DYNEX CAPITAL INC
Form 10-Q
August 05, 2016

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
FORM 10-Q
x Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended June 30, 2016
or
o 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 (State or other jurisdiction of incorporation or organization)	52-1549373 (I.R.S. Employer Identification No.)
4991 Lake Brook Drive, Suite 100, Glen Allen, Virginia (Address of principal executive offices)	23060-9245 (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 x No o

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 x No o

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 o	Accelerated filer x
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

On July 31, 2016, the registrant had 49,146,918 shares outstanding of common stock, $0.01 par value, which is the registrant's only class of common stock.

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
DYNEX CAPITAL, INC.
CONSOLIDATED BALANCE SHEETS
($ in thousands except share data)

	June 30, 2016 (unaudited)	December 31, 2015
ASSETS		
Mortgage-backed securities (including pledged of $3,116,798 and $3,361,635, respectively)	$3,208,735	$3,493,701
Mortgage loans held for investment, net	21,815	24,145
Investment in limited partnership	—	10,835
Investment in FHLB stock	5,260	11,475
Cash and cash equivalents	96,897	33,935
Restricted cash	83,679	51,190
Derivative assets	18,421	7,835
Principal receivable on investments	7,794	6,193
Accrued interest receivable	19,619	22,764
Other assets, net	6,853	7,975
Total assets	$3,469,073	$3,670,048
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Repurchase agreements	$2,600,480	$2,589,420
FHLB advances	263,000	520,000
Non-recourse collateralized financing	7,520	8,442
Derivative liabilities	90,260	41,205
Accrued interest payable	1,714	1,743
Accrued dividends payable	12,257	13,709
Other liabilities	2,316	3,504
Total liabilities	2,977,547	3,178,023
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	54,251
Common stock, par value $.01 per share, 200,000,000 shares authorized; 49,145,087 and 49,047,335 shares issued and outstanding, respectively	491	490
Additional paid-in capital	726,063	725,358
Accumulated other comprehensive income (loss)	51,908	(12,768)
Accumulated deficit	(396,594)	(330,713)
Total shareholders' equity	491,526	492,025
Total liabilities and shareholders' equity	$3,469,073	$3,670,048

See notes to the unaudited consolidated financial statements.

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

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2016	2015	2016	2015
Interest income	$22,816	$24,527	$47,905	$48,626
Interest expense	6,100	5,542	12,410	10,913
Net interest income	16,716	18,985	35,495	37,713
(Loss) gain on derivative instruments, net	(16,297)	17,090	(64,561)	(8,233)
Loss on sale of investments, net	(297)	(1,491)	(4,238)	(183)
Fair value adjustments, net	28	20	51	59
Other income, net	290	612	353	645
General and administrative expenses:				
Compensation and benefits	(1,875)	(2,351)	(4,093)	(4,467)
Other general and administrative	(1,796)	(2,403)	(3,669)	(4,544)
Net (loss) income	(3,231)	30,462	(40,662)	20,990
Preferred stock dividends	(2,294)	(2,294)	(4,588)	(4,588)
Net (loss) income to common shareholders	$(5,525)	$28,168	$(45,250)	$16,402
Other comprehensive income:				
Change in net unrealized gain on available-for-sale investments	$22,730	$(42,027)	$60,491	$(18,722)
Reclassification adjustment for loss on sale of investments, net	297	1,491	4,238	183
Reclassification adjustment for de-designated cash flow hedges	(80)	857	(53)	1,914
Total other comprehensive income (loss)	22,947	(39,679)	64,676	(16,625)
Comprehensive income (loss) to common shareholders	$17,422	$(11,511)	$19,426	$(223)
Net (loss) income per common share-basic and diluted	$(0.11)	$0.52	$(0.92)	$0.30
Weighted average common shares-basic and diluted	49,119	54,574	49,080	54,687

See notes to the unaudited consolidated financial statements.

DYNEX CAPITAL, INC.
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
(UNAUDITED)
($ in thousands)

	Preferred Stock	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive (Loss) Income	Accumulated Deficit	Total Shareholders' Equity
Balance as of December 31, 2015	$109,658	$ 490	$725,358	$ (12,768)	$ (330,713)	$ 492,025
Stock issuance	—	—	77	—	—	77
Restricted stock granted, net of amortization	—	2	1,441	—	—	1,443
Adjustments for tax withholding on share-based compensation	—	(1)	(484)	—	—	(485)
Stock issuance costs amortization	—	—	(19)	—	—	(19)
Common stock repurchased	—	—	(310)	—	—	(310)
Net loss	—	—	—	—	(40,662)	(40,662)
Dividends on preferred stock	—	—	—	—	(4,588)	(4,588)
Dividends on common stock	—	—	—	—	(20,631)	(20,631)
Other comprehensive income	—	—	—	64,676	—	64,676
Balance as of June 30, 2016	$109,658	$ 491	$726,063	$ 51,908	$ (396,594)	$ 491,526

See notes to the unaudited consolidated financial statements.

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

	Six Months Ended June 30,	
	2016	2015
Operating activities:		
Net (loss) income	$(40,662)	$20,990
Adjustments to reconcile net (loss) income to cash provided by operating activities:		
Decrease (increase) in accrued interest receivable	3,145	(158)
(Decrease) increase in accrued interest payable	(29)	120
Loss on derivative instruments, net	64,561	8,233
Loss on sale of investments, net	4,238	183
Fair value adjustments, net	(51)	(59)
Amortization of investment premiums, net	73,597	74,737
Other amortization and depreciation, net	850	2,847
Stock-based compensation expense	1,443	1,475
Other operating activities	(862)	18
Net cash and cash equivalents provided by operating activities	106,230	108,386
Investing activities:		
Purchase of investments	(4,970)	(1,000,070)
Principal payments received on investments	187,437	236,598
Proceeds from sales of investments	94,033	233,238
Principal payments received on mortgage loans held for investment, net	2,319	9,825
Payment to acquire interest in limited partnership	—	(6,000)
Distributions received from limited partnership	10,835	—
Net payments on derivatives, including terminations	(26,092)	(10,968)
Other investing activities	(55)	(135)
Net cash and cash equivalents provided by (used in) investing activities	263,507	(537,512)
Financing activities:		
Borrowings under repurchase agreements and FHLB advances	11,394,652	9,719,787
Repayments of repurchase agreement borrowings and FHLB advances	(11,640,592)	(9,221,857)
Principal payments on non-recourse collateralized financing	(939)	(2,035)
Increase in restricted cash	(32,489)	(15,617)
Proceeds from issuance of common stock, net of issuance costs	58	59
Cash paid for repurchases of common stock	(310)	(6,688)
Payments related to tax withholding for stock-based compensation	(485)	(557)
Dividends paid	(26,670)	(31,447)
Net cash and cash equivalents (used in) provided by financing activities	(306,775)	441,645
Net increase in cash and cash equivalents	62,962	12,519
Cash and cash equivalents at beginning of period	33,935	43,944
Cash and cash equivalents at end of period	$96,897	$56,463
Supplemental Disclosure of Cash Activity:		
Cash paid for interest	$12,476	$8,842

See notes to the unaudited consolidated financial statements.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
DYNEX CAPITAL, INC.
($ in thousands except per share data)

NOTE 1 –ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization

Dynex Capital, Inc., ("Company") was incorporated in the Commonwealth of Virginia on December 18, 1987 and commenced operations in February 1988. The Company primarily earns income from investing on a leveraged basis in mortgage-backed securities ("MBS") that are issued or guaranteed by the U.S. Government or U.S. Government sponsored agencies ("Agency MBS") and MBS issued by others ("non-Agency MBS").

Basis of Presentation

The accompanying unaudited consolidated financial statements of Dynex Capital, Inc. and its subsidiaries (together, "Dynex" or, as appropriate, the "Company") have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and 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 GAAP for complete financial statements. 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 six months ended June 30, 2016 are not necessarily indicative of the results that may be expected for any other interim periods or for the entire year ending December 31, 2016. 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, 2015 filed with the SEC.

Reclassifications

Certain items in the prior periods' consolidated financial statements have been reclassified to conform to the current period's presentation. The Company's equity in income of limited partnership for the three and six months ended June 30, 2015 is now included within "other income (expense), net" on the Company's consolidated statements of comprehensive income. This presentation change has 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 and the accounts of its majority owned subsidiaries and variable interest entities ("VIE") for which it is the primary beneficiary. As a primary beneficiary, the Company has both the power to direct the activities that most significantly impact the economic performance of the VIE and a right to receive benefits or absorb losses of the entity that could be potentially significant to the VIE. The Company is required to reconsider its evaluation of whether to consolidate a VIE each reporting period, based upon changes in the facts and circumstances pertaining to the VIE. The Company consolidates certain trusts through which it has securitized mortgage loans as a result of not meeting the sale criteria under GAAP at the time the financial assets were transferred to the trust. All intercompany accounts and transactions have been eliminated in consolidation.

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, 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.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
DYNEX CAPITAL, INC.
($ in thousands except per share data)

Income Taxes

The Company has elected to be taxed as a real estate investment trust ("REIT") under the Internal Revenue Code of 1986 and the corresponding provisions of state law. To qualify as a REIT, the Company must meet certain tests including investing in primarily real estate-related assets and the required distribution of at least 90% of its annual REIT taxable income to stockholders after consideration of its net operating loss ("NOL") carryforward and not including taxable income retained in its taxable subsidiaries. As a REIT, the Company generally will not be subject to federal income tax on the amount of its income or capital gains that is distributed as dividends to shareholders.

The Company assesses its tax positions for all open tax years and determines whether the Company has any material unrecognized liabilities in accordance with Accounting Standards Codification ("ASC") Topic 740. The Company records these liabilities, if any, to the extent they are deemed more likely than not to have been incurred.

Net Income (Loss) Per Common Share

The Company calculates basic net income (loss) per common share by dividing net income (loss) to common shareholders for the period by weighted-average shares of common stock outstanding for that period. The Company did not have any potentially dilutive securities outstanding during the three or six months ended June 30, 2016 or June 30, 2015.

Holders of unvested shares of the Company's 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 Topic 260-10 and therefore are included in the computation of basic net income (loss) per common share using the two-class method. Upon vesting, restrictions on transfer expire on each share of restricted stock, and each such share of restricted stock is converted to one equal share of common stock.

Because the Company's 8.50% Series A Cumulative Redeemable Preferred Stock (the “Series A Preferred Stock”) and 7.625% Series B Cumulative Redeemable Preferred Stock (the “Series B 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 and their related dividends is excluded from the calculation of diluted net income (loss) per common share.

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 financing and derivative counterparties.

Mortgage-Backed Securities

The Company invests in Agency and non-Agency RMBS, CMBS and CMBS IO securities, all of which are designated as available-for-sale ("AFS"). All of the Company’s MBS are recorded at fair value on the consolidated balance sheet. Changes in unrealized gain (loss) on the Company's MBS are reported in other comprehensive income ("OCI") until each security is collected, disposed of, or determined to be other than temporarily impaired. Although the Company generally intends to hold its AFS securities until maturity, it may sell any of these securities as part of the overall management of its business. Upon the sale of an AFS 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.

The Company’s MBS pledged as collateral against repurchase agreements and derivative instruments are included in MBS on the consolidated balance sheets with the fair value of the MBS pledged disclosed parenthetically.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
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($ in thousands except per share data)

Interest Income, Premium Amortization, and Discount Accretion. Interest income on MBS is accrued based on the outstanding principal balance (or notional balance in the case of interest-only, or "IO", securities) and their contractual terms. Premiums and discounts on Agency MBS as well as any non-Agency MBS rated 'AA' and higher at the time of purchase are amortized into interest income over the expected life of such securities using the effective yield method and adjustments to premium amortization are made for actual cash payments as well as changes in projected future cash payments. The Company's projections of future cash payments are based on input and analysis received from external sources and internal models, and include 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.

The Company holds certain non-Agency MBS that had credit ratings of less than 'AA' at the time of purchase or were not rated by any of the nationally recognized credit rating agencies. A portion of these non-Agency MBS were purchased at discounts to their par value, which management does not believe to be substantial. The discount is accreted into income over the security's expected life, which reflects management's estimate of the security's projected cash flows. Future changes in the timing of projected cash flows or differences arising between projected cash flows and actual cash flows received may result in a prospective change in the effective yield on those securities.

Determination of MBS Fair Value. The Company estimates the fair value of the majority of its MBS based upon prices obtained from third-party pricing services and broker quotes. The remainder of the Company's 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, and credit enhancements as well as certain other relevant information. Refer to Note 6 for further discussion of MBS fair value measurements.

Other-than-Temporary Impairment. MBS is considered impaired when its fair value is less than its amortized cost. The Company evaluates all of its impaired MBS for other-than-temporary impairments ("OTTI") on at least a quarterly basis. An impairment is considered other-than-temporary if: (1) the Company intends to sell the MBS; (2) it is more likely than not that the Company will be required to sell the MBS before its fair value recovers; or (3) the Company does not expect to recover the full amortized cost basis of the MBS. If either of the first two conditions is met, the entire amount of the impairment is recognized in earnings. If the impairment is solely due to the inability to fully recover the amortized cost basis, the security is further analyzed to quantify any credit loss, which is the difference between the present value of cash flows expected to be collected on the MBS and its amortized cost. The credit loss, if any, is then recognized in earnings, while the balance of impairment related to other factors is recognized in other comprehensive income.

Following the recognition of an OTTI through earnings, a new cost basis is established for the security. Any subsequent recoveries in fair value may be accreted back into the amortized cost basis of the MBS on a prospective basis through interest income. Please see Note 2 for additional information related to the Company's evaluation for OTTI.

Investment in Limited Partnership

The Company is in the process of liquidating its remaining interests in a limited partnership which is accounted for using the equity method.

Secured Borrowings

The Company's repurchase agreements and Federal Home Loan Bank (or "FHLB") advances, which are used to finance its purchases of MBS, are accounted for as secured borrowings 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.

As a result of a final rule issued by the Federal Housing Finance Administration ("FHFA") in January 2016 regarding the exclusion of captive insurance entities from membership in the FHLB, the Company's wholly owned subsidiary, Mackinaw Insurance Company, LLC ("Mackinaw"), must terminate its membership in the FHLB of Indianapolis by February 19, 2017 and will no longer be permitted new advances or renewals of existing advances. FHLB advances outstanding on the Company's consolidated balance sheet as of June 30, 2016 will be repaid before December 31, 2016.

Derivative Instruments

The Company's derivative instruments, which currently include interest rate swaps and Eurodollar futures, are accounted for at fair value and recognized accordingly as either derivative assets or derivative liabilities on the Company's consolidated balance sheet. All periodic interest costs and changes in fair value of derivative instruments, including gains and losses realized upon termination, are recorded in "gain (loss) on derivative instruments, net" on the Company's consolidated statement of comprehensive income. Please refer to Note 4 for additional information regarding the Company's accounting for its derivative instruments.

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

Share-Based Compensation

Pursuant to the Company’s 2009 Stock and Incentive Plan, the Company may grant share-based compensation to eligible employees, directors or consultants or advisers to the Company, including stock awards, stock options, stock appreciation rights, dividend equivalent rights, performance shares, and restricted stock units. The Company's restricted stock currently issued and outstanding 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 and recognized as compensation cost over the requisite service period with a corresponding credit to shareholders' equity. The requisite service period is the period during which an employee is required to provide service in exchange for an award, which is equivalent to the vesting period specified in the terms of the time-based restricted stock award. None of the Company's restricted stock awards have performance based conditions. The Company does not currently have any share-based compensation issued or outstanding other than restricted stock.

Contingencies

In the normal course of business, there may be various lawsuits, claims, and other contingencies pending against the Company. On a quarterly basis, the Company evaluates whether to establish provisions for estimated losses from those matters. The Company recognizes a liability 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. If the contingent loss (or an additional loss in excess of any 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.

Recent Accounting Pronouncements

The Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-02, Leases, which includes the following amendments:

- for operating and finance leases, a lessee is required to recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments in its consolidated balance sheet;
- for finance leases, a lessee is required to recognize interest on the lease liability separately from amortization of the right-of-use asset in the statement of comprehensive income;

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NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
DYNEX CAPITAL, INC.
($ in thousands except per share data)

- for finance leases, a lessee is required to classify repayments of the principal portion of the lease liability within financing activities and payments of interest on the lease liability and variable lease payments within operating activities in the statement of cash flows;
- for operating leases, a lessee is required to recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term on a generally straight-line basis in the statement of comprehensive income; and
- for operating leases, a lessee is required to classify all cash payments within operating activities in the statement of cash flows.

Under the new guidance, lessor accounting is largely unchanged. ASU No. 2016-02 is effective for public companies for fiscal years beginning after December 15, 2018, and early adoption is permitted. The Company does not expect this ASU to have a material impact on the Company's consolidated financial statements.

The FASB issued ASU No. 2016-09, Compensation - Stock Compensation, which simplifies several aspects of the accounting for share-based payment award transactions, including income tax consequences, classification of awards as either equity or liabilities, and classification on the statement cash flows. The amendments are effective for public companies for fiscal years beginning after December 15, 2016, and early adoption is permitted. The Company does not expect this ASU to have a material impact on the Company's consolidated financial statements.

The FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses, which replaces the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. For assets measured at amortized cost, the amendments in this ASU eliminate the probable initial recognition threshold in current GAAP and broaden the information that an entity must consider in developing its expected credit loss estimate to include the use of forecasted information. For assets classified as available-for-sale with changes in fair value recorded in other comprehensive income, measurement of credit losses will be similar to current GAAP. However, the amendments in this ASU require that credit losses be presented as an allowance rather than as a write-down, which is referred to in current GAAP as an other-than-temporary impairment. An entity will be able to record reversals of credit losses, if credit loss estimates decline, in net income for the current period. The amendments in this ASU will not permit an entity to use the length of time a debt security has been in an unrealized loss position to avoid recording a credit loss and removes the requirements to consider historical and implied volatility of the fair value of a security as well as recoveries or declines in fair value after the balance sheet date. The amendments in this ASU will affect an entity by varying degrees depending on the credit quality of the assets held by the entity, their duration, and how the entity applies current GAAP. These amendments will become effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years, and early adoption will be permitted as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. An entity will apply the amendments in this ASU through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective. The Company is currently evaluating the impact of this ASU on its consolidated financial statements.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
DYNEX CAPITAL, INC.
($ in thousands except per share data)

NOTE 2 – MORTGAGE-BACKED SECURITIES

The majority of the Company's MBS are pledged as collateral to cover initial and variation margins for the Company's secured borrowings and derivative instruments. The following tables present the Company’s MBS by investment type as of the dates indicated:

	June 30, 2016						
	Par	Net Premium (Discount)	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value	WAC (1)
RMBS:							
Agency	$1,329,159	$65,558	$1,394,717	$ 7,031	$(8,545)	$1,393,203	3.03%
Non-Agency	55,603	(29)	55,574	82	(418)	55,238	3.56%
	1,384,762	65,529	1,450,291	7,113	(8,963)	1,448,441	
CMBS:							
Agency	856,352	10,713	867,065	37,329	(82)	904,312	3.40%
Non-Agency	117,696	(7,671)	110,025	8,511	—	118,536	5.00%
	974,048	3,042	977,090	45,840	(82)	1,022,848	
CMBS IO (2):							
Agency	—	386,628	386,628	7,732	(889)	393,471	0.67%
Non-Agency	—	342,101	342,101	3,606	(1,732)	343,975	0.60%
	—	728,729	728,729	11,338	(2,621)	737,446	
Total AFS securities:	$2,358,810	$797,300	$3,156,110	$ 64,291	$(11,666)	$3,208,735	

(1) The current weighted average coupon ("WAC") is the gross interest rate of the pool of mortgages underlying the security weighted by the outstanding principal balance (or by notional balance in the case of an IO security).
(2) The notional balance for Agency CMBS IO and non-Agency CMBS IO was $12,078,342 and $10,597,035, respectively, as of June 30, 2016.

	December 31, 2015						
	Par	Net Premium (Discount)	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value	WAC (1)
RMBS:							
Agency	$1,536,733	$77,617	$1,614,350	$ 4,362	$(20,190)	$1,598,522	3.03%
Non-Agency	66,003	(45)	65,958	70	(818)	65,210	3.25%
	1,602,736	77,572	1,680,308	4,432	(21,008)	1,663,732	
CMBS:							
Agency	876,751	13,252	890,003	10,542	(14,614)	885,931	3.45%
Non-Agency	156,218	(8,133)	148,085	7,039	(941)	154,183	4.29%
	1,032,969	5,119	1,038,088	17,581	(15,555)	1,040,114	
CMBS IO (2):							
Agency	—	421,857	421,857	5,922	(1,651)	426,128	0.80%
Non-Agency	—	365,554	365,554	1,992	(3,819)	363,727	0.71%
	—	787,411	787,411	7,914	(5,470)	789,855	
Total AFS securities:	$2,635,705	$870,102	$3,505,807	$ 29,927	$(42,033)	$3,493,701	

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(1) The current weighted average coupon ("WAC") is the gross interest rate of the pool of mortgages underlying the security weighted by the outstanding principal balance (or by notional balance in the case of an IO security).
(2) The notional balance for the Agency CMBS IO and non-Agency CMBS IO was $12,180,291 and $10,328,628, respectively, as of December 31, 2015.

Actual maturities of MBS are affected by the contractual lives of the underlying mortgage collateral, periodic payments of principal, prepayments of principal, and the payment priority structure of the security; therefore, actual maturities are generally shorter than the securities' stated contractual maturities.

The following table presents information regarding the sales included in "(loss) gain on sale of investments, net" on the Company's consolidated statements of comprehensive income for the periods indicated:

	Three Months Ended June 30,			
	2016		2015	
	Proceeds Received	Realized Gain (Loss)	Proceeds Received	Realized Gain (Loss)
Agency RMBS	$10,287	$ (297)	$96,025	$(1,875)
Agency CMBS	—	—	98,887	(822)
Non-Agency CMBS IO	—	—	31,972	1,206
	$10,287	$ (297)	$226,884	$(1,491)

	Six Months Ended June 30,			
	2016		2015	
	Proceeds Received	Realized Gain (Loss)	Proceeds Received	Realized Gain (Loss)
Agency RMBS	$54,178	$(3,010)	$156,370	$(2,196)
Agency CMBS	—	—	98,887	(822)
Non-Agency CMBS	33,640	(1,228)	—	—
Agency CMBS IO	—	—	29,385	1,474
Non-Agency CMBS IO	—	—	44,764	1,361
	$87,818	$(4,238)	$329,406	$(183)

The following table presents certain information for those MBS in an unrealized loss position as of the dates indicated:

	June 30, 2016			December 31, 2015		
	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	$322,585	$ (2,095)	45	$1,332,849	$(19,062)	109
Non-Agency MBS	89,794	(807)	20	351,650	(5,347)	72

Continuous unrealized loss position for 12 months or longer:						
Agency MBS	$368,509	$(7,421)	55	$775,484	$(17,393)	72
Non-Agency MBS	92,521	(1,343)	28	8,306	(231)	7

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Because the principal related to Agency MBS is guaranteed by the government-sponsored entities Fannie Mae and Freddie Mac which 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 June 30, 2016 and December 31, 2015 were temporary.

The Company reviews any non-Agency MBS in an unrealized loss position to evaluate whether any decline in fair value represents an OTTI. 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 OTTI amounts as of June 30, 2016 or December 31, 2015.

NOTE 3 – SECURED BORROWINGS

The Company's secured borrowings, which consist of repurchase agreements and FHLB advances, that were outstanding as of June 30, 2016 and December 31, 2015 are summarized in the table below:

	June 30, 2016			
Collateral Type	Balance	Weighted Average Rate		Fair Value of Collateral Pledged
Agency RMBS	$1,284,519	0.67	%	$1,334,785
Non-Agency RMBS	45,581	1.81	%	54,577
Agency CMBS	547,234	0.67	%	592,932
Non-Agency CMBS	101,795	1.37	%	117,564
Agency CMBS IO	331,263	1.30	%	388,185
Non-Agency CMBS IO	283,906	1.39	%	338,357
Securitization financing bond	6,182	1.80	%	6,685
Total repurchase agreements	$2,600,480	0.88	%	$2,833,085
FHLB advances (1)	263,000	0.51	%	283,295
Total secured borrowings	$2,863,480	0.85	%	$3,116,380

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	December 31, 2015			
Collateral Type	Balance	Weighted Average Rate		Fair Value of Collateral Pledged
Agency RMBS	$1,439,436	0.47	%	$1,483,152
Non-Agency RMBS	52,128	1.77	%	64,286
Agency CMBS	301,427	0.49	%	345,728
Non-Agency CMBS	126,378	1.26	%	143,785
Agency CMBS IOs	360,245	1.24	%	421,285
Non-Agency CMBS IOs	302,771	1.33	%	359,351
Securitization financing bond	7,035	1.65	%	8,054
Total repurchase agreements	$2,589,420	0.75	%	$2,825,641
FHLB advances (1)	520,000	0.40	%	541,771
Total secured borrowings	$3,109,420	0.69	%	$3,367,412

(1) As of June 30, 2016 and December 31, 2015, FHLB advances were collateralized primarily with Agency CMBS.

As of June 30, 2016, the weighted average remaining term to maturity of our repurchase agreements was 21 days compared to 22 days as of December 31, 2015. The remaining balance of FHLB advances is due in October 2016. The following table provides a summary of the original term to maturity of our secured borrowings as of June 30, 2016 and December 31, 2015:

Original Term to Maturity	June 30, 2016	December 31, 2015
Less than 30 days	$657,966	$ 551,643
30 to 90 days	1,846,757	782,393
91 to 180 days	95,757	1,512,384
181 to 364 days	263,000	—
1 year or longer	—	263,000
	$2,863,480	$ 3,109,420

The following table lists the counterparties with whom the Company had over 10% of its shareholders' equity at risk (defined as the excess of collateral pledged over the borrowings outstanding):

	June 30, 2016			
Counterparty Name	Balance	Weighted Average Rate		Equity at Risk
Wells Fargo Bank, N. A. and affiliates	$281,421	1.34	%	$52,582

Of the amount outstanding with Wells Fargo Bank, N.A. and affiliates, $267,866 is under a committed repurchase facility which has an aggregate maximum borrowing capacity of $350,000 and is scheduled to mature on August 6, 2018, subject to early termination provisions contained in the master repurchase agreement. The facility is collateralized primarily by CMBS IO, and its weighted average borrowing rate as of June 30, 2016 was 1.34%.

As of June 30, 2016, the Company had repurchase agreement amounts outstanding with 19 of its 32 available repurchase agreement 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

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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. With respect to outstanding repurchase agreement and FHLB advance financings as of June 30, 2016, the Company was in compliance with all covenants.

Please see Note 5 for the Company's disclosures related to offsetting assets and liabilities.

NOTE 4 – DERIVATIVES

The Company utilizes derivative instruments to economically hedge a portion of its exposure to interest rate risk. The Company primarily uses pay-fixed interest rate swaps and Eurodollar contracts to hedge its exposure to changes in interest rates and uses receive-fixed interest rate swaps to offset a portion of its pay-fixed interest rate swaps in order to manage its overall hedge position. The objective of the Company's risk management strategy is to mitigate declines in book value resulting from fluctuations in the fair value of the Company's assets from changing interest rates and to protect some portion of the Company's earnings from rising interest rates. Please refer to Note 1 for information related to the Company's accounting policy for its derivative instruments.

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

	June 30, 2016			
	Derivative Assets		Derivative Liabilities	
Trading Instruments	Fair Value	Notional	Fair Value	Notional
Interest rate swaps	$18,421	$425,000	$(44,791)	$1,355,000
Eurodollar futures (1)	—	—	(45,469)	6,300,000
Total	$18,421	$425,000	$(90,260)	$7,655,000

	December 31, 2015			
	Derivative Assets		Derivative Liabilities	
Trading Instruments	Fair Value	Notional	Fair Value	Notional
Interest rate swaps	$7,835	$460,000	$(12,108)	$2,920,000
Eurodollar futures (1)	—	—	(29,097)	6,300,000
Total	$7,835	$460,000	$(41,205)	$9,220,000

(1) The Eurodollar futures aggregate notional amount represents the total notional of the 3-month contracts with expiration dates from 2017 to 2020. The maximum notional outstanding for any future 3-month period did not exceed $725,000 as of June 30, 2016 or as of December 31, 2015.

The following table summarizes the contractual maturities remaining for the Company’s outstanding interest rate swap agreements as of June 30, 2016:

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Remaining Maturity	Pay-Fixed Interest Rate Swaps	Pay-Fixed Weighted-Average Rate		Receive-Fixed Interest Rate Swaps	Receive-Fixed Weighted-Average Rate	
12 months or less	$185,000	0.92	%	$ —	—	%
13-24 months	—	—	%	—	—	%
25-36 months	160,000	1.37	%	—	—	%
37-48 months	335,000	1.61	%	250,000	1.91	%
49-60 months	50,000	1.35	%	150,000	1.71	%
61-72 months	—	—	%	—	—	%
73-84 months	—	—	%	—	—	%
85-96 months	—	—	%	—	—	%
97-108 months	375,000	2.83	%	25,000	2.71	%
109-120 months	250,000	2.43	%	—	—	%

The following table summarizes the volume of activity related to derivative instruments for the period indicated:

For the six months ended June 30, 2016:	Beginning of Period Notional Amount	Additions	Settlement, Termination, Expiration or Exercise	End of Period Notional Amount
Receive-fixed interest rate swaps	$425,000	$—	$—	$425,000
Pay-fixed interest rate swaps (1)	2,955,000	1,250,000	(2,850,000)	1,355,000
Eurodollar futures	6,300,000	—	—	6,300,000
	$9,680,000	$1,250,000	$(2,850,000)	$8,080,000

(1) The notional amount of pay-fixed interest rate swaps that were forward starting as of June 30, 2016 was $625,000.

The table below provides detail of the Company's "(loss) gain on derivative instruments, net" by type of derivative for the periods indicated:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
Type of Derivative Instrument	2016	2015	2016	2015
Receive-fixed interest rate swaps	$3,743	$(1,746)	$14,277	$2,782
Pay-fixed interest rate swaps	(15,854)	16,263	(62,466)	2,900
Eurodollar futures	(4,186)	2,573	(16,372)	(13,915)
(Loss) gain on derivative instruments, net	$(16,297)	$17,090	$(64,561)	$(8,233)

There is a net unrealized gain of $868 remaining in AOCI on the Company's consolidated balance sheet as of June 30, 2016 which represents the activity related to interest rate swap agreements while they were previously designated as cash flow hedges, and this amount will be recognized in the Company's net income as a portion of "interest expense" over the remaining contractual life of the agreements. The Company estimates a credit of $386 will be reclassified to net income as a reduction of "interest expense" within the next 12 months.

A portion of the Company's interest rate swaps were entered into under bilateral agreements which contain cross-default provisions with other agreements between the parties. In addition, these bilateral agreements contain financial and operational covenants similar to those contained in our repurchase agreements, as described in Note 3. With respect to interest rate agreements under which interest rate swaps were entered into as of June 30, 2016, the Company was in compliance with all covenants.

Please see Note 5 for the Company's disclosures related to offsetting assets and liabilities.

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NOTE 5 – OFFSETTING ASSETS AND LIABILITIES

The Company's derivatives, repurchase agreements, and FHLB advances 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 June 30, 2016 and December 31, 2015:

	Offsetting of Assets					
				Gross Amount Not Offset in the Balance Sheet [1]		
	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
June 30, 2016						
Derivative assets	$18,421	$ —	$ 18,421	$(18,421)	$ —	$ —
December 31, 2015:						
Derivative assets	$7,835	$ —	$ 7,835	$(7,835)	$ —	$ —