

DYNEX CAPITAL INC
Form 10-Q
November 12, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 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 September 30, 2013

or
 Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
Commission File Number: 1-9819

DYNEX CAPITAL, INC.

(Exact name of registrant as specified in its charter)

Virginia 52-1549373
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)

4991 Lake Brook Drive, Suite 100, Glen Allen, Virginia 23060-9245
(Address of principal executive offices) (Zip Code)

(804) 217-5800
(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.

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

On November 8, 2013, the registrant had 54,428,943 shares outstanding of common stock, \$0.01 par value, which is the registrant's only class of common stock.

DYNEX CAPITAL, INC.
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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

DYNEX CAPITAL, INC.
CONSOLIDATED BALANCE SHEETS
(amounts in thousands except share data)

| | September 30, 2013 (unaudited) | December 31, 2012 |
|---|--------------------------------------|----------------------|
| ASSETS | | |
| Mortgage-backed securities, at fair value (including pledged of \$4,013,556 and \$3,967,134, respectively) | \$4,141,744 | \$4,103,981 |
| Securitized mortgage loans, net | 59,797 | 70,823 |
| Other investments, net | 1,305 | 858 |
| | 4,202,846 | 4,175,662 |
| Cash and cash equivalents | 39,608 | 55,809 |
| Restricted cash | 15,849 | — |
| Derivative assets | 12,908 | — |
| Principal receivable on investments | 18,267 | 17,008 |
| Accrued interest receivable | 22,167 | 23,073 |
| Other assets, net | 7,999 | 8,677 |
| Total assets | \$4,319,644 | \$4,280,229 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Liabilities: | | |
| Repurchase agreements | \$3,674,850 | \$3,564,128 |
| Non-recourse collateralized financing | 21,148 | 30,504 |
| Derivative liabilities | 20,837 | 42,537 |
| Accrued interest payable | 2,433 | 2,895 |
| Accrued dividends payable | 16,632 | 16,770 |
| Other liabilities | 2,703 | 6,685 |
| Total liabilities | 3,738,603 | 3,663,519 |
| Commitments and Contingencies (Note 9) | | |
| Shareholders' equity: | | |
| Preferred stock, par value \$.01 per share, 8.5% Series A Cumulative Redeemable; 8,000,000 shares authorized; 2,300,000 shares issued and outstanding (\$57,500 aggregate liquidation preference) | 55,407 | 55,407 |
| Preferred stock, par value \$.01 per share, 7.625% Series B Cumulative Redeemable; 7,000,000 shares authorized; 2,250,000 shares issued and outstanding (\$56,250 aggregate liquidation preference) | 54,251 | — |
| Common stock, par value \$.01 per share, 200,000,000 shares authorized; 54,426,049 and 54,268,915 shares issued and outstanding, respectively | 544 | 543 |
| Additional paid-in capital | 761,862 | 759,214 |
| Accumulated other comprehensive (loss) income | (34,363 |) 52,511 |
| Accumulated deficit | (256,660 |) (250,965 |
| Total shareholders' equity | 581,041 | 616,710 |
| Total liabilities and shareholders' equity | \$4,319,644 | \$4,280,229 |
| See notes to consolidated financial statements. | | |

DYNEX CAPITAL, INC.
CONSOLIDATED STATEMENTS OF INCOME (LOSS)
(UNAUDITED)

(amounts in thousands except per share data)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|----------|------------------------------------|----------|
| | 2013 | 2012 | 2013 | 2012 |
| Interest income: | | | | |
| Mortgage-backed securities | \$30,820 | \$27,254 | \$95,827 | \$77,236 |
| Securitized mortgage loans | 832 | 1,299 | 2,659 | 4,330 |
| Other investments | 14 | 21 | 52 | 405 |
| | 31,666 | 28,574 | 98,538 | 81,971 |
| Interest expense: | | | | |
| Repurchase agreements | 8,477 | 9,166 | 29,860 | 23,673 |
| Non-recourse collateralized financing | 241 | 308 | 760 | 1,043 |
| | 8,718 | 9,474 | 30,620 | 24,716 |
| Net interest income | 22,948 | 19,100 | 67,918 | 57,255 |
| Provision for loan losses | — | (110) | (261) | (170) |
| Net interest income after provision for loan losses | 22,948 | 18,990 | 67,657 | 57,085 |
| Loss on derivative instruments, net | (24,019) | (333) | (12,683) | (907) |
| (Loss) gain on sale of investments, net | (825) | 3,480 | 2,597 | 6,418 |
| Fair value adjustments, net | 150 | 297 | (590) | 778 |
| Other income (loss), net | 748 | (177) | 761 | 350 |
| General and administrative expenses: | | | | |
| Compensation and benefits | (2,282) | (1,699) | (6,948) | (5,276) |
| Other general and administrative | (1,347) | (1,391) | (4,284) | (3,959) |
| Net (loss) income | \$(4,627) | \$19,167 | \$46,510 | \$54,489 |
| Preferred stock dividends | (2,294) | (814) | (5,608) | (814) |
| Net (loss) income to common shareholders | \$(6,921) | \$18,353 | \$40,902 | \$53,675 |
| Weighted average common shares: | | | | |
| Basic | 54,904 | 54,367 | 54,728 | 52,752 |
| Diluted | 54,904 | 54,368 | 54,728 | 52,752 |
| Net (loss) income per common share: | | | | |
| Basic | \$(0.13) | \$0.34 | \$0.75 | \$1.02 |
| Diluted | \$(0.13) | \$0.34 | \$0.75 | \$1.02 |
| Dividends declared per common share | \$0.27 | \$0.29 | \$0.85 | \$0.86 |

See notes to consolidated financial statements.

DYNEX CAPITAL, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(UNAUDITED)
(amounts in thousands)

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|------------|-------------------|-------------|
| | September 30, | | September 30, | |
| | 2013 | 2012 | 2013 | 2012 |
| Net (loss) income | \$(4,627 |) \$19,167 | \$46,510 | \$54,489 |
| Other comprehensive income (loss): | | | | |
| Change in fair value of available-for-sale investments | (2,671 |) 44,905 | (112,037 |) 80,671 |
| Reclassification adjustment from accumulated other comprehensive income for loss (gain) on sale of investments, net | 825 | (3,275 |) (2,597 |) (3,275 |
| Change in fair value of cash flow hedges | — | (11,073 |) 16,381 | (28,853 |
| Reclassification adjustment from accumulated other comprehensive income for cash flow hedges (including de-designated hedges) | 2,583 | 3,827 | 11,379 | 10,602 |
| Other comprehensive income (loss) | 737 | 34,384 | (86,874 |) 59,145 |
| Comprehensive (loss) income | (3,890 |) 53,551 | (40,364 |) 113,634 |
| Dividends declared on preferred stock | (2,294 |) (814 |) (5,608 |) (814 |
| Comprehensive (loss) income to common shareholders | \$(6,184 |) \$52,737 | \$(45,972 |) \$112,820 |
| See notes to consolidated financial statements. | | | | |

DYNEX CAPITAL, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)
(amounts in thousands)

| | Nine Months Ended September 30, | |
|---|------------------------------------|-------------|
| | 2013 | 2012 |
| Operating activities: | | |
| Net income | \$46,510 | \$54,489 |
| Adjustments to reconcile net income to cash provided by operating activities: | | |
| Decrease (increase) in accrued interest receivable | 906 | (9,383) |
| (Decrease) increase in accrued interest payable | (462) | 216 |
| Provision for loan losses | 261 | 170 |
| Loss on derivative instruments, net | 12,683 | 907 |
| Gain on sale of investments, net | (2,597) | (6,418) |
| Fair value adjustments, net | 590 | (778) |
| Amortization and depreciation | 102,258 | 58,999 |
| Stock-based compensation expense | 1,762 | 1,294 |
| Net change in other assets and other liabilities | (3,907) | (2,347) |
| Net cash and cash equivalents provided by operating activities | 158,004 | 97,149 |
| Investing activities: | | |
| Purchase of investments | (1,325,082) | (2,454,851) |
| Principal payments received on investments | 743,810 | 459,380 |
| Increase in principal receivable on investments | (1,259) | (6,548) |
| Proceeds from sales of investments | 327,962 | 185,485 |
| Principal payments received on securitized mortgage loans | 10,775 | 34,038 |
| Net payments on derivatives not designated as hedges | (23,644) | — |
| Other investing activities | 5,402 | (3,001) |
| Net cash and cash equivalents used in investing activities | (262,036) | (1,785,497) |
| Financing activities: | | |
| Borrowings under repurchase agreements, net | 110,409 | 1,577,943 |
| Deferred borrowing costs paid | — | (825) |
| Principal payments on non-recourse collateralized financing | (9,502) | (39,773) |
| Increase in restricted cash | (15,849) | — |
| Proceeds from issuance of preferred stock | 54,251 | 55,407 |
| Proceeds from issuance of common stock | 7,375 | 123,832 |
| Cash paid for repurchases of common stock | (5,965) | — |
| Payments related to tax withholding for share-based compensation | (545) | — |
| Dividends paid | (52,343) | (42,289) |
| Net cash and cash equivalents provided by financing activities | 87,831 | 1,674,295 |
| Net decrease in cash and cash equivalents | (16,201) | (14,053) |
| Cash and cash equivalents at beginning of period | 55,809 | 48,776 |
| Cash and cash equivalents at end of period | \$39,608 | \$34,723 |
| Supplemental Disclosure of Cash Activity: | | |
| Cash paid for interest | \$22,065 | \$24,284 |

See notes to consolidated financial statements.

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NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
DYNEX CAPITAL, INC.

(amounts in thousands except share and per share data)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying consolidated financial statements of Dynex Capital, Inc. and its qualified real estate investment trust (“REIT”) subsidiaries and its taxable REIT subsidiary (together, “Dynex” or the “Company”) have been prepared in accordance with the instructions to the Quarterly Report on Form 10-Q and Article 10, Rule 10-01 of Regulation S-X promulgated by the Securities and Exchange Commission (the “SEC”). Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America (“GAAP”) for complete financial statements. The financial information included herein is unaudited; however, in the opinion of management, all significant adjustments, consisting of normal recurring accruals considered necessary for a fair presentation of the consolidated financial statements, have been included. Operating results for the three and nine months ended September 30, 2013 are not necessarily indicative of the results that may be expected for any other interim periods or for the entire year ending December 31, 2013. The unaudited consolidated financial statements included herein should be read in conjunction with the audited financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2012 filed with the SEC.

Certain items in the prior years' consolidated financial statements have been reclassified to conform to the current year's presentation. The Company's consolidated balance sheet as of December 31, 2012 now presents its Agency and non-Agency mortgage-backed securities as "mortgage-backed securities, at fair value". The Company's consolidated statements of income for the three and nine months ended September 30, 2012 now present interest income from Agency and non-Agency mortgage-backed securities together as "interest income: mortgage-backed securities". In addition, changes in fair value and other activity related to the Company's derivative instruments have been reclassified from "fair value adjustments, net" to "gain (loss) on derivative instruments, net". As a result, the respective amounts on the Company's consolidated statement of cash flows for the nine months ended September 30, 2012 have been changed to reflect this reclassification. These presentation changes have no effect on reported total assets, total liabilities, results of operations, or cash flow activities.

Consolidation

The consolidated financial statements include the accounts of the Company, its qualified REIT subsidiaries and its taxable REIT subsidiary. The consolidated financial statements represent the Company's accounts after the elimination of intercompany balances and transactions. The Company consolidates entities in which it owns more than 50% of the voting equity and control does not rest with others and variable interest entities in which it is determined to be the primary beneficiary in accordance with Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 810-10. The Company follows the equity method of accounting for investments in which it owns greater than a 20% and less than 50% interest in partnerships and corporate joint ventures or when it is able to influence the financial and operating policies of the investee but owns less than 50% of the voting equity.

In accordance with ASC Topic 810-10, the Company also consolidates certain trusts through which it has securitized mortgage loans. Additional information regarding the accounting policy for securitized mortgage loans is provided below under "Investments".

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements as well as the reported amounts of revenue and expenses during the reported period. Actual results could differ from those estimates. The most significant estimates used by management include but are not limited to fair value measurements of its investments, allowance for loan losses, other-than-temporary impairments, contingencies, and amortization of premiums and discounts. These items are discussed further below within this note to the consolidated financial statements.

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Federal Income Taxes

The Company believes it has complied with the requirements for qualification as a REIT under the Internal Revenue Code of 1986, as amended (the "Code"). As such, the Company believes that it qualifies as a REIT for federal income tax purposes, and it generally will not be subject to federal income tax on the amount of its income or gain that is distributed as dividends to shareholders. The Company uses the calendar year for both tax and financial reporting purposes. There may be differences between taxable income and income computed in accordance with GAAP.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand and highly liquid investments with original maturities of three months or less.

Restricted Cash

Restricted cash consists of cash the Company has pledged to cover initial and variation margin with its counterparties. Investments

The Company's investments include Agency mortgage-backed securities ("MBS"), non-Agency MBS, securitized mortgage loans, and other investments.

Agency MBS. The Company accounts for its investment in Agency MBS in accordance with ASC Topic 320, which requires that investments in debt and equity securities be designated at the time of acquisition as either "held-to-maturity," "available-for-sale" or "trading". As of September 30, 2013, the majority of the Company's Agency MBS are designated as available-for-sale (or "AFS") with the remainder designated as trading. Although the Company generally intends to hold its available-for-sale securities until maturity, it may, from time to time, sell any of these securities as part of the overall management of its business. The available-for-sale designation provides the Company with this flexibility.

All of the Company's Agency MBS are recorded at their fair value on the consolidated balance sheet. In accordance with ASC Topic 820, the Company determines the fair value of its Agency MBS based upon prices obtained from a third-party pricing service and broker quotes. The Company's application of ASC Topic 820 guidance is discussed further in Note 7. Changes in the fair value of Agency MBS designated as trading are recognized in net income within "fair value adjustments, net". Gains and losses realized upon the sale, impairment, or other disposal of a trading security are also recognized within "fair value adjustments, net". Alternatively, changes in the fair value of Agency MBS designated as available-for-sale are reported in other comprehensive income as unrealized gains (losses) until the security is collected, disposed of, or determined to be other than temporarily impaired. Upon the sale of an available-for-sale security, any unrealized gain or loss is reclassified out of accumulated other comprehensive income ("AOCI") into net income as a realized "gain (loss) on sale of investments, net" using the specific identification method.

Non-Agency MBS. The Company accounts for its investment in non-Agency MBS in accordance with ASC Topic 320. As of September 30, 2013, all of the Company's non-Agency MBS are designated as available-for-sale and are recorded at their fair value on the consolidated balance sheet. Changes in fair value are reported in other comprehensive income until the security is collected, disposed of, or determined to be other than temporarily impaired. Like Agency MBS, the Company generally intends to hold its investments in non-Agency MBS until maturity, but it may, from time to time sell any of these securities as part of the overall management of its business. Upon the sale of an available-for-sale security, any unrealized gain or loss is reclassified out of AOCI into net income as a realized "gain (loss) on sale of investments, net" using the specific identification method.

In accordance with ASC Topic 820, the Company determines the fair value for the majority of its non-Agency MBS based upon prices obtained from a third-party pricing service and broker quotes. The remainder of the non-Agency MBS are valued by discounting the estimated future cash flows derived from cash flow models that utilize information such as the security's coupon rate, estimated prepayment speeds, expected weighted average life, collateral composition, estimated future interest rates, expected losses, credit enhancement, as well as certain other relevant information. The Company's application of ASC Topic 820 guidance is discussed further in Note 7.

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Other-than-Temporary Impairment. The Company evaluates all MBS in its investment portfolio for other-than-temporary impairments by applying the guidance prescribed in ASC Topic 320-10. The Company compares the amortized cost of each security in an unrealized loss position against the present value of expected future cash flows of the security. If there has been a significant adverse change in the cash flow expectations for a security resulting in its amortized cost becoming greater than the present value of its expected future cash flows, an other-than-temporary credit impairment has occurred. If the Company does not intend to sell and is not more likely than not required to sell the security, the credit loss is recognized in earnings and the balance of the unrealized loss is recognized in other comprehensive income (loss). If the Company intends to sell the security or will be more likely than not required to sell the security, the full unrealized loss is recognized in earnings.

In periods after the recognition of an other-than-temporary impairment loss for MBS, the Company shall account for the other-than-temporarily impaired MBS as if the MBS had been purchased on the measurement date of the other-than-temporary impairment at an amortized cost basis equal to the previous amortized cost basis less the other-than-temporary impairment recognized in earnings. For MBS for which other-than-temporary impairments were recognized in earnings, the difference between the new amortized cost basis and the cash flows expected to be collected shall be accreted into interest income using the effective interest method. The Company shall continue to estimate the present value of cash flows expected to be collected over the life of the MBS. For all other MBS, if upon subsequent evaluation, there is an increase in the cash flows expected to be collected or if actual cash flows are greater than cash flows previously expected, such changes shall be accounted for as a prospective adjustment to the accretable yield in accordance with Subtopic 310-30 even if the MBS would not otherwise be within the scope of that Subtopic. Subsequent increases and decreases in the fair value of the MBS that are not other-than-temporary shall be included in other comprehensive income. Please see Note 3 for additional information related to the Company's evaluation for other-than-temporary impairments.

Securitized Mortgage Loans. Securitized mortgage loans consist of loans pledged to support the repayment of securitization financing bonds issued by the Company. The associated securitization financing bonds are treated as debt of the Company and are presented as a portion of "non-recourse collateralized financing" on the consolidated balance sheet. In accordance with ASC Topic 310-10, the Company's securitized mortgage loans are reported at amortized cost. Securitized mortgage loans can only be sold subject to the lien of the respective securitization financing indenture. An allowance has been established for currently existing and probable losses on such loans as further discussed below.

Other Investments. Other investments include unsecuritized mortgage loans owned by the Company as well as the Company's investment in a limited partnership that invests in pools of non-qualifying mortgage loans. The Company accounts for its other investments using the cost method in accordance with ASC Topic 325-20.

Allowance for Loan Losses. An allowance for loan losses has been estimated and established for currently existing and probable losses for securitized and unsecuritized mortgage loans that are considered impaired in accordance with ASC Topic 310-10. Provisions made to increase the allowance are charged as a current period expense. Commercial mortgage loans are secured by income-producing real estate and are evaluated individually for impairment when the debt service coverage ratio on the mortgage loan is less than 1:1 or when the mortgage loan is delinquent. Commercial mortgage loans not evaluated for individual impairment are evaluated for a general allowance. Certain of the commercial mortgage loans are covered by mortgage loan guarantees that limit the Company's exposure on these mortgage loans. Single-family mortgage loans are considered homogeneous and are evaluated on a pool basis for a general allowance.

The Company considers various factors in determining its specific and general allowance requirements, including whether a loan is delinquent, the Company's historical experience with similar types of loans, historical cure rates of

delinquent loans, and historical and anticipated loss severity of the mortgage loans as they are liquidated. The factors may differ by mortgage loan type (e.g., single-family versus commercial) and collateral type (e.g., multifamily versus office property). The allowance for loan losses is evaluated and adjusted periodically by management based on the actual and estimated timing and amount of probable credit losses, using the above factors, as well as industry loss experience.

Repurchase Agreements

Repurchase agreements are treated as financings in accordance with the provision of ASC Topic 860 under which the Company pledges its securities as collateral to secure a loan, which is equal in value to a specified percentage of the estimated fair

value of the pledged collateral. The Company retains beneficial ownership of the pledged collateral. At the maturity of a repurchase agreement, the Company is required to repay the loan and concurrently receives back its pledged collateral from the lender or, with the consent of the lender, the Company may renew the agreement at the then prevailing financing rate. A repurchase agreement lender may require the Company to pledge additional collateral in the event of a decline in the fair value of the collateral pledged. Repurchase agreement financing is recourse to the Company and the assets pledged. Most of the Company's repurchase agreements are based on the September 1996 version of the Bond Market Association Master Repurchase Agreement, which generally provides that the lender, as buyer, is responsible for obtaining collateral valuations from a generally recognized source agreed to by both the Company and the lender, or, in an instance when such source is not available, the value determination is made by the lender.

Derivative Instruments

The Company accounts for its derivative instruments in accordance with ASC Topic 815. ASC Topic 815 requires an entity to recognize all derivatives as either assets or liabilities in the balance sheet and to measure those instruments at fair value.

Effective June 30, 2013, the Company discontinued hedge accounting for derivative instruments which had previously been accounted for as cash flow hedges under ASC Topic 815. Activity up to and including June 30, 2013 for those agreements previously designated as cash flow hedges was recorded in accordance with cash flow hedge accounting as prescribed by ASC Topic 815, which states that the effective portion of the hedge relationship on an instrument designated as a cash flow hedge is reported in the current period's other comprehensive income while the ineffective portion is immediately reported in the current period's consolidated statement of income. The balance remaining in AOCI related to the de-designated cash flow hedges is being recognized in the Company's consolidated statement of income as a portion of "interest expense" over the remaining life of the interest rate swap agreements. Subsequent to June 30, 2013 changes in the fair value of the Company's derivative instruments, plus periodic settlements, are recorded in the Company's consolidated statement of income as a portion of "(loss) gain on derivative instruments, net".

The Company has Eurodollar futures, which are valued based on closing exchange prices. Variation margin is exchanged daily to settle any changes in the value of the Eurodollar futures. Gains and losses associated with purchases and short sales of futures contracts are reported in "(loss) gain on derivative instruments, net", in our consolidated statements of income.

The Company has elected to use the portfolio exception in ASC 820-10-35-18D with respect to measuring counterparty credit risk for derivative instruments. The Company manages credit risk for its derivative positions on a counterparty-by-counterparty basis (that is, on the basis of its net portfolio exposure with each counterparty), consistent with its risk management strategy for such transactions. The Company manages credit risk by considering indicators of risk such as credit ratings, and by negotiating terms in its ISDA master netting arrangements and, if applicable, any associated Credit Support Annex documentation, with each individual counterparty. Since the effective date of ASC 820, management has monitored and measured credit risk and calculated credit valuation adjustments for its derivative transactions on the basis of its relationships at the counterparty portfolio level. Management receives reports from an independent third-party valuation specialist on a monthly basis providing the credit valuation adjustments at the counterparty portfolio level for purposes of reviewing and managing its credit risk exposures. Since the portfolio exception applies only to the fair value measurement and not to financial statement presentation, the portfolio-level adjustments are then allocated in a reasonable and consistent manner each period to the individual assets or liabilities that make up the group, in accordance with other applicable accounting guidance and the Company's accounting policy elections.

Although MBS have characteristics that meet the definition of a derivative instrument, ASC 815 specifically excludes these instruments from its scope because they are accounted for as debt securities under ASC 320.

Interest Income, Premium Amortization, and Discount Accretion

Interest income is accrued based on the outstanding principal balance (or notional balance in the case of interest-only, or "IO", securities) on the Company's investment securities and their contractual terms. Premiums and discounts on Agency and non-Agency MBS and on loans are recognized over the expected life of the investment using the effective yield method in accordance with ASC Topic 310-20. Adjustments to premium amortization are made for actual prepayment activity as well as changes in projected future cash flows in accordance with 320-10. Interest income on non-Agency MBS that are rated lower than "AA" are recognized over the expected life as adjusted for the estimated prepayments and credit losses of the securities. Actual prepayment

and any credit losses experienced are compared to projected prepayments and credit losses, and effective yields are adjusted when those amounts differ.

The Company's projections of future cash flows are based on input and analysis received from external sources and internal models, and includes assumptions about the amount and timing of credit losses, loan prepayment rates, fluctuations in interest rates, and other factors. On at least a quarterly basis, the Company reviews and makes any necessary adjustments to its cash flow projections and updates the yield recognized on these assets.

For securities, the accrual of interest is discontinued when, in the opinion of management, it is probable that all amounts contractually due will not be collected, and in certain instances, as a result of the other-than-temporary impairment analysis. For loans, the accrual of interest is discontinued when, in the opinion of management, the interest is not collectible in the normal course of business, when the loan is significantly past due or when the primary servicer of the loan fails to advance the interest and/or principal due on the loan. Loans are considered past due when the borrower fails to make a timely payment in accordance with the underlying loan agreement. All interest accrued but not collected for investments that are placed on a non-accrual status or are charged-off is reversed against interest income. Interest on these investments is accounted for on the cash-basis or cost-recovery method until qualifying for return to accrual status. Investments are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Stock-Based Compensation

Pursuant to the Company's 2009 Stock and Incentive Plan ("SIP"), the Company may grant stock-based compensation to eligible employees, directors or consultants or advisers to the Company, including stock awards, stock options, stock appreciation rights ("SARs"), dividend equivalent rights, performance shares, and restricted stock units. Currently, the Company's stock options and restricted stock issued under this plan may be settled only in shares of its common stock, and therefore are treated as equity awards with their fair value measured at the grant date as required by ASC Topic 718. Outstanding SARs issued by the Company may be settled only in cash, and therefore have been treated as liability awards with their fair value estimated at the grant date and remeasured at the end of each reporting period using the Black-Scholes option valuation model as required by ASC Topic 718. Please see Note 8 for additional disclosures regarding the Company's SIP.

Contingencies

In the normal course of business, there are various lawsuits, claims, and other contingencies pending against the Company. We evaluate whether to establish provisions for estimated losses from those matters in accordance with ASC Topic 450, which states that a liability is recognized for a contingent loss when: (a) the underlying causal event has occurred prior to the balance sheet date; (b) it is probable that a loss has been incurred; and (c) there is a reasonable basis for estimating that loss. A liability is not recognized for a contingent loss when it is only possible or remotely possible that a loss has been incurred, however, possible contingent losses shall be disclosed. Please refer to Note 9 for details on the most significant matters currently pending.

Recent Accounting Pronouncements

In July 2013, the FASB issued ASU 2013-10, Derivatives and Hedging (Topic 815), Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes (a consensus of the FASB Emerging Issues Task Force) ("ASU 2013-10"). The new guidance permits the use of the Federal Funds Effective Swap Rate as a benchmark interest rate for hedge accounting purposes and removes certain restrictions on being able to apply hedge accounting for similar hedges using different benchmark interest rates. ASU 2013-10 is effective prospectively for qualifying new or re-designated hedging relationships entered into on or after

July 17, 2013. The adoption of this ASU does not have an impact on our derivatives and will not have a material impact on the Company's consolidated financial statements.

In June 2013, the FASB issued ASU 2013-08, Financial Services - Investment Companies: Amendments to the Scope, Measurement, and Disclosure Requirements ("ASU 2013-08"). In general, the amendments of this ASU: (i) revise the definition of an investment company; (ii) require an investment company to measure non-controlling ownership interests in other investment companies at fair value rather than using the equity method of accounting; and (iii) require information to be disclosed concerning the status of the entity and any financial support provided, or contractually required to be provided, by the investment company to its investees. ASU 2013-08 is effective for interim and annual periods that begin after December 15, 2013 and early application

is prohibited. As the FASB has decided to retain the current U.S. GAAP scope exception from investment company accounting and financial reporting for real estate investment trusts, the adoption of this ASU will not have a material impact on the Company's consolidated financial statements.

NOTE 2 – NET (LOSS) INCOME PER COMMON SHARE

Net (loss) income per common share is presented on both a basic and diluted basis. Diluted net (loss) income per common share assumes the exercise of stock options, if any were outstanding during the period presented, using the treasury stock method. Because the Company's Series A and Series B Cumulative Redeemable Preferred Stock are redeemable at the Company's option for cash only, and may convert into shares of common stock only upon a change of control of the Company, the effect of those shares is excluded from the calculation of diluted net (loss) income per common share.

Holders of unvested shares of our issued and outstanding restricted common stock are eligible to receive non-forfeitable dividends. As such, these unvested shares are considered participating securities as per ASC 260-10 and therefore are included in the computation of basic net (loss) income per share using the two-class method.

The following table presents the calculation of the numerator and denominator for both basic and diluted net (loss) income per common share:

| | Three Months Ended | | 2012 | Weighted-Average Common Shares |
|--|-----------------------|------------|-----------|-----------------------------------|
| | September 30, 2013 | | | |
| | Net Loss | | Income | |
| Net (loss) income | \$ (4,627) | | \$ 19,167 | |
| Preferred stock dividends | (2,294) | | (814) | |
| Net (loss) income to common shareholders | (6,921) | 54,903,637 | 18,353 | 54,367,349 |
| Effect of dilutive stock options | — | — | — | 866 |
| Diluted | \$ (6,921) | 54,903,637 | \$ 18,353 | 54,368,215 |
| Net (loss) income per common share: | | | | |
| Basic | | \$ (0.13) | | \$ 0.34 |
| Diluted | | \$ (0.13) | | \$ 0.34 |

| | Nine Months Ended September 30, 2013 | | 2012 | |
|-----------------------------------|--|-----------------------------------|---------------|--|
| | Net Income | Weighted-Average Common Shares | Net Income | Weighted- Average Common Shares |
| Net income | \$46,510 | | \$54,489 | |
| Preferred stock dividends | (5,608) |) | (814) |) |
| Net income to common shareholders | 40,902 | 54,727,950 | 53,675 | 52,751,763 |
| Effect of dilutive stock options | — | — | — | — |
| Diluted | \$40,902 | 54,727,950 | \$53,675 | 52,751,763 |
| Net income per common share: | | | | |
| Basic | | \$ 0.75 | | \$1.02 |
| Diluted ⁽¹⁾ | | \$ 0.75 | | \$1.02 |

(1) For the nine months ended September 30, 2012, the calculation of diluted net income per common share excludes the effect of 15,000 unexercised stock option awards because their inclusion would have been anti-dilutive.

NOTE 3 – MORTGAGE-BACKED SECURITIES

The following table presents the components of the Company's MBS designated as AFS as of September 30, 2013 and December 31, 2012:

| | September 30, 2013 | | | | | |
|------------------------|--------------------|---------------------------|-------------------|----------------------------------|-------------|-------------------------------|
| | Par | Net Premium (Discount) | Amortized Cost | Net Unrealized Gain (Loss) | Fair Value | Weighted average coupon |
| Agency: | | | | | | |
| RMBS | \$2,723,084 | \$162,370 | \$2,885,454 | \$(56,407) | \$2,829,047 | 3.26 % |
| CMBS | 261,440 | 19,844 | 281,284 | 11,941 | 293,225 | 4.82 % |
| CMBS IO ⁽¹⁾ | — | 466,494 | 466,494 | 9,114 | 475,608 | 0.89 % |
| Total Agency AFS: | 2,984,524 | 648,708 | 3,633,232 | (35,352) | 3,597,880 | |
| Non-Agency: | | | | | | |
| RMBS | 14,972 | (351) | 14,621 | (33) | 14,588 | 4.58 % |
| CMBS | 381,342 | (17,213) | 364,129 | 10,620 | 374,749 | 5.52 % |
| CMBS IO ⁽¹⁾ | — | 123,172 | 123,172 | 2,377 | 125,549 | 0.87 % |
| Total non-Agency AFS: | 396,314 | 105,608 | 501,922 | 12,964 | 514,886 | |
| Total AFS securities | \$3,380,838 | \$754,316 | \$4,135,154 | \$(22,388) | \$4,112,766 | |

(1) The notional balance for Agency CMBS IO and non-Agency CMBS IO is \$9,682,065 and \$2,857,343, respectively, as of September 30, 2013.

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December 31, 2012

| | Par | Net Premium (Discount) | Amortized Cost | Net Unrealized Gain (Loss) | Fair Value | Weighted average coupon | |
|------------------------|-------------|---------------------------|-------------------|----------------------------------|-------------|-------------------------------|---|
| Agency: | | | | | | | |
| RMBS | \$2,425,826 | \$137,168 | \$2,562,994 | \$8,343 | \$2,571,337 | 3.67 | % |
| CMBS | 280,602 | 21,907 | 302,509 | 21,564 | 324,073 | 5.19 | % |
| CMBS IO ⁽¹⁾ | — | 550,171 | 550,171 | 17,009 | 567,180 | 0.95 | % |
| Total Agency AFS: | 2,706,428 | 709,246 | 3,415,674 | 46,916 | 3,462,590 | | |
| Non-Agency: | | | | | | | |
| RMBS | 11,411 | (781) | 10,630 | 408 | 11,038 | 4.28 | % |
| CMBS | 463,747 | (17,313) | 446,434 | 39,908 | 486,342 | 5.31 | % |
| CMBS IO ⁽¹⁾ | — | 108,928 | 108,928 | 5,014 | 113,942 | 0.86 | % |
| Total non-Agency AFS: | 475,158 | 90,834 | 565,992 | 45,330 | 611,322 | | |
| Total AFS securities | \$3,181,586 | \$800,080 | \$3,981,666 | \$92,246 | \$4,073,912 | | |

(1) The notional balance for the Agency CMBS IO and non-Agency CMBS IO is \$10,059,495 and \$2,393,614, respectively, as of December 31, 2012.

The Company has investments in additional Agency CMBS not included in the tables above that are designated as trading securities by the Company with fair values of \$28,978 and \$30,069 as of September 30, 2013 and December 31, 2012, respectively. Changes in the fair value of these Agency CMBS are recognized each reporting period within "fair value adjustments, net" in the Company's consolidated statements of income. As of September 30, 2013 and December 31, 2012, the amortized cost of these Agency CMBS designated as trading securities was \$27,078 and \$27,535, respectively. The Company recognized a net unrealized gain (loss) for the three and nine months ended September 30, 2013 of \$96 and \$(634), respectively, compared to a net unrealized gain of \$283 and \$716 for the three and nine months ended September 30, 2012, respectively, related to changes in fair value.

The following table presents certain information for those Agency MBS in an unrealized loss position as of September 30, 2013 and December 31, 2012:

| | September 30, 2013 | | | December 31, 2012 | | |
|--|--------------------|-------------------------------|--------------------|-------------------|-------------------------------|--------------------|
| | Fair Value | Gross Unrealized Losses | # of Securities | Fair Value | Gross Unrealized Losses | # of Securities |
| Continuous unrealized loss position for less than 12 months: | | | | | | |
| Agency MBS | \$2,129,694 | \$(48,337) | 164 | \$1,026,277 | \$(6,552) | 83 |
| Non-Agency MBS | 126,846 | (5,902) | 23 | 13,877 | (76) | 3 |
| Continuous unrealized loss position for 12 months or longer: | | | | | | |
| Agency MBS | \$558,070 | \$(17,718) | 67 | \$271,719 | \$(5,797) | 34 |
| Non-Agency MBS | 1,820 | (100) | 6 | 2,701 | (198) | 8 |

Because the principal and interest related to Agency MBS are guaranteed by the government-sponsored entities Fannie Mae and Freddie Mac who have the implicit guarantee of the U.S. government, the Company does not consider any of the unrealized losses on its Agency MBS to be credit related. Although the unrealized losses are not credit related, the Company assesses its ability and intent to hold any Agency MBS with an unrealized loss until the

recovery in its value. This assessment is based on the amount of the unrealized loss and significance of the related investment as well as the Company's current leverage and anticipated

liquidity. Based on this analysis, the Company has determined that the unrealized losses on its Agency MBS as of September 30, 2013 and December 31, 2012 were temporary.

The Company also reviews any non-Agency MBS in an unrealized loss position to evaluate whether any decline in fair value represents an other-than-temporary impairment. The evaluation includes a review of the credit ratings of these non-Agency MBS and the seasoning of the mortgage loans collateralizing these securities as well as the estimated future cash flows which include projected losses. The Company performed this evaluation for the non-Agency MBS in an unrealized loss position and has determined that there have not been any adverse changes in the timing or amount of estimated future cash flows that necessitate a recognition of other-than-temporary impairment amounts as of September 30, 2013 or December 31, 2012.

NOTE 4 – REPURCHASE AGREEMENTS

The following tables present the components of the Company's repurchase agreements as of September 30, 2013 and December 31, 2012 by the fair value and type of securities pledged as collateral to the repurchase agreements:

| September 30, 2013 | | | |
|--------------------------------|-------------|--------------------------|---|
| Collateral Type | Balance | Weighted Average Rate | Fair Value of Collateral Pledged |
| Agency RMBS | \$2,634,120 | 0.41 | % 2,721,562 |
| Agency CMBS | 234,633 | 0.39 | % 294,556 |
| Agency CMBS IOs | 377,977 | 1.17 | % 463,894 |
| Non-Agency RMBS | 10,932 | 1.80 | % 13,616 |
| Non-Agency CMBS | 298,548 | 1.29 | % 364,977 |
| Non-Agency CMBS IO | 97,584 | 1.68 | % 125,539 |
| Securitization financing bonds | 21,403 | 1.60 | % 24,853 |
| Deferred costs | (347 |) n/a | n/a |
| | \$3,674,850 | 0.59 | % \$4,008,997 |
| December 31, 2012 | | | |
| Collateral Type | Balance | Weighted Average Rate | Fair Value of Collateral Pledged |
| Agency RMBS | \$2,365,982 | 0.48 | % \$2,458,200 |
| Agency CMBS | 248,771 | 0.47 | % 291,445 |
| Agency CMBS IOs | 443,540 | 1.22 | % 565,494 |
| Non-Agency RMBS | 7,808 | 1.84 | % 9,634 |
| Non-Agency CMBS | 382,352 | 1.34 | % 465,306 |
| Non-Agency CMBS IOs | 88,221 | 1.46 | % 113,942 |
| Securitization financing bonds | 28,113 | 1.64 | % 31,483 |
| Deferred costs | (659 |) n/a | n/a |
| | \$3,564,128 | 0.70 | % \$3,935,504 |

The combined weighted average original term to maturity for the Company's repurchase agreements increased to 91 days as of September 30, 2013 from 57 days as of December 31, 2012. The Company has been able to extend the maturity dates for its repurchase agreements due to discontinuing cash flow hedge accounting. The following table provides a summary of the original maturities as of September 30, 2013 and December 31, 2012:

| Original Maturity | September 30, 2013 | December 31, 2012 |
|-----------------------|-----------------------|----------------------|
| 30 days or less | \$486,150 | \$622,957 |
| 31 to 60 days | 677,725 | 1,263,105 |
| 61 to 90 days | 333,007 | 298,660 |
| 91 to 120 days | 1,021,594 | 1,092,681 |
| 121 to 150 days | 583,888 | — |
| Greater than 150 days | 572,833 | 287,384 |
| | \$3,675,197 | \$3,564,787 |

As of September 30, 2013, the Company had approximately 17% of its shareholders' equity at risk (defined as the excess of collateral pledged over the borrowing outstanding) with Wells Fargo Bank National Association together with its affiliate Wells Fargo Securities, LLC. The borrowings outstanding with that counterparty and its affiliates as of September 30, 2013 were \$401,404 with a weighted average borrowing rate of 1.17%. Of the amount outstanding with this counterparty and its affiliate, \$187,508 is under a two-year repurchase facility with Wells Fargo Bank National Association. The facility is collateralized primarily by CMBS IO, and its weighted average borrowing rate as of September 30, 2013 was 1.44%. Shareholders' equity at risk did not exceed 10% for any of the Company's other counterparties. Please see Note 10 regarding changes to the master repurchase agreement for this facility that occurred subsequent to September 30, 2013.

As of September 30, 2013, the Company had repurchase agreement amounts outstanding with 21 of its 31 available counterparties. The Company's counterparties, as set forth in the master repurchase agreement with the counterparty, require the Company to comply with various customary operating and financial covenants, including, but not limited to, minimum net worth, maximum declines in net worth in a given period, and maximum leverage requirements as well as maintaining the Company's REIT status. In addition, some of the agreements contain cross default features, whereby default under an agreement with one lender simultaneously causes default under agreements with other lenders. To the extent that the Company fails to comply with the covenants contained in these financing agreements or is otherwise found to be in default under the terms of such agreements, the counterparty has the right to accelerate amounts due under the master repurchase agreement. The Company was in compliance with all covenants as of September 30, 2013.

NOTE 5 – DERIVATIVES

The Company utilizes a variety of derivative instruments to economically hedge a portion of its exposure to market risks, primarily interest rate risk. The principal instruments used to hedge these risks are interest rate swaps and Eurodollar futures. The objective of the Company's risk management strategy is to protect the Company's earnings from rising interest rates and to mitigate declines in book value resulting from fluctuations in the fair value of the Company's assets from changing interest rates. The Company seeks to limit its exposure to changes in interest rates but does not seek to eliminate this risk.

Effective June 30, 2013, the Company voluntarily discontinued hedge accounting for interest rate swaps which had previously been accounted for as cash flow hedges under GAAP. The Company discontinued hedge accounting for its interest rate swap agreements in order to gain greater flexibility in managing the maturities of its repurchase agreement borrowings. In addition, the Company began purchasing Eurodollar futures during the third quarter of 2013. Please refer to Note 1 for additional information related to the Company's accounting policy for its derivative instruments.

The table below summarizes information about the Company's derivative instruments on its consolidated balance sheet as of the dates indicated:

| | | | September 30, 2013 | |
|-------------------------------|------------------------|-------------------------|--------------------|---------------------------|
| Type of Derivative Instrument | Accounting Designation | Balance Sheet Location: | Fair Value | Aggregate Notional Amount |
| Interest rate swaps | Non-hedging | Derivative assets | \$ 12,908 | \$425,000 |
| Interest rate swaps | Non-hedging | | \$(20,837 |) \$1,267,000 |
| Eurodollar futures | Non-hedging | | — | 20,250,000 |
| | | Derivative liabilities | \$(20,837 |) \$21,517,000 |
| | | | December 31, 2012 | |
| Type of Derivative Instrument | Accounting Designation | Balance Sheet Location: | Fair Value | Aggregate Notional Amount |
| Interest rate swaps | Hedging | | \$(39,813 |) \$1,435,000 |
| Interest rate swaps | Non-hedging | | (2,724 |) 27,000 |
| | | Derivative liabilities | \$(42,537 |) \$1,462,000 |

(1) Margin requirements from fluctuations in fair value of the Company's Eurodollar futures are settled daily with counterparties.

Information related to the volume of activity for our interest rate derivative instruments subsequent to December 31, 2012 is as follows:

| (amounts in thousands) | Interest Rate Swaps | Eurodollar Futures |
|--|---------------------|--------------------|
| Notional amount as of December 31, 2012: | \$1,462,000 | \$— |
| Additions: | 380,000 | 22,100,000 |
| Settlements, terminations, or expirations: | (150,000 |) (1,850,000 |
| Notional amount as of September 30, 2013: ⁽¹⁾ | \$1,692,000 | \$20,250,000 |

The Eurodollar futures notional amount as of September 30, 2013 represents the total notional of the 3-month (1)contracts with expiration dates from 2013 to 2020. The maximum notional outstanding for any 3-month period does not exceed \$1,275,000.

The following table summarizes the contractual maturities remaining for the Company's outstanding interest rate swap agreements as of September 30, 2013:

| Remaining Maturity | Notional Amount: Trading | Weighted-Average Fixed Rate Swapped | |
|--------------------|--------------------------|-------------------------------------|---|
| 0-12 months | \$435,000 | 1.26 | % |
| 13-24 months | 130,000 | 2.06 | % |
| 25-36 months | 260,000 | 1.96 | % |
| 37-48 months | 212,000 | 0.01 | % |
| 49-60 months | 15,000 | 2.17 | % |
| 61-72 months | 385,000 | 1.58 | % |
| 73-84 months | 25,000 | 1.61 | % |
| 109-127 months | 230,000 | 2.27 | % |
| | \$1,692,000 | 1.64 | % |

As of September 30, 2013, three of these agreements with a total notional balance of \$150,000 and a weighted average pay-fixed rate of 2.17% are 10-year forward-starting swaps which will not be effective until 2014.

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The tables below summarize the effect of the Company's interest rate derivatives reported in "(loss) gain on derivative instruments, net" on the Company's consolidated statements of income for the periods indicated:

| Type of Derivative Instrument | Three Months Ended | | Nine Months Ended | |
|-------------------------------------|--------------------|----------|-------------------|----------|
| | September 30, | | September 30, | |
| | 2013 | 2012 | 2013 | 2012 |
| Interest rate swaps | \$(6,225 |) \$(333 |) \$5,111 | \$(907 |
| Eurodollar futures | (17,794 |) — | (17,794 |) — |
| Loss on derivative instruments, net | \$ (24,019 |) \$(333 |) \$(12,683 |) \$(907 |

Please refer to Note 10 for important information regarding derivative instruments the Company has terminated subsequent to September 30, 2013.

As a result of discontinuing hedge accounting, the net unrealized loss remaining in AOCI as of September 30, 2013 of \$11,975 related to the interest rate swap agreements previously designated as cash flow hedges will be recognized into the Company's consolidated statement of income as a portion of "interest expense" over the remaining contractual life of the agreements. The Company reclassified \$2,583 from AOCI to its consolidated statement of income for the three months ended September 30, 2013. All forecasted transactions associated with interest rate swap agreements previously designated as cash flow hedges are expected to occur. No amounts have been reclassified to net income (loss) in any period in connection with forecasted transactions that are no longer considered probable of occurring. The Company estimates the net amount of existing net unrealized loss on discontinued cash flow hedges expected to be reclassified to earnings within the next 12 months is \$7,911.

All of the Company's derivative instruments contain various covenants related to the Company's credit risk. Specifically, if the Company defaults on any of its indebtedness, including those circumstances whereby repayment of the indebtedness has not yet been accelerated by the lender, or is declared in default of any of its covenants with any counterparty, then the Company could also be declared in default of its derivative obligations. Additionally, the agreements outstanding with its derivative counterparties allow those counterparties to require settlement of its outstanding derivative transactions if the Company fails to earn GAAP net income greater than one dollar as measured on a rolling two quarter basis. These interest rate agreements also contain provisions whereby, if the Company fails to maintain a minimum net amount of shareholders' equity, then the Company may be declared in default on its derivative obligations.

NOTE 6 – OFFSETTING ASSETS AND LIABILITIES

The Company's derivatives and repurchase agreements are subject to underlying agreements with master netting or similar arrangements, which provide for the right of offset in the event of default or in the event of bankruptcy of either party to the transactions. The Company reports its assets and liabilities subject to these arrangements on a gross basis. The following tables present information regarding those assets and liabilities subject to such arrangements as if the Company had presented them on a net basis as of September 30, 2013 and December 31, 2012:

| | Offsetting of Assets | | | Gross Amount Not Offset in the Balance Sheet | | |
|--------------------|-----------------------------------|--|---|--|-----------------------------|------------|
| | Gross Amount of Recognized Assets | Gross Amount Offset in the Balance Sheet | Net Amount of Assets Presented in the Balance Sheet | Financial Instruments Received as Collateral | Cash Received as Collateral | Net Amount |
| September 30, 2013 | | | | | | |
| Derivative assets | \$12,908 | \$— | \$12,908 | \$(1,689 |) \$(11,219 |) \$— |

December 31, 2012:

| | | | | | | |
|-------------------|-----|-----|-----|-----|-----|-----|
| Derivative assets | \$— | \$— | \$— | \$— | \$— | \$— |
|-------------------|-----|-----|-----|-----|-----|-----|

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| | Offsetting of Liabilities | | | Gross Amount Not Offset in the Balance Sheet | | Net Amount |
|------------------------|--|--|--|--|---------------------------|------------|
| | Gross Amount of Recognized Liabilities | Gross Amount Offset in the Balance Sheet | Net Amount of Liabilities Presented in the Balance Sheet | Financial Instruments Posted as Collateral | Cash Posted as Collateral | |
| September 30, 2013 | | | | | | |
| Derivative liabilities | \$20,837 | \$— | \$20,837 | \$(20,175) | \$(490) | \$172 |
| Repurchase agreements | 3,674,850 | — | 3,674,850 | (3,674,850) | — | — |
| | \$3,695,687 | \$— | \$3,695,687 | \$(3,695,025) | \$(490) | \$172 |
| December 31, 2012: | | | | | | |
| Derivative liabilities | \$42,537 | \$— | \$42,537 | \$(42,499) | \$(38) | \$— |
| Repurchase agreements | 3,564,128 | — | 3,564,128 | (3,564,128) | — | — |
| | \$3,606,665 | \$— | \$3,606,665 | \$(3,606,627) | \$(38) | \$— |

(1) Amount disclosed for collateral received by or posted to the same counterparty include cash and the fair value of MBS up to and not exceeding the net amount of the asset or liability presented in the balance sheet. The fair value of the actual collateral received by or posted to the same counterparty may exceed the amounts presented.

NOTE 7 – FAIR VALUE OF FINANCIAL INSTRUMENTS

ASC Topic 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC 820 clarifies that fair value should be based on the assumptions market participants would use when pricing an asset or liability and also requires an entity to consider all aspects of nonperformance risk, including the entity's own credit standing, when measuring fair value of a liability. ASC Topic 820 established a valuation hierarchy of three levels as follows:

Level 1 – Inputs are unadjusted, quoted prices in active markets for identical assets or liabilities as of the measurement date. None of the Company's assets and liabilities that are measured at fair value are included in this category.

Level 2 – Inputs include quoted prices in active markets for similar assets or liabilities; quoted prices in inactive markets for identical or similar assets or liabilities; or inputs either directly observable or indirectly observable through correlation with market data at the measurement date and for the duration of the instrument's anticipated life. The Company's fair valued assets and liabilities that are generally included in this category are Agency MBS, certain non-Agency MBS, and derivatives.

Level 3 – Unobservable inputs are supported by little or no market activity. The unobservable inputs represent management's best estimate of how market participants would price the asset or liability at the measurement date. Consideration is given to the risk inherent in the valuation technique and the risk inherent in the inputs to the model. The Company's fair valued assets and liabilities that are generally included in this category are certain non-Agency MBS and other investments.

The following table presents the fair value of the Company's assets and liabilities, segregated by the hierarchy level of the fair value estimate, that are measured at fair value on a recurring basis as of the periods indicated:

| | September 30, 2013 | | | |
|---|--------------------|--|-----------------------------------|-------------------------------------|
| | Fair Value | Level 1 - Unadjusted Quoted Prices in Active Markets | Level 2 - Observable Inputs | Level 3 - Unobservable Inputs |
| Assets: | | | | |
| Mortgage-backed securities | \$4,141,744 | \$— | \$4,039,331 | \$102,413 |
| Derivative assets | 12,908 | — | 12,908 | — |
| Total assets carried at fair value | \$4,154,652 | \$— | \$4,052,239 | \$102,413 |
| Liabilities: | | | | |
| Derivative liabilities | \$20,837 | \$— | \$20,837 | \$— |
| Total liabilities carried at fair value | \$20,837 | \$— | \$20,837 | \$— |
| | December 31, 2012 | | | |
| | Fair Value | Level 1 - Unadjusted Quoted Prices in Active Markets | Level 2 - Observable Inputs | Level 3 - Unobservable Inputs |
| Assets: | | | | |
| Mortgage-backed securities | \$4,103,981 | \$— | \$3,998,761 | \$105,220 |
| Other investments | 25 | — | — | 25 |
| Total assets carried at fair value | \$4,104,006 | \$— | \$3,998,761 | \$105,245 |
| Liabilities: | | | | |
| Derivative liabilities | \$42,537 | \$— | \$42,537 | \$— |
| Total liabilities carried at fair value | \$42,537 | \$— | \$42,537 | \$— |

The Company's valuation of its interest rate swaps is determined using the income approach. The primary input into the valuation represents the forward interest rate swap curve, which is considered an observable input and thus their fair values are considered Level 2 measurements. The Company's valuation of its Eurodollar futures is based on the closing exchange prices. Accordingly, these financial futures are classified as Level 1.

The Company's Agency MBS, as well a majority of its non-Agency MBS, are substantially similar to securities that either are currently actively traded or have been recently traded in their respective market. Their fair values are derived from an average of multiple dealer quotes and thus are considered Level 2 fair value measurements. The Company's remaining non-Agency MBS are comprised of securities for which there are not substantially similar securities that trade frequently. As such, the Company determines the fair value of those securities by discounting the estimated future cash flows derived from cash flow models using assumptions that are confirmed to the extent possible by third party dealers or other pricing indicators. Significant inputs into those pricing models are Level 3 in nature due to the lack of readily available market quotes. Information utilized in those pricing models include the security's credit rating, coupon rate, estimated prepayment speeds, expected weighted average life, collateral composition, estimated future interest rates, expected credit losses, and credit enhancement as well as certain other relevant information. Significant changes in any of these inputs in isolation would result in a significantly different fair value measurement. Generally Level 3 assets are most sensitive to the default rate and severity assumptions.

The table below presents information about the significant unobservable inputs used in the fair value measurement for the Company's Level 3 non-Agency CMBS and RMBS as of September 30, 2013:

| | Quantitative Information about Level 3 Fair Value Measurements ⁽¹⁾ | | | |
|-----------------|---|--------------|----------|---------------|
| | Prepayment Speed | Default Rate | Severity | Discount Rate |
| Non-Agency CMBS | 20 CPY | 2.5 | % 35.0 | % 6.5 |
| Non-Agency RMBS | 10 | CPR 1.0 | % 19.9 | % 6.9 |

(1) Data presented are weighted averages.

The following tables present the activity of the instruments fair valued at Level 3 during the nine months ended September 30, 2013:

| | Nine Months Ended September 30, 2013 Level 3 Fair Values | | | |
|--|--|--------------------|-------|--------------|
| | Non-Agency CMBS | Non-Agency RMBS | Other | Total assets |
| Balance as of beginning of the period | \$100,102 | \$5,118 | \$25 | \$105,245 |
| Purchases | 26,021 | — | — | 26,021 |
| Sales/write-offs to net income | — | — | (25 |) (25 |
| Unrealized (loss) gain included in OCI | (4,706 |) (108 |) — | (4,814 |
| Principal payments | (21,731 |) (2,255 |) — | (23,986 |
| (Amortization) accretion | (61 |) 33 | — | (28 |
| Balance as of end of period | \$99,625 | \$2,788 | \$— | \$102,413 |

The following table presents a summary of the recorded basis and estimated fair values of the Company's financial instruments as of the periods indicated:

| | September 30, 2013 | | December 31, 2012 | |
|---------------------------------------|--------------------|-------------|-------------------|-------------|
| | Recorded Basis | Fair Value | Recorded Basis | Fair Value |
| Assets: | | | | |
| Mortgage-backed securities | \$4,141,744 | \$4,141,744 | \$4,103,981 | \$4,103,981 |
| Securitized mortgage loans, net | 59,797 | 50,932 | 70,823 | 61,916 |
| Other investments | 1,305 | 1,305 | 858 | 810 |
| Derivative assets | 12,908 | 12,908 | — | — |
| Liabilities: | | | | |
| Repurchase agreements | \$3,674,850 | \$3,675,197 | \$3,564,128 | \$3,564,787 |
| Non-recourse collateralized financing | 21,148 | 20,855 | 30,504 | 30,756 |
| Derivative liabilities | 20,837 | 20,837 | 42,537 | 42,537 |

There were no assets or liabilities which were measured at fair value on a non-recurring basis as of September 30, 2013 or December 31, 2012.

NOTE 8 – SHAREHOLDERS' EQUITY

Preferred Stock

The Company declared its regular quarterly dividend of \$0.53125 per share on its 8.50% Series A Cumulative Redeemable Preferred Stock and \$0.4765625 per share on its 7.625% Series B Cumulative Redeemable Preferred Stock for the third quarter of 2013 payable on October 15, 2013 to shareholders of record as of October 7, 2013.

Common Stock

The following table presents a summary of the changes in the number of common shares outstanding since December 31, 2012:

| | 2013 |
|---|------------|
| Balance as of January 1, 2013 | 54,268,915 |
| Common stock issued under DRIP | 509,831 |
| Common stock issued under ATM program | 180,986 |
| Common stock issued or redeemed under stock and incentive plans | 270,158 |
| Common stock forfeited for tax withholding on share-based compensation | (52,385) |
| Common stock repurchased during the period (weighted average price of \$7.94 per share) | (751,456) |
| Balance as of September 30, 2013 | 54,426,049 |

The Company has approximately 7,416,520 shares of common stock that remain available to offer and sell through its sales agent, JMP Securities LLC, under its "at the market", or "ATM" program, as of September 30, 2013. The Company did not issue any common shares under this program during the three months ended September 30, 2013.

The Company's Dividend Reinvestment and Share Purchase Plan ("DRIP") allows registered shareholders to automatically reinvest some or all of their quarterly dividends in shares of the Company's stock and provides an opportunity for investors to purchase shares of the Company's stock, potentially at a discount to the prevailing market price. Of the 3,000,000 shares reserved for issuance under the Company's DRIP, there are 2,472,324 shares remaining for issuance as of September 30, 2013. The Company declared a third quarter common stock dividend of \$0.27 per share payable on October 31, 2013 to shareholders of record as of October 7, 2013. There was no discount for shares purchased through the DRIP during the third quarter of 2013.

Of the \$50,000 authorized by the Company's Board of Directors for the repurchase of its common stock through December 31, 2014, approximately \$43,115 remains available as of September 30, 2013.

Incentive Plans. Pursuant to the Company's 2009 Stock and Incentive Plan, the Company may grant stock-based compensation to eligible employees, directors or consultants or advisers to the Company, including stock awards, stock options, SARs, dividend equivalent rights, performance shares, incentive awards, and restricted stock units. Of the 2,500,000 shares of common stock authorized for issuance under this plan, 1,550,118 shares remain available for issuance as of September 30, 2013. Total stock-based compensation expense recognized by the Company for the three and nine months ended September 30, 2013 was \$612 and \$1,726, respectively, compared to \$490 and \$1,410, respectively, for the three and nine months ended September 30, 2012.

The following table presents a rollforward of the restricted stock activity for the periods indicated:

| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|----------|-------------------|------------|
| | September 30, | | September 30, | |
| | 2013 | 2012 | 2013 | 2012 |
| Restricted stock outstanding as of beginning of period | 526,803 | 454,117 | 448,283 | 365,506 |
| Restricted stock granted | — | — | 255,158 | 220,821 |
| Restricted stock vested | (2,917) | (2,917) | (179,555) | (135,127) |
| Restricted stock outstanding as of end of period | 523,886 | 451,200 | 523,886 | 451,200 |

The restricted stock granted during the nine months ended September 30, 2013 and September 30, 2012 had fair values of \$2,708 and \$2,073, respectively, at their grant dates. As of September 30, 2013, the balance of the Company's outstanding

restricted stock remaining to be amortized into compensation expense is \$3,951 of which \$640 is expected to be amortized in the remaining three months of 2013, \$1,643 in 2014, \$1,155 in 2015, \$447 in 2016, and \$66 in 2017.

As of September 30, 2013, the Company also has 25,000 SARs outstanding which were granted pursuant to the Company's 2004 Stock Incentive Plan and are all vested and exercisable at their exercise price of \$7.06 per share any time prior to their expiration date of December 31, 2013. No new awards may be granted under this plan. As of September 30, 2013 and December 31, 2012, the fair value of the Company's outstanding SARs of \$43 and \$66, respectively, are recorded as liabilities on its consolidated balance sheet for the respective periods.

Additional Paid-In Capital

The following table presents a rollforward of the Company's changes in additional paid-in capital since December 31, 2012:

| | | |
|---|-----------|---|
| | 2013 | |
| Balance as of January 1, 2013 | \$759,214 | |
| Common stock issuances: | | |
| DRIP issuances | 5,401 | |
| ATM issuances | 1,954 | |
| Incentive plans | 147 | |
| Adjustments related to tax withholding for share-based compensation | (545 |) |
| Common stock repurchases | (5,956 |) |
| Amortization of restricted stock, net of additional grants | 1,736 | |
| Capitalized expenses | (89 |) |
| Balance as of September 30, 2013 | \$761,862 | |

Accumulated Other Comprehensive Income

Accumulated other comprehensive income as of September 30, 2013 and December 31, 2012 is comprised of the following items:

| | September 30, 2013 | December 31, 2012 | |
|--|-----------------------|----------------------|---|
| Available for sale investments: | | | |
| Unrealized gains | \$49,669 | \$104,869 | |
| Unrealized losses | (72,057 |) (12,623 |) |
| | (22,388 |) 92,246 | |
| Hedging instruments: | | | |
| Unrealized gains | 3,779 | — | |
| Unrealized losses | (15,754 |) (39,735 |) |
| | (11,975 |) (39,735 |) |
| Accumulated other comprehensive income | \$(34,363 |) \$52,511 | |

Due to the Company's REIT status, the items comprising other comprehensive income do not have related tax effects.

NOTE 9 – COMMITMENTS AND CONTINGENCIES

The Company records accruals for certain outstanding legal proceedings, investigations or claims when it is probable that a liability will be incurred and the amount of the loss can be reasonably estimated. The Company evaluates, on a quarterly

basis, developments in legal proceedings, investigations and claims that could affect the amount of any accrual, as well as any developments that would make a loss contingency both probable and reasonably estimable. When a loss contingency is not both probable and reasonably estimable, the Company does not accrue the loss. However, if the loss (or an additional loss in excess of the accrual) is at least a reasonable possibility and material, then the Company discloses a reasonable estimate of the possible loss or range of loss, if such reasonable estimate can be made. If the Company cannot make a reasonable estimate of the possible material loss, or range of loss, then that fact is disclosed.

The Company and its subsidiaries are parties to various legal proceedings, including those described below. Although the ultimate outcome of these legal proceedings cannot be ascertained at this time, and the results of legal proceedings cannot be predicted with certainty, the Company believes, based on current knowledge, that the resolution of any of these proceedings, including those described below, will not have a material effect on the Company's consolidated financial condition or liquidity. However, the resolution of any of the proceedings described below could have a material impact on consolidated results of operations or cash flows in a given future reporting period as the proceedings are resolved.

One of the Company's subsidiaries, GLS Capital, Inc. ("GLS"), and the County of Allegheny, Pennsylvania ("Allegheny County") are defendants in a class action lawsuit filed in 1997 in the Court of Common Pleas of Allegheny County, Pennsylvania (the "Court"). Between 1995 and 1997, GLS purchased from Allegheny County delinquent property tax lien receivables for properties located in the county. The plaintiffs in this matter alleged that GLS improperly recovered or sought recovery for certain fees, costs, interest, and attorneys' fees and expenses in connection with GLS' collection of the property tax lien receivables. The Court granted class action status and defined the class to include only owners of real estate in Allegheny County who paid an attorneys' fee between 1996 and 2003 in connection with the forced collection of delinquent property tax receivables by GLS (generally through the initiation of a foreclosure action). Amendments to the statute that governs the collection of delinquent tax liens in Pennsylvania, related case law, and GLS' filing of one or more successful motions for summary judgment resulted in the dismissal of certain claims against GLS and narrowed the issues being litigated to whether attorneys' fees and related expenses charged by GLS in connection with the collection of the receivables were reasonable. Such attorneys' fees and lien costs were assessed by GLS in its collection efforts pursuant to the prevailing Allegheny County ordinance. On April 23, 2012, as a result of a petition to discontinue filed by the plaintiffs, the Court dismissed the remaining claim against GLS regarding the reasonableness of the attorney fees. Plaintiffs subsequently appealed the dismissal to the Pennsylvania Commonwealth Court of Appeals ("Court of Appeals"). The claims made by plaintiffs on appeal included only the legality of charging and recovering attorneys' fees and tax lien revival and assignment costs from the class members. Plaintiffs had never enumerated their damages in this matter. On July 15, 2013, the Court of Appeals affirmed the Court of Common Pleas' ruling allowing GLS to recover attorney's fees and lien revival and assignment fees from the class members. According to the Court of Appeals, the named representative plaintiffs may recover the attorneys' fees they paid GLS in order to stop the foreclosure action but only one of the two named plaintiffs ever paid any attorney fees to GLS and the amount was less than \$3. The Court of Appeals also affirmed the finding that revival and assignment are collection tools that may be utilized by GLS as an assignee of the County and such fees are properly collected from the delinquent taxpayers. Plaintiffs had the right to file an application for re-argument to the Court of Appeals or a Petition for Allowance of Appeal with the Supreme Court of Pennsylvania. Plaintiffs failed to apply for re-argument or petition for appeal with the Supreme Court of Pennsylvania within the allotted time period, and therefore the Company considers this matter resolved.

The Company, GLS, and Allegheny County are named defendants in a putative class action lawsuit filed in June 2012 in the Court of Common Pleas of Allegheny County, Pennsylvania. The lawsuit relates to the activities of GLS in Allegheny County related to the purchase and collection of delinquent property tax lien receivables discussed above. The purported class in this action consists of owners of real estate in Allegheny County whose property is or has been subject to a tax lien filed by Allegheny County that Allegheny County either retained or sold to GLS and who were billed by Allegheny County or GLS for attorneys' fees, interest, and certain other fees and who sustained economic

damages on and after August 14, 2003. The putative class allegations are that Allegheny County, GLS, and the Company violated the class's constitutional due process rights in connection with delinquent tax collection efforts. There are also allegations that amounts recovered from the class by GLS and / or Allegheny County are an unconstitutional taking of private property. The claims against the Company are solely based upon its ownership of GLS. The complaint requests that the Court order GLS to account for amounts alleged to have been collected in violation of the putative class members' rights and create a constructive trust for the return of such amounts to members of the purported class. The Company believes the claims are without merit and intends to defend against them vigorously in this matter. The same class previously filed substantially the same lawsuit in 2004 against GLS and Allegheny County (ACORN v. County of Allegheny and GLS Capital, Inc.), and that case was dismissed by the Court of Common Pleas with prejudice on June 28, 2013.

The Company and DCI Commercial, Inc. ("DCI"), a former affiliate of the Company and formerly known as Dynex Commercial, Inc., are appellees (or respondents) in the matter of Basic Capital Management, Inc. et al. (collectively, "BCM" or the "Plaintiffs") versus DCI et al. currently pending in state court in Dallas, Texas. The matter was initially filed in the state court in Dallas County, Texas in April 1999 against DCI, and in March 2000, BCM amended the complaint and added the Company as a defendant. Following a trial court decision in favor of both the Company and DCI, Plaintiffs appealed, seeking reversal of the trial court's judgment and rendition of judgment against the Company for alleged breach of loan agreements for tenant improvements in the amount of \$250. Plaintiffs also sought reversal of the trial court's judgment and rendition of judgment against DCI in favor of BCM under two mutually exclusive damage models, for \$2,200 and \$25,600, respectively, related to the alleged breach by DCI of a \$160,000 "master" loan commitment. Plaintiffs also sought reversal and rendition of a judgment in their favor for attorneys' fees in the amount of \$2,100. Alternatively, Plaintiffs sought a new trial. On February 13, 2013, the Fifth Circuit Court of Appeals in Dallas, Texas (the "Fifth Circuit") ruled on Plaintiff's appeal, affirming the previous decision of no liability with respect to the Company, and reversing the previous decision of no liability with respect to DCI relating to the \$160,000 "master" loan commitment. The Fifth Circuit ordered a new trial to determine the amount of attorneys' fees and prejudgment and post-judgment interest due to Plaintiffs and reinstated the \$25,600 damage award against DCI. On May 22, 2013, the Fifth Circuit vacated its order on February 13, 2013 and remanded the case to the trial court for entry of judgment against DCI and for a new trial with respect to attorney's fees and for costs and pre-judgment and post-judgment interest as determined by the trial court. The Fifth Circuit also affirmed the trial court's decision with respect to a take nothing judgment against the Company. DCI has appealed the matter to the Supreme Court of Texas to reverse the \$25,600 damage award. Management believes the Company will not be obligated for any amounts that may ultimately be awarded against DCI.

NOTE 10 – SUBSEQUENT EVENTS

Management has evaluated events and circumstances occurring as of and through the date this Quarterly Report on Form 10-Q was filed with the SEC and has determined that there have been no significant events or circumstances that qualify as a "recognized" subsequent event as defined by ASC Topic 855. Management has determined that the following events or circumstances qualify as "nonrecognized" subsequent events as defined by ASC Topic 855:

Effective October 1, 2013, the Company amended its master repurchase agreement with Wells Fargo Bank, N.A. to extend the termination date to August 6, 2015 and increase the aggregate maximum borrowing capacity to \$250,000.

Subsequent to September 30, 2013, the Company terminated interest rate swaps with a combined notional of \$902,000.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with our unaudited financial statements and the accompanying notes included in Item 1. "Financial Statements" in this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2012. References herein to "Dynex," the "Company," "we," "us," and "our" include Dynex Capital, Inc. and its consolidated subsidiaries, unless the context otherwise requires. In addition to current and historical information, the following discussion and analysis contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to our future business, financial condition or results of operations. For a description of certain factors that may have a significant impact on our future business, financial condition or results of operations, see "Forward-Looking Statements" at the end of this discussion and analysis.

EXECUTIVE OVERVIEW

Company Overview

We are an internally managed mortgage real estate investment trust, or mortgage REIT, which invests in mortgage assets on a leveraged basis. Our common stock is traded on the New York Stock Exchange ("NYSE") under the symbol "DX", our 8.50% Series A Cumulative Redeemable Preferred Stock (the "Series A Preferred Stock") is traded on the NYSE under the symbol "DXPRA", and our 7.625% Series B Cumulative Redeemable Preferred Stock is traded on the NYSE under the symbol "DXPRB". Our objective is to provide attractive risk-adjusted returns to our shareholders over the long term that are reflective of a leveraged, high quality fixed income portfolio with a focus on capital preservation. We seek to provide returns to our shareholders through regular quarterly dividends and through capital appreciation.

We were formed in 1987 and commenced operations in 1988. Beginning with our inception through 2000, our operations largely consisted of originating and securitizing various types of loans, principally single-family and commercial mortgage loans and manufactured housing loans. Since 2000, we have been an investor in Agency and non-Agency mortgage-backed securities ("MBS"). Agency MBS consist of residential MBS ("RMBS") and commercial MBS ("CMBS"), which come with a guaranty of principal payment by an agency of the U.S. government or a U.S. government-sponsored entity such as Fannie Mae and Freddie Mac. Non-Agency MBS (also consisting of RMBS and CMBS) have no such guaranty of payment.

Our primary source of income is net interest income, which is the excess of the interest income earned on our investments over the cost of financing these investments. We invest our capital pursuant to our operating policies as approved by our Board of Directors which include an investment management policy and investment risk policy. Our diversified investment strategy permits investment in Agency MBS and investment grade non-Agency MBS, and since 2008 our investments have been in higher credit quality, shorter duration investments. We also believe that our shorter duration strategy will provide less volatility in our results and in our book value per common share than strategies which invest in longer duration assets that may be more exposed to interest rate risk. Investments considered to be of higher credit quality have less or limited exposure to loss of principal while investments which have shorter durations have less or limited exposure to changes in interest rates.

RMBS. The Company's RMBS investments currently consist predominantly of Agency RMBS and to a lesser extent non-Agency RMBS. Agency RMBS include hybrid Agency adjustable-rate mortgage loans ("ARMs") and Agency ARMs. Hybrid Agency ARMs are MBS collateralized by hybrid adjustable-rate mortgage loans which are loans that have a fixed rate of interest for a specified period (typically three to ten years) and which then adjust their interest rate at least annually to an increment over a specified interest rate index as further discussed below. Agency ARMs are MBS collateralized by adjustable-rate mortgage loans which have interest rates that generally will adjust at least

annually to an increment over a specified interest rate index. Agency ARMs also include hybrid Agency ARMs that are past their fixed-rate periods or within twelve months of their initial reset period. The Company may also invest in fixed-rate Agency RMBS from time to time. Additionally, the Company invests in non-Agency RMBS which generally resemble similar types of Agency ARMs, but lack a guaranty of principal payment by an agency of the U.S. government or a U.S. government-sponsored entity.

Interest rates on the adjustable-rate mortgage loans collateralizing hybrid Agency ARMs, Agency ARMs, and non-Agency ARMs are based on specific index rates, such as the London Interbank Offered Rate, or LIBOR, the one-year constant maturity treasury rate, or CMT, the Federal Reserve U.S. 12-month cumulative average one-year CMT, or MTA, or the 11th District Cost

of Funds Index, or COFI. These loans will typically have interim and lifetime caps on interest rate adjustments, or interest rate caps, limiting the amount that the rates on these loans may reset in any given period.

CMBS. The Company's Agency and non-Agency CMBS are collateralized by first mortgage loans and are comprised of substantially fixed-rate securities. The majority of the loans collateralizing our CMBS are secured by multifamily properties. Typically these loans have some form of prepayment protection provisions (such as prepayment lock-out) or prepayment compensation provisions (such as yield maintenance or prepayment penalty). Yield maintenance and prepayment penalty requirements are intended to create an economic disincentive for the loans to prepay. Amounts required to be paid decline over time however, and as loans age, interest rates decline, or market values of the collateral supporting the loan increase, prepayment penalties may not serve as a meaningful economic disincentive to the borrower.

CMBS IO. A portion of the Company's Agency and non-Agency CMBS also include interest only securities ("IOs") which represent the right to receive excess interest payments (but not principal cash flows) based on the underlying unpaid principal balance of the underlying pool of mortgage loans. As these securities have no principal associated with them, the interest payments received are based on the unpaid principal balance (often referred to as the notional amount) of the underlying pool of mortgage loans. CMBS IO securities generally have prepayment protection in the form of lock-outs, prepayment penalties, or yield maintenance associated with the underlying loans similar to CMBS described above. Like CMBS, yield maintenance and prepayment penalties required to be paid decline over time, and as loans age, interest rates change, or market values of the collateral supporting the loan increase, prepayment penalties may not serve as a meaningful economic disincentive to the borrower.

Factors that Affect Our Results of Operations and Financial Condition

The performance of our investment portfolio, including the amount of net interest income we earn and fluctuations in investment values, will depend on many factors, many of which are beyond our control. These factors include, but are not limited to, interest rates, trends of interest rates, the relative steepness of interest rate curves, prepayment rates on our investments, competition for investments, economic conditions and their impact on the credit performance of and demand for our investments, and market required yields as reflected by market credit spreads. In addition, the performance of our investment portfolio, the cost and availability of financing and the availability of investments at acceptable return levels could be influenced by actions taken by the Federal Reserve and policy measures of the U.S. government including the Federal Housing Finance Administration and the U. S. Department of the Treasury (the "Treasury"), and actions taken by and policy measures of the U.S. Federal Reserve.

Effective June 30, 2013, we voluntarily discontinued hedge accounting for all interest rate swaps we had previously designated as cash flow hedges under GAAP, in order to better position us to extend maturity dates for our repurchase agreements. As a result, changes in the fair value of interest rate swaps and other derivative instruments will be reported in gain (loss) on derivative instruments, net, and will directly impact our GAAP net income. Please refer to "Highlights for the Third Quarter of 2013" for additional information.

Our business model may also be impacted by other factors such as the availability and cost of financing and the state of the overall credit markets. Reductions in the availability of financing for our investments could significantly impact our business and force us to sell assets that we otherwise would not sell, potentially at losses or at amounts below their true fair value. Other factors also impacting our business include changes in regulatory requirements, including requirements to qualify for registration under the Investment Company Act of 1940 and REIT requirements.

Investing in mortgage-related securities while using leverage to increase our return on shareholders' capital subjects us to a number of risks including interest rate risk, prepayment and reinvestment risk, credit risk, market value risk and liquidity risk, which are discussed in "Liquidity and Capital Resources" within this Item 2 of this Quarterly Report on

Form 10-Q as well as in Item 1A, "Risk Factors" of Part I, and in Item 7A, "Quantitative and Qualitative Disclosures about Market Risk" of Part II of our Annual Report on Form 10-K for the year ended December 31, 2012. Please see these Items for a detailed discussion of these risks and the potential impact on our results of operations and financial condition.

Highlights for the Third Quarter of 2013

The third quarter continued the volatility that was experienced during the second quarter. The Treasury yield curve steepened modestly during the quarter as shorter duration rates (2 years and less) decreased and longer duration rates increased.

At September 30, 2013, the spread between the two-year Treasury rate and the ten-year Treasury rate was 2.29% versus 2.13% at June 30, 2013. The ten-year Treasury touched a high of 3.00% after starting the quarter at 2.49% and ended the quarter at 2.61%. Market credit spreads were similarly volatile during the quarter.

Management believes the events contributing to the market volatility included the fixed income markets anticipating the Federal Reserve reducing or ending its bond purchase program (referred to as "QE3") which triggered global de-risking in virtually all asset classes. Market expectations were for the Federal Reserve to announce at its September 18th meeting that it would begin to taper its bond purchases. At that meeting, the Federal Reserve did not announce a reduction in the purchases under QE3 and the fixed income markets rallied significantly as a result. During the quarter, book value per common share declined by \$(0.35) per common share, or (4)%, to \$8.59 as of September 30, 2013. We estimate that \$(0.21) of the decline in book value per common share was due to the widening in credit spreads and \$(0.27) was due to the increase in interest rates. Most of the decline in book value due to changes in interest rates resulted from derivative hedging instruments added during the quarter (in the form of interest rate swaps and Eurodollar futures) to protect the Company from further increases in interest rates. As interest rates declined toward the end of the quarter, we experienced losses on these economic hedges. In management's view, most of the decline in book value from widening credit spreads was due to general market illiquidity for MBS given the uncertainty regarding the Federal Reserve's tapering of its QE3 bond purchase program.

During the quarter, we reduced our exposure to interest rates by adding hedging instruments as noted above and our modeled duration gap (a measure of our sensitivity to changes in interest rates) was at the low end of our 0.5-1.5 years target range. Most of the hedges were intended to reduce our exposure to changes in interest rates on the longer-end (5 year - 30 year points) on the Treasury curve. We also did not reinvest repayments on our investment assets which resulted in our leverage being reduced during the quarter. Finally we began extending repurchase agreement maturities (in particular in terms greater than 120 days) given the declining cost and availability of longer-term borrowing.

We continue to believe that economic fundamentals are uncertain and that the U.S. economy cannot withstand sustained levels of higher interest rates and still meet the growth and employment levels sought by the Federal Reserve. We anticipate that the Federal Reserve will continue to keep the targeted federal funds rate very low for an extended period as discussed further in "Trends and Recent Market Impacts". We believe that market volatility around the reduction of the QE3 bond purchase program is likely to persist, however, leading to continued volatility with respect to asset prices and our book value. We continue to manage toward the longer term and remain focused on managing through this period of unusual volatility.

Effective June 30, 2013, we voluntarily discontinued hedge accounting for all interest rate swaps which we previously designated as hedges under GAAP. This decision to discontinue hedge accounting was made to facilitate our ability to more effectively manage the maturity dates of our repurchase agreements. During the third quarter of 2013 we began extending repurchase maturities as far out as 180 days. In addition, changes in the fair value of interest rate swaps and other derivative instruments are reported in our consolidated statements of income (loss) as "gain (loss) on derivative instruments, net" and will no longer be reported in shareholders' equity through accumulated other comprehensive income (loss).

Non-GAAP Financial Measures

In addition to our operating results presented in accordance with GAAP, this Quarterly Report on Form 10-Q contains the following non-GAAP financial measures: core net operating income to common shareholders, effective borrowing costs, adjusted net interest income, and adjusted net interest spread. Management uses these non-GAAP financial measures in its internal analysis of results and operating performance and believes these measures may be important to investors and present useful information about the Company's performance.

Core net operating income to common shareholders equals GAAP net income to common shareholders adjusted for amortization of accumulated other comprehensive loss on de-designated interest rate swaps included in GAAP interest expense, net change in fair value of derivative instruments, gains and losses on terminated derivative instruments, gains and losses on sales of investments, and fair value adjustments on investments not classified as available for sale. Effective borrowing costs equals GAAP interest expense excluding the amortization of accumulated other comprehensive loss on interest rate swaps de-designated as cash flow hedges on June 30, 2013 plus net periodic costs on interest rate derivatives (including accrued amounts) which are not already included in GAAP interest expense. Adjusted net interest income equals GAAP net interest income less effective borrowing costs. Adjusted net interest spread equals average annualized yields on investments less effective borrowing costs.

Schedules reconciling these non-GAAP financial measures to GAAP financial measures are provided in "Results of Operations" within Part 1, Item 2 of this Quarterly Report on Form 10-Q.

Management believes these non-GAAP financial measures are useful because they provide investors greater transparency to the information we use in our financial and operational decision-making processes. Management also believes the presentation of these measures, when analyzed in conjunction with the our GAAP operating results, allows investors to more effectively evaluate and compare our performance to that of our peers, particularly those competitors that continue to use hedge accounting in reporting their financial results, as well as to our performance in periods prior to discontinuing hedge accounting. However, because these non-GAAP financial measures exclude certain items used to compute GAAP net income to common shareholders and GAAP interest expense, these non-GAAP measures should be considered as a supplement to, and not as a substitute for, our GAAP results as reported in our consolidated statements of income (loss). In addition, because not all companies use identical calculations, our presentation of core net operating income, effective borrowing costs, adjusted net interest income, and adjusted net interest spread may not be comparable to other similarly-titled measures of other companies.

Trends and Recent Market Impacts

There are certain conditions and prospective trends in the marketplace that have impacted our current financial condition and results of operations and which may continue to impact us in the future. For additional information, please refer to "Trends and Recent Market Impacts" within Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" within our Annual Report on Form 10-K for the year ended December 31, 2012. The following provides a discussion of those conditions and trends discussed in that Annual Report on Form 10-K which have had significant developments during the third quarter of 2013 or are new conditions and trends that are important to our financial condition and results of operations.

Federal Reserve Monetary Policy

The Federal Open Market Committee ("FOMC") continues its purchase of U.S. Treasury and fixed-rate Agency MBS under its asset purchase program known as "QE3". The FOMC has indicated that it will adjust its purchases of these securities to maintain appropriately accommodative policy as the outlook for the labor market or inflation changes. At a press conference on June 19, 2013, the Chairman of the Federal Reserve made comments suggesting that the FOMC may taper its purchases of these securities in a more accelerated time frame than had been previously forecasted by the markets. Markets then began pricing in a reduction in securities purchases in September and as a result, the U.S. Treasury market immediately sold off (causing interest rates to rise) and global fixed income markets immediately began to reprice the risk of owning all forms of fixed income instruments (via credit spread widening). At its September meeting, the FOMC did not taper its securities purchases and reiterated that any future reductions in purchases would be dependent on economic data. The FOMC also reiterated its commitment to maintaining a highly accommodative stance of monetary policy for a considerable time after the QE3 asset purchase program ends and the economic recovery strengthens. The FOMC has pledged to keep the target range for the federal funds rate at 0%-0.25% and indicated that it anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6.5%, inflation between one and two years ahead is projected to be no more than a half percentage point above the FOMC's 2% longer-run goal, and longer-term inflation expectations continue to be well anchored. In determining how long to maintain a highly accommodative stance of monetary policy, the FOMC stated that it will also consider other information, including additional measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. Market participants have subsequently revised expectations for the FOMC to taper its asset purchases in early 2014. As a result, since the September FOMC meeting through October 31, 2013, ten-year Treasury rates have rallied approximately 30 basis points and the two-year versus ten-year spread has declined to 2.25% from 2.37%.

Asset Spreads and Competition for Assets

Over the past few years, credit markets in the United States have generally experienced tightening credit spreads (where credit spreads are defined as the difference between yields on securities with credit risk and yields on benchmark securities and that reflects the relative riskiness of the securities versus the benchmark). Changes in credit spreads results from the expansion or contraction of the perceived riskiness of an investment versus the benchmark. Spreads on MBS had tightened throughout the first half of the year from increased competition for these assets from lack of supply, from favorable market conditions in large part due to the Federal Reserve's involvement in the markets, and from substantial amounts of capital raised by mortgage REITs and other market participants. Reductions in credit spreads resulted in an increase in asset prices which increased our book value.

During the latter part of the second quarter of 2013, credit spreads widened on MBS due to perceived hawkish commentary from Federal Reserve and due to overall lack of liquidity in the markets (as discussed above under "Federal Reserve Monetary Policy"). During the third quarter of 2013, credit spreads widened further but generally tightened before quarter-end. Although spreads have continued to tighten into the fourth quarter, they have not yet returned to levels experienced earlier in the year. The following table provides various credit spreads on assets owned by the Company as well as other market credit spreads as of the end of the first three quarters of 2013:

| (amounts in basis points) | September 30, 2013 | June 30, 2013 | March 31, 2013 |
|--|-----------------------|---------------|----------------|
| Hybrid ARM 5/1 (2.0% coupon) spread to Treasuries | 40 | 45 | 18 |
| Hybrid ARM 10/1 (2.5% coupon) spread to Treasuries | 80 | 75 | 34 |
| Agency CMBS spread to interest rate swaps | 72 | 92 | 59 |
| 'A'-rated CMBS spread to interest rate swaps | 255 | 287 | 205 |
| Agency CMBS IO spread to Treasuries | 200 | 200 | 115 |

The above table indicates the magnitude of the changes to credit spreads during the last several quarters on securities that we own. Spread widening results from a higher required yield for these investments by the markets. We continue to expect credit spreads to remain wide for the near term due to the uncertainty around FOMC policy as discussed above and by technical factors such as lack of buying by other mortgage REITs due to their reduced capacity to raise capital.

GSE Reform

Policy makers in Washington DC continue to debate the future of Fannie Mae and Freddie Mac's participation in the U.S. mortgage market. Several bills have been introduced in the U.S. Senate and the U.S. House of Representatives regarding the reform and/or dissolution of the GSEs. Any changes to the structure of the GSEs, or the revocations of their charters, if enacted, may have broad adverse implications for the MBS market and our business, results of operations, and financial condition. We expect such proposals to be the subject of significant discussion, and it is not yet possible to determine whether such proposals will be enacted. We do not believe the ultimate reform of Fannie Mae and Freddie Mac will occur in 2013. However, it is possible that new types of Agency MBS could be proposed and sold by Fannie Mae and Freddie Mac that are structured differently from current Agency MBS. This may have the effect of reducing the amount of available investment opportunities for the Company. For further discussion of the uncertainties and risks related to GSE reform, please refer to "Risk Factors" contained within Part I, Item 1A of this Annual Report on Form 10-K.

U.S. Fiscal Policy

Uncertainty around the long-term financial health of the United States government has recently led to bitter partisanship in the U.S. Congress that resulted in a brief shutdown of the U.S. government over lack of funding and a series of temporary authorizations to raise the U.S. debt ceiling. As of the date of this Quarterly Report on Form 10-Q, the U.S. Congress will need to approve additional funding and raise the debt ceiling in order for the U. S. government to continue to effectively fund itself in the first quarter 2014. In addition, the U.S. Congress has passed a series of discretionary spending cuts in the U.S. budget. The uncertainty around the resolution of the long-term fiscal issues and the negative effect of spending cuts in our view is a drag on the economic output of the U.S. and is in part a factor influencing Federal Reserve monetary policy.

CRITICAL ACCOUNTING POLICIES

The discussion and analysis of our financial condition and results of operations are based in large part upon our consolidated financial statements, which have been prepared in accordance with GAAP. The preparation of these financial statements requires management to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and disclosure of contingent assets and liabilities. We base these estimates and judgments on historical experience and assumptions believed to be reasonable under current facts and circumstances. Actual results, however, may differ from the estimated amounts we have recorded.

Critical accounting policies are defined as those that require management's most difficult, subjective or complex judgments, and which may result in materially different results under different assumptions and conditions. Our accounting policies that require the most significant management estimates, judgments, or assumptions and considered most critical to our results of operations or financial position relate to amortization of investment premiums, other-than-temporary impairments, and fair value measurements. Our critical accounting policies are discussed in our Annual Report on Form 10-K for the year ended December 31, 2012 under "Management's Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies". There have been no significant changes in our critical accounting policies during the nine months ended September 30, 2013.

FINANCIAL CONDITION

The following tables provides our asset allocation by issuer type and by collateral type as of September 30, 2013 and as of the end of each of the four preceding quarters:

| | September 30, 2013 | June 30, 2013 | March 31, 2013 | December 31, 2012 | September 30, 2012 |
|-------------------|-----------------------|---------------|----------------|----------------------|-----------------------|
| Agency MBS | 86.3% | 85.9% | 84.9% | 83.6% | 84.6% |
| Non-Agency MBS | 12.3% | 12.6% | 13.6% | 14.6% | 13.6% |
| Other investments | 1.5% | 1.5% | 1.5% | 1.8% | 1.8% |

| | September 30, 2013 | June 30, 2013 | March 31, 2013 | December 31, 2012 | September 30, 2012 |
|---------|-----------------------|---------------|----------------|----------------------|-----------------------|
| RMBS | 68.5% | 67.9% | 65.0% | 75.1% | 66.2% |
| CMBS | 17.2% | 17.4% | 19.3% | 24.9% | 19.6% |
| CMBS IO | 14.3% | 14.7% | 15.7% | 19.5% | 14.2% |

The following discussion addresses items from our unaudited consolidated balance sheet that had significant activity during the past nine months and should be read in conjunction with "Notes to the Unaudited Consolidated Financial Statements" contained within Item 1 of this Quarterly Report on Form 10-Q.

Agency MBS

Activity related to our Agency MBS for the nine months ended September 30, 2013 is as follows:

| (amounts in thousands) | RMBS | CMBS | CMBS IO | Total |
|----------------------------------|-------------|-----------|------------|-------------|
| Balance as of January 1, 2013 | \$2,571,337 | \$354,142 | \$567,180 | \$3,492,659 |
| Purchases | 1,063,862 | 18,336 | 119,048 | 1,201,246 |
| Principal payments | (712,007) | (3,931) | — | (715,938) |
| Sales | (4,496) | (32,958) | (145,992) | (183,446) |
| Change in net unrealized gain | (64,750) | (10,258) | (7,894) | (82,902) |
| Net premium amortization | (24,899) | (3,128) | (56,734) | (84,761) |
| Balance as of September 30, 2013 | \$2,829,047 | \$322,203 | \$475,608 | \$3,626,858 |

As of September 30, 2013, 63% of our Agency portfolio was comprised of Fannie Mae investments with the balance being comprised of 34% Freddie Mac investments and 3% Ginnie Mae investments compared to 65% Fannie Mae investments and 29% Freddie Mac investments with the remaining 6% in Ginnie Mae investments as of December 31, 2012. As of September 30, 2013, 77% of our Agency MBS investments are variable-rate MBS with the remainder fixed-rate MBS compared to 73% variable-rate Agency MBS as of December 31, 2012.

The following table presents the weighted average coupon ("WAC") by weighted average MTR for the variable-rate portion of our Agency RMBS portfolio based on par value as of September 30, 2013 and December 31, 2012:

| (amounts in thousands) | September 30, 2013 | | December 31, 2012 | | |
|------------------------|--------------------|------|-------------------|------|---|
| | Par Value | WAC | Par Value | WAC | |
| 0-12 MTR | \$486,752 | 2.91 | % \$523,711 | 3.94 | % |
| 13-24 MTR | 305,266 | 3.80 | % 105,372 | 4.41 | % |
| 25-36 MTR | 116,072 | 3.98 | % 194,814 | 3.82 | % |
| 37-48 MTR | 216,798 | 4.03 | % 155,660 | 4.38 | % |
| 49-60 MTR | 423,791 | 3.39 | % 315,499 | 3.85 | % |
| 61-72 MTR | 179,479 | 2.95 | % 468,188 | 3.34 | % |
| 73-84 MTR | 5,767 | 4.54 | % 151,911 | 3.10 | % |
| 85-108 MTR | 679,980 | 3.23 | % 301,450 | 3.61 | % |
| 109-132 MTR | 290,077 | 2.47 | % 189,309 | 3.05 | % |
| | \$2,703,982 | 3.26 | % \$2,405,914 | 3.69 | % |

As of September 30, 2013, approximately 96.4% of our variable-rate Agency RMBS portfolio resets based on one-year LIBOR plus a weighted average rate of 1.78%, which was relatively unchanged from the characteristics of that portion of our portfolio as of December 31, 2012. Because we typically finance these investments using repurchase agreement financing with 30 - 180 day maturities for which we pay interest expense based on the related LIBOR index plus a spread, our net interest income is sensitive to changes in the interest rate environment. This sensitivity is discussed further in Item 3 "Quantitative and Qualitative Disclosures About Market Risk" of this Quarterly Report on Form 10-Q.

During the first nine months of 2013, we received principal payments (both scheduled and unscheduled) on our Agency RMBS of \$712.0 million. Below is a table of the CPRs on our Agency RMBS for the periods indicated:

| | Three Months Ended | | | | |
|-------------|--------------------|---------------|----------------|-------------------|--------------------|
| | September 30, 2013 | June 30, 2013 | March 31, 2013 | December 31, 2012 | September 30, 2012 |
| Agency RMBS | 23.8 | % 25.7 | % 24.8 | % 24.3 | % 23.4 |

Non-Agency MBS

Activity related to our non-Agency MBS for the nine months ended September 30, 2013 is as follows:

| (amounts in thousands) | RMBS | CMBS | CMBS IO | Total |
|----------------------------------|----------|-------------|-----------|-----------|
| Balance as of January 1, 2013 | \$11,038 | \$486,342 | \$113,942 | \$611,322 |
| Purchases | 13,989 | 77,015 | 27,831 | 118,835 |
| Principal payments | (4,427) |) (23,289) |) — | (27,716) |
| Sales | (5,631) |) (136,430) |) — | (142,061) |
| Change in net unrealized gain | (441) |) (29,288) |) (2,637) | (32,366) |
| Net accretion (amortization) | 60 | 399 | (13,587) | (13,128) |
| Balance as of September 30, 2013 | \$14,588 | \$374,749 | \$125,549 | \$514,886 |

Although generally a normal part of our operations due to ordinary portfolio reallocations, our significant sales of non-Agency CMBS investments for the third quarter of 2013 were primarily the result of management's decision to reduce portfolio risk given the volatile market environment.

The weighted average months to maturity for all of our non-Agency CMBS (including IO securities) as of September 30, 2013 was 81 months with 80% having origination dates of 2009 or later, and the remainder prior to 2000. Our non-Agency CMBS investments consist principally of securities rated 'A' or higher and are primarily Freddie Mac Multifamily K Certificates on pools of recently originated multifamily mortgage loans. These certificates are not guaranteed by Freddie Mac, and, therefore, repayment is based solely on the performance of the underlying pool of loans. These loans have prepayment lock-out provisions which reduce the risk of early repayment of our investment.

The following table presents the fair value, net unrealized gain (loss) and related borrowings as of September 30, 2013 for our non-Agency CMBS and CMBS IO investments by credit rating:

| (amounts in thousands) | Non-Agency CMBS | | | Non-Agency CMBS IO | | |
|------------------------|-----------------|----------------------------|--------------------|--------------------|---------------------|--------------------|
| | Fair Value | Net Unrealized Gain (Loss) | Related Borrowings | Fair Value | Net Unrealized Gain | Related Borrowings |
| AAA | \$65,568 | \$2,803 | \$53,497 | \$123,993 | \$2,294 | \$97,567 |
| AA | 44,221 | 855 | 34,867 | 1,556 | 82 | 17 |
| A | 224,800 | 7,868 | 181,953 | — | — | — |
| Below A/Not Rated | 40,160 | (906) | 28,231 | — | — | — |
| | \$374,749 | \$10,620 | \$298,548 | \$125,549 | \$2,376 | \$97,584 |

The following table presents the geographic diversification of the collateral underlying our non-Agency CMBS by the top 5 states as of September 30, 2013:

| (amounts in thousands) | Market Value of Collateral | Percentage |
|--|----------------------------|------------|
| California | \$77,968 | 13.8 % |
| Florida | 76,094 | 13.5 % |
| Texas | 67,533 | 12.0 % |
| Virginia | 31,083 | 5.5 % |
| North Carolina | 29,534 | 5.2 % |
| Remaining states (not exceeding 5.1% individually) | 282,194 | 50.0 % |
| | \$564,406 | 100.0 % |

Derivative Assets and Liabilities

As discussed in "Executive Overview", effective June 30, 2013 we voluntarily discontinued hedge accounting for all interest rate swaps that were previously designated as cash flow hedges under GAAP because certain accounting requirements to qualify for cash flow hedge treatment limited our ability to extend maturity dates for our repurchase agreements beyond 30 days. During the third quarter of 2013, we began using Eurodollar futures in addition to interest rate swaps to economically hedge our interest rate risk.

As of September 30, 2013, the weighted average notional amount of interest rate derivatives instruments that will be effective for future periods are shown in the following table:

| (amounts in thousands) | Interest Rate Swaps | Eurodollar futures | Total | Weighted-Average Rate ⁽¹⁾ | |
|---------------------------------|---------------------|--------------------|--------------|--------------------------------------|---|
| Effective for remainder of 2013 | \$ 1,542,000 | \$ 44,444 | \$ 1,586,444 | 1.55 | % |
| Effective 2014 | 1,333,496 | 250,000 | 1,583,496 | 1.51 | % |
| Effective 2015 | 1,135,792 | 551,183 | 1,686,975 | 1.55 | % |
| Effective 2016 | 881,959 | 1,275,623 | 2,157,582 | 1.89 | % |
| Effective 2017 | 732,610 | 1,142,500 | 1,875,110 | 2.52 | % |
| Effective 2018 | 649,185 | 766,111 | 1,415,296 | 2.93 | % |
| Effective 2019 | 313,223 | 624,695 | 937,918 | 3.61 | % |
| Effective 2020 | 241,277 | 441,277 | 682,554 | 3.79 | % |
| Effective 2021 | 230,000 | — | 230,000 | 2.27 | % |
| Effective 2022 | 230,000 | — | 230,000 | 2.27 | % |
| Effective 2023 | 188,690 | — | 188,690 | 2.25 | % |
| Effective 2024 | 38,874 | — | 38,874 | 2.18 | % |

(1) Weighted average rate is based on the weighted average notional outstanding.

Please refer to Note 5 of the Notes to Unaudited Consolidated Financial Statements contained with this Quarterly Report on Form 10-Q as well as "Loss on Derivative Instruments, Net" within "Results of Operations" contained within this Item 2 for additional information related to our derivative assets and liabilities.

Repurchase Agreements

Repurchase agreements increased a net \$110.7 million from December 31, 2012 to September 30, 2013 due to additional borrowings to finance our purchases of investments during the nine months ended September 30, 2013, but decreased \$396.5 million during the third quarter of 2013 as we reduced the size of our investment portfolio. Please refer to Note 4 of the Notes to the Unaudited Consolidated Financial Statements contained within this Quarterly Report on Form 10-Q as well as "Interest Expense, Annualized Cost of Funds, and Effective Borrowings Costs" within "Results of Operations" and "Liquidity and Capital Resources" contained within this Item 2 for additional information relating to our repurchase agreements.

Supplemental Information

The tables below present the allocation of our shareholders' equity to our assets and liabilities. The allocation of shareholders' equity is determined by subtracting the associated financing for each asset from that asset's carrying basis:

| (amounts in thousands) | As of September 30, 2013 | | | | |
|---------------------------------|--------------------------|--|--------------------------------|---------------------------|----|
| | Asset Carrying Basis | Associated Financing ⁽¹⁾ / Liability Carrying Basis | Allocated Shareholders' Equity | % of Shareholders' Equity | |
| Agency MBS | \$3,626,858 | \$3,246,474 | \$380,384 | 65.5 | % |
| Non-Agency MBS | 514,886 | 414,797 | 100,089 | 17.2 | % |
| Securitized mortgage loans | 59,797 | 34,727 | 25,070 | 4.3 | % |
| Other investments | 1,305 | — | 1,305 | 0.2 | % |
| Derivative assets (liabilities) | 12,908 | 20,837 | (7,929) | (1.4) |)% |
| Cash and cash equivalents | 39,608 | — | 39,608 | 6.8 | % |
| Restricted cash | 15,849 | — | 15,849 | 2.7 | % |
| Other assets/other liabilities | 48,433 | 21,768 | 26,665 | 4.7 | % |
| | \$4,319,644 | \$3,738,603 | \$581,041 | 100.0 | % |

| (amounts in thousands) | As of December 31, 2012 | | | | |
|---------------------------------|-------------------------|--|--------------------------------|---------------------------|----|
| | Asset Carrying Basis | Associated Financing ⁽¹⁾ / Liability Carrying Basis | Allocated Shareholders' Equity | % of Shareholders' Equity | |
| Agency MBS | \$3,492,659 | \$3,057,634 | \$435,025 | 70.5 | % |
| Non-Agency MBS | 611,322 | 493,188 | 118,134 | 19.2 | % |
| Securitized mortgage loans | 70,823 | 43,810 | 27,013 | 4.4 | % |
| Other investments | 858 | — | 858 | 0.1 | % |
| Derivative assets (liabilities) | — | 42,537 | (42,537) | (6.9) |)% |
| Cash and cash equivalents | 55,809 | — | 55,809 | 9.1 | % |
| Other assets/other liabilities | 48,758 | 26,350 | 22,408 | 3.6 | % |
| | \$4,280,229 | \$3,663,519 | \$616,710 | 100.0 | % |

Associated financing related to investments includes repurchase agreements as well as payables pending for (1)unsettled trades, if any, as of the date indicated, and non-recourse collateralized financing. Associated financing for derivative instruments represents the fair value of the interest rate swap agreements in a liability position.

The tables below present the allocation of our invested capital by type of investment:

| (amounts in thousands) | As of September 30, 2013 | | | | |
|------------------------|--------------------------|----------------------|-----------------------------|---------------------------------|---|
| | Asset Carrying Basis | Associated Financing | Invested Capital Allocation | % of Allocated Invested Capital | |
| RMBS and loans | \$2,880,737 | \$2,671,078 | \$209,659 | 41.4 | % |
| CMBS and loans | 720,952 | 549,706 | 171,246 | 33.8 | % |
| CMBS IO | 601,157 | 475,214 | 125,943 | 24.8 | % |
| | \$4,202,846 | \$3,695,998 | \$506,848 | 100.0 | % |

| (amounts in thousands) | As of December 31, 2012 | | | | % of Allocated Invested Capital | % |
|------------------------|-------------------------|-------------------------|-----------------------------------|-------|---------------------------------------|---|
| | Asset Carrying Basis | Associated Financing | Invested Capital Allocation | | | |
| RMBS and loans | \$2,624,897 | \$2,405,131 | \$219,766 | 37.8 | | % |
| CMBS and loans | 869,643 | 658,399 | 211,244 | 36.4 | | % |
| CMBS IO | 681,122 | 531,102 | 150,020 | 25.8 | | % |
| | \$4,175,662 | \$3,594,632 | \$581,030 | 100.0 | | % |

RESULTS OF OPERATIONS

Net (loss) income and core net operating income

For the three months ended September 30, 2013, we incurred a net loss to common shareholders of \$(6.9) million compared to net income of \$18.4 million for the three months ended September 30, 2012. For the nine months ended September 30, 2013, we reported net income to common shareholders of \$40.9 million compared to \$53.7 million for the nine months ended September 30, 2012. As a result of our discontinuing hedge accounting at the end of the second quarter of 2013, we are providing certain non-GAAP financial measures, including "core net operating income", in order to provide a more meaningful comparison of current period results to those of prior periods during which we utilized cash flow hedge accounting. Please refer to the section "Use of Non-GAAP Financial Measures" contained within Executive Overview for additional important information on this and other non-GAAP financial measures discussed throughout this Quarterly Report on Form 10-Q. For the three months and nine months ended September 30, 2013, we reported core net operating income of \$14.9 million and \$48.2 million compared to \$14.7 million and \$46.9 million for the three and nine months ended September 30, 2012.

The following table presents a reconciliation of our GAAP net (loss) income to our core net operating income for the periods presented:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | | |
|---|-------------------------------------|------------|------------------------------------|----------|---|
| | 2013 | 2012 | 2013 | 2012 | |
| GAAP net (loss) income to common shareholders | \$(6,921 |) \$18,353 | \$40,902 | \$53,675 | |
| Amortization of de-designated cash flow hedges ⁽¹⁾ | 2,583 | — | 2,583 | — | |
| Change in fair value on derivative instruments, net | 19,348 | 170 | 7,510 | 421 | |
| Gain on terminations of derivative instruments, net | (800 |) — | (800 |) — | |
| Loss (gain) on sale of investments | 825 | (3,480 |) (2,597 |) (6,418 |) |
| Fair value adjustments, net | (150 |) (297 |) 590 | (778 |) |
| Core net operating income to common shareholders | \$14,885 | \$14,746 | \$48,188 | \$46,900 | |

Core net operating income to common shareholders per share \$0.27 \$0.27 \$0.88 \$0.89

(1) Amount recorded as a portion of "interest expense" in accordance with GAAP related to the amortization of the balance remaining in accumulated other comprehensive loss as of June 30, 2013 as a result of the Company's discontinuation of hedge accounting.

Interest Income and Asset Yields

The majority of our interest income is from our MBS portfolio with the remainder resulting from investments in securitized mortgage loans and other investments. The following tables present interest income and weighted average yields by type of MBS investment for the three and nine months ended September 30, 2013 and 2012:

| | Three Months Ended | | | | | | |
|---------------------|--------------------|--------------------------------|--------------------------------|-----------------|--------------------------------|--------------------------------|---|
| | September 30, 2013 | | | 2012 | | | |
| | Interest Income | Average Balance ⁽¹⁾ | Effective Yield ⁽²⁾ | Interest Income | Average Balance ⁽¹⁾ | Effective Yield ⁽²⁾ | |
| Agency RMBS | \$15,093 | \$2,985,731 | 1.98 | % \$12,268 | \$2,438,925 | 2.15 | % |
| Agency CMBS | 2,874 | 316,190 | 3.56 | % 2,878 | 308,946 | 3.66 | % |
| Agency CMBS IO | 5,589 | 488,150 | 4.40 | % 4,531 | 361,899 | 4.93 | % |
| Total Agency | 23,556 | 3,790,071 | 2.42 | % 19,677 | 3,109,770 | 2.63 | % |
| Non-Agency RMBS | 167 | 12,898 | 4.86 | % 235 | 16,384 | 5.63 | % |
| Non-Agency CMBS | 5,446 | 379,372 | 5.80 | % 6,434 | 449,342 | 5.72 | % |
| Non-Agency CMBS IO | 1,651 | 125,727 | 4.45 | % 908 | 67,810 | 5.39 | % |
| Total Non-Agency | 7,264 | 517,997 | 5.45 | % 7,577 | 533,536 | 5.67 | % |
| Total MBS portfolio | \$30,820 | \$4,308,068 | 2.78 | % \$27,254 | \$3,643,306 | 3.08 | % |
| | Nine Months Ended | | | | | | |
| | September 30, 2013 | | | 2012 | | | |
| | Interest Income | Average Balance ⁽¹⁾ | Effective Yield ⁽²⁾ | Interest Income | Average Balance ⁽¹⁾ | Effective Yield ⁽²⁾ | |
| Agency RMBS | \$43,399 | \$2,847,667 | 2.01 | % \$36,835 | \$2,118,615 | 2.33 | % |
| Agency CMBS | 8,923 | 328,115 | 3.59 | % 8,611 | 305,433 | 3.67 | % |
| Agency CMBS IO | 20,345 | 542,314 | 4.87 | % 9,338 | 259,151 | 4.83 | % |
| Total Agency | 72,667 | 3,718,096 | 2.57 | % 54,784 | 2,683,199 | 2.73 | % |
| Non-Agency RMBS | 472 | 12,048 | 5.19 | % 710 | 16,373 | 5.73 | % |
| Non-Agency CMBS | 18,491 | 435,019 | 5.66 | % 18,451 | 397,622 | 6.11 | % |
| Non-Agency CMBS IO | 4,197 | 114,991 | 4.75 | % 3,291 | 62,092 | 7.11 | % |
| Total Non-Agency | 23,160 | 562,058 | 5.47 | % 22,452 | 476,087 | 6.22 | % |
| Total MBS portfolio | \$95,827 | \$4,280,154 | 2.95 | % \$77,236 | \$3,159,286 | 3.25 | % |

(1) Average balances are calculated as a simple average of the daily amortized cost and exclude unrealized gains and losses as well as securities pending settlement if applicable.

(2) Effective yields are based on annualized amounts. Recalculation of effective yields may not be possible using data provided because certain items of a one-time nature are not annualized for the calculation. An example of such a one-time item is the retrospective adjustments of investment discount and premium amortizations arising from adjustments of effective interest rates.

The following table presents the estimated impact of changes in average yields and average balances on the increase (decrease) in interest income for the three and nine months ended September 30, 2013 compared to their respective periods in 2012:

| (amounts in thousands) | Three Months Ended September 30, 2013 vs. September 30, 2012 | | | Nine Months Ended September 30, 2013 vs. September 30, 2012 | | |
|------------------------|---|--------------------|---------------|--|--------------------|---------------|
| | Increase (Decrease) | Due to Change in | | Increase (Decrease) | Due to Change in | |
| | | Average Balance | Average Yield | | Average Balance | Average Yield |
| Agency MBS | \$3,879 | \$4,556 | \$(677) | \$17,883 | \$21,559 | \$(3,676) |
| Non-Agency MBS | (313) | (220) | (93) | 708 | 3,843 | (3,135) |
| Total | \$3,566 | \$4,336 | \$(770) | \$18,591 | \$25,402 | \$(6,811) |

As shown in the table above, the increase in our interest income from MBS investments for the three and nine months ended September 30, 2013 compared to the respective periods in 2012 is due to the growth of our MBS portfolio. Over the last twelve months, we purchased approximately \$1.5 billion in MBS, increasing our average MBS portfolio by \$664.8 million and \$1.1 billion for the three and nine month periods ended September 30, 2013, respectively, compared to the same periods in 2012. Partially offsetting the benefit of a larger portfolio, the effective yields earned by our MBS portfolio were lower by 0.30% during the three and nine months ended September 30, 2013 compared to the respective periods in 2012. These lower yields are a reflection of lower market rates on purchased investments given the lower level of absolute interest rates and the tighter market credit spreads in 2013 versus 2012.

Interest Expense, Annualized Cost of Funds, and Effective Borrowing Costs

The following table summarizes the components of interest expense as well as average balances and annualized cost of funds for the periods indicated:

| (amounts in thousands) | Three Months Ended | | Nine Months Ended | | |
|--|-----------------------|-----------------------|-----------------------|-----------------------|---|
| | September 30, 2013 | September 30, 2012 | September 30, 2013 | September 30, 2012 | |
| Repurchase agreements | \$5,893 | \$5,339 | \$18,480 | \$13,071 | |
| Interest rate swap expense from cash flow hedging | — | 3,827 | 8,796 | 10,602 | |
| Amortization of de-designated cash flow hedges (1) | 2,583 | — | 2,583 | — | |
| Securitization financing and other expenses | 242 | 308 | 761 | 1,043 | |
| Total interest expense | \$8,718 | \$9,474 | \$30,620 | \$24,716 | |
| Average balance of repurchase agreements | \$3,836,249 | \$3,265,816 | \$3,831,123 | \$2,818,697 | |
| Average balance of securitization financing | 23,404 | 31,014 | 26,388 | 53,453 | |
| Average balance of borrowings | \$3,859,653 | \$3,296,830 | \$3,857,511 | \$2,872,150 | |
| Annualized cost of funds (2) | 0.88 | % 1.12 | % 1.05 | % 1.13 | % |

(1) Amount recorded in accordance with GAAP related to the amortization of the balance remaining in accumulated other comprehensive loss as of June 30, 2013 as a result of the Company's discontinuation of hedge accounting.

(2) Recalculation of annualized cost of funds using data shown in table may not be possible because certain expense items of a one-time nature are not annualized for the calculation.

Total interest expense for the third quarter of 2013 was lower than total interest expense for the same period in 2012 as a result of our discontinuing cash flow hedge accounting on June 30, 2013. As shown in the table below, interest expense from repurchase agreement borrowings increased for the three months ended September 30, 2013 compared to the three months ended September 30, 2012 due to our increased borrowings. This increase was partially offset by

the overall lower interest rate paid to our lenders during the three months ended September 30, 2013 compared to the same period in 2012. The following table presents

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the amount that our interest expense increased for the three and nine months ended September 30, 2013 compared to the same periods in 2012 due to changes in average balances and changes in average rates.

| (amounts in thousands) | Three Months Ended September 30, 2013 vs. September 30, 2012 | | | Nine Months Ended September 30, 2013 vs. September 30, 2012 | | |
|------------------------|---|--------------------|------------------------------|--|--------------------|------------------------------|
| | Increase in Interest Expense | Due to Change in | | Increase in Interest Expense | Due to Change in | |
| | | Average Balance | Average Borrowing Rate | | Average Balance | Average Borrowing Rate |
| Repurchase agreements | \$554 | \$933 | \$(379) | \$5,409 | \$4,695 | \$714 |

In addition to the interest expense and annualized costs of funds, management utilizes a non-GAAP financial measure "effective borrowing costs" and calculates an effective borrowing rate. Management uses this financial measure because, although we have elected to discontinue cash flow hedge accounting for our interest rate swaps, we view our interest rate derivative instruments as economic hedges of our exposure to higher interest rates. Effective borrowing costs equal GAAP interest expense less the amortization from de-designated cash flow hedges (which is included in GAAP interest expense) plus net periodic costs on interest rate derivatives (which are not included in GAAP interest expense). Net periodic costs on interest rate derivatives include interest rate swap payments (including accrued amounts) and gains/losses on expiration of Eurodollar futures. Please refer to the section "Use of Non-GAAP Financial Measures" contained within Executive Overview for additional important information on this and other non-GAAP financial measures discussed throughout this Quarterly Report on Form 10-Q.

The tables below present a reconciliation of GAAP interest expense and annualized costs of funds to our effective borrowing costs and related rates during the three and nine months ended September 30, 2013 and 2012:

| | Three Months Ended September 30, 2013 | | September 30, 2012 | | |
|--|--|---------------------|--------------------|---------------------|---|
| | Amount | Rate ⁽⁴⁾ | Amount | Rate ⁽⁴⁾ | |
| GAAP interest expense/annualized cost of funds | \$8,718 | 0.88 | % \$9,474 | 1.12 | % |
| Amortization of de-designated cash flow hedges ⁽¹⁾ | (2,583) | (0.26) |)% — | — | % |
| Net periodic costs on interest rate derivatives ⁽²⁾ | 5,471 | 0.55 | % 163 | 0.02 | % |
| Effective borrowing costs/rate | \$11,606 | 1.17 | % \$9,637 | 1.14 | % |
| Average balance of borrowings ⁽³⁾ | \$3,859,653 | | \$3,296,830 | | |
| | Nine Months Ended September 30, 2013 | | September 30, 2012 | | |
| | Amount | Rate ⁽⁴⁾ | Amount | Rate ⁽⁴⁾ | |
| GAAP interest expense/annualized cost of funds | \$30,620 | 1.05 | % \$24,716 | 1.13 | % |
| Amortization of de-designated cash flow hedges ⁽¹⁾ | (2,583) | (0.09) |)% — | — | % |
| Net periodic costs on interest rate derivatives ⁽²⁾ | 5,973 | 0.19 | % 486 | 0.06 | % |
| Effective borrowing costs/rate | \$34,010 | 1.15 | % \$25,202 | 1.19 | % |
| Average balance of borrowings ⁽³⁾ | \$3,857,511 | | \$2,872,150 | | |

(1) Amount recorded as a portion of "interest expense" in accordance with GAAP related to the amortization of the balance remaining in accumulated other comprehensive loss as of June 30, 2013 as a result of the Company's discontinuation of hedge accounting.

(2) Amount equals the net interest rate swap payments (including accrued amounts) and gains/losses on expiration of Eurodollar futures which are not already included in "interest expense" in accordance with GAAP.

(3) Average balances are calculated as a simple average of the daily borrowings outstanding for both repurchase agreement and securitization financing.

(4) Rates shown are based on annualized expense amounts. Recalculation of rates as shown may not be possible using data provided because certain expense items of a one-time nature are not annualized for the calculation.

Effective borrowing costs increased for the three and nine months ended September 30, 2013 versus the same period in 2012 due to increased repurchase agreement borrowings used to fund our investment purchases and additional derivative instruments we used to hedge exposure to increases in interest rates during the 2013 period. The effective borrowing rate increased for the three and nine months ended September 30, 2013 versus the same periods in 2012 due to higher net periodic costs on our interest rate derivatives.

Net Interest Income and Net Interest Spread

Our net interest income increased for the three and nine months ended September 30, 2013 compared to the same periods in 2012 due to the portfolio growth since September 30, 2012. In addition, net interest income increased for the three months ended September 30, 2013 compared to three months ended September 30, 2012 because interest expense for the third quarter of 2013 was lower than interest expense for the same period in 2012. This lower interest expense is the result of our discontinuing cash flow hedge accounting on June 30, 2013. Net periodic costs on our interest rate swaps which were previously included in interest expense are now included in "(loss) gain on derivative investments, net" and not in net interest income. As discussed above, our net periodic costs from interest rate swaps were higher for the three and nine months ended September 30, 2013 compared to the same periods in 2012. To adjust for the impact of the de-designation and to make our results more comparable to prior periods and to competitors using cash flow hedge accounting, management uses the non-GAAP financial measures "adjusted net interest income" and "adjusted net interest spread" detailed in the table below. These measures include the net periodic cost of interest rate derivatives in our net interest income and net interest spread. The following table reconciles GAAP net interest income and related net interest spread to our adjusted net interest income and adjusted net interest spread for the periods indicated:

| | Three Months Ended | | September 30, 2012 | | |
|--|--------------------|--------|--------------------|--------|----|
| | September 30, 2013 | | September 30, 2012 | | |
| | Amount | Yield | Amount | Yield | |
| GAAP interest income | \$31,666 | 2.82 | % \$28,574 | 3.12 | % |
| GAAP interest expense | (8,718) | (0.88) |)% (9,474) | (1.12) |)% |
| Net interest income/spread | \$22,948 | 1.94 | % \$19,100 | 2.00 | % |
| Amortization of de-designated cash flow hedges ⁽¹⁾ | 2,583 | 0.26 | % — | — | % |
| Net periodic costs on interest rate derivatives ⁽²⁾ | (5,471) | (0.55) |)% (163) | (0.02) |)% |
| Adjusted net interest income/spread | \$20,060 | 1.65 | % \$18,937 | 1.98 | % |
| | | | | | |
| Average interest bearing assets ⁽³⁾ | \$4,371,485 | | \$3,729,124 | | |
| Average interest bearing liabilities ⁽⁴⁾ | \$(3,859,653) | | \$(3,296,830) | | |
| | Nine Months Ended | | September 30, 2012 | | |
| | September 30, 2013 | | September 30, 2012 | | |
| | Amount | Yield | Amount | Yield | |
| GAAP interest income | \$98,538 | 2.98 | % \$81,971 | 3.32 | % |
| GAAP interest expense | (30,620) | (1.05) |)% (24,716) | (1.13) |)% |
| Net interest income/spread | \$67,918 | 1.93 | % \$57,255 | 2.19 | % |
| Amortization of de-designated cash flow hedges ⁽¹⁾ | 2,583 | 0.09 | % — | — | % |
| Net periodic costs on interest rate derivatives ⁽²⁾ | (5,973) | (0.19) |)% (486) | (0.06) |)% |
| Adjusted net interest income/spread | \$64,528 | 1.83 | % \$56,769 | 2.13 | % |
| | | | | | |
| Average interest bearing assets ⁽³⁾ | \$4,346,283 | | \$3,281,027 | | |
| Average interest bearing liabilities ⁽⁴⁾ | \$(3,857,511) | | \$(2,872,150) | | |

(1) Amount recorded as a portion of "interest expense" in accordance with GAAP related to the amortization of the balance remaining in accumulated other comprehensive loss as of June 30, 2013 as a result of the Company's discontinuation of hedge accounting.

(2) Amount equals the net interest rate swap payments (including accrued amounts) and gains/losses on expiration of Eurodollar futures which are not already included in "interest expense" in accordance with GAAP.

(3) Average balances are calculated as a simple average of the daily amortized cost and exclude unrealized gains and losses as well as securities pending settlement if applicable.

(4) Average balances are calculated as a simple average of the daily borrowings outstanding for both repurchase agreement and securitization financing.

Loss on Derivative Instruments, Net

As discussed in "Executive Overview" effective June 30, 2013, we voluntarily discontinued hedge accounting for all interest rate swaps previously designated as cash flow hedges under GAAP and began purchasing or short selling Eurodollar futures during the third quarter of 2013.

The following tables provide information on the components of loss on derivatives, net for the three and nine months ended September 30, 2013 and 2012:

| | Three Months Ended September 30, 2013 | | | 2012 | | |
|--|---|-----------------------|-------------|------------------------|-----------------------|----------|
| | Interest Rate Swaps | Eurodollar Futures | Total | Interest Rate Swaps | Eurodollar Futures | Total |
| Periodic interest costs (receipts) | \$(5,476) | \$5 | \$(5,471) | \$(163) | \$— | \$(163) |
| Gain on terminations of derivative instruments, net | 698 | 102 | 800 | — | — | — |
| Change in fair value of derivative instruments, net | (1,447) | (17,901) | (19,348) | (170) | — | (170) |
| | \$(6,225) | \$(17,794) | \$(24,019) | \$(333) | \$— | \$(333) |
| | Nine Months Ended September 30, 2013 | | | 2012 | | |
| | Interest Rate Swaps | Eurodollar Futures | Total | Interest Rate Swaps | Eurodollar Futures | Total |
| Periodic interest costs (receipts) | \$(5,978) | \$5 | \$(5,973) | \$(486) | \$— | \$(486) |
| Gain on terminations of derivative instruments, net | 698 | 102 | 800 | — | — | — |