts into interest income for its Agency mortgage-backed securities (other than multifamily securities), taking into account

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 1. Financial Statements

estimates of future principal prepayments in the calculation of the effective yield. The Company recalculates the effective yield as differences between anticipated and actual prepayments occur. Using third-party model and market information to project future cash flows and expected remaining lives of securities, the effective interest rate determined for each security is applied as if it had been in place from the date of the security's acquisition. The amortized cost of the security is then adjusted to the amount that would have existed had the new effective yield been applied since the acquisition date, which results in a cumulative premium amortization adjustment in each period. The adjustment to amortized cost is offset with a charge or credit to interest income. Changes in interest rates and other market factors will impact prepayment speed projections and the amount of premium amortization recognized in any given period.

Premiums or discounts associated with the purchase of Agency interest-only securities, reverse mortgages and residential credit securities are amortized or accreted into interest income based upon current expected future cash flows with any adjustment to yield made on a prospective basis.

Premiums and discounts associated with the purchase of residential mortgage loans and with those transferred or pledged to securitization trusts are primarily amortized or accreted into interest income over their estimated remaining lives using the effective interest rates inherent in the estimated cash flows from the mortgage loans. Amortization of premiums and accretion of discounts are presented in Interest income in the Consolidated Statements of Comprehensive Income (Loss). Refer to the "Interest Income and Interest Expense" Note for further discussion of interest income.

Income Taxes – The Company has elected to be taxed as a REIT and intends to comply with the provisions of the Code, with respect thereto. As a REIT, the Company will not incur federal income tax to the extent that it distributes its taxable income to its stockholders. The Company and certain of its direct and indirect subsidiaries have made separate joint elections to treat these subsidiaries as taxable REIT subsidiaries ("TRSs"). As such, each of these TRSs is taxable as a domestic C corporation and subject to federal, state and local income taxes based upon its taxable income. Refer to the "Income Taxes" Note for further discussion on income taxes.

Recent Accounting Pronouncements

The Company considers the applicability and impact of all Accounting Standards Updates ("ASUs"). ASUs not listed below were not applicable, not expected to have a significant impact on the Company's consolidated financial statements when adopted or did not have a significant impact on the Company's consolidated financial statements upon adoption.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
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| Standard | Description | Effective Date | Effect on the Financial Statements or Other Significant Matters |
|---|---|---|---|
| Standards that are not yet adopted | | | |
| ASU 2016-13 Financial instruments - Credit losses (Topic 326): Measurement of credit losses on financial instruments | This ASU updates the existing incurred loss model to a current expected credit loss ("CECL") model for financial assets and net investments in leases that are not accounted for at fair value through earnings. The amendments affect certain loans, held-to-maturity debt securities, trade receivables, net investments in leases, off-balance sheet credit exposures and any other financial assets not excluded from the scope. There are also limited amendments to the impairment model for available-for-sale debt securities. | January 1, 2020 (early adoption permitted) | The Company plans to adopt the new standard on its effective date. While the Company is continuing to assess the impact the ASU will have on the consolidated financial statements, the measurement of expected credit losses under the CECL model will be based on relevant information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amounts of the financial assets in scope of the model. The Company has decided to apply a probability of default methodology to loans that will be impacted by the adoption and is continuing to assess the impact on the consolidated financial statements and determine appropriate internal controls and financial statement disclosures. Further, based on the amended guidance for available-for-sale debt securities, the Company:<br>•will be required to use an allowance approach to recognize credit impairment, with the allowance to be limited to the amount by which the security's fair value is less than its amortized cost |

basis;

- may not consider the length of time fair value has been below amortized cost, and
- may not consider recoveries of fair value after the balance sheet date when assessing whether a credit loss exists.

| Standard | Description | Effective Date | Effect on the Financial Statements or Other Significant Matters |
|---|---|---|---|
| Standards that were adopted | | | |
| ASU 2017-01 Business combinations (Topic 805): Clarifying the definition of a business | This update provides a screen to determine and a framework to evaluate when a set of assets and activities is a business. | January 1, 2018 | The amendments are expected to result in fewer transactions being accounted for as business combinations. |
| ASU 2016-15 Statement of cash flows (Topic 230): Classification of certain cash receipts and cash payments | This update provides specific guidance on certain cash flow classification issues, including classification of cash receipts and payments that have aspects of more than one class of cash flows. If cash flows cannot be separated by source or use, the appropriate classification should depend on the activity that is likely to be the predominant source or use of cash flows. | January 1, 2018 | As a result of adopting this standard, the Company reclassified its cash flows on reverse repurchase and repurchase agreements entered into by Arcola Securities, Inc. (“Arcola”) from operating activities to investing and financing activities, respectively, in the Consolidated Statements of Cash Flows. The Company applied the retrospective transition method, which resulted in reclassification of comparative periods. |

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4. FINANCIAL INSTRUMENTS

The following table presents characteristics for certain of the Company's financial instruments at March 31, 2019 and December 31, 2018.

Financial Instruments [1]

| Balance Sheet Line Item | Type / Form | Measurement Basis | March 31, 2019 | December 31, 2018 |
|---|---|---|---|---|
| | Assets | (dollars in thousands) | | |
| Securities | Agency mortgage-backed securities [2] | Fair value, with unrealized gains (losses) through other comprehensive income | $102,222,237 | $89,840,322 |
| Securities | Agency mortgage-backed securities [3] | Fair value, with unrealized gains (losses) through earnings | 871,289 | 912,673 |
| Securities | Credit risk transfer securities | Fair value, with unrealized gains (losses) through earnings | 607,945 | 552,097 |
| Securities | Non-agency mortgage-backed securities | Fair value, with unrealized gains (losses) through earnings | 1,116,569 | 1,161,938 |
| Securities | Commercial real estate debt investments - CMBS | Fair value, with unrealized gains (losses) through other comprehensive income | 96,566 | 138,242 |
| Securities | Commercial real estate debt investments - CMBS [4] | Fair value, with unrealized gains (losses) through earnings | 78,665 | 18,516 |
| Total securities | | | 104,993,271 | 92,623,788 |
| Loans, net | Residential mortgage loans | Fair value, with unrealized gains (losses) through earnings | 1,311,720 | 1,359,806 |
| Loans, net | Commercial real estate debt and preferred equity, held for investment | Amortized cost | 722,962 | 1,296,803 |
| Loans, net | Commercial loans held for sale, net | Lower of amortized cost or fair value | 42,035 | 42,184 |
| Loans, net | Corporate debt | Amortized cost | 1,758,082 | 1,887,182 |
| Loans, net | Corporate debt held for sale, net | Lower of amortized cost or fair value | 44,525 | — |
| Total loans, net | | | 3,879,324 | 4,585,975 |
| Assets transferred or pledged to securitization vehicles | Residential mortgage loans | Fair value, with unrealized gains (losses) through earnings | 1,425,668 | 1,094,831 |
| Assets transferred or pledged to securitization vehicles | Commercial mortgage loans | Fair value, with unrealized gains (losses) through earnings | 2,939,632 | 2,738,369 |
| Total assets transferred or pledged to securitization vehicles | | | 4,365,300 | 3,833,200 |
| Reverse repurchase agreements | Reverse repurchase agreements | Amortized cost | 523,449 | 650,040 |
| | Liabilities | | | |
| Repurchase agreements | Repurchase agreements | Amortized cost | 88,554,170 | 81,115,874 |
| Other secured financing | Loans | Amortized cost | 4,144,623 | 4,183,311 |
| | Securities | | 3,693,766 | 3,347,062 |

| | | | | |
|---|---|---|---|---|
| Debt issued by securitization vehicles | | Fair value, with unrealized gains (losses) through earnings | | |
| Mortgages payable | Loans | Amortized cost | 510,386 | 511,056 |

(1) Receivable for unsettled trades, Interest receivable, Payable for unsettled trades, Interest payable and Dividends payable are accounted for at cost.
(2) Includes Agency pass-through, collateralized mortgage obligation ("CMO") and multifamily securities.
(3) Includes interest-only securities and reverse mortgages.
(4) Includes conduit CMBS.

5. SECURITIES

The Company's investments in securities include agency, credit risk transfer, non-agency and commercial mortgage-backed securities. All of the debt securities are classified as available-for-sale. Available-for-sale securities are carried at fair value, with changes in fair value recognized in other comprehensive income, unless the fair value option is elected in which case changes in fair value are recognized in Net unrealized gains (losses) on instruments measured at fair value through earnings in the Consolidated Statements of Comprehensive Income (Loss). Transactions for securities are recorded on trade date, including TBA securities that meet the regular-way securities scope exception from derivative accounting. Gains and losses on disposals of securities are recorded on trade date based on the specific identification method.

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Other-Than-Temporary Impairment – Management evaluates available-for-sale securities and held-to-maturity debt securities for other-than-temporary impairment at least quarterly, and more frequently when economic or market conditions warrant such evaluation.

When the fair value of an available-for-sale security is less than its amortized cost, the security is considered impaired. For securities that are impaired, the Company determines if it (1) has the intent to sell the security, (2) is more likely than not that it will be required to sell the security before recovery of its amortized cost basis, or (3) does not expect to recover the entire amortized cost basis of the security. Further, the security is analyzed for credit loss (the difference between the present value of cash flows expected to be collected and the amortized cost basis). The credit loss, if any, will then be recognized in the Consolidated Statements of Comprehensive Income (Loss), while the balance of losses related to other factors will be recognized as a component of Other comprehensive income (loss). When the fair value of a held-to-maturity security is less than the cost, the Company performs an analysis to determine whether it expects to recover the entire cost basis of the security. There was no other-than-temporary impairment recognized for the three months ended March 31, 2019 and 2018.

Agency Mortgage-Backed Securities - The Company invests in mortgage pass-through certificates, collateralized mortgage obligations and other MBS representing interests in or obligations backed by pools of residential or multifamily mortgage loans and certificates. Many of the underlying loans and certificates are guaranteed by the Government National Mortgage Association ("Ginnie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac") or the Federal National Mortgage Association ("Fannie Mae") (collectively, "Agency mortgage-backed securities"). Agency mortgage-backed securities may include forward contracts for Agency mortgage-backed securities purchases or sales of a generic pool, on a to-be-announced basis ("TBA securities"). TBA securities without intent to accept delivery ("TBA derivatives"), are accounted for as derivatives as discussed in the "Derivative Instruments" Note.

CRT Securities - CRT securities are risk sharing instruments issued by Fannie Mae and Freddie Mac, and similarly structured transactions arranged by third party market participants. CRT securities are designed to synthetically transfer mortgage credit risk from Fannie Mae and Freddie Mac to private investors.

Non-Agency Mortgage-Backed Securities- The Company invests in non-Agency mortgage-backed securities such as those issued in prime loan, Alt-A loan, subprime loan, non-performing loan ("NPL") and re-performing loan ("RPL") securitizations.

Agency mortgage-backed securities, non-Agency mortgage-backed securities and CRT securities are referred to herein as "Residential Securities." Although the Company generally intends to hold most of its Residential Securities until maturity, it may, from time to time, sell any of its Residential Securities as part of the overall management of its portfolio.

Commercial Mortgage-Backed Securities ("Commercial Securities") - Certain commercial mortgage-backed securities are classified as available-for-sale and reported at fair value with unrealized gains and losses reported as a component of Other comprehensive income (loss). Management evaluates such Commercial Securities for other-than-temporary impairment at least quarterly. The Company elected the fair value option on certain Commercial Securities, including conduit commercial mortgage-backed securities, to simplify the accounting where the unrealized gains and losses on these financial instruments are recorded through earnings.

The following represents a rollforward of the activity for the Company's securities:

March 31, 2019

| | Residential Securities | Commercial Securities | Total |
|---|---|---|---|
| | (dollars in thousands) | | |
| Beginning balance January 1 | $92,467,030 | $ 156,758 | $92,623,788 |
| Purchases | 23,649,271 | 98,633 | 23,747,904 |
| Sales | (10,456,466) | (39,834) | (10,496,300) |
| Principal paydowns | (2,343,260) | (42,859) | (2,386,119) |
| Amortization / accretion | (247,447) | 78 | (247,369) |
| Fair value adjustment | 1,748,912 | 2,455 | 1,751,367 |

| | | | |
|---|---|---|---|
| Ending balance March 31 | $104,818,040 | $175,231 | $104,993,271 |

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The following tables present the Company's Residential Investment Securities portfolio that was carried at their fair value at March 31, 2019 and December 31, 2018:

| | March 31, 2019 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Principal / Notional | Remaining Premium | Remaining Discount | Amortized Cost | Unrealized Gains | Unrealized Losses | Estimated Fair Value |
| Agency | (dollars in thousands) | | | | | | |
| Fixed-rate pass-through | $92,064,633 | $4,060,260 | $(41,614) | $96,083,279 | $789,557 | $(1,118,629) | $95,754,207 |
| Adjustable-rate pass-through | 4,046,258 | 204,672 | (1,317) | 4,249,613 | 7,395 | (104,972) | 4,152,036 |
| CMO | 10,699 | 50 | — | 10,749 | 199 | — | 10,948 |
| Interest-only | 5,522,373 | 1,070,160 | — | 1,070,160 | 1,900 | (239,282) | 832,778 |
| Multifamily | 2,186,848 | 18,783 | (5,249) | 2,200,382 | 104,664 | — | 2,305,046 |
| Reverse mortgages | 34,415 | 4,031 | — | 38,446 | 68 | (3) | 38,511 |
| Total agency securities | $103,865,226 | $5,357,956 | $(48,180) | $103,652,629 | $903,783 | $(1,462,886) | $103,093,526 |
| Residential credit | | | | | | | |
| CRT | $593,949 | $24,891 | $(16,883) | $601,957 | $9,488 | $(3,500) | $607,945 |
| Alt-A | 215,630 | 374 | (30,467) | 185,537 | 12,926 | (95) | 198,368 |
| Prime | 312,534 | 2,205 | (21,319) | 293,420 | 16,786 | (179) | 310,027 |
| Subprime | 393,362 | 1,480 | (61,911) | 332,931 | 38,800 | (446) | 371,285 |
| NPL/RPL | 3,431 | — | (22) | 3,409 | 27 | — | 3,436 |
| Prime jumbo (>=2010 vintage) | 220,289 | 1,070 | (4,626) | 216,733 | 3,004 | (915) | 218,822 |
| Prime jumbo (>=2010 vintage) Interest-only | 837,030 | 12,445 | — | 12,445 | 2,517 | (331) | 14,631 |
| Total residential credit securities | $2,576,225 | $42,465 | $(135,228) | $1,646,432 | $83,548 | $(5,466) | $1,724,514 |
| Total residential securities | $106,441,451 | $5,400,421 | $(183,408) | $105,299,061 | $987,331 | $(1,468,352) | $104,818,040 |
| Commercial | | | | | | | |
| Commercial securities | $180,992 | $497 | $(9,513) | $171,976 | $3,546 | $(291) | $175,231 |
| Total securities | $106,622,443 | $5,400,918 | $(192,921) | $105,471,037 | $990,877 | $(1,468,643) | $104,993,271 |

| | December 31, 2018 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Principal / Notional | Remaining Premium | Remaining Discount | Amortized Cost | Unrealized Gains | Unrealized Losses | Estimated Fair Value |
| Agency | (dollars in thousands) | | | | | | |
| Fixed-rate pass-through | $81,144,650 | $3,810,808 | $(36,987) | $84,918,471 | $264,443 | $(2,130,362) | $83,052,552 |
| Adjustable-rate pass-through | 4,835,983 | 247,981 | (1,337) | 5,082,627 | 7,127 | (151,770) | 4,937,984 |
| CMO | 11,113 | 53 | — | 11,166 | 55 | — | 11,221 |
| Interest-only | 6,007,008 | 1,179,855 | — | 1,179,855 | 1,446 | (307,412) | 873,889 |
| Multifamily | 1,802,292 | 12,329 | (5,332) | 1,809,289 | 32,753 | (3,477) | 1,838,565 |
| Reverse mortgages | 34,650 | 4,175 | — | 38,825 | 69 | (110) | 38,784 |
| Total agency investments | | | | | | | |