

Western Asset Mortgage Capital Corp  
Form 10-Q  
November 14, 2012  
[Table of Contents](#)

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**For the quarterly period ended September 30, 2012**

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**For the transition period from      to**

**Commission File Number: 001-35543**

**Western Asset Mortgage Capital Corporation**

(Exact name of Registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**27-0298092**

(IRS Employer  
Identification Number)

Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

**Western Asset Mortgage Capital Corporation**

**385 East Colorado Boulevard**

**Pasadena, California 91101**

(Address of Registrant's principal executive offices)

**(626) 844-9400**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

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

		Non-accelerated filer <input checked="" type="checkbox"/>	
Large accelerated filer <input type="checkbox"/>	Accelerated filer <input type="checkbox"/>	(Do not check if a smaller reporting company)	Smaller reporting company <input type="checkbox"/>

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 under the Securities Exchange Act of 1934). Yes  No

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

As of November 14, 2012, there were 24,143,944 shares, par value \$0.01, of the registrant's common stock issued and outstanding.



Table of Contents

**TABLE OF CONTENTS**

	<b>Page</b>
Part I FINANCIAL INFORMATION	
ITEM 1.	Financial Statements 2
<u>ITEM 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> 21
<u>ITEM 3.</u>	<u>Quantitative and Qualitative Disclosures about Market Risk</u> 41
<u>ITEM 4.</u>	<u>Controls and Procedures</u> 44
<u>Part II OTHER INFORMATION</u>	
<u>ITEM 1.</u>	<u>Legal Proceedings</u> 45
<u>ITEM 1A.</u>	<u>Risk Factors</u> 45
<u>ITEM 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u> 45
<u>ITEM 3.</u>	<u>Defaults Upon Senior Securities</u> 45
<u>ITEM 4.</u>	<u>Mine Safety Disclosures</u> 45
<u>ITEM 5.</u>	<u>Other Information</u> 45
<u>ITEM 6.</u>	<u>Exhibits</u> 46
<u>Signatures</u>	47

---

Table of Contents**Western Asset Mortgage Capital Corporation****Balance Sheets (Unaudited)****(in thousands except share and per share data)**

	September 30, 2012	December 31, 2011
<b>Assets:</b>		
Cash and cash equivalents	\$ 19,459	\$ 1
Residential mortgage-backed securities, at fair value (\$2,032,285 pledged as collateral, at fair value)	4,613,796	-
Investment related receivables	182,741	-
Accrued interest receivable	9,330	-
Stock subscription receivable	306,360	-
Due from counterparties	24,780	-
Derivative assets, at fair value	3,729	-
Other assets	405	-
<b>Total Assets</b>	<b>\$ 5,160,600</b>	<b>\$ 1</b>
<b>Liabilities and Stockholders' Equity:</b>		
<b>Liabilities:</b>		
Borrowings under repurchase agreements	\$ 1,923,517	\$ -
Investment related payables	2,669,070	-
Accrued interest payable	4,033	-
Due to counterparties	7,035	-
Derivative liability, at fair value	15,916	-
Accounts payable and accrued expenses	845	-
Underwriting and offering costs payable	5,323	-
Payable to related party	810	-
Dividend payable	8,792	-
<b>Total Liabilities</b>	<b>4,635,341</b>	<b>-</b>
<b>Commitments and contingencies</b>		
<b>Stockholders' Equity:</b>		
Common stock, \$0.01 par value, 500,000,000 and 100,000 shares authorized, 10,343,944 and 100 shares issued and outstanding, respectively	103	-
Common stock subscribed, 13,800,000 shares to be issued at \$22.20 per share, net of underwriting and offering costs of \$5,401	300,959	-
Preferred stock, \$0.01 par value, 100,000,000 shares authorized and no shares outstanding	-	-
Additional paid-in capital	204,465	1
Retained earnings	19,732	-
<b>Total Stockholders' Equity</b>	<b>525,259</b>	<b>1</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 5,160,600</b>	<b>\$ 1</b>

See notes to unaudited financial statements.

Table of Contents**Western Asset Mortgage Capital Corporation****Statements of Operations (Unaudited)****(in thousands except share and per share data)**

	For the Three Months Ended September 30, 2012	For the period from May 15, 2012 (commencement of operations) through September 30, 2012
<b>Net Interest Income:</b>		
Interest income	\$ 14,688	\$ 21,538
Interest expense	1,935	2,660
Net Interest Income	12,753	18,878
<b>Other Income (Loss):</b>		
Interest income on cash balances	2	2
Realized gain on sale of Residential mortgage-backed securities and other securities, net	6,454	7,574
Other loss on Residential mortgage-backed securities	(5,545)	(6,150)
Unrealized gain on Residential mortgage-backed securities and other securities, net	28,329	32,254
Loss on derivative instruments (includes \$11,668 and \$17,076 mark-to-market adjustments on derivative instruments, respectively), net	(11,676)	(16,989)
Other Income (Loss), net	17,564	16,691
<b>Operating Expenses:</b>		
General and administrative (includes \$157 and \$211 non-cash stock based compensation, respectively)	1,321	1,905
Management fee related party	802	1,209
Total Operating Expenses	2,123	3,114
Net income available to Common Stock and participating securities	\$ 28,194	\$ 32,455
Earnings per Common Share - Basic	\$ 2.73	\$ 3.14
Earnings per Common Share - Diluted	\$ 2.72	\$ 3.14
Basic weighted average number of common shares outstanding	10,343,944	10,340,860
Diluted weighted average number of common shares outstanding	10,364,252	10,340,860
Dividends Declared per Share of Common Stock	\$ 0.85	\$ 1.23

See notes to unaudited financial statements.





Table of Contents**Western Asset Mortgage Capital Corporation****Statement of Changes in Stockholders' Equity (Unaudited)****(in thousands except shares and share data)**

	Common Stock		Additional Paid- In Capital	Common Stock Subscribed	Retained Earnings	Total
	Shares	Par				
Balance at May 15, 2012 (commencement of operations)	100	\$ -	\$ 1	\$ -	\$ -	1
Redemption of common stock	(100)	-	(1)	-	-	(1)
Proceeds from public offering of common stock	8,000,000	80	159,920	-	-	160,000
Offering costs, public offering of common stock	-	-	(1,200)	-	-	(1,200)
Proceeds from private placement of common stock	2,277,830	23	42,588	-	-	42,611
Warrants	-	-	2,946	-	-	2,946
Grants of restricted stock	66,114	-	-	-	-	-
Vesting of restricted stock	-	-	211	-	-	211
Common stock subscribed, 13,800,000 shares at \$22.20 per share	-	-	-	306,360	-	306,360
Underwriting and offering costs, common stock subscribed	-	-	-	(5,401)	-	(5,401)
Net income	-	-	-	-	32,455	32,455
Dividends on common stock	-	-	-	-	(12,723)	(12,723)
Balance at September 30, 2012	10,343,944	\$ 103	\$ 204,465	\$ 300,959	\$ 19,732	\$ 525,259

See notes to unaudited financial statements.

Table of Contents**Western Asset Mortgage Capital Corporation****Statement of Cash Flows (Unaudited)**

(in thousands)

	For the period from May 15, 2012 (commencement of operations) through September 30, 2012
Cash flows from operating activities:	
Net income	\$ 32,455
Adjustments to reconcile net income to net cash provided by operating activities:	
Premium amortization and (discount accretion), net	9,054
Restricted stock amortization expense	211
Unrealized (gain) loss on Residential mortgage-backed securities and other securities, net	(32,254)
Mark-to-market adjustments on derivative instruments	17,076
Other loss on Residential mortgage-backed securities	6,150
Realized (gain) loss on sale of Residential mortgage-backed securities and other securities, net	(7,574)
Changes in operating assets and liabilities:	
Increase in accrued interest receivable	(9,330)
Increase in other assets	(405)
Increase in accrued interest payable	4,033
Increase in accounts payable and accrued expenses	845
Increase in payable to related party	810
Net cash provided by operating activities	21,071
Cash flows from investing activities:	
Purchase of Residential mortgage-backed securities and other securities	(2,956,569)
Proceeds from sale of Residential mortgage-backed securities and other securities	814,448
Principal payments received on Residential mortgage-backed securities and other securities	35,619
Payment of premium for interest rate swaptions	(1,230)
Net cash used in investing activities	(2,107,732)
Cash flows from financing activities:	
Proceeds from issuance of common stock	160,000
Proceeds from private placements of units and common stock (concurrent with initial public offering)	45,557
Payment of offering costs	(1,278)
Redemption of common stock	(1)
Proceeds from repurchase agreement borrowings	7,393,018
Repayments of repurchase agreement borrowings	(5,469,501)
Due from counterparties	(24,780)
Due to counterparties	7,035
Dividends on common stock	(3,931)
Net cash provided by financing activities	2,106,119
Net increase in cash and cash equivalents	19,458
Cash and cash equivalents beginning of period	1
Cash and cash equivalents end of period	\$ 19,459
Supplemental disclosure of operating cash flow information:	
Interest paid	\$ 1,923
Supplemental disclosure of non-cash financing/investing activities:	

Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

Underwriting and offering costs payable	\$	5,323
Mortgage-backed securities sold, not settled	\$	182,741
Mortgage-backed securities purchased, not settled	\$	(2,669,070)
Stock subscription receivable	\$	306,360
Dividends and distributions declared, not paid	\$	8,792

See notes to unaudited financial statements.

Table of Contents

**Western Asset Mortgage Capital Corporation**

**Notes to Financial Statements (Unaudited)**

**(in thousands- except share and per share data)**

*The following defines certain of the commonly used terms in these Notes to Financial Statements: Agency or Agencies refer to a federally chartered corporation, such as the Federal National Mortgage Association ( Fannie Mae or FNMA ) or the Federal Home Loan Mortgage Corporation ( Freddie Mac or FHLMC ), or an agency of the U.S. Government, such as the Government National Mortgage Association ( Ginnie Mae or GNMA ); references to RMBS refer to residential mortgage-backed securities, Agency RMBS refer to RMBS issued or guaranteed by the Agencies while non-Agency RMBS refer to RMBS that are not issued or guaranteed by the Agencies; references to ARMs refers to adjustable rate mortgages; and references to Agency Derivatives or Agency Interest-Only Strips refer to interest-only( IO ) and inverse interest-only ( IIO ) securities issued as part of or collateralized with Agency RMBS.*

**Note 1 Organization**

Western Asset Mortgage Capital Corporation (is referred to throughout this report as the Company ) is a residential real estate finance company that invests in residential mortgage assets in the United States. The Company has selectively constructed a portfolio of assets that currently consists of Agency RMBS and that over time may be diversified to cover a broader range of other residential mortgage assets, including non-Agency RMBS, as well as asset-backed securities ( ABS ) and commercial mortgage-backed securities ( CMBS ).

The Company was organized in the state of Delaware on June 3, 2009. The Company filed a Certificate of Dissolution in Delaware on May 5, 2010 and revoked such dissolution by filing a Certificate of Revocation of Dissolution on March 24, 2011. On March 24, 2011, Western Asset Management Company ( WAM , or the Manager ), an investment advisor registered with the Securities and Exchange Commission, made a \$1,000 initial capital contribution to the Company. WAM is a wholly-owned subsidiary of Legg Mason, Inc and is the external manager of the Company. The Company intends to elect and qualify to be taxed as a real estate investment trust or REIT commencing with its taxable year ending December 31, 2012.

Through May 14, 2012, the Company complied with the reporting requirements for development stage enterprises. The Company incurred organizational, accounting and offering costs in connection with the Company's initial public offering (the IPO ) of its common stock and concurrent private placements. In accordance with the Management Agreement (as defined herein in Note 8) between the Company and the Manager, the Company reimbursed the Manager for \$1.2 million of offering and other related organization costs, which were paid by the Manager, from the proceeds of the IPO and concurrent private placements. The Manager paid all costs in excess of \$1.2 million. The Company ceased reporting as a development stage company on May 15, 2012.

**Note 2 Summary of Significant Accounting Policies**

***Basis of Presentation***

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America ( GAAP ) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary have been made to present fairly the Company s financial position, results of operations and cash flows. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted in accordance with Article 10 of Regulation S-X and the instructions to Form 10-Q. These financial statements should be read in conjunction with the Company s Registration Statement on Form S-11, as originally filed on and declared effective on September 28, 2012 with the Securities and Exchange Commission ( SEC ). The results of operations for the period ended September 30, 2012 are not necessarily indicative of the results to be expected for the full year or any other future period.

The Company currently operates as one business segment.

Table of Contents

**Western Asset Mortgage Capital Corporation**

**Notes to Financial Statements (Unaudited)**

**(in thousands- except share and per share data)**

***Cash and Cash Equivalents***

The Company considers all highly-liquid short term investments with original maturities of 90 days or less when purchased to be cash equivalents. Cash and cash equivalents are exposed to concentrations of credit risk. The Company places its cash and cash equivalents with what it believes to be high credit quality institutions. At times such investments may be in excess of the Federal Deposit Insurance Corporation insurance limit.

***Classification of mortgage-backed securities and valuations of financial instruments***

***Mortgage-backed and US Treasury securities - Fair value election***

The Company has elected the fair value option for all of its RMBS and US Treasury securities at the date of purchase, which permits the Company to measure these securities at estimated fair value with the change in estimated fair value included as a component of earnings. In the Manager's view, this election more appropriately reflects the results of the Company's operations for a particular reporting period, as financial asset fair value changes are presented in a manner consistent with the presentation and timing of the fair value changes of economic hedging instruments.

***Balance Sheet Presentation***

The Company's mortgage-backed securities purchases and sales are recorded on the trade date, which results in an investment related payable (receivable) for RMBS purchased (sold) for which settlement has not taken place as of the balance sheet date. The Company's RMBS pledged as collateral against borrowings under repurchase agreements are included in residential mortgage-backed securities on the balance sheet, with the fair value of such securities pledged disclosed parenthetically.

***Valuation of financial instruments***

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

The Company discloses the estimated fair value of its financial instruments according to a fair value hierarchy (Levels I, II, and III, as defined below). In accordance with GAAP, the Company is required to provide enhanced disclosures regarding instruments in the Level III category (which require significant management judgment), including a separate reconciliation of the beginning and ending balances for each major category of assets and liabilities. GAAP establishes a framework for measuring estimated fair value and expands financial statement disclosure requirements for fair value measurements. GAAP further specifies a hierarchy of valuation techniques, which is based on whether the inputs into the valuation technique are observable or unobservable. The hierarchy is as follows:

Level I Quoted prices in active markets for identical assets or liabilities.

Level II Quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.

Level III Prices are determined using significant unobservable inputs. In situations where quoted prices or observable inputs are unavailable (for example, when there is little or no market activity for an investment at the end of the period), unobservable inputs may be used.

The level in the fair value hierarchy within which a fair measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety.

When available, the Company uses quoted market prices to determine the estimated fair value of an asset or liability. If quoted market prices are not available, the Company consults with independent pricing services or third party broker quotes. If independent pricing service, or third party broker quotes are not available, the Company determines the estimated fair value of the securities using valuation techniques that use, when possible, current market-based or independently-sourced market parameters, such as interest rates.

Valuation techniques for RMBS may be based upon models that consider the estimated cash flows of the security. The primary inputs to the model include yields for to-be-announced, also known as TBAs, Agency RMBS, the U.S. Treasury market and floating rate indices such as LIBOR, the Constant Maturity Treasury rate and the prime rate as a benchmark yield. The model incorporates the current weighted average maturity and additional pool level information such as prepayment speeds, default frequencies and default severities, if applicable. To the extent, the inputs are observable and timely, the values are categorized in Level II of the fair value hierarchy; otherwise they would be categorized as Level III.

Table of Contents

**Western Asset Mortgage Capital Corporation**

**Notes to Financial Statements (Unaudited)**

**(in thousands- except share and per share data)**

The Company determines the estimated fair value of derivative financial instruments and obtains quotes from a third party to facilitate the process of determining these fair values.

In May 2011, the Financial Accounting Standards Board or FASB issued amendments, which were adopted by the Company, to achieve common fair value measurement and disclosure requirements in GAAP and International Financial Reporting Standards. New disclosures, with a particular focus on Level III measurement are required. All transfers between Level I and Level II are required to be disclosed. Information about when the current use of a non-financial asset measured at fair value differs from its highest and best use is to be disclosed. The Company does not hold any Level III assets and therefore, this update has no significant effect on the Company's financial statements.

Fair value under GAAP represents an exit price in the normal course of business, not a forced liquidation price. If the Company is forced to sell assets in a short period to meet liquidity needs, the prices it receives can be substantially less than their recorded fair values. Furthermore, the analysis of whether it is more likely than not that the Company will be required to sell securities in an unrealized loss position prior to an expected recovery in value (if any), the amount of such expected required sales, and the projected identification of which securities will be sold is also subject to significant judgment, particularly in times of market illiquidity.

Any changes to the valuation methodology will be reviewed by the Company to ensure the changes are appropriate. As markets and products develop and the pricing for certain products becomes more transparent, the Company will continue to refine its valuation methodologies. The methods used by the Company may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Company anticipates that its valuation methods will be appropriate and consistent with other market participants, the use of different methodologies, or assumptions, to determine the estimated fair value of certain financial instruments can result in a different estimate of estimated fair value at the reporting date. The Company uses inputs that are current as of the measurement date, which may include periods of market dislocation, during which price transparency may be reduced.

***Interest income recognition***

Interest income on mortgage-backed securities is accrued based on the respective outstanding principal balances and corresponding contractual terms. Premiums and discounts associated with Agency RMBS and, to the extent the Company invests in such assets, non-Agency RMBS rated AA and higher at the time of purchase, are amortized into interest income over the estimated life of such securities using the effective yield method. Adjustments to premium and discount amortization are made for actual prepayment activity. The Company estimates prepayments for its securities and as a result, if prepayments increase (or are expected to increase), the Company will accelerate the rate of amortization on premiums or discounts and make a retrospective adjustment to historical amortization. Alternatively, if prepayments decrease (or are expected



## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

to decrease) the Company will reduce the rate of amortization on the premiums or discounts and make a retrospective adjustment to historical amortization.

To the extent, the Company invests in non-Agency RMBS that are purchased at a discount to par value and/or are rated below AA at the time of purchase, interest income is recognized based on the effective yield method. Similar treatment is afforded to the Company's portfolio of Agency Interest-Only Strips that are not classified as derivatives. The effective yield on these securities is based on the projected cash flows from each security, which is estimated based on the Company's observation of the then current information and events and will include assumptions related to interest rates, prepayment rates and the timing and amount of credit losses. On at least a quarterly basis, the Company reviews and, if appropriate, makes adjustments to its cash flow projections based on input and analysis received from external sources, internal models, and its judgment about interest rates, prepayment rates, the timing and amount of credit losses (if applicable), and other factors. Changes in cash flows from those originally projected, or from those estimated at the last evaluation, may result in a prospective change in the yield/interest income recognized on such securities. Actual maturities of the securities are affected by the contractual lives of the associated mortgage collateral, periodic payments of scheduled principal, and prepayments of principal. Therefore, actual maturities of the securities will generally be shorter than stated contractual maturities. In addition, in determining other-than-temporary impairment, the Company compares the present value of the remaining cash flows expected to be collected at the purchase date (or last date previously revised) against the present value of the cash flows expected to be collected at the current financial reporting date. If the market value of a security is less than the carrying value, the security is considered impaired and the loss is recorded into earnings as a realized loss.

Based on the projected cash flow of any non-Agency RMBS purchased at a discount to par value, the Company may designate a portion of such purchase discount as credit protection against future credit losses and, therefore, not accrete such amount into interest income. The amount designated as credit discount may be adjusted over time, based on the actual performance of the security, its underlying collateral, actual and projected cash flow from such collateral, economic conditions and other factors. If the performance of a security with a credit discount is more favorable than forecasted, a portion of the amount designated as credit discount may be accreted into interest income prospectively.

Table of Contents

**Western Asset Mortgage Capital Corporation**

**Notes to Financial Statements (Unaudited)**

**(in thousands- except share and per share data)**

***Earnings per share***

GAAP requires use of the two-class method of computing earnings per share for all periods presented for each class of common stock and participating securities as if all earnings for the period had been distributed. Under the two-class method, during periods of net income, the net income is first reduced for dividends declared on all classes of securities to arrive at undistributed earnings. During periods of net losses, the net loss is reduced for dividends declared on participating securities only if the security has the right to participate in the earnings of the entity and an objectively determinable contractual obligation to share in net losses of the entity.

The remaining earnings are allocated to common stockholders and participating securities, to the extent that each security shares in earnings, as if all of the earnings for the period had been distributed. Each total is then divided by the applicable number of shares to arrive at basic earnings per share. For the diluted earnings, the denominator includes all outstanding common shares and all potential common shares assumed issued if they are dilutive. The numerator is adjusted for any changes in income or loss that would result from the assumed conversion of these potential common shares.

***Due from counterparties/Due to counterparties***

Due from counterparties represents cash posted with its counterparties as collateral for the Company's interest rate swaps and repurchase agreements. Due to counterparties represents cash posted with the Company by its counterparties as collateral under the Company's interest rate swaps and repurchase agreements. Due from counterparties and Due to counterparties are carried at cost, which approximates fair value.

***Hedging instruments and hedging activities***

Subject to maintaining its qualification as a REIT for U.S. federal income tax purposes, the Company utilizes derivative financial instruments, including interest rate swaps, U.S. treasuries and Agency Interest-Only Strips to hedge the interest rate risk associated with its portfolio and related borrowings. Derivatives are used for hedging purposes rather than speculation. The Company determines the estimated fair value of its derivative positions and obtains quotations from a third party to facilitate the process of determining these estimated fair values. If the Company's hedging activities do not achieve the desired results, reported earnings may be adversely affected.

GAAP requires an entity to recognize all derivatives as either assets or liabilities and to measure those instruments at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives are classified as either hedges of the fair value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge) or hedges of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge). Fair value adjustments are recorded in earnings immediately, if the Company does not elect hedge accounting for a derivative instrument.

The Company elected not to apply hedge accounting for its derivative instruments and records the change in estimated fair value and net interest rate swap payments (including accrued amounts) related to interest rate swaps in earnings.

***Repurchase agreements***

Mortgage-backed securities sold under repurchase agreements are treated as collateralized financing transactions, unless they meet sales treatment. Securities financed through a repurchase agreement remain on the Company's balance sheet as an asset and cash received from the lender is recorded in the Company's balance sheet as a liability. Interest paid in accordance with repurchase agreements is recorded as interest expense.

Table of Contents

**Western Asset Mortgage Capital Corporation**

**Notes to Financial Statements (Unaudited)**

**(in thousands- except share and per share data)**

In instances where the Company acquires securities through repurchase agreements with the same counterparty from which the securities were purchased, the Company will account for the purchase commitment and repurchase agreement on a net basis and record a forward commitment to purchase securities as a derivative instrument if the transaction does not comply with the criteria for gross presentation. Such forward commitments will be recorded at fair value with subsequent changes in fair value recognized in income. Additionally, the Company will record the cash portion of its investment in securities as a mortgage-related receivable from the counterparty on its balance sheet. If the transaction complies with the criteria for gross presentation, the Company will record the assets and the related financing on a gross basis in its balance sheet and the corresponding interest income and interest expense in its statement of operations. All of the Company's repurchase agreements are treated as collateralized financing transactions.

***Share-based compensation***

The Company accounts for share-based compensation to its independent directors, to its employees, to its Manager and to employees of its Manager and its affiliates using the fair value based methodology prescribed by GAAP. Compensation cost related to restricted common stock issued to the Company's independent directors and employees of the Company is measured at its estimated fair value at the grant date, and amortized into expense over the vesting period on a straight-line basis. Compensation costs related to restricted common stock issued to the Manager and to employees of the Manager and its affiliates is initially measured at estimated fair value at the grant date, and amortized into expense over the vesting period on a straight-line basis and re-measured on subsequent dates to the extent the awards are unvested.

***Warrants***

The Company evaluates all of its financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. For derivative financial instruments that are accounted for as liabilities, the derivative instrument is initially recorded at its fair value and is then re-valued at each reporting date, with changes in the fair value reported in the statements of operations. Financial instruments without these features are recorded as a component of equity. For the Company's warrants, the Company uses a variation of the adjusted Black-Scholes option valuation model to record the financial instruments at their relative fair values at issuance. The warrants issued with the Company's common stock in the private placement to certain accredited institutional investors on May 15, 2012, have been evaluated by the Company and have been recorded at their relative fair value as a component of equity.

The Company evaluates all of its financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. For stock-based derivative financial instruments, the Company uses a variation of the adjusted Black-Scholes option valuation model to value the derivative instruments at inception. In addition, certain of the Company's Agency Interest-Only Strips may be

considered derivatives for GAAP purposes.

*Income taxes*

The Company intends to elect and qualify to be taxed as a REIT commencing with its taxable year ending December 31, 2012. Accordingly, the Company will generally not be subject to corporate U.S. federal or state income tax to the extent that the Company makes qualifying distributions to stockholders, and provided that the Company satisfies, on a continuing basis, through actual investment and operating results, the REIT requirements including certain asset, income, distribution and stock ownership tests. If the Company fails to qualify as a REIT, and does not qualify for certain statutory relief provisions, the Company will be subject to U.S. federal, state and local income taxes and may be precluded from qualifying as a REIT for the subsequent four taxable years following the year in which the Company lost its REIT qualification. Accordingly, the failure to qualify as a REIT could have a material adverse impact on the Company's results of operations and amounts available for distribution to stockholders.

The dividends paid deduction for qualifying dividends paid to stockholders is computed using the Company's taxable income as opposed to net income reported on the financial statements. Taxable income, generally, will differ from net income reported on the financial statements because the determination of taxable income is based on tax provisions and not GAAP.

The Company may create and elect to treat certain subsidiaries as Taxable REIT Subsidiaries ( TRS ). In general, a TRS may hold assets and engage in activities that the Company cannot hold or engage in directly and generally may engage in any real estate or non-real estate-related business. A TRS is subject to U.S. federal, state and local corporate income taxes and its value may not exceed 25% of the value of the Company. As of September 30, 2012, the Company does not have a TRS.

While a TRS will generate net income, a TRS can declare dividends to the Company, which will be included in the Company's taxable income and necessitate a distribution to the Company's stockholders. Conversely, if the earnings are retained at a TRS level, no distribution is required, thereby increasing the book equity of the Company.

Table of Contents

**Western Asset Mortgage Capital Corporation**

**Notes to Financial Statements (Unaudited)**

**(in thousands- except share and per share data)**

The Company evaluates uncertain tax positions, if any, and classifies interest and penalties, if any, related to unrecognized tax benefits as a component of the provision for income taxes.

***Offering costs***

Offering costs borne by the Company in connection with the IPO and concurrent private placements completed on May 15, 2012 as well as its follow-on stock offering executed on September 28, 2012 are reflected as a reduction of additional paid-in-capital.

***Stock Subscription Receivable***

A stock subscription is a transaction in which an investor agrees to purchase capital stock in an entity, but is not required to pay for the capital stock until later. An entity that offers a stock subscription sets aside, but does not issue, shares in exchange for the subscriber's promise to pay consideration for the stock. When all consideration is received by the issuer, the stock is issued. If the investor does not have the right to cancel its subscription and have its consideration refunded, the entity may account for the consideration received as a component of stockholders equity. Typically, a subscription receivable is reported as a reduction in stockholder's equity. However, a stock subscription receivable can be reflected as an asset when payment for the stock is received by the issuer prior to the issuance of its financial statements. In the case of the Company's September 28, 2012 follow-on offering described in Note 10, the Company entered into a binding agreement with a group of underwriters to sell shares of the Company's common stock, which settled on October 3, 2012. The transaction settled on October 3, 2012 and was non-cancellable, accordingly the transaction is reflected in the financial statements at September 30, 2012 as a stock subscription receivable and a component of stockholders' equity.

***Accounting standards applicable to emerging growth companies***

The JOBS Act contains provisions that relax certain requirements for emerging growth companies, which includes the Company. For as long as the Company is an emerging growth company, which may be up to five full fiscal years, unlike other public companies, the Company will not be required to: (i) comply with any new or revised financial accounting standards applicable to public companies until such standards are also applicable to private companies under Section 102(b)(1) of the JOBS Act; (ii) provide an auditor's attestation report on management's assessment of the effectiveness of the Company's system of internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act;

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

(iii) comply with any new requirements adopted by the PCAOB requiring mandatory audit firm rotation or a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer; or (iv) comply with any new audit rules adopted by the PCAOB after April 5, 2012, unless the SEC determines otherwise.

As noted above, under the JOBS Act, emerging growth companies can delay adopting new or revised accounting standards that have different effective dates for public and private companies until such time as those standards apply to private companies. The Company intends to take advantage of such extended transition period. Since the Company will not be required to comply with new or revised accounting standards on the relevant dates on which adoption of such standards is required for other public companies, its financial statements may not be comparable to the financial statements of companies that comply with public company effective dates. If the Company were to elect to comply with these public company effective dates, such election would be irrevocable pursuant to Section 107 of the JOBS Act.

### *Recent accounting pronouncements*

#### Accounting Standards to be adopted in Future Periods

In May 2011, the FASB issued guidance that clarifies its intent regarding the application of existing fair value measurement requirements including: (i) prohibiting the inclusion of block discounts in all fair value measurements, not just Level I measurements; (ii) adding guidance on when to include other premiums and discounts in fair value measurements; (iii) clarifying that the concepts of "highest and best use" and "valuation premise" apply only when measuring the fair value of non-financial assets; and (iv) adding an exception that allows the measurement of a group of financial assets and liabilities with offsetting risks (e.g., a portfolio of derivative contracts) at their net exposure to a particular risk if certain criteria are met. The Company does not hold any Level III assets and therefore, this update will have no significant effect on the Company's financial statements.

In December 2011, the FASB issued guidance requiring additional disclosure information about offsetting and related arrangements. Entities will be required to disclose both gross information and net information about both instruments and transactions eligible for offset in the balance sheet as well as instruments and transactions subject to an agreement similar to a master netting arrangement. This scope would include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements. The objective of this disclosure is to facilitate comparison between those entities that prepare their financial statements on the basis of GAAP and those entities that prepare their financial statements on the basis of International Financial Reporting Standards (IFRS).

Table of Contents

**Western Asset Mortgage Capital Corporation**

**Notes to Financial Statements (Unaudited)**

**(in thousands- except share and per share data)**

The guidance is effective for periods beginning on or after January 1, 2013 and interim periods within those annual periods. While this guidance may result in certain additional disclosures, it is not expected to have a material impact on the Company's financial statements.

FASB Exposure Drafts and Decisions

On September 5, 2012, the FASB decided to remove the scope exception for mortgage REITs and require a mortgage REIT that meets the requirements to be an investment company to follow investment company guidance. The FASB is currently in the process of redeliberations and will continue to consider feedback received on this Exposure Draft. If promulgated in its current form, this proposal may result in changes to the presentation of the Company's financial statements.

On October 3, 2012, the FASB decided to eliminate the existing guidance for evaluating if a repurchase agreement entered into as part of a repurchase financing should be considered linked to a previously transferred financing asset. The decision means that under its proposed amendments to the existing model, these repurchase agreements will be accounted for as secured borrowings. This decision will impact companies that engage in repurchase financing agreements and currently account for the components as linked transactions. As of September 30, 2012, the Company does not account for any of its repurchase agreements as linked transactions; however additional disclosures may be required. The exposure draft is expected during the fourth quarter 2012. No effective date has been proposed.

**Note 3 Fair Value of Financial Instruments**

*Fair Value Accounting Elections*

The Company has elected the fair value option for all of its RMBS and as a result, all changes in the estimated fair value of such securities are reflected in the results of operations.

*Financial Instruments carried at Fair Value*



## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

The following tables present the Company's financial instruments carried at fair value as of September 30, 2012, based upon the valuation hierarchy:

	Estimated Fair Value			Total
	Level I	Level II	Level III	
<b>Assets</b>				
Agency RMBS	\$ -	\$ 4,579,933	\$ -	\$ 4,579,933
Agency Interest-Only Strips accounted for as derivatives, included in RMBS	-	33,863	-	33,863
Subtotal		4,613,796		4,613,796
Derivative assets	-	3,729	-	3,729
<b>Total</b>	<b>\$ -</b>	<b>\$ 4,617,525</b>	<b>\$ -</b>	<b>\$ 4,617,525</b>
<b>Liabilities</b>				
Derivative liabilities	\$ -	\$ 15,916	\$ -	\$ 15,916
<b>Total</b>	<b>\$ -</b>	<b>\$ 15,916</b>	<b>\$ -</b>	<b>\$ 15,916</b>

The Company uses third party pricing services to price its RMBS and derivative instruments. The Company compares this pricing to pricing from other third party pricing services to validate the reasonableness of the pricing obtained from the primary pricing service for its RMBS and derivative instruments.

### *Other Fair Value Disclosures*

Cash and cash equivalents as well as Due from counterparties and Due to counterparties on the Company's balance sheet are reflected at cost which approximates estimated fair value.

The fair value of the repurchase agreements is based on an expected present value technique. This method discounts future estimated cash flows using rates the Company determined best reflect current market interest rates that would be offered for loans with similar characteristics and credit quality. The use of different market assumptions or estimation methodologies can have a material effect on the estimated fair value amounts. At September 30, 2012, the Company's borrowings under repurchase agreements had a fair value of approximately \$1.9 billion and a carrying value of approximately \$1.9 billion.

Table of Contents

**Western Asset Mortgage Capital Corporation**

**Notes to Financial Statements (Unaudited)**

**(in thousands- except share and per share data)**

**Note 4 Residential Mortgage-Backed Securities**

The following table presents certain information about the Company's investment portfolio as of September 30, 2012:

	Principal Balance (1)	Unamortized Premium (Discount), net	Amortized Cost (1)	Unrealized Gain (Loss), net	Estimated Fair Value (1)	Net Weighted Average Coupon (2)	Weighted Average Yield (3)
<b>Agency RMBS:</b>							
30-Year Mortgage	\$ 3,591,602	\$ 289,580	\$ 3,881,182	\$ 26,507	\$ 3,907,689	3.6%	3.0%
20-Year Mortgage	481,626	32,962	514,588	3,629	518,217	3.3%	2.4%
CMO Fixed rate	66,000	10,684	76,684	183	76,867	6.5%	2.6%
IOs and IIOs (4)	N/A	N/A	81,203	(4,043)	77,160	4.4%	17.9%
Agency Interest-Only Strips, accounted for as derivatives (4)	N/A	N/A	N/A	N/A	33,863	4.0%(5)	33.6%
<b>Total</b>	<b>\$ 4,139,228</b>	<b>\$ 333,226</b>	<b>\$ 4,553,657</b>	<b>\$ 26,276</b>	<b>4,613,796</b>	<b>3.7%</b>	<b>3.4%</b>

(1) Includes unsettled purchases with an aggregate cost of \$2,667,281 and estimated fair value of \$2,666,351 at September 30, 2012.

(2) Net weighted average coupon as of September 30, 2012 is presented, net of servicing and other fees.

(3) Weighted average yield as of September 30, 2012 incorporates estimates for future prepayment and loss assumptions.

(4) IOs and IIOs and Agency Interest-Only Strips, accounted for as derivatives have no principal balances and bear interest based on a notional balance. The notional balance is used solely to determine interest distributions on interest-only class of securities.

(5) Interest on these securities is reported as a component of Loss on derivative instruments.

Weighted average expected remaining term to maturity of the investment portfolio is 9.3 years.

The components of the carrying value of the Company's investment portfolio are as follows:

Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

September 30, 2012

Principal balance	\$	4,139,228
Amortized cost of IOs and IIOs		81,203
Carrying value of Agency Interest-Only Strips accounted for as derivatives		33,863
Unamortized premium		333,226
Unamortized discount		-
Gross unrealized gains		39,254
Gross unrealized losses		(12,978)
Estimated fair value	\$	4,613,796

As of September 30, 2012, the Company held Agency RMBS with a fair value of approximately \$1.2 billion in an unrealized loss position of approximately \$13.0 million. As of September 30, 2012, the Company held no investments in an unrealized loss position for greater than one year. At September 30, 2012, the Company did not intend to sell any of its Agency RMBS that were in an unrealized loss position, and it is more likely than not that the Company will not be required to sell these Agency RMBS before recovery of their amortized cost basis, which may be at their maturity.

The Company assesses its Agency RMBS for other-than-temporary impairment on at least a quarterly basis. When the fair value of an investment is less than its amortized cost at the balance sheet date of the reporting period for which impairment is assessed, the impairment is designated as either temporary or other-than-temporary. In deciding on whether or not a security is other than temporarily impaired, the Company considers several factors, including the nature of the investment, communications (if any) from the trustees of securitizations regarding the credit quality of the security, the severity and duration of the impairment, the cause of the impairment, and the Company's intent that it is more likely than not that the Company can hold the security until recovery of its cost basis. The Company did not have other than temporary impairments for the period from May 15, 2012 (commencement of operations) through September 30, 2012.

For non-Agency RMBS that are purchased at a discount to par value and/or are rated below AA at the time of purchase and Agency Interest-Only Strips that are not classified as derivatives, an other-than-temporary impairment is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the beneficial interest is less than its carrying amount. These adjustments are reflected in the Company's Statement of Operations as Other loss on Residential mortgage-backed securities. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a market participant would use and are discounted at a rate equal to the current yield used to accrete interest income. If an other-than-temporary impairment is recognized as a result of this analysis, the yield is changed to the market rate. The last revised estimated cash flows are then used for future impairment analysis purposes.

Table of Contents**Western Asset Mortgage Capital Corporation****Notes to Financial Statements (Unaudited)****(in thousands- except share and per share data)**

The following tables present components of interest income on the Company's Agency RMBS.

For the three months ended September 30, 2012

	Coupon Interest	Net (Premium) Discount Amortization	Interest Income
Agency RMBS	\$ 21,544	\$ (6,856)	\$ 14,688
Total	\$ 21,544	\$ (6,856)	\$ 14,688

For the period from May 15, 2012 (commencement of operations) through September 30, 2012

	Coupon Interest	Net (Premium) Discount Amortization	Interest Income
Agency RMBS	\$ 30,592	\$ (9,054)	\$ 21,538
Total	\$ 30,592	\$ (9,054)	\$ 21,538

**Note 5 Borrowings under Repurchase Agreements**

As of September 30, 2012, the Company had master repurchase agreements with 13 counterparties, and was in discussions with additional counterparties, to finance substantially its entire Agency RMBS portfolio. As of September 30, 2012, the Company had borrowings under repurchase agreements with 11 counterparties. For the period from May 15, 2012 (commencement of operations) through September 30, 2012, the Company had average borrowings under its repurchase agreements of approximately \$1.7 billion and had a maximum month-end balance during the period of approximately \$1.9 billion.

The repurchase agreements bear interest at a contractually agreed-upon rate and typically have terms ranging from one month to three months. The Company's repurchase agreement borrowings are accounted for as secured borrowings given that the Company maintains effective control of the financed assets. Under the repurchase agreements, the respective lender retains the right to mark the underlying collateral to fair value. A reduction in the value of pledged assets requires the Company to post additional securities as collateral, pay down borrowings or establish cash margin accounts with the counterparties in order to re-establish the agreed-upon collateral requirements, referred to as margin calls. The

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

inability of the Company to post adequate collateral for a margin call by the counterparty can result in a condition of default under the Company's repurchase agreements, thereby enabling the counterparty to liquidate the collateral pledged by the Company, which may have an adverse effect on the Company's financial condition and results of operations.

Further, if the Company is unable to renew, replace or expand repurchase financing with other sources of financing on substantially similar terms it may have an adverse effect on the Company's business and results of operations, due to the long term nature of the Company's investments and relatively short-term maturities of the Company's repurchase agreements. The financial covenants of certain of the repurchase agreements require the Company to maintain certain equity and leverage metrics. The Company is in compliance with these covenants at September 30, 2012.

The following table summarizes certain characteristics of the Company's repurchase agreements as September 30, 2012:

RMBS Pledged	Repurchase Agreement Borrowings	Weighted Average Interest Rate on Borrowings Outstanding at end of period	Weighted Average Remaining Maturity (days)
Agency RMBS	\$ 1,923,517	0.44 %	53
Total	\$ 1,923,517	0.44 %	53

Table of Contents

**Western Asset Mortgage Capital Corporation**

**Notes to Financial Statements (Unaudited)**

(in thousands- except share and per share data)

**Note 6 Collateral Positions**

The following tables summarize the Company's collateral positions, with respect to its borrowings under repurchase agreements, derivatives and clearing margin account at September 30, 2012:

	Assets Pledged- Fair Value	Amortized Cost	Accrued Interest	Fair Value of Assets Pledged and Accrued Interest
Assets pledged for borrowings under repurchase agreements:				
Agency RMBS	\$ 2,032,285	\$ 2,051,871	\$ 6,001	\$ 2,038,286
Cash (1)	880	-	-	880
Cash collateral for derivatives (1):	23,900	-	-	23,900
Total	\$ 2,057,065	\$ 2,051,871	\$ 6,001	\$ 2,063,066

(1) Cash posted as collateral is included in Due from counterparties on the Company's balance sheet.

A reduction in the value of pledged assets typically results in the repurchase agreement counterparty initiating a daily margin call. At September 30, 2012, Agency RMBS held by counterparties as security for repurchase agreements totaled approximately \$2.0 billion. Cash collateral held by counterparties at September 30, 2012 was approximately \$24.8 million. In addition, the Company's counterparties have posted cash of approximately \$7.0 million as collateral under the Company's interest rate swaps and repurchase agreements, which is included in Due to counterparties in the balance sheet.

**Note 7 Derivative Instruments**

The Company's derivatives currently include interest rate swaps ( interest rate swaps ), interest rate swaptions and Agency Interest-Only Strips that are classified as derivatives.

*Interest rate swaps and interest rate swaptions*

The Company is exposed to certain risk arising from both its business operations and economic conditions. Specifically, the Company's primary source of debt funding is repurchase agreements and the Company enters into derivative financial instruments to manage exposure to variable cash flows on portions of its borrowings under those repurchase agreements. Since the interest rates on repurchase agreements typically change with market interest rates such as the London interbank offered rate or LIBOR, the Company is exposed to constantly changing interest rates, which accordingly affects cash flows associated with these rates on its borrowings. To mitigate the effect of changes in these interest rates, the Company enters into interest rate swap agreements which help to mitigate the volatility in the interest rate exposures and their related cash flows. Interest rate swaps involve the receipt of variable-rate amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the interest rate swap without exchange of the underlying notional amount.

While the Company has not elected to account for its interest rate swap derivative instruments as hedges under GAAP, it does not use derivatives for speculative purposes, but rather uses such instruments to manage interest rate risk and views them as economic hedges. Changes in the estimated fair value of derivatives not designated in hedging relationships are recorded directly in earnings together with or including periodic net interest settlement amounts.

The Company's interest rate swap and interest rate swaption derivative instruments consisted of the following as of September 30, 2012:

	Notional Amount	Fair Value, excluding accrued interest	Accrued Interest
Interest rate swaps, assets	\$ 774,000	\$ 2,797	\$ (455)
Interest rate swaption, assets	75,000	932	-
Total derivative instruments, assets	849,000	3,729	(455)
Interest rate swaps, liabilities	1,489,500	(15,916)	(2,841)
Total derivative instruments	\$ 2,338,500	\$ (12,187)	\$ (3,296)

The following table summarizes the average fixed pay rate and average maturity for the Company's interest rate swaps as of September 30, 2012 (excludes interest rate swaptions):

Term to Maturity	Notional Amount	Average Fixed Pay Rate	Average Maturity (Years)
Greater than 1 year and less than 3 years	\$ 542,000	0.6 %	2.2
Greater than 3 years and less than 5 years	260,100	0.9	3.9
Greater than 5 years	1,461,400	1.6	9.5
Total	\$ 2,263,500	1.3 %	7.1

Table of Contents

**Western Asset Mortgage Capital Corporation**

**Notes to Financial Statements (Unaudited)**

**(in thousands- except share and per share data)**

As of September 30, 2012, approximately 26% of these instruments are forward starting swaps (approximately ten months forward). The Company's agreements with certain of its interest rate swap counterparties may be terminated at the option of the counterparty if the Company does not maintain certain equity and leverage metrics. Through September 30, 2012, the Company was in compliance with the terms of such financial tests.

At September 30, 2012, the Company had entered into a swaption with a notional amount of \$75.0 million that expires in 11 months. If exercised, the Company can enter into a 10 year fixed pay swap agreement at a predetermined strike price.

As of September 30, 2012, the estimated fair value of derivatives in a net liability position, which includes accrued interest, related to these agreements was approximately \$16.5 million. The Company has minimum collateral posting thresholds with certain of its derivative counterparties, for which it typically pledges cash. As of September 30, 2012, the Company had cash pledged as collateral of \$23.9 million, which is reported on the balance sheet as Due from counterparties. If the Company had breached any of these provisions at September 30, 2012, it could have been required to settle its obligations under the agreements at their termination value of approximately \$16.5 million.

***Agency Interest-Only Strips***

The Company also invests in Agency Interest-Only Strips. The Company has evaluated the terms and conditions of its holdings of Agency Interest-Only Strips to determine if these instruments have the characteristics of investments or would be considered derivatives under GAAP. Accordingly, Agency Interest-Only Strips having the characteristics of derivatives have been accounted for at fair value with changes in recognized in Loss on derivative instruments in the Statement of Operations, along with any interest received. The carrying value of these Agency Interest-Only Strips is included in Residential mortgage-backed securities on the balance sheet.

The following table summarizes the amounts recognized on the statements of operations related to the Company's derivative instruments for the three months ended September 30, 2012, and for the period from May 15, 2012 (commencement of operations) through September 30, 2012:

**Three months ended September 30, 2012**



Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

Derivative Instrument	Interest Income (expense), net	Mark-to-market adjustments on derivative instruments	(Loss) gain on derivative instruments
Interest rate swaps(1)	\$ (1,630)	\$ (8,075)	\$ (9,705)
Interest rate swaptions	-	(298)	(298)
Agency Interest-Only Strips(2)	1,622	(3,295)	(1,673)
Total	\$ (8)	\$ (11,668)	\$ (11,676)

(1) Interest income (expense), net on interest rate swaps represents the net amount paid, including accrued amounts, for swaps during the period and realized gains (losses) on swap terminations.

(2) Interest Income (expense), net on Agency Interest-Only Strips represents interest income on these securities based on the actual coupon.

**Period from May 15, 2012 (commencement of operations) through September 30, 2012**

Derivative Instrument	Interest Income (expense), net	Mark-to-market adjustments on derivative instruments	Loss on derivative instruments
Interest rate swaps(1)	\$ (2,352)	\$ (13,119)	\$ (15,471)
Interest rate swaptions	-	(298)	(298)
Agency Interest-Only Strips(2)	2,439	(3,659)	(1,220)
Total	\$ 87	\$ (17,076)	\$ (16,989)

(1) Interest income (expense), net on interest rate swaps represents the net amount paid, including accrued amounts, for swaps during the period and realized gains (losses) on swap terminations.

(2) Interest Income (expense), net on Agency Interest-Only Strips represents interest income on these securities based on the actual coupon.

Table of Contents

**Western Asset Mortgage Capital Corporation**

**Notes to Financial Statements (Unaudited)**

**(in thousands- except share and per share data)**

**Note 8 Related Party Transactions**

***Management Agreement***

In connection with the Company's IPO in May 2012, the Company entered into a management agreement (the "Management Agreement") with the Manager, which describes the services to be provided by the Manager and compensation for such services. The Manager is responsible for managing the Company's operations, including: (i) performing all of its day-to-day functions other than those provided by the Company's chief financial officer; (ii) determining investment criteria in conjunction with the board of directors; (iii) sourcing, analyzing and executing investments, asset sales and financings; (iv) performing asset management duties; and (v) performing financial and accounting management, subject to the direction and oversight of the Company's board of directors. Pursuant to the terms of the Management Agreement, the Manager is paid a management fee equal to 1.50% per annum of the Company's adjusted stockholders' equity, calculated and payable (in cash) quarterly in arrears. For purposes of calculating the management fee, "adjusted stockholders' equity" means the sum of the net proceeds from any issuances of the Company's equity securities since inception (allocated on a pro rata daily basis for such issuances during the fiscal quarter of any such issuance), plus retained earnings, calculated in accordance with GAAP, at the end of the most recently completed fiscal quarter (without taking into account any non-cash equity compensation expense incurred in current or prior periods), less any amount paid for repurchases of the Company's shares of common stock, excluding any unrealized gains, losses or other non-cash items that have impacted stockholder's equity as reported in the Company's financial statements prepared in accordance with GAAP, regardless of whether such items are included in other comprehensive income or loss, or in net income, and excluding one-time events pursuant to changes in GAAP and certain other non-cash charges after discussions between the Manager and the Company's independent directors and after approval by a majority of the Company's independent directors. However, if the Company's stockholders' equity for any given quarter is negative based on the calculation described above, the Manager will not be entitled to receive any management fee for that quarter.

In addition, the Company may be required to reimburse the Manager for certain expenses as described below. Expense reimbursements to the Manager are made in cash on a monthly basis following the end of each month. The Company's reimbursement obligation is not subject to any dollar limitation. Because the Manager's personnel perform certain legal, accounting, due diligence tasks and other services that outside professionals or outside consultants otherwise would perform, the Manager may be paid or reimbursed for the documented cost of performing such tasks, provided that such costs and reimbursements are in amounts which are no greater than those which would be payable to outside professionals or consultants engaged to perform such services pursuant to agreements negotiated on an arm's-length basis.

The Management Agreement may be amended, supplemented or modified by agreement between the Company and the Manager. The initial term of the Management Agreement expires on May 15, 2015 and it is automatically renewed for one-year terms on each anniversary thereafter unless previously terminated as described below. The Company's independent directors will review the Manager's performance and any fees payable to the Manager annually and, following the initial term, the Management Agreement may be terminated annually upon the affirmative

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

vote of at least two-thirds of the Company's independent directors, based upon: (i) the Manager's unsatisfactory performance that is materially detrimental to the Company; or (ii) the Company's determination that any fees payable to the Manager are not fair, subject to the Manager's right to prevent such termination due to unfair fees by accepting a reduction of management fees agreed to by at least two-thirds (2/3) of the Company's independent directors. The Company will provide the Manager 180 days prior notice of any such termination. Unless terminated for cause, the Company will pay the Manager a termination fee equal to three times the average annual management fee earned by the Manager during the prior 24-month period immediately preceding the date of termination, calculated as of the end of the most recently completed fiscal quarter prior to the date of termination.

The Company may also terminate the Management Agreement at any time, including during the initial term, without the payment of any termination fee, with 30 days prior written notice from the Company's board of directors for cause, which will be determined by a majority of the Company's independent directors, which is defined as: (i) the Manager's continued material breach of any provision of the Management Agreement (including the Manager's failure to comply with the Company's investment guidelines); (ii) the Manager's fraud, misappropriation of funds, or embezzlement against the Company; (iii) the Manager's gross negligence in the performance of its duties under the Management Agreement; (iv) the occurrence of certain events with respect to the bankruptcy or insolvency of the Manager, including an order for relief in an involuntary bankruptcy case or the Manager authorizing or filing a voluntary bankruptcy petition; (v) the Manager is convicted (including a plea of nolo contendere) of a felony; or (vi) the dissolution of the Manager.

For the three months ended September 30, 2012 and for the period from May 15, 2012 (commencement of operations) through September 30, 2012, the Company incurred approximately \$0.8 million and approximately \$1.2 million, respectively in management fees. In addition to the management fee, the Company is also responsible for reimbursing the Manager for certain expenses paid by the Manager on behalf of the Company and for certain services provided by the Manager to the Company. For the three months ended September 30, 2012 and for the period from May 15, 2012 (commencement of operations) through September 30, 2012, the Company recorded expenses included in general and administrative expense totaling \$9 thousand related to salary or employee benefits associated with the Company's sole employee paid by the Manager on behalf of the Company. Notwithstanding the foregoing, any such expenses incurred by the Manager and reimbursed by the Company are typically included in the Company's general and administrative expense on its statement of operations, or may be reflected on the balance sheet and associated statement of changes in stockholders' equity, based on the nature of the item. At September 30, 2012, approximately \$0.8 million for management fees incurred but not yet paid was included in payable to related party on the balance sheet.

Table of Contents

**Western Asset Mortgage Capital Corporation**

**Notes to Financial Statements (Unaudited)**

**(in thousands- except share and per share data)**

***Offering Costs***

For the period from May 15, 2012 (commencement of operations) through September 30, 2012, the Company was responsible for \$1.2 million of offering costs incurred in connection with the Company's IPO of its common stock and concurrent private placements. The Manager agreed to pay for all costs in excess of \$1.2 million. During the three months ended September 30, 2012, the Company paid the Manager \$1.2 million as reimbursement for offering costs previously incurred by the Company with respect to its IPO and paid by the Manager. Offering costs of approximately \$5.4 million were borne by the Company in connection with its follow-on common stock offering executed in September 2012.

**Note 9 Share-Based Payments**

In conjunction with the Company's IPO and concurrent private placement, the Company's board of directors approved the Western Asset Mortgage Capital Corporation Equity Plan (the "Equity Plan") and the Western Asset Manager Equity Plan (the "Manager Equity Plan" and collectively the "Equity Incentive Plans").

On May 15, 2012, the Company granted 51,159 shares of restricted common stock to the Manager under the Manager Equity Plan that is equal to 0.5% of the aggregate number of shares of common stock sold in the IPO and units sold in the concurrent private placement to certain institutional accredited investors. These shares vest on each of the first, second and third anniversaries of the grant date.

On May 15, 2012, the Company granted a total of 4,500 shares (1,500 each) of restricted common stock under the Equity Plan to the Company's three independent directors. These restricted shares will vest in full on the first anniversary of the grant date.

On June 25, 2012, the Company granted 10,455 shares of restricted common stock to its chief financial officer under the Equity Plan. One-third of these restricted shares will vest on January 1, 2013, one-third will vest on January 1, 2014 and the remaining one-third will vest on January 1, 2015.

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

The Equity Incentive Plans include provisions for grants of restricted common stock and other equity-based awards to the Manager, its employees and employees of its affiliates and to the Company's directors, officers and employees. The Company can issue up to 3.0% of the total number of issued and outstanding shares of its common stock (on a fully diluted basis) at the time of each award (other than any shares previously issued or subject to awards made pursuant to one of our Equity Incentive Plans) under these Equity Incentive Plans. At May 15, 2012, there were 308,335 shares of common stock initially reserved for issuance under the Equity Incentive Plans. Subsequent to the settlement of the September follow-on common stock offering, the number of shares of common stock available for issuance under the Equity Incentive Plans increased to 722,335, inclusive of the 66,114 enumerated above. The Company recognized stock-based compensation expense of approximately \$157 thousand and \$211 thousand for the three months ended September 30, 2012 and for the period from May 15, 2012 (commencement of operations) through September 30, 2012, respectively.

All restricted common shares granted possess all incidents of ownership, including the right to receive dividends and distributions, and the right to vote. The award agreements include restrictions whereby the restricted shares cannot be sold, assigned, transferred, pledged, hypothecated or otherwise disposed of prior to the lapse of restrictions under the respective award agreement. The restrictions lapse on the unvested restricted shares awarded when vested, subject to the grantee's continuing to provide services to the Company as of the vesting date. Unvested restricted shares and rights to dividends thereon are forfeited upon termination of grantee.

Table of Contents

**Western Asset Mortgage Capital Corporation**

**Notes to Financial Statements (Unaudited)**

**(in thousands- except share and per share data)**

The following is a summary of restricted common stock vesting dates as of September 30, 2012:

Vesting Date	Shares Vesting
January 2013	3,485
May 2013	21,553
January 2014	3,485
May 2014	17,053
January 2015	3,485
May 2015	17,053
	66,114

**Note 10 Initial Public Offering, Private Placements and September 28, 2012 Follow-On Offering**

On May 9, 2012, the Company entered into: (i) a binding underwriting agreement with a group of underwriters to sell 8.0 million shares of the Company's common stock for \$20.00 per share for an aggregate offering price of \$160.0 million; (ii) unit purchase agreements, pursuant to a private placement, with certain institutional accredited investors to sell 2,231,787 warrant units for \$20.00 per unit for an aggregate offering price of approximately \$44.6 million; and (iii) an agreement to sell 46,043 shares of the Company's common stock, for \$20.00 per share to our Manager's deferred compensation plan in another private placement for an aggregate offering price of approximately \$0.9 million.

Each of the aforementioned warrant units consists of one share of the Company's common stock and a warrant to purchase 0.5 of a share of the Company's common stock. At the time of issuance, each warrant had an exercise price of \$20.50 per share, subject to adjustment upon the occurrence of customary events triggering an anti-dilution adjustment and certain sales of the Company's common stock (see discussion below). In addition, the warrants are subject to certain limitations on exercise. The warrants expire on May 15, 2019.

The net proceeds to the Company from the IPO and two concurrent private placements were approximately \$204.4 million, net of offering expenses of \$1.2 million for which the Company agreed to be responsible. The Manager agreed to be responsible for all offering expenses in excess of \$1.2 million, including the underwriting discount and the placement agent fees in the two private placements (in the aggregate, approximately \$7.8 million).

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

On September 27, 2012, the Company entered into a binding agreement with a group of underwriters to sell an incremental 12.0 million shares of the Company's common stock, effective as of September 28, 2012. The agreement provided the underwriters with the right to purchase an additional 1.8 million shares (15% of 12.0 million) during the succeeding thirty (30) days. The shares were offered to the market at a price of \$22.20 per share and the underwriters exercised their option to purchase the incremental 1.8 million shares on September 28, 2012. Net proceeds to the Company were approximately \$301.0 million after subtracting underwriting commissions and offering expenses of approximately \$5.4 million. Settlement date for the stock offering was October 3, 2012. Accordingly, the transaction is reflected on the September 30, 2012 balance sheet as a Stock subscription receivable and an increase to Stockholders' Equity. On October 3, 2012, as a result of the offering, the exercise price of the warrants was reduced from \$20.50 to \$19.44.

Table of Contents**Western Asset Mortgage Capital Corporation****Notes to Financial Statements (Unaudited)****(in thousands- except share and per share data)****Note 11 Net Income per Common Share**

The table below presents basic and diluted net income per share of common stock for the three months ended September 30, 2012 and for the period from May 15, 2012 (commencement of operations) through September 30, 2012:

	<b>Three Months Ended September 30, 2012</b>	<b>For the Period from May 15, 2012 (commencement of operations) through September 30, 2012</b>
<b>Numerator:</b>		
Net income attributable to common stockholders and participating securities for basic and diluted earnings per share	\$ 28,194	\$ 32,455
<b>Denominator:</b>		
Weighted average shares of common stock outstanding	10,277,830	10,277,830
Weighted average participating securities	66,114	63,030
Denominator for basic earnings per share weighted average shares of common stock outstanding and common stock equivalents outstanding	10,343,944	10,340,860
Weighted average diluted shares outstanding (warrants)	20,308	-
Denominator for diluted earnings per share weighted average shares of common stock outstanding and common stock equivalents outstanding	10,364,252	10,340,860
Basic net income per weighted average share of common stock	\$ 2.73	\$ 3.14
Diluted net income per weighted average share of common stock	\$ 2.72	\$ 3.14

**Note 12 Income Taxes**



## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

Based on the Company's analysis of any potential uncertain income tax positions, the Company concluded that it does not have any uncertain tax positions that meet the recognition or measurement criteria as of September 30, 2012. In the event that the Company incurs income tax related interest and penalties, the Company's policy is to classify them as a component of provision for income taxes.

### **Note 13 Subsequent Events**

On September 20, 2012, the Company declared a dividend of \$0.85 per share to shareholders of record at October 1, 2012 which was paid on October 25, 2012.

Table of Contents

**ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

**FORWARD-LOOKING INFORMATION**

The Company makes forward-looking statements herein and will make forward-looking statements in future filings with the Securities and Exchange Commission (the "SEC"), press releases or other written or oral communications within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act") and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). For these statements, the Company claims the protections of the safe harbor for forward-looking statements contained in such sections. Forward-looking statements are subject to substantial risks and uncertainties, many of which are difficult to predict and are generally beyond the Company's control. These forward-looking statements include information about possible or assumed future results of the Company's business, financial condition, liquidity, results of operations, plans and objectives. When the Company uses the words "believe," "expect," "anticipate," "estimate," "plan," "continue," "intend," "should," "may" or similar expressions, the Company intends to identify forward-looking statements. Statements regarding the following subjects, among others, may be forward-looking: market trends in the Company's industry; interest rates; real estate values; the debt securities markets; the U.S. housing market or the general economy or the demand for residential mortgage loans; the Company's business and investment strategy; the Company's projected operating results; actions and initiatives of the U.S. Government and changes to U.S. Government policies and the execution and impact of these actions, initiatives and policies; the state of the U.S. economy generally or in specific geographic regions; economic trends and economic recoveries; the Company's ability to obtain and maintain financing arrangements, including securitizations; the currently attractive Agency RMBS (as defined herein) return dynamics available; the level of government involvement in the U.S. mortgage market; the anticipated default rates on Agency and non-Agency RMBS (as defined herein); the loss severity on non-Agency RMBS; the return of the non-Agency RMBS securitization market; general volatility of the securities markets in which the Company participates; changes in the value of the Company's assets; the Company's expected portfolio of assets; the Company's expected investment and underwriting process; interest rate mismatches between the Company's target assets and any borrowings used to fund such assets; changes in interest rates and the market value of the Company's target assets; changes in prepayment rates on the Company's target assets; effects of hedging instruments on the Company's target assets; rates of default or decreased recovery rates on the Company's target assets; the degree to which the Company's hedging strategies may or may not protect the Company from interest rate volatility; impact of and changes in governmental regulations, tax law and rates, accounting guidance and similar matters; the Company's ability to maintain the Company's qualification as a REIT for U.S. federal income tax purposes; the Company's ability to maintain its exemption from registration under the Investment Company Act of 1940, as amended (the "1940 Act"); the availability of opportunities to acquire Agency RMBS, non-Agency RMBS, residential mortgage loans and other residential mortgage assets; the availability of qualified personnel; estimates relating to the Company's ability to make distributions to its stockholders in the future; and the Company's understanding of its competition.

The forward-looking statements are based on the Company's beliefs, assumptions and expectations of its future performance, taking into account all information currently available to it. Forward-looking statements are not predictions of future events. These beliefs, assumptions and expectations can change as a result of many possible events or factors, not all of which are known to the Company. See "Risk Factors" in the Company Registration Statement on Form S-11, as originally filed and declared effective on September 28, 2012 with the SEC. These and other risks, uncertainties and factors, including those described in the annual, quarterly and current reports that the Company files with the SEC, could cause its actual results to differ materially from those included in any forward-looking statements the Company makes. All forward-looking statements speak only as of the date they are made. New risks and uncertainties arise over time and it is not possible to predict those events or how they may affect the Company. Except as required by law, the Company is not obligated to, and does not intend to, update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

The following discussion should be read in conjunction with the Company's financial statements and the accompanying notes to the Company's financial statements, which are included in Item 1 of this Quarterly Report on Form 10-Q, as well as the information contained in the Company's Registration Statement on Form S-11, as originally filed on and declared effective on September 28, 2012 with the SEC.

**Overview**

Western Asset Mortgage Capital Corporation (the Company unless otherwise indicated or except where the context otherwise requires we, us or our) is primarily focused on investing in, financing and managing Agency RMBS. Although our core investment strategy is focused on Agency RMBS, we may opportunistically supplement our portfolio with non-Agency RMBS, CMBS and ABS, which we refer to as our Potential Target Assets. We finance investments in Agency RMBS and our potential target assets primarily through the use of repurchase agreements.

Table of Contents

We are organized as a Delaware corporation. We intend to elect and qualify to be taxed as a REIT, commencing with our taxable year ending December 31, 2012. We generally will not be subject to U.S. federal income taxes on our taxable income to the extent that we annually distribute all of our net taxable income to stockholders and maintain our intended qualification as a REIT. We also intend to operate our business in a manner that will permit us to maintain our exemption from registration under the 1940 Act.

We are externally managed and advised by Western Asset Management Company ( WAM ), or the Manager , an SEC-registered investment advisor and a wholly-owned subsidiary of Legg Mason. Our Manager is responsible for administering our business activities and our day-to-day operations, subject to the supervision of our board of directors. On May 9, 2012, we entered into: (i) a binding underwriting agreement with a group of underwriters to sell 8.0 million shares of our common stock for \$20.00 per share in our initial public offering ( IPO ) for an aggregate offering price of \$160.0 million; (ii) unit purchase agreements, pursuant to a private placement, with certain institutional accredited investors to purchase 2,231,787 warrant units for \$20.00 per unit for an aggregate offering price of approximately \$44.6 million; and (iii) a security purchase agreement to sell 46,043 shares of our common stock, for \$20.00 per share to our Manager s deferred compensation plan in another private placement for an aggregate offering price of approximately \$0.9 million.

Each of the aforementioned warrant units consists of one share of our common stock and a warrant to purchase 0.5 of a share of our common stock. Each warrant had an initial exercise price of \$20.50 per share, subject to adjustment upon the occurrence of customary events triggering an anti-dilution adjustment and certain sales of our common stock (see discussion below). In addition, the warrants are subject to certain limitations on exercise.

The net proceeds from our IPO and concurrent private placements were received on May 15, 2012. The net proceeds to us were approximately \$204.4 million, net of offering expenses of \$1.2 million for which we agreed to be responsible. Our Manager agreed to be responsible for all offering expenses in excess of \$1.2 million, including the underwriting discount and the placement agent fees in the two private placements (in the aggregate, approximately \$7.8 million).

On September 27, 2012, we entered into a binding agreement with a group of underwriters to sell an incremental 12.0 million shares of our common stock, effective as of September 28, 2012. The agreement provided the underwriters with the right to purchase an additional 1.8 million shares (15% of 12.0 million) during the succeeding thirty (30) days. The shares were offered to the market at a price of \$22.20 per share and the underwriters exercised their option to purchase the incremental 1.8 million shares on September 28, 2012. Net proceeds to the Company were approximately \$301.0 million after subtracting underwriting commissions and offering expenses of approximately \$5.4 million. Settlement date for the stock offering was October 3, 2012. Accordingly, the transaction is reflected on the September 30, 2012 balance sheet as a Stock subscription receivable and an increase to Stockholders Equity. On October 3, 2012, as a result of this offering closing, the exercise price of the warrants was reduced from \$20.50 to \$19.44.

We use leverage, currently comprised of borrowings under repurchase agreements, as part of our business strategy in order to increase potential returns to stockholders. We accomplish this by borrowing against existing mortgage-backed securities through repurchase agreements. There are no limits on the maximum amount of leverage that we may use, and we are not required to maintain any particular debt-to-equity leverage ratio. We may also change our financing strategy and leverage without the consent of stockholders.

As of September 30, 2012, we had entered into master repurchase agreements with 13 counterparties and are in discussions with other financial institutions for additional repurchase agreement capacity. Upon closing of our follow-on offering on October 3, 2012, we will have potential funding capacity in excess of \$5.0 billion. As of September 30, 2012, we had approximately \$1.9 billion of borrowings outstanding under our

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

repurchase agreements collateralized by approximately \$2.0 billion of Agency RMBS. We have entered into swaps to effectively fix (for the life of the swap) the floating interest rate of approximately \$2.3 billion of borrowings under our repurchase agreements, inclusive of swaps entered into in anticipation of the overall increase in the size of the portfolio and its corresponding funding requirements as of September 30, 2012. As of September 30, 2012, our debt-to-equity ratio was approximately 3.7 to 1, or 8.5 to 1 assuming all unsettled trades were settled with repurchase agreements at our average advance rate from May 15, 2012 (commencement of operations) through September 30, 2012 on settled trades.

### **Recent Market Conditions and Strategy**

Our business is affected by general U.S. residential real estate fundamentals and the overall U.S. economic environment. In particular, our strategy is influenced by the specific characteristics of these markets, including prepayment rates and interest rate levels. We expect the results of our operations to be affected by various factors, many of which are beyond our control. Our results of operations will primarily depend on, among other things, the level of our net interest income, the market value of our investment portfolio and the supply of and demand for mortgage-related securities. Our net interest income, which includes the amortization of purchase premiums and accretion of discounts, will vary primarily as a result of changes in interest rates, borrowing costs, and prepayment speeds on our RMBS investments, which is a measurement of how quickly borrowers pay down the unpaid principal balance on their residential mortgage loans.

Table of Contents

The current economic and market outlook are shaped in a significant manner by the unprecedented level of fiscal and monetary stimulus that the U.S. Government and U.S. Federal Reserve Board provided in the aftermath of the 2008 credit crisis. The current rate environment is characterized by a steep yield curve with the spread between two-year U.S. Treasury Notes and ten-year U.S. Treasury Notes well above the average spread over the last three decades. The U.S. Federal Reserve Board has maintained a near-zero target for the federal funds rate, and has reiterated its commitment to fulfilling its mandate to promote higher growth and lower unemployment and to maintain price stability in the U.S. economy.

It is our Manager's view that while recent economic data suggests an improvement in U.S. economic growth, the significant mortgage debt burden, run-off of fiscal stimulus and budget discipline at both the U.S. federal and state level will serve as an impediment to real GDP and employment growth during the balance of 2012 and in 2013. Recent headline inflation data has been relatively modest and we do not believe core rates will increase meaningfully, largely due to a plentiful supply of labor, thereby effectively eliminating wage pressure, and low rates of resource utilization. For these reasons, and considering its dual mandate to manage both inflation and unemployment, we believe that the U.S. Federal Reserve Board will exercise patience before unwinding any form of monetary stimulus now in effect. We expect this type of muted recovery to keep the yield curve relatively steep and, barring any system shocks to the capital markets, provide for the strong demand for Agency RMBS to continue.

We believe investors continue to seek incremental spreads relative to U.S. Treasury Notes in a low yield environment and financial institutions continue to prefer high quality, liquid Agency RMBS. Yield spreads on Agency RMBS remain attractive relative to historical spread levels. As the capital markets have recovered, commercial banks have re-entered the secured lending market, which has quickened the pace of asset recovery, and the return to more normalized credit spreads. Financing of Agency and non-Agency RMBS is currently widely available through, among other vehicles, repurchase agreements. Haircuts, or the discount attributed to the value of securities sold under repurchase agreements, average between 3% and 5% for Agency RMBS, depending on the specific security used as collateral for such repurchase agreements and haircuts for IOs and IIOs can be as high as 25%.

The U.S. government, through the FHA, the Federal Deposit Insurance Corporation, or FDIC, and the U.S. Treasury, has commenced or proposed implementation of programs designed to provide homeowners with assistance in avoiding residential mortgage loan foreclosures. These loan modification and refinance programs, future U.S. federal, state and/or local legislative or regulatory actions that result in the modification of outstanding mortgage loans, as well as changes in the requirements necessary to qualify for refinancing mortgage loans with FNMA, FHLMC or GNMA, may adversely affect the value of, and the returns on, residential mortgage loans, RMBS, real estate-related securities and various other asset classes in which we may invest. In addition to the foregoing, the U.S. Congress and/or various states and local legislators may enact additional legislation or regulatory action designed to address the current economic crisis or for other purposes that could have a material adverse effect on our ability to execute our business strategies.

On January 4, 2012, the U.S. Federal Reserve Board released a report titled *The U.S. Housing Market: Current Conditions and Policy Considerations* to Congress providing a framework for thinking about certain issues and tradeoffs that policy makers might consider. It is unclear how future legislation may impact the housing finance market and the investing environment for agency securities as the method of reform is undecided and has not yet been defined by the regulators.

In a statement issued at the conclusion of its August 1, 2012 meeting, the U.S. Federal Reserve Board acknowledged that despite some signs of improvement, the U.S. housing sector remains depressed. Based on the deceleration in economic and employment growth as well as the expectation for continued low inflation, the U.S. Federal Reserve Board announced that it would continue its highly accommodative fiscal policy and extend through the end of the year its program to extend the average maturity of its holdings of securities by continuing to reinvest principal payments received on its holdings of Agency debt and Agency mortgage-backed securities in additional Agency mortgage-backed securities. This program dubbed "Operation Twist" was originally announced in September 2011. By extending the average maturity of securities held by the

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

U.S. Federal Reserve Board in its portfolio, the expectation is that such action will continue to create downward pressure on longer-term interest rates, which, in turn, will ease financial conditions in the U.S. and provide additional stimulus to support the economic recovery. On September 13, 2012, the U.S. Federal Reserve affirmed its intention to continue to reinvest principal payments received on its Agency mortgage-backed bond portfolio in new Agency mortgage-backed securities through the end of the year and that it will also purchase an incremental \$40 billion of Agency mortgage-backed securities each month. This most recent action by the U.S. Federal Reserve Board is commonly referred to as QE3 .

Table of Contents

**Investment Strategy**

Our Manager's investment philosophy, which developed from a singular focus in fixed-income asset management over a variety of credit cycles and conditions, is to provide clients with diversified, tightly controlled, long-term value-oriented portfolios. Through rigorous analysis of all sectors of the fixed-income market, our Manager seeks to identify assets with the greatest risk-adjusted total value potential. In making investment decisions on our behalf, our Manager incorporates its views on the economic environment and the outlook for the mortgage markets, including relative valuation, supply and demand trends, the level of interest rates, the shape of the yield curve, prepayment rates, financing and liquidity, commercial and residential real estate prices, delinquencies, default rates, recovery of various segments of the economy and vintage of collateral, subject to maintaining our REIT qualification and our exemption from registration under the 1940 Act. We benefit from the breadth and depth of our Manager's overall investment philosophy, which focuses on a macroeconomic analysis as well as an in-depth analysis of individual assets and their relative value.

We rely on our Manager's expertise in asset allocation and identifying attractive assets within our investment strategy. Although our core investment strategy is currently focused on solely on Agency RMBS, our Manager's expertise in related investment disciplines such as non-Agency RMBS, CMBS (as defined herein), and ABS (as defined herein) provides our Manager with both: (i) valuable investment insights to our Agency RMBS investment selection and strategy; and (ii) flexibility to invest in assets other than Agency RMBS opportunistically as market conditions warrant.

We currently purchase and sell Agency RMBS and, in the future, may purchase and sell our other potential target assets. Our Manager has not and does not expect to purchase securities on our behalf with a view to selling them shortly after purchase. However, in order to maximize returns and manage portfolio risk while remaining opportunistic, we may dispose of securities earlier than anticipated or hold securities longer than anticipated depending upon prevailing market conditions, credit performance, availability of leverage or other factors regarding a particular security or our capital position.

**Target Assets**

We have invested the proceeds of our IPO and concurrent private placements and expect to continue to focus on investing in the following types of securities:

*Agency RMBS* - Agency RMBS, which are RMBS for which the principal and interest payments are guaranteed by a U.S. Government agency, such as GNMA, or a U.S. Government-sponsored entity, such as FNMA or FHLMC. The Agency RMBS we acquire could be secured by fixed-rate mortgages, adjustable-rate mortgages or hybrid adjustable-rate mortgages. Fixed-rate mortgages have interest rates that are fixed for the term of the loan and do not adjust. The interest rates on adjustable-rate mortgages generally adjust annually (although some may adjust more frequently) to an increment over a specified interest rate index. Hybrid adjustable-rate mortgages have interest rates that are fixed for a specified period of time (typically three, five, seven or ten years) and, thereafter, adjust to an increment over a specified interest rate index. Adjustable-rate mortgages and hybrid adjustable-rate mortgages generally have periodic and lifetime constraints on the amount by which the loan interest rate can change on any predetermined interest rate reset date. As of September 30, 2012, all of our Agency RMBS are secured by fixed-rate mortgages.



## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

*Mortgage pass-through certificates.* - Mortgage pass-through certificates are securities representing interests in pools of mortgage loans secured by residential real property where payments of both interest and scheduled principal, plus pre-paid principal, on the securities are made monthly to holders of the securities, in effect passing through monthly payments made by the individual borrowers on the mortgage loans that underlie the securities, net of fees paid to the issuer/guarantor of the securities and servicers of the underlying mortgages.

### *Agency Derivatives:*

*Agency Interest-Only Strips.* - This type of security only entitles the holder to interest payments. The yield to maturity of Agency Interest-Only Strips is extremely sensitive to the rate of principal payments (particularly prepayments) on the underlying pool of mortgages. We invest in these types of securities primarily to take advantage of particularly attractive prepayment-related or structural opportunities in the Agency RMBS markets, as well as to help manage the duration of our overall portfolio.

*Agency Inverse Interest-Only RMBS.* - This type of security has a coupon with an inverse relationship to its index and is subject to caps and floors. Agency Inverse Interest-Only RMBS entitles the holder to interest only payments based on a notional principal balance, which is typically equal to a fixed rate of interest on the notional principal balance less a floating rate of interest on the notional principal balance that adjusts according to an index subject to set minimum and maximum rates. The value of Agency Inverse Interest-Only RMBS will generally decrease when its related index rate increases and increase when its related index rate decreases.

Table of Contents

*Collateralized Mortgage Obligations, or CMOs.* - CMOs are securities that are structured from residential pass-through certificates, which receive monthly payments of principal and interest. CMOs divide the cash flows which come from the underlying mortgage pass-through certificates into different classes of securities that may have different maturities and different weighted average lives than the underlying pass-through certificates.

CMOs include Agency stripped securities, which are mortgage-backed securities structured with two or more classes that receive different distributions of principal or interest on a pool of Agency RMBS. Stripped securities include interest only Agency RMBS and inverse interest only Agency RMBS, each of which we may invest in subject to maintaining our qualification as a REIT.

One type of Agency RMBS we intend to invest in, but had not yet done so as of the end of the quarter, is described below.

*TBAs.* - We may utilize to-be-announced forward contracts, or TBAs, in order to invest in Agency RMBS. Pursuant to these TBAs, we would agree to purchase, for future delivery, Agency RMBS with certain principal and interest terms and certain types of underlying collateral, but the particular Agency RMBS to be delivered would not be identified until shortly before the TBA settlement date. Our ability to purchase Agency RMBS through TBAs may be limited by the 75% income and asset tests applicable to REITs.

**Potential Target Assets**

Although our core investment strategy is focused on Agency RMBS, we may opportunistically supplement our portfolio with the types of assets described below.

*Non-Agency RMBS.* - RMBS that are not guaranteed by a U.S. Government agency or U.S. Government-sponsored entity, with an emphasis on securities that when originally issued were rated in the highest rating category by one or more of the nationally recognized statistical rating organizations.

The mortgage loan collateral for non-Agency RMBS consists of residential mortgage loans that do not generally conform to underwriting guidelines issued by a U.S. Government agency or U.S. Government-sponsored entity due to certain factors, including mortgage balances in excess of agency underwriting guidelines, borrower characteristics, loan characteristics and level of documentation, and therefore are not issued or guaranteed by an Agency. The mortgage loan collateral may be classified as subprime, Alternative-A or prime depending on the borrower's credit rating and the underlying level of documentation. The non-Agency RMBS we may acquire could be secured by fixed-rate mortgages, adjustable-rate mortgages or hybrid adjustable-rate mortgages.

*CMBS.* - Fixed and floating rate CMBS, with an emphasis on securities that when originally issued were rated in the highest rating category by one or more of the nationally recognized statistical rating organizations. We have not established a minimum current rating requirement.

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

*ABS.* - Debt and/or equity tranches of securitizations backed by various asset classes including, but not limited to, small balance commercial mortgages, aircrafts, automobiles, credit cards, equipment, manufactured housing, franchises, recreational vehicles and student loans with an emphasis on securities that when originally issued were rated in the highest rating category by one or more of the nationally recognized statistical rating organizations. Investments in ABS generally are not qualifying assets for purposes of the 75% asset test applicable to REITs and generally do not generate qualifying income for purposes of the 75% income test applicable to REITs. As a result, we may be limited in our ability to invest in such assets.

*Other Agency MBS.* - We may also invest in mortgage-backed securities, or MBS, for which the principal and interest payments are guaranteed by a U.S. Government agency or U.S. Government-sponsored entity, but for which the underlying mortgage loans are secured by real property other than single family residences. These may include, but are not limited to Fannie Mae DUS (Delegated Underwriting and Servicing) MBS, Freddie Mac Multifamily Mortgage Participation Certificates and Ginnie Mae project loan pools, and/or CMOs structured from such collateral.

### **Financing Strategy**

The leverage that we employ is specific to each asset class and is determined based on several factors, including potential asset price volatility, margin requirements, the current cycle for interest rates, the shape of the yield curve, the outlook for interest rates and our ability to use and the effectiveness of interest rate hedges. We analyze both historical volatility and market-driven implied volatility for each asset class in order to determine potential asset price volatility. Our leverage targets attempt to risk-adjust asset classes based on each asset class's potential price volatility. The goal of our leverage strategy is to ensure that, at all times, our investment portfolio's overall leverage ratio is appropriate for the level of risk inherent in the investment portfolio, and that each asset class has individual leverage targets that are appropriate for its potential price volatility.

Table of Contents

We fund the acquisition of our assets through the use of leverage from a number of financing sources, subject to maintaining our qualification as a REIT. We finance purchases of Agency RMBS and intend to fund our potential target assets primarily through the use of repurchase agreements.

Our operating results depend in large part on differences between the income earned on our assets and our cost of borrowing and hedging activities. We use leverage to increase potential returns to our stockholders. We accomplish this by borrowing against existing assets through repurchase agreements. There are no limits on the maximum amount of leverage that we may use, and we are not required to maintain any particular debt-to-equity leverage ratio. We may also change our financing strategy and leverage without the consent of our stockholders.

The costs associated with our borrowings are generally based on prevailing market interest rates. During a period of rising interest rates, our borrowing costs generally will increase while the yields earned on our existing portfolio of leveraged fixed-rate RMBS will remain static. This could result in a decline in our net interest spread and net interest margin. The severity of any such decline would depend on our asset/liability composition at the time, as well as the magnitude and duration of the interest rate increase. Further, an increase in short-term interest rates could also have a negative impact on the market value of our assets. If any of these events happen, we could experience a decrease in net income or incur a net loss during these periods, which could adversely affect our liquidity and results of operations.

We expect to maintain a debt to equity ratio seven to eleven times the amount of our stockholders' equity (calculated in accordance with GAAP), although there is no minimum or maximum leverage that our investment policies explicitly require. Depending on the different cost of borrowing funds at different maturities, we will vary the maturities of our borrowed funds to attempt to produce lower borrowing costs and reduce interest rate risk. We enter into collateralized borrowings only with institutions that are rated investment grade by at least one nationally-recognized statistical rating organization. We rely on financing to acquire, on a leveraged basis, the target assets in which we invest. If market conditions deteriorate, our lenders may exit the repurchase market, and tighten lending standards, or increase the amount of equity capital required to obtain financing making it more difficult and costly for us to obtain financing.

For the period from May 15, 2012 (commencement of operations) through September 30, 2012, we financed Agency RMBS with repurchase agreements employing, on a debt-to-equity basis, approximately eight-to-one leverage. In the future, we may, however, be limited or restricted in the amount of leverage we may employ by the terms and provisions of any financing or other agreements, and may be subject to margin calls as a result of its financing activity. We had an aggregate debt-to-equity ratio of approximately 3.7 to 1 at September 30, 2012, or 8.5 to 1 assuming all unsettled trades were settled with repurchase agreements at our average advance rate from May 15, 2012 (commencement of operations) through September 30, 2012 on settled trades.

We initially financed our Agency RMBS with repurchase agreement financing with maturities from one to three months, but in some cases longer. At September 30, 2012, we had entered into master repurchase agreements with 13 counterparties, and are in discussions with additional financial institutions in order to potentially provide us with additional repurchase agreement capacity. As of September 30, 2012, we had approximately \$1.9 billion outstanding under our repurchase agreements.

**Hedging Strategy**

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

Subject to maintaining our qualification as a REIT for U.S. federal income purposes, we pursue various hedging strategies to seek to reduce our exposure to adverse changes in interest rates. The U.S. federal income tax rules applicable to REITs may require us to implement certain of these techniques through a domestic Taxable REIT Subsidiary ( TRS ) that is fully subject to federal corporate income taxation. At this time we do not utilize a domestic TRS, although we may consider doing so in future. Our hedging activity varies in scope based on the level and volatility of interest rates, the type of assets held and other changing market conditions. As of September 30, 2012, we had entered into swaps designed to mitigate the effects of increases in interest rates under a portion of our repurchase agreements. These swaps provide for fixed interest rates indexed off of LIBOR and effectively fix the floating interest rates on approximately \$2.3 billion of borrowings under our repurchase agreements, inclusive of swaps entered into in anticipation of the overall increase in the size of the portfolio and its corresponding funding requirements as of September 30, 2012. To date, we have not elected to apply hedge accounting for our derivatives and, as a result, we record the change in estimated fair value of our derivatives and the associated interest in earnings.

Table of Contents

Our hedging techniques are partly based on assumed levels of prepayments of our target assets. If prepayments are slower or faster than assumed, the life of the investment will be longer or shorter, which would reduce the effectiveness of any hedging strategies we may use and may cause losses on such transactions. Hedging strategies involving the use of derivative securities are highly complex and may produce volatile returns.

**Critical Accounting Policies**

Our financial statements are prepared in accordance with GAAP, which requires the use of estimates and assumptions that involve the exercise of judgment and use of assumptions as to future uncertainties. In accordance with SEC guidance, the following discussion addresses the accounting policies that we will apply based on our expectation of our initial operations. Our most critical accounting policies will involve decisions and assessments that could affect our reported assets and liabilities, as well as our reported revenues and expenses. We believe that all of the decisions and assessments upon which our financial statements have been based were reasonable at the time made and based upon information available to us at that time. We rely on independent pricing of our assets at each quarter's end to arrive at what we believe to be reasonable estimates of fair market value. We have identified what we believe will be our most critical accounting policies to be the following:

**Investments**

We elected the fair value option for all of our RMBS at the date of purchase, which permits us to measure these securities at estimated fair value with the change in estimated fair value included as a component of earnings.

A decline in the fair market value of our assets may require us to recognize an other-than-temporary impairment against such assets under GAAP if we were to determine that, with respect to any assets in unrealized loss positions, we do not have the ability and intent to hold such assets to maturity or for a period of time sufficient for a forecasted market price recovery up to or beyond the cost of such assets. If such a determination is made, we would recognize unrealized losses through earnings and write down the amortized cost of such assets to a new cost basis, based on the fair value of such assets on the date they are considered to be other-than-temporarily impaired. Such impairment charges reflect non-cash losses at the time of recognition; subsequent disposition or sale of such assets can further affect our future losses or gains, as they are based on the difference between the sale price received and adjusted amortized cost of such assets at the time of sale.

**Valuation of financial instruments**

We disclose the estimated fair value of our financial instruments according to a fair value hierarchy (Levels I, II, and III, as defined below). In accordance with GAAP, we are required to provide enhanced disclosures regarding instruments in the Level III category (which require significant management judgment), including a separate reconciliation of the beginning and ending balances for each major category of assets and liabilities. GAAP establishes a framework for measuring estimated fair value in accordance with GAAP and expands financial statement disclosure requirements for fair value measurements. GAAP further specifies a hierarchy of valuation techniques, which is based on whether the inputs into the valuation technique are observable or unobservable. The hierarchy is as follows:

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

Level I Quoted prices in active markets for identical assets or liabilities.

Level II Quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.

Level III Prices are determined using significant unobservable inputs. In situations where quoted prices or observable inputs are unavailable (for example, when there is little or no market activity for an investment at the end of the period), unobservable inputs may be used.

The level in the fair value hierarchy within which a fair measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety.

When available, we use quoted market prices to determine the estimated fair value of an asset or liability. If quoted market prices are not available, we consult with independent pricing services or third party broker quotes, provided that there is no ongoing material event that affects the issuer of the securities being valued or the market thereof. If independent pricing service, or third party broker quotes are not available, we determine the estimated fair value of the securities using valuation techniques that use, when possible, current market-based or independently-sourced market parameters, such as interest rates.

Table of Contents

Valuation techniques for RMBS may be based upon models that consider the estimated cash flows of the security. The primary inputs to the model include yields for to-be-announced, also known as TBAs, Agency RMBS, the U.S. Treasury market and floating rate indices such as LIBOR, the Constant Maturity Treasury rate and the prime rate as a benchmark yield. The model incorporates the current weighted average maturity and additional pool level information such as prepayment speeds, default frequencies and default severities, if applicable. To the extent, the inputs are observable and timely, the values are categorized in Level II of the fair value hierarchy; otherwise they would be categorized as Level III.

Fair value under GAAP represents an exit price in the normal course of business, not a forced liquidation price. If we are forced to sell assets in a short period to meet liquidity needs, the prices we receive could be substantially less than the recorded fair values of our assets. Furthermore, the analysis of whether it is more likely than not that we will be required to sell securities in an unrealized loss position prior to an expected recovery in value (if any), the amount of such expected required sales, and the projected identification of which securities will be sold is also subject to significant judgment, particularly in times of market illiquidity.

We determine the estimated fair value of derivative financial instruments and obtain quotations from a third party to facilitate the process of determining these fair values.

We will review any changes to the valuation methodology to ensure the changes are appropriate. The methods used may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while we anticipate that our valuation methods will be appropriate and consistent with other market participants, the use of different methodologies, or assumptions, to determine the estimated fair value of certain financial instruments can result in a different estimate of estimated fair value at the reporting date. We use inputs that are current as of the measurement date, which may include periods of market dislocation, during which price transparency may be reduced.

**Interest income**

Interest income on mortgage-backed securities is accrued based on the respective outstanding principal balances and their corresponding contractual terms. Premiums and discounts associated with Agency RMBS and non-Agency RMBS rated AA and higher at the time of purchase are amortized into interest income over the estimated life of such securities using the effective yield method. We estimate prepayments for our securities and, as a result, if prepayments increase (or are expected to increase), we will accelerate the rate of amortization on premiums or discounts and make a retrospective adjustment to historical amortization. Alternatively, if prepayments decrease (or are expected to decrease) we will reduce the rate of amortization on the premiums or discounts and make a retrospective adjustment to historical amortization.

To the extent, we invest in non-Agency RMBS that are purchased at a discount to par value and/or are rated below AA at the time of purchase, interest income is recognized based on the effective yield method. Similar treatment is afforded to our portfolio of Agency Interest-Only Strips that are not classified as derivatives. The effective yield on these securities is based on the projected cash flows from each security, which is estimated based on our observation of the then current information and events and will include assumptions related to interest rates, prepayment rates and the timing and amount of credit losses. On at least a quarterly basis, we review and, if appropriate, make adjustments to our cash flow projections based on input and analysis received from external sources, internal models, and our judgment about interest rates, prepayment rates, the timing and amount of credit losses (if applicable), and other factors. Changes in cash flows from those originally projected, or from those estimated at the last evaluation, may result in a prospective change in the yield/interest income recognized on such securities. Actual maturities of the securities are affected by the contractual lives of the associated mortgage collateral, periodic payments of scheduled principal, and prepayments of principal. Therefore, actual maturities of the securities will generally be shorter than stated contractual



## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

maturities. In addition, in determining other-than-temporary impairment, we compare the present value of the remaining cash flows expected to be collected at the purchase date (or last date previously revised) against the present value of the cash flows expected to be collected at the current financial reporting date. If the market value of a security is less than the carrying value, the security is considered impaired and the loss is recorded into earnings as a realized loss.

Based on the projected cash flows from any non-Agency RMBS, which we may purchase at a discount to par value, a portion of the purchase discount, may be designated as credit protection against future credit losses and, therefore, not accreted into interest income. The amount designated as credit discount may be adjusted over time, based on the actual performance of the security, its underlying collateral, actual and projected cash flow from such collateral, economic conditions and other factors. If the performance of a security with a credit discount is more favorable than forecasted, a portion of the amount designated as credit discount may be accreted into interest income prospectively.

Table of Contents

**Repurchase agreements**

Mortgage-backed securities sold under repurchase agreements are treated as collateralized financing transactions, unless they meet sales treatment. Securities financed through a repurchase agreement remain on our balance sheet as an asset and the amount of cash received from the lender is recorded in our balance sheet as a liability. Interest paid in accordance with repurchase agreements is recorded as interest expense.

In instances where we acquire securities through repurchase agreements with the same counterparty from which the securities were purchased, we will account for the purchase commitment and repurchase agreement on a net basis and record a forward commitment to purchase securities as a derivative instrument if the transaction does not comply with the criteria for gross presentation. Such forward commitments will be recorded at fair value with subsequent changes in fair value recognized in income. Additionally, we will record the cash portion of our investment in securities as a mortgage-related receivable from the counterparty on our balance sheet. If the transaction complies with the criteria for gross presentation, we will record the assets and the related financing on a gross basis in our balance sheet and the corresponding interest income and interest expense in our statements of operations and comprehensive income (loss).

**Derivatives and hedging activities**

Subject to maintaining our qualification as a REIT for U.S. federal income tax purposes, we utilize derivative financial instruments to hedge the interest rate risk associated with our borrowings. Derivatives are used for hedging purposes rather than speculation. We determine their estimated fair value and obtain quotations from a third party to facilitate the process of determining these estimated fair values. If our hedging activities do not achieve the desired results, reported earnings may be adversely affected.

GAAP requires an entity to recognize all derivatives as either assets or liabilities in the balance sheet and to measure those instruments at estimated fair value. Fair value adjustments are recorded in earnings immediately, if the reporting entity does not elect hedge accounting for a derivative instrument.

We elected not to apply hedge accounting for these derivative instruments and record the change in estimated fair value and net interest rate swap payments (including accrued amounts) related to interest rate swaps in earnings.

We also invest in Agency Interest-Only Strips. We evaluate the terms and conditions of our holdings of Agency Interest-Only Strips to determine if these instruments have the characteristics of an investment or should be considered a derivative under GAAP. Accordingly, interest-only strips having the characteristics of derivatives are accounted for at fair value with such changes recognized in Loss on derivative instruments in our statement of operations, along with any interest earned. The carrying value of these Agency Interest-Only Strips is included in Residential mortgage-backed securities on the balance sheet.

**Income taxes**

We intend to elect and qualify to be taxed as a REIT commencing with our taxable year ending December 31, 2012. Accordingly, we will generally not be subject to corporate U.S. federal or state income tax to the extent that we make qualifying distributions to our stockholders, and provided that we satisfy on a continuing basis, through actual investment and operating results, the REIT requirements including certain asset, income, distribution and stock ownership tests. If we fail to qualify as a REIT, and do not qualify for certain statutory relief provisions, we will be subject to U.S. federal, state and local income taxes and may be precluded from qualifying as a REIT for the subsequent four taxable years following the year in which we lost our REIT qualification. Accordingly, our failure to qualify as a REIT could have a material adverse impact on our results of operations and amounts available for distribution to our stockholders.

## Table of Contents

Our dividends paid deduction for qualifying dividends paid to our stockholders is computed using our taxable income as opposed to net income reported on the financial statements. Taxable income, generally, will differ from net income reported on the financial statements because the determination of taxable income is based on tax provisions and not financial accounting principles.

We may elect to treat certain of our subsidiaries as TRSs. In general, a TRS of ours may hold assets and engage in activities that we cannot hold or engage in directly and generally may engage in any real estate or non-real estate-related business. A TRS is subject to U.S. federal, state and local corporate income taxes. While a TRS will generate net income, a TRS can declare dividends to us, which will be included in our taxable income and necessitate a distribution to our stockholders. Conversely, if we retain earnings at a TRS level, no distribution is required and we can increase book equity of the consolidated entity. As of September 30, 2012, we did not have a TRS, or any other subsidiary.

## **Warrants**

We account for the warrants comprising a part of the units issued in the private placement to certain institutional accredited investors concurrent with our IPO in accordance with Accounting Standards Codification 815, Accounting for Derivative Instruments and Hedging Activities, which provides guidance on the specific accounting treatment of a multitude of derivative instruments. The warrants issued by us have been evaluated by the Company and have been recorded at their relative fair value as a component of equity, using a variation of the adjusted Black-Scholes option valuation model to record these financial instruments at their relative fair values at issuance.

We evaluate all of our financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. For derivative financial instruments that are accounted for as liabilities, the derivative instrument is initially recorded at its fair value and is then re-valued at each reporting date, with changes in the fair value reported in the statements of operations. For stock-based derivative financial instruments, we use a variation of the adjusted Black-Scholes option valuation model to value the derivative instruments at inception.

## **Share-based compensation**

We account for share-based compensation to our independent directors, to our officers and employees, to our Manager and to employees of our Manager and its affiliates using the fair value based methodology prescribed by GAAP. Compensation cost related to restricted common stock issued to our independent directors and employees is measured at its estimated fair value at the grant date, and amortized into expense over the vesting period on a straight-line basis. Compensation costs related to restricted common stock issued to our Manager and to employees of our Manager and its affiliates are initially measured at estimated fair value at the grant date, and re-measured on subsequent dates to the extent the awards are unvested and are reported in the statement of operations as non-cash stock based compensation.

## **Accounting standards applicable to emerging growth companies**

The JOBS Act contains provisions that relax certain requirements for emerging growth companies for which we qualify. For as long as we are an emerging growth company, which may be up to five full fiscal years, unlike other public companies, we will not be required to: (i) comply with any new or revised financial accounting standards applicable to public companies until such standards are also applicable to private companies

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

under Section 102(b)(1) of the JOBS Act; (ii) provide an auditor's attestation report on management's assessment of the effectiveness of our system of internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act; (iii) comply with any new requirements adopted by the PCAOB requiring mandatory audit firm rotation or a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer; or (iv) comply with any new audit rules adopted by the PCAOB after April 5, 2012 unless the SEC determines otherwise. We may take advantage of any or all of such exemptions, but have not yet made a decision on whether to do so.

As noted above, under the JOBS Act, emerging growth companies can delay adopting new or revised accounting standards that have different effective dates for public and private companies until such time as those standards apply to private companies. We currently intend to take advantage of such extended transition period. Since we are not required to comply with new or revised accounting standards on the relevant dates on which adoption of such standards is required for other public companies, our financial statements may not be comparable to the financial statements of companies that comply with public company effective dates. If we were to elect to comply with these public company effective dates, such election would be irrevocable pursuant to Section 107 of the JOBS Act.

Table of Contents

**Recent accounting pronouncements**

In May 2011, the Financial Accounting Standards Board, or FASB, issued guidance that clarifies its intent regarding the application of existing fair value measurement requirements including: (i) prohibiting the inclusion of block discounts in all fair value measurements, not just Level I measurements; (ii) adding guidance on when to include other premiums and discounts in fair value measurements; (iii) clarifying that the concepts of highest and best use and valuation premise apply only when measuring the fair value of non-financial assets; and (iv) adding an exception that allows the measurement of a group of financial assets and liabilities with offsetting risks (a portfolio of derivative contracts) at their net exposure to a particular risk if certain criteria are met. For non-public entities, this guidance is effective for fiscal years beginning after December 15, 2011. We do not hold any Level III assets and, therefore, this update is not expected to have a material impact on our financial statements.

In December 2011, the FASB issued guidance requiring additional disclosure information about offsetting and related arrangements. Entities will be required to disclose both gross information and net information about both instruments and transactions eligible for offset in the balance sheet as well as instruments and transactions subject to an agreement similar to a master netting arrangement. This scope would include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements. The objective of this disclosure is to facilitate comparison between those entities that prepare their financial statements on the basis of GAAP and those entities that prepare their financial statements on the basis of International Financial Reporting Standards. The guidance is effective for periods beginning on or after January 1, 2013 and interim periods within those annual periods. While this guidance may result in certain additional disclosures, it is not expected to have a material impact on our financial statements.

FASB Exposure Drafts and Decisions

On September 5, 2012, the FASB decided to remove the scope exception for mortgage REITs and require a mortgage REIT that meets the requirements to be an investment company to follow investment company guidance. The FASB is currently in the process of redeliberations and will continue to consider feedback received on this Exposure Draft. If promulgated in its current form, this proposal may result in changes to the presentation of our financial statements.

On October 3, 2012, the FASB decided to eliminate the existing guidance for evaluating if a repurchase agreement entered into as part of a repurchase financing should be considered linked to a previously transferred financing asset. The decision means that under its proposed amendments to the existing model, these repurchase agreements will be accounted for as secured borrowings. This decision will impact companies that engage in repurchase financing agreements and currently account for the components as linked transactions. As of September 30, 2012, we do not account for any of its repurchase agreements as linked transactions; however additional disclosures may be required. The exposure draft is expected during the fourth quarter 2012. No effective date has been proposed.

Table of Contents

**Results of Operations**

The following discussion of our results of operations highlights our performance for the period from May 15, 2012 (commencement of operations) through September 30, 2012.

**Investments**

The following table presents certain information about our investment portfolio at September 30, 2012:

	Principal Balance (1)	Unamortized Premium (Discount)	Amortized Cost (1)	Unrealized Gain (Loss)	Estimated Fair Value (1)	Net Weighted Average Coupon(2)	Weighted Average Yield(3)
<b>30-Year Mortgage</b>							
Coupon Rate:							
3.00%	\$ 268,369	\$ 10,869	\$ 279,238	\$ 4,278	\$ 283,516	3.0%	2.7%
3.50%	2,263,298	164,868	2,428,166	19,457	2,447,623	3.5%	2.9%
4.00%	989,669	105,166	1,094,835	3,189	1,098,024	4.0%	3.1%
5.50%	70,266	8,677	78,943	(417)	78,526	5.5%	4.4%
	3,591,602	289,580	3,881,182	26,507	3,907,689	3.6%	3.0%
<b>20-Year Mortgage</b>							
Coupon Rate:							
3.00%	224,344	14,489	238,833	345	239,178	3.0%	2.3%
3.50%	182,685	10,783	193,468	3,262	196,730	3.5%	2.4%
4.00%	74,597	7,690	82,287	22	82,309	4.0%	2.6%
	481,626	32,962	514,588	3,629	518,217	3.3%	2.4%
<b>CMO - Fixed Rate</b>	66,000	10,684	76,684	183	76,867	6.5%	2.6%
<b>IOs and IIOs(4)</b>	N/A	N/A	81,203	(4,043)	77,160	4.4%	17.9%
Agency interest-only strips accounted for as derivatives (4)							
	N/A	N/A	N/A	N/A	33,863	4.0%(5)	33.6%
	N/A	N/A	81,203	(4,043)	111,023	4.3%	22.7%
<b>Total</b>	<b>\$ 4,139,228</b>	<b>\$ 333,226</b>	<b>\$ 4,553,657</b>	<b>\$ 26,276</b>	<b>\$ 4,613,796</b>	<b>3.7%</b>	<b>3.4%</b>

(1) Includes unsettled purchases with an aggregate cost of \$2,667,281 and estimated fair value of \$2,666,351 at September 30, 2012.

(2) Net weighted average coupon as of September 30, 2012 is presented net of servicing and other fees.

(3) Weighted average yield as of September 30, 2012 incorporates estimates for future prepayment and loss assumptions.

(4) IOs and IIOs and Agency Interest-Only Strips, accounted for as derivatives, have no principal balances and bear interest based on a notional balance. The notional balance is used solely to determine interest distributions on interest-only class of securities.

(5) Interest on these securities is reported as a component of Loss on derivative instruments.

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

As of September 30, 2012, our portfolio consisted primarily of fixed rate RMBS which our Manager believes exhibit prepayment mitigation attributes, including Agency RMBS collateralized by low loan balances or loans where the underlying borrower is unable to access the Making Home Affordable Program, including the Home Affordable Refinance Program or HARP.

### *Investment Activity*

*RMBS, Agency Derivatives and Other Securities.* For the period from May 15, 2012 (commencement of operations) through September 30, 2012, we acquired approximately \$5.5 billion (of which approximately \$2.7 billion were unsettled) of Agency RMBS and Agency Derivatives and \$100.7 million of other securities consisting of U.S Treasury Notes. During the same period, we received principal payments of approximately \$35.6 million for Agency RMBS. Proceeds from sales received for the period from May 15, 2012 (commencement of operations) through September 30, 2012 were approximately \$896.3 million for Agency RMBS and Agency Derivatives and \$100.9 million for other securities. The average unlevered yield on Agency RMBS, including Agency Derivatives, for the period from May 15, 2012 (commencement of operations) through September 30, 2012 was approximately 2.9%.

*Financing and Other Liabilities.* We have entered into repurchase agreements to finance a substantial majority of our Agency RMBS. These agreements are secured by substantially all of our Agency RMBS and bear interest at rates that have historically moved in close relationship to LIBOR. For the period from May 15, 2012 (commencement of operations) through September 30, 2012, we received proceeds of approximately \$7.4 billion and made repayments of approximately \$5.5 billion under repurchase agreements. At September 30, 2012, we had outstanding repurchase agreement borrowings with the following eleven (11) counterparties totaling approximately \$1.9 billion:

(dollars in thousands)

<b>Repurchase Agreement Counterparties</b>	<b>Amount Outstanding</b>	<b>Percent of Total Amount Outstanding</b>	<b>Company MBS Held as Collateral(1)</b>
JP Morgan Securities LLC	\$ 329,186	17.1%	\$ 345,386
Merrill Lynch Pierce Fenner & Smith Inc.	267,693	13.9%	279,432
Credit Suisse Securities (USA) LLC	257,024	13.4%	273,811
Deutsche Bank Securities LLC	239,355	12.4%	250,849
Barclays Capital Inc.	161,561	8.4%	170,926
RBC Capital Markets LLC	142,673	7.4%	152,347
Morgan Stanley & Co. LLC	141,490	7.4%	151,530
BNP Paribas Securities Corporation	139,791	7.3%	149,944
Goldman Sachs Bank USA	97,335	5.1%	103,412
UBS Securities LLC	96,482	5.0%	101,368
Citigroup Global Markets Inc.	50,927	2.6%	53,280
<b>Total</b>	<b>\$ 1,923,517</b>	<b>100.0%</b>	<b>\$ 2,032,285</b>

(1)At fair value.

We record the liability for RMBS and other securities purchased, for which settlement has not taken place as an investment related payable. As of September 30, 2012, we had investment related payables of approximately \$2.7 billion, of which no items were outstanding greater than 30 days.



## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

### Table of Contents

The following table presents our borrowings by type of collateral pledged as of September 30, 2012, and the respective Effective Cost of Funds (non-GAAP financial measure) for the period then ended (dollars in thousands) See Non-GAAP financial measures :

Collateral	Balance September 30, 2012	Weighted Average Cost of Funds for the three months ended September 30, 2012	Weighted Average Effective Cost of Funds for the three months ended September 30, 2012 (1)	Weighted Average Cost of Funds for the period from May 15, 2012 (commencement of operations) through September 30, 2012	Weighted Average Effective Cost of Funds for the period from May 15, 2012 (commencement of operations) through September 30, 2012 (1)
Agency RMBS	\$ 1,923,517	0.43%	0.79%	0.41%	0.79%
Total	\$ 1,923,517	0.43%	0.79%	0.41%	0.79%

(1) The effective cost of funds for the periods presented are calculated on an annualized basis and include interest expense for the periods and net payments on interest rate swaps of approximately \$1.6 million and \$2.4 million respectively. While swaps are not accounted for using hedge accounting, such instruments are viewed by us as an economic hedge against increases in interest rates. See Non GAAP Financial Measures .

*Derivative Instruments.* As of September 30, 2012, we had entered into swaps and swaptions designed to mitigate the effects of increases in interest rates under a portion of our repurchase agreements. These swaps and swaptions provide for fixed interest rates indexed off of LIBOR and are viewed by us to effectively fix the floating interest rates on approximately \$2.3 billion of borrowings under our repurchase agreements, inclusive of swaps entered into in anticipation of the overall increase in the size of the portfolio and the corresponding funding requirements as of September 30, 2012.

The following table presents information about our interest rate swaps as of September 30, 2012 (dollars in thousands):

Remaining Interest Rate interest rate swap Term	Notional Amount	Average Fixed Pay Rate	Average Maturity (Years)
Greater than 1 year and less than 3 years	\$ 542,000	0.6 %	2.2
Greater than 3 years and less than 5 years	260,100	0.9	3.9
Greater than 5 years	1,461,400	1.6	9.5
Total	\$ 2,263,500	1.3 %	7.1

As of September 30, 2012, approximately 26% of these instruments are forward starting swaps (approximately ten months forward).

At September 30, 2012, we had entered into a swaption with a notional amount of \$75.0 million that expires in 11 months. If exercised, we can enter into a 10 year fixed pay swap agreement at a predetermined strike price.

### *Net Interest Income*

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

We earned interest income, net of premium (discount) amortization, of approximately \$14.7 million and approximately \$21.5 million for the three months ended September 30, 2012 and for the period from May 15, 2012 (commencement of operations) through September 30, 2012, respectively, representing interest earned on our assets. We incurred interest expense of approximately \$1.9 million and approximately \$2.7 million for the three months ended September 30, 2012 and for the period from May 15, 2012 (commencement of operations) through September 30, 2012, respectively, which was related to borrowings from repurchase agreements.

(dollars in thousands)	Three months ended September 30, 2012	Period from May 15, 2012 (commencement of operations) through September 30, 2012
Average amortized cost of RMBS (1)	\$2,076,122	\$1,957,129
Total interest income (2)	\$14,688	\$21,538
Yield on average RMBS	2.77%	2.85%
Average balance of repurchase agreements	\$1,787,408	\$1,717,583
Total interest expense	\$1,935	\$2,660
Average cost of funds (3)	0.43%	0.41%
Net interest income	\$12,753	\$18,878
Net interest rate spread	2.34%	2.44%

(1) Amount reflects amortized cost, which does not include net mark-to-market adjustments on Agency Interest-Only Strips accounted for as derivatives.

(2) Amount includes net amortization of premiums and discounts of approximately \$(6.9) million and \$(9.1) million for the three months ended September 30, 2012 and for the period from May 15, 2012 (commencement of operations) through September 30, 2012, respectively.

(3) Cost of funds does not include accrual and settlement of interest associated with derivative instruments. In accordance with GAAP, those costs are included in gain (loss) on derivative instruments in the statement of operations.

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

### Table of Contents

The following table sets forth certain information regarding our net investment income for the three months ended September 30, 2012 and for the period from May 15, 2012 (commencement of operations) through September 30, 2012, See **Non-GAAP Financial Measures** :

<b>Non-GAAP Financial Measures:</b>	Three months ended September 30, 2012	Period from May 15, 2012 (commencement of operations) through September 30, 2012
Average amortized cost of RMBS held including Agency interest-only strips accounted for as derivatives	\$2,102,659	\$1,984,169
Total interest income including interest income on Agency Interest-Only Strips accounted for as derivatives (1)	\$14,801	\$22,032
Yield on average amortized cost of RMBS including adjustments related to purchase premiums and discounts on Agency Interest-Only Strips accounted for as derivatives	2.79%	2.92%
Total interest expense including interest income (expense), net incurred on interest rate swaps (2)	\$3,565	\$5,015
Average cost of funds including interest income on Agency Interest-Only Strips accounted for as derivatives	0.79%	0.77%
Net interest income including interest income on Agency Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps	\$11,236	\$17,017
Net interest rate spread including interest income on Agency Interest-Only Strips classified as derivatives and interest income (expense), net incurred on interest rate swaps	2.00%	2.15%

(1) For the three months ended September 30, 2012 and period from May 15, 2012 (commencement of operations) through September 30, 2012, this amount also includes net amortization of premiums and discounts of approximately \$(8.4) million and \$(11.0) million, respectively, inclusive of approximately \$1.5 million and \$1.9 million, respectively of amortization of premiums on Agency Interest-Only Strips accounted for as derivatives, not reported in interest income for GAAP.

(2) Represents the net amount paid, including accrued amounts and realized termination gain (loss), for interest rate swaps during the period.

Interest income is subject to interest rate risk. Refer to Item 3, **Quantitative and Qualitative Disclosures about Market Risk**, for more information relating to interest rate risk and its impact on our operating results.

### ***Realized and Unrealized Gain (Loss)***

For the three months ended September 30, 2012, we sold Agency RMBS and other securities of approximately \$657.5 million realizing gross gains of approximately \$7.4 million and gross losses of approximately \$955 thousand. During the period from May 15, 2012 (commencement of operations) through September 30, 2012, we sold Agency RMBS and other securities of approximately \$997.2 million realizing gross gains of approximately \$8.6 million and gross losses of approximately \$980 thousand. We sold these RMBS in order to: (i) adjust the prepayment

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

characteristics of our portfolio; or (ii) adjust the duration of our portfolio.

With respect to our RMBS, we elected the fair value option and, as a result, we record the change in estimated fair value related to RMBS in earnings. The following table presents amounts related to realized gains and losses as well as changes in estimated fair value of our RMBS portfolio and derivative instruments that are included in our statement of operations for the three months ended September 30, 2012 and for the period from May 15, 2012 (commencement of operations) through September 30, 2012 (dollars in thousands):

### Three months ended September 30, 2012

Description	Realized Gain (Loss), net	Other loss on Residential mortgage -backed securities	Unrealized Gain (Loss), net	Mark-to- market adjustments	Total
RMBS and Other Securities	\$ 6,454	\$ -	\$ 28,329	\$ -	\$ 34,783
IOs and IIOs	-	(5,545)	-	-	(5,545)
Interest rate swaps and interest rate swaptions (1)	(1,630)	-	(8,373)	-	(10,003)
Agency Interest-Only Strips accounted for as derivative(2)	1,622	-	-	(3,295)	(1,673)
<b>Total</b>	<b>\$ 6,446</b>	<b>\$ (5,545)</b>	<b>\$ 19,956</b>	<b>\$ (3,295)</b>	<b>\$ 17,562</b>

(1) Realized Gain (Loss), net on interest rate swaps represents the net amount incurred, for swaps during the period and realized gains (losses) on swap terminations.

(2) Realized Gain (Loss), net on Agency Interest-Only Strips represents interest income earned on these securities based on the actual coupon. Mark-to-Market adjustments on Agency Interest-Only Strips represent the change in fair value for the period.

Table of Contents**Period from May 15, 2012 (commencement of operations) through September 30, 2012**

Description	Realized Gain (Loss), net	Other loss on Residential mortgage -backed securities	Unrealized Gain (Loss), net	Mark-to- market adjustments	Total
RMBS and Other Securities	\$ 7,574	\$ -	\$ 32,254	\$ -	\$ 39,828
IOs and IIOs	-	(6,150)	-	-	(6,150)
Interest rate swaps and interest rate swaptions (1)	(2,352)	-	(13,417)	-	(15,769)
Agency Interest-Only Strips accounted for as derivative(2)	2,439	-	-	(3,659)	(1,220)
<b>Total</b>	<b>\$ 7,661</b>	<b>\$ (6,150)</b>	<b>\$ 18,837</b>	<b>\$ (3,659)</b>	<b>\$ 16,689</b>

(1) Realized Gain (Loss), net on interest rate swaps represent the net amount incurred, for swaps during the period and realized gains (losses) on swap terminations.

(2) Realized Gain (Loss), net on Agency Interest-Only Strips represents interest income earned on these securities based on the actual coupon. Mark-to-Market adjustments on Agency Interest-Only Strips represent the change in fair value for the period.

In order to mitigate interest rate risk resulting from our repurchase agreements, we entered into interest rate swaps with an aggregate notional amount of approximately \$2.3 billion, inclusive of swaps entered into in anticipation of the overall increase in the size of the portfolio and the corresponding funding requirements. While not designated as a hedge for accounting purposes, our interest rate swaps are viewed as an economic hedge on a portion of our floating-rate borrowings. Since we do not apply hedge accounting for our interest rate swaps, we record the change in estimated fair value related to such agreements in earnings as unrealized gain or loss on derivative transactions. Included in realized gain or loss on derivative instruments are the net interest rate swap payments (including accrued amounts) associated with our interest rate swaps.

***Expenses******General and Administrative Expenses***

We incurred general and administrative expenses of approximately \$1.3 million and approximately \$1.9 million for the three months ended September 30, 2012 and for the period from May 15, 2012 (commencement of operations) through September 30, 2012, respectively, which represents professional fees, insurance, non-cash stock based compensation and overhead costs of the Company.

***Management Fee Expense***

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

We incurred management fee expense of approximately \$0.8 million and approximately \$1.2 million for the three months ended September 30, 2012 and for the period from May 15, 2012 (commencement of operations) through September 30, 2012, respectively, of which approximately \$0.8 million was payable at September 30, 2012 to our Manager under the Management Agreement. Pursuant to the terms of the Management Agreement, our Manager is paid a management fee equal to 1.5% per annum of our stockholders' equity (as defined in the Management Agreement), calculated and payable (in cash) quarterly in arrears.

The management fees, expense reimbursements and the relationship between our Manager and us are discussed further in Note 8, Related Party Transactions, to the financial statements contained in this Quarterly Report on Form 10-Q.

Table of Contents

***Dividends***

The following table presents cash dividends declared and paid by us on our common stock:

Declaration Date	Record Date	Payment Date	Amount per Share
July 26, 2012	August 6, 2012	August 14, 2012	\$ 0.38
September 20, 2012	October 1, 2012	October 25, 2012	\$ 0.85

***Subsequent Event***

***Follow-On Offering***

On October 3, 2012, we completed a follow-on equity offering 13.8 million shares of our common stock, generating net proceeds to the Company of approximately \$301.0 million.

**Liquidity and Capital Resources**

***General***

Our liquidity and capital resources are managed on a daily basis to ensure that we have sufficient liquidity to absorb market events that could negatively impact collateral valuations and result in margin calls and to ensure that we have the flexibility to manage our investment portfolio to take advantage of market opportunities.

Liquidity is a measure of our ability to meet potential cash requirements, including ongoing commitments to repay borrowings, fund and maintain our assets and operations, make distributions to our stockholders and other general business needs. We use cash to purchase our target assets, repay principal and interest on our borrowings, make distributions to our stockholders and fund our operations.

Under our repurchase agreements, lenders retain the right to mark the collateral pledged to estimated fair value. A reduction in the value of the collateral pledged will require us to provide additional collateral or fund cash margin calls. As part of our risk management process, our Manager closely monitors our liquidity position and subjects our balance sheet to scenario testing designed to assess the our liquidity in the face of different economic and market developments. We believe we have sufficient current liquidity and access to additional liquidity to meet

financial obligations for at least the next 12 months.

Our primary sources of liquidity are as follows:

*Cash Generated from Initial Public Offering, Concurrent Private Placements and Follow-On Offering*

On May 15, 2012, we completed our IPO and concurrent private placements generating net proceeds of approximately \$204.4 million. On October 3, 2012, we completed a follow-on equity offering generating net proceeds of approximately \$301.0 million.



Table of Contents

***Borrowing under Various Financing Arrangements***

As of September 30, 2012, we had master repurchase agreements with 13 counterparties and are in discussions with other financial institutions in order to potentially provide us with additional repurchase agreement capacity. We had borrowings under repurchase agreements with 11 counterparties of approximately \$1.9 billion at September 30, 2012. The following tables present our borrowings by type of collateral pledged as of September 30, 2012, and the respective effective cost of funds (non-GAAP financial measure) for the period then ended (dollars in thousands) See Non-GAAP Financial Measures :

Collateral	Principal Balance	Fair Value of Collateral Pledged (1)	Weighted Average Interest Rate, end of period	Weighted Average Cost of Funds for the three months ended September 30, 2012	Weighted Average Effective Cost of Funds for the three months ended September 30, 2012 (2)	Weighted Average Cost of Funds for the period from May 15, 2012 (commencement of operations) through September 30, 2012	Weighted Average Effective Cost of Funds for the period from May 15, 2012 (commencement of operations) through September 30, 2012 (2)
Agency RMBS	\$ 1,923,517	\$ 2,033,165	0.44%	0.43%	0.79%	0.41%	0.77%
Total	\$ 1,923,517	\$ 2,033,165	0.44%	0.43%	0.79%	0.41%	0.77%

(1) Includes approximately \$0.9 million of cash collateral for Agency RMBS.

(2) The effective cost of funds for the periods presented are calculated on an annualized basis and include interest expense for the periods and net payments on interest rate swaps of approximately \$1.6 million and \$2.4 million, respectively. While interest rate swaps are not accounted for using hedge accounting, such instruments are viewed by us as an economic hedge against increases in interest rates. See Non-GAAP Financial Measures .

As of September 30, 2012, our transactions under 13 repurchase agreements for Agency RMBS, require collateral in excess of the loan amount, or haircuts, ranging from a low of 3% to a high of 5%, exclusive of IOs and IIOs for which the haircut is a high as 25%. Declines in the value of our Agency RMBS portfolio can trigger margin calls by our lenders under our repurchase agreements. An event of default or termination event would give some of our counterparties the option to terminate all existing repurchase transactions with us and require any amount due to the counterparties by us to be payable immediately.

Under the repurchase agreements, the respective lenders, subject to the terms of the individual agreement, retain the right to mark the underlying collateral to fair value. A reduction in the value of pledged assets requires us to provide additional collateral or fund margin calls. In addition, certain of the repurchase agreements may be terminated by our counterparties if we do not maintain certain equity and leverage metrics. We were not aware of any failure to meet these tests at September 30, 2012. RMBS held by counterparties as security for repurchase agreements totaled approximately \$2.0 billion. Cash collateral held by counterparties at September 30, 2012 was approximately \$24.8 million, which is included in Due from counterparties on our balance sheet, comprised of approximately \$0.9 million held in connection with repurchase borrowings and approximately \$23.9 million held by our interest rate swap counterparties. Further, Due to counterparties includes approximately \$7.0 million posted with us by our repurchase agreement counterparties.

We had approximately \$2.7 billion of unsettled securities as of September 30, 2012, which would have increased our total outstanding borrowing balance at such time if the purchases had been settled with repurchase agreements at or prior to September 30, 2012.

***Cash Generated from Operations***

Our operating activities provided net cash of approximately \$21.1 million for the period from May 15, 2012 (commencement of operations) through September 30, 2012. The cash provided by operating activities was primarily a result of our operating income during our initial period of operation. Our net income for the period from May 15, 2012 (commencement of operations) through September 30, 2012 was \$32.5 million. Included in our net income for the period from May 15, 2012 (commencement of operations) through September 30, 2012 were non-cash items that do not generate cash such as amortization of the premium and discount of RMBS, unrealized gain/(loss) on securities, mark-to-market adjustments on derivatives and other losses on residential mortgage-backed securities. Also included in net income for the period from May 15, 2012 (commencement of operations) through September 30, 2012 were net realized gains of \$7.5 million which is cash generated from investing activities. During the same period, cash from operations of \$4.1 million was used to increase our net operating assets over operating liabilities.

***Cash Generated from Investing Activities***

Our investing activities used net cash of approximately \$2.1 billion for the period from May 15, 2012 (commencement of operations) through September 30, 2012. During the period from May 15, 2012 (commencement of operations) through September 30, 2012, we utilized cash to purchase approximately \$3.0 billion of Agency RMBS and other securities and purchased an interest rate swaption for approximately \$1.2 million, which was offset by proceeds from asset sales of approximately \$814.4 million and principal payments of approximately \$35.6 million.

Table of Contents

***Other Potential Sources of Financing***

We held cash of approximately \$19.5 million at September 30, 2012. Our primary sources of cash currently consist of repurchase facility borrowings, investment income and settlement of our follow-on equity offering. In the future, we expect our primary sources of liquidity to consist of payments of principal and interest we receive on our portfolio of assets, unused borrowing capacity under our financing sources and future issuances of equity and debt securities.

To maintain our qualification as a REIT under the Internal Revenue Code, we must distribute annually at least 90% of our taxable income. This distribution requirement limits our ability to retain earnings and thereby replenish or increase capital for operations. We believe that our significant capital resources and access to financing will provide us with financial flexibility at levels sufficient to meet current and anticipated capital requirements, including funding new investment opportunities, paying distributions to our stockholders and servicing our debt obligations.

**Contractual Obligations and Commitments**

Our contractual obligations as of September 30, 2012 are as follows (dollars in thousands):

	Less than 1 year	1 to 3 years	3 to 5 years	More than 5 years	Total
Borrowings under repurchase agreements	\$ 1,923,517	-	-	-	\$ 1,923,517
Total	\$ 1,923,517	-	-	-	\$ 1,923,517

As of September 30, 2012, we have an obligation for approximately \$2.0 million in contractual interest payments related to our repurchase agreements through the respective maturity date of each repurchase agreement. In addition, as of September 30, 2012, we had an obligation for unsettled RMBS purchase transactions that settled in October 2012 of approximately \$2.7 billion which are included in Investment Related Payables on our Balance Sheet.

The table above does not include amounts due under the Management Agreement (as defined herein) with our Manager, as those obligations do not have fixed and determinable payments. For a description of the Management Agreement, see Our Manager and the Management Agreement the Management Agreement.

On May 9, 2012, we entered into a management agreement (the Management Agreement ) with our Manager pursuant to which our Manager is entitled to receive a management fee and reimbursement of certain expenses. Our Manager is responsible for: (i) performing all of our

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

day-to-day functions, other than those provided by our chief financial officer; (ii) determining investment criteria in conjunction with our board of directors; (iii) sourcing, analyzing and executing investments, asset sales and financings; (iv) performing asset management duties; and (v) performing financial and accounting management, subject to the direction and oversight of our board of directors. Pursuant to the terms of the Management Agreement, our Manager is paid a management fee equal to 1.5% per annum of our stockholders' equity, calculated and payable (in cash) quarterly in arrears. For purposes of calculating the management fee, stockholders' equity means the sum of the net proceeds from any issuances of our equity securities since inception (allocated on a pro rata daily basis for such issuances during the fiscal quarter of any such issuance), plus retained earnings, calculated in accordance with GAAP, at the end of the most recently completed fiscal quarter (without taking into account any non-cash equity compensation expense incurred in current or prior periods), less any amount paid for repurchases of our shares of common stock, excluding any unrealized gains, losses or other non-cash items that have impacted stockholders' equity as reported in our financial statements prepared in accordance with GAAP, regardless of whether such items are included in other comprehensive income or loss, or in net income, and excluding one-time events pursuant to changes in GAAP and certain other non-cash charges after discussions between our Manager and our independent directors and after approval by a majority of our independent directors. However, if our stockholders' equity for any given quarter is negative based on the calculation described above, our Manager will not be entitled to receive any management fee for that quarter.

In addition, under the Management Agreement, we are required to reimburse our Manager for the expenses described below. Expense reimbursements to the Manager are made in cash on a monthly basis following the end of each month. Our reimbursement obligation is not subject to any dollar limitation. Because our Manager's personnel perform certain legal, accounting, due diligence tasks and other services that outside professionals or outside consultants otherwise would perform, our Manager is paid or reimbursed for the documented cost of performing such tasks, provided that such costs and reimbursements are in amounts which are no greater than those which would be payable to outside professionals or consultants engaged to perform such services pursuant to agreements negotiated on an arm's-length basis. For the period May 15, 2012 (commencement of operations) through September 30, 2012, our Manager did not request any such reimbursements, exclusive of any salary or employee benefits associated with our sole employee.

Table of Contents

The Management Agreement may be amended, supplemented or modified by agreement between our Manager and us. The initial term of the Management Agreement expires on May 15, 2015 and it is automatically renewed for one-year terms on each anniversary thereafter unless previously terminated as described below. Our independent directors will review the Manager's performance and any fees payable to the Manager annually and, following the initial term, the Management Agreement may be terminated annually upon the affirmative vote of at least two-thirds (2/3) of our independent directors, based upon: (i) our Manager's unsatisfactory performance that is materially detrimental to us; or (ii) our determination that any fees payable to our Manager are not fair, subject to our Manager's right to prevent such termination due to unfair fees by accepting a reduction of management fees agreed to by at least two-thirds (2/3) of our independent directors. We will provide our Manager 180 days prior notice of any such termination. Unless terminated for cause, we will pay the Manager a termination fee equal to three times the average annual management fee earned by the Manager during the prior 24-month period immediately preceding the date of termination, calculated as of the end of the most recently completed fiscal quarter prior to the date of termination.

We may also terminate the Management Agreement at any time, including during the initial term, without the payment of any termination fee, with 30 days prior written notice from our board of directors for cause, which will be determined by a majority of our independent directors, which is defined as: (i) our Manager's continued material breach of any provision of the Management Agreement (including our Manager's failure to comply with our investment guidelines); (ii) our Manager's fraud, misappropriation of funds, or embezzlement against us; (iii) the Manager's gross negligence in the performance of its duties under the Management Agreement; (iv) the occurrence of certain events with respect to the bankruptcy or insolvency of our Manager, including an order for relief in an involuntary bankruptcy case or our Manager authorizing or filing a voluntary bankruptcy petition; (v) our Manager is convicted (including a plea of nolo contendere) of a felony; or (vi) the dissolution of our Manager.

**Off-Balance Sheet Arrangements**

We do not have any relationships with any entities or financial partnerships, such as entities often referred to as structured investment vehicles, or special purpose or variable interest entities, established to facilitate off-balance sheet arrangements or other contractually narrow or limited purposes.

Further, we have not guaranteed any obligations of any entities or entered into any commitment to provide additional funding to any such entities.

**Dividends**

We intend to make regular quarterly dividend distributions to holders of our common stock. U.S. federal income tax law generally requires that a REIT distribute annually at least 90% of its REIT taxable income for the taxable year, without regard to the deduction for dividends paid and excluding net capital gains, and that it pay tax at regular corporate rates to the extent that it annually distributes less than 100% of its net taxable income. During the course of our taxable year, we intend to pay regular quarterly dividends to our stockholders based on our net taxable income, if and to the extent authorized by our board of directors. Before we pay any dividend, whether for U.S. federal income tax purposes or otherwise, we must first meet both our operating requirements and debt service on our repurchase agreements and other debts payable. If our cash available for distribution is less than our net taxable income, we could be required to sell assets or borrow funds to make cash distributions or we may make a portion of the required distribution in the form of a taxable stock distribution or distribution of debt securities.

**Non-GAAP Financial Measures**

*Total Interest Income and Net Interest Income, including Interest Income on Agency Interest-Only Strips accounted for as derivatives and Effective Cost of Funds*

Total interest income including interest income on Agency Interest-Only Strips classified as derivatives and Effective Cost of Funds for the three months ended September 30, 2012 and for the period from May 15, 2012 (commencement of operations) through September 30, 2012, constitutes a non-GAAP financial measure within the meaning of Regulation G promulgated by the SEC. We believe that the measures presented in this quarterly report on Form 10-Q, when considered together with U.S. GAAP financial measures, provide information that is useful to investors in understanding our borrowing costs and net interest income, as viewed by us. An analysis of any non-GAAP financial measure should be made in conjunction with results presented in accordance with GAAP.

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

### Table of Contents

The following table reconciles total interest income to interest income including interest income on Agency Interest-Only Strips classified as derivatives for the three months ended September 30, 2012 and for the period from May 15, 2012 (commencement of operations) through September 30, 2012:

	Three months ended September 30, 2012	For the period from May 15, 2012 (commencement of operations) through September 30, 2012
Coupon Interest	\$ 21,544	30,592
Premium Amortization	(6,856)	(9,054)
Interest Income	14,688	21,538
Contractual Interest income, net of amortization of premiums or discounts, net, on Agency Interest-Only Strips, classified as derivatives(1):		
Coupon Interest	1,622	2,439
Premium (Discount) Amortization	(1,509)	(1,945)
Subtotal	113	494
Total interest income, including interest income on Agency Interest-Only Strips, classified as derivatives - Non-GAAP Financial Measure	\$ 14,801	\$ 22,032

(1) Reported in Loss on derivative instruments in the Statement of Operations.

Effective Cost of Funds includes the net interest component related to our interest rate swaps. While we have not elected hedge accounting for our interest rate swaps, such derivative instruments are viewed by us as an economic hedge against increases in future market interest rates, and therefore the Effective Cost of Funds reflects interest expense adjusted to include the realized loss (i.e., the interest expense component) for all of our interest rate swaps.

The following table reconciles the Effective Cost of Funds (non-GAAP financial measure) with interest expense for the three months ended September 30, 2012 and for the period from May 15, 2012 (commencement of operations) through September 30, 2012:

Three Months Ended September 30, 2012

(dollars in thousands)	Reconciliation	Cost of Funds/Effective Borrowing Costs
Interest expense	\$ 1,935	0.43 %
Net interest paid - interest rate swaps	1,630	0.36 %
Effective Borrowing Costs	\$ 3,565	0.79 %

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

Weighted average repurchase borrowings 1,787,408

Period from May 15, 2012 (commencement of operations) through September 30, 2012

(dollars in thousands)	Reconciliation	Cost of Funds/Effective Borrowing Costs
Interest expense	\$ 2,660	0.41 %
Net interest paid - interest rate swaps	2,355	0.36 %
Effective Borrowing Costs	\$ 5,015	0.77 %
Weighted average repurchase borrowings	1,717,583	

### *Core Earnings*

Our Core Earnings were approximately \$9.3 million and approximately \$14.1 million for the three months ended September 30, 2012 and for the period from May 15, 2012 (commencement of operations) through September 30, 2012, respectively. Core Earnings is a non-GAAP financial measure that is used by us to approximate cash available for distribution and is defined as GAAP net income (loss) as adjusted, excluding: (i) net realized gain (loss) on investments and derivative contracts; (ii) net unrealized gain (loss) on investments; (iii) loss resulting from mark-to-market adjustments on derivative contracts; (iv) non-cash stock-based compensation expense; and (v) one-time events pursuant to changes in GAAP and certain other non-cash charges after discussions between the us, the Manager and our independent directors and after approval by a majority of the our independent directors.

In order to evaluate the effective yield of the portfolio, we use Core Earnings to reflect the net investment income of our portfolio as adjusted to reflect the net interest rate swap interest income (expense). Core Earnings allows us to isolate the interest income (expense) associated with our interest rate swaps in order to monitor and project our borrowing costs and interest rate spread. In addition, we utilize Core Earnings as a key metric in conjunction with other portfolio and market factors to determine the appropriate leverage and hedge ratios, as well as the overall structure of the portfolio. We believe that the presentation of Core Earnings is useful to investors because Core Earnings isolates the net interest rate swap interest income (expense) which provides investors with an additional metric to identify trends in our portfolio as they relate to the interest rate environment. We also believe that our investors use Core Earnings or a comparable supplemental performance measure to evaluate and compare our performance and our peers, and as such, we believe that the disclosure of Core Earnings is useful to our investors.



Table of Contents

Our presentation of Core Earnings may not be comparable to similarly-titled measures of other companies, who may use different calculations. As a result, Core Earnings should not be considered as a substitute for our GAAP net income as a measure of our financial performance or any measure of our liquidity under GAAP.

The table below summarizes the reconciliation from Net Income to Core Earnings for the three months ended September 30, 2012 and for the period from May 15, 2012 (commencement of operations) through September 30, 2012:

	Three months ended September 30, 2012	For the period from May 15, 2012 (commencement of operations) through September 30, 2012
(dollars in thousands)		
Net Income GAAP	\$ 28,194	\$ 32,455
Adjustments:		
Non-cash stock-based compensation expense	157	211
Unrealized gain on RMBS	(28,329)	(32,254)
Realized gain on termination of interest rate swap	-	(4)
Unrealized loss on interest rate swaps and swaptions	8,373	13,417
Mark-to-market adjustments on Agency Interest-Only Strips accounted for as derivatives	1,786	1,714
Other loss on Residential mortgage-backed securities	5,545	6,150
Realized gain on sale of RMBS	(6,454)	(7,574)
Total adjustments	(18,922)	(18,340)
Core Earnings Non-GAAP Financial Measure	\$ 9,272	\$ 14,115
Basic Core Earnings per Share of Common Stock and Participating Securities - Non-GAAP Financial Measure	\$ 0.90	\$ 1.36
Diluted Core Earnings per Share of Common Stock and Participating Securities - Non-GAAP Financial Measure	\$ 0.89	\$ 1.36
Basic weighted average common shares and participating securities	10,343,944	10,340,860
Diluted weighted average common shares and participating securities	10,364,252	10,340,860

**ITEM 3. Quantitative and Qualitative Disclosures about Market Risk.**

We seek to manage the risks related to the credit quality of our assets, interest rates, liquidity, prepayment speeds and market values while, at the same time, seeking to provide an opportunity to stockholders to realize attractive risk-adjusted returns from our assets through ownership of our common stock. While we do not seek to avoid risk completely, our Manager seeks to actively manage risk for us, to earn sufficient compensation to justify taking those risks and to maintain capital levels consistent with the risks we undertake.

**Credit Risk**

We are subject to varying degrees of credit risk in connection with our assets. Although we do not expect to encounter credit risk in our Agency RMBS, we do expect, to the extent we invest in such securities, to encounter credit risk related to non-Agency RMBS and any of our other target assets we may acquire. Investment decisions are made following a bottom-up credit analysis and specific risk assumptions. As part of the risk management process, our Manager uses detailed proprietary models to evaluate, depending on the asset class, house price appreciation and depreciation by region, prepayment speeds and foreclosure frequency, cost and timing. If our Manager determines that the proposed investment can meet the appropriate risk and return criteria as well as complement our existing asset portfolio, the investment will undergo a more thorough analysis.

Table of Contents

***Interest Rate Risk***

Interest rates are highly sensitive to many factors, including fiscal and monetary policies and domestic and international economic and political considerations, as well as other factors beyond our control. We are subject to interest rate risk in connection with our assets and our related financing obligations. In general, we expect to finance the acquisition of our assets through financings in the form of repurchase agreements, warehouse facilities, securitizations, resecuritizations, bank credit facilities (including term loans and revolving facilities) and public and private equity and debt issuances in addition to transaction or asset specific funding arrangements. Subject to maintaining our qualification as a REIT for U.S. federal income tax purposes, we utilize derivative financial instruments to hedge the interest rate risk associated with our borrowings. We also may engage in a variety of interest rate management techniques that seek to mitigate changes in interest rates or other potential influences on the values of our assets.

***Interest Rate Effect on Net Interest Income***

Our operating results will depend in large part on differences between the income earned on our assets and our borrowing costs. The cost of our borrowings is generally based on prevailing market interest rates. During a period of rising interest rates, our borrowing costs generally will increase and the yields earned on our leveraged fixed rate mortgage assets will remain static. Further, the cost of such financing could increase at a faster pace than the yields earned on our leveraged ARM and hybrid ARM assets, if any. This could result in a decline in our net interest spread and net interest margin. The severity of any such decline would depend on our asset/liability composition at the time as well as the magnitude and duration of the interest rate increase. Further, an increase in short-term interest rates could also have a negative impact on the market value of our assets. If any of these events happen, we could experience a decrease in net income or incur a net loss during these periods, which could adversely affect our liquidity and results of operations.

***Interest Rate Cap Risk***

If we elect to invest in adjustable-rate RMBS, such securities are generally subject to interest rate caps, which potentially could cause such RMBS to acquire many of the characteristics of fixed-rate securities if interest rates were to rise above the cap levels. This issue is magnified to the extent we acquire ARM and hybrid ARM assets that are not based on mortgages which are fully indexed. In addition, ARM and hybrid ARM assets may be subject to periodic payment caps that result in some portion of the interest being deferred and added to the principal outstanding or a portion of the incremental interest rate increase being deferred. To the extent we invest in such ARM and/or hybrid ARM assets, we could potentially receive less cash income on such assets than we would need to pay the interest cost on our related borrowings. To mitigate interest rate mismatches, we may utilize the hedging strategies discussed above under Interest Rate Risk.

***Interest Rate Effects on Estimated Fair Value***

Another component of interest rate risk is the effect that changes in interest rates will have on the market value of the assets that we acquire. We face the risk that the market value of our assets will increase or decrease at different rates than those of our liabilities, including our hedging instruments.

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

The impact of changing interest rates on estimated fair value can change significantly when interest rates change materially. Therefore, the volatility in the estimated fair value of our assets could increase significantly in the event interest rates change materially. In addition, other factors impact the estimated fair value of our interest rate-sensitive investments and hedging instruments, such as the shape of the yield curve, market expectations as to future interest rate changes and other market conditions. Accordingly, changes in actual interest rates may have a material adverse effect on us.

### *Market Risk*

*Market value risk.* Our RMBS are reflected at their estimated fair value with unrealized gains and losses included in earnings. The estimated fair value of these securities fluctuates primarily due to changes in interest rates and other factors. Generally, in a rising interest rate environment, the estimated fair value of these securities would be expected to decrease; conversely, in a decreasing interest rate environment, the estimated fair value of these securities would be expected to increase.

Table of Contents

The sensitivity analysis table presented below shows the estimated impact of an instantaneous parallel shift in the yield curve, up and down 50 and 100 basis points, on the market value of our interest rate-sensitive investments, including interest rate swaps, Agency Interest-Only Strips, and net interest income at September 30, 2012, assuming a static portfolio of assets. When evaluating the impact of changes in interest rates, prepayment assumptions and principal reinvestment rates are adjusted based on our Manager's expectations. The analysis presented utilizes our Manager's assumptions, models and estimates, which are based on our Manager's judgment and experience.

Change in Interest Rates	Percentage Change in Projected Net Interest Income	Percentage Change in Projected Portfolio Value
+1.00%	39.06%	(2.12)%
+0.50%	22.48%	(0.82)%
-0.50%	(27.79)%	(0.37)%
-1.00%	NA(1)	NA(1)

(1) Not applicable, borrowing rate is below zero.

While the table above reflects the estimated immediate impact of interest rate increases and decreases on a static portfolio, we rebalance our portfolio from time to time either to seek to take advantage of or reduce the impact of changes in interest rates. It is important to note that the impact of changing interest rates on market value and net interest income can change significantly when interest rates change beyond 100 basis points from current levels. Therefore, the volatility in the market value of our assets could increase significantly when interest rates change beyond amounts shown in the table above. In addition, other factors impact the market value of and net interest income from our interest rate-sensitive investments and derivative instruments, such as the shape of the yield curve, market expectations as to future interest rate changes and other market conditions. Accordingly, interest income would likely differ from that shown above and such difference might be material and adverse to our stockholders.

Certain assumptions have been made in connection with the calculation of the information set forth in the table above and, as such, there can be no assurance that assumed events will occur or that other events will not occur that would affect the outcomes. The base interest rate scenario assumes interest rates at September 30, 2012. The analysis presented utilizes assumptions and estimates based on our Manager's judgment and experience. Furthermore, while we generally expect to retain such assets and the associated interest rate risk, future purchases and sales of assets could materially change our interest rate risk profile.

**Prepayment Risk**

The value of our assets may be affected by prepayment rates on residential mortgage loans. We acquire RMBS and anticipate that the underlying residential mortgages loans will prepay at a projected rate generating an expected yield. If we purchase assets at a premium to par value, when borrowers prepay their residential mortgage loans faster than expected, the corresponding prepayments on the mortgage-related securities may reduce the expected yield on such securities because the Company will have to amortize the related premium on an accelerated basis and make a retrospective adjustment to historical amortization. Conversely, if we purchase assets at a discount to par value, when borrowers prepay their residential mortgage loans slower than expected, the decrease in corresponding prepayments on the RMBS may reduce the expected yield on such securities because we will not be able to accrete the related discount as quickly as originally anticipated and will have to make a retrospective adjustment to historical amortization.

***Counterparty Risk***

The following discussion on counterparty risk describes how these transactions work, rather than how they are presented for financial reporting purposes.

When we engage in repurchase transactions, we generally sell securities to lenders (i.e., repurchase agreement counterparties) and receive cash from the lenders. The lenders are obligated to resell the same securities back to us at the end of the term of the transaction. Because the cash we receive from the lender when we initially sell the securities to the lender is less than the value of those securities (this difference is the haircut), if the lender defaults on its obligation to resell the same securities back to us, we could incur a loss on the transaction up to the amount of the haircut (assuming there was no change in the value of the securities).

If a counterparty to an interest rate swap cannot perform under the terms of the interest rate swap, we may not receive payments due under that agreement, and thus, we may lose any unrealized gain associated with the interest rate swap. We may also risk the loss of any collateral we have pledged to secure our obligations under interest rate swap if the counterparty becomes insolvent or files for bankruptcy. In addition, the interest rate swap would no longer mitigate the impact of changes in interest rates as intended.

***Funding Risk***

We have financed a substantial majority of our RMBS with repurchase agreement financing. Over time, as market conditions change, in addition to these financings, we may use other forms of leverage. Weakness in the financial markets, the residential mortgage markets and the economy generally could adversely affect one or more of our potential lenders and could cause one or more of our potential lenders to be unwilling or unable to provide us with financing or to increase the costs of that financing.

***Liquidity Risk***

Our liquidity risk is principally associated with the financing of long-maturity assets with short-term borrowings in the form of repurchase agreements. Although the interest rate adjustments of these assets and liabilities fall within the guidelines established by our operating policies, maturities are not required to be, nor are they, matched.

Table of Contents

Should the value of our assets pledged as collateral suddenly decrease, margin calls relating to our repurchase agreements could increase, causing an adverse change in our liquidity position. Our inability to post adequate collateral for a margin call by the counterparty could result in a condition of default under our repurchase agreements, thereby enabling the counterparty to liquidate the collateral pledged by us, which may have a material adverse consequence on our business and results of operations.

Additionally, if one or more of our repurchase agreement counterparties chose not to provide on-going funding, our ability to finance would decline or exist at possibly less advantageous terms. Further, if we are unable to renew, replace or expand repurchase financing with other sources of financing on substantially similar terms, it may have an adverse effect on our business and results of operations, due to the long term nature of our investments and relatively short-term maturities of our repurchase agreements. As such, we cannot assure that it will always be able to roll over its repurchase agreements.

The costs associated with our borrowings are generally based on prevailing market interest rates. During a period of rising interest rates, our borrowing costs generally will increase while the yields earned on our existing portfolio of leveraged fixed-rate RMBS will remain static. This could result in a decline in our net interest spread and net interest margin. The severity of any such decline would depend on our asset/liability composition at the time, as well as the magnitude and duration of the interest rate increase. Further, an increase in short-term interest rates could also have a negative impact on the market value of our assets. If any of these events happen, we could experience a decrease in net income or incur a net loss during these periods, which could adversely affect our liquidity and results of operations.

In addition, the assets that comprise our asset portfolio are not traded on a public exchange. A portion of these assets may be subject to legal and other restrictions on resale or will otherwise be less liquid than publicly-traded securities. The illiquidity of our assets may make it difficult for us to sell such assets if the need or desire arises, including in response to changes in economic and other conditions.

***Inflation***

Virtually all of our assets and liabilities are interest rate sensitive in nature. As a result, interest rates and other factors influence our performance far more so than does inflation. Changes in interest rates do not necessarily directly correlate with inflation rates or changes in inflation rates. Our financial statements are prepared in accordance with GAAP and our distributions will be determined by our board of directors consistent with our obligation to distribute to our stockholders at least 90% of our net taxable income on an annual basis in order to maintain our REIT qualification; in each case, Our activities and balance sheet are measured with reference to historical cost and/or fair market value without considering inflation.

**ITEM 4. Controls and Procedures.**

The Company's Chief Executive Officer and Chief Financial Officer, based on their evaluation of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) required by paragraph (b) of Rule 13a-15 or Rule 15d-15, have concluded that as of September 30, 2012, the Company's disclosure controls and procedures were effective to give reasonable assurances to the timely collection, evaluation and disclosure of information relating to the Company that would potentially be subject to disclosure under the Exchange Act and the rules and regulations promulgated thereunder.

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

During the period from May 15, 2012 (commencement of operations) through September 30, 2012, there was no change in the Company's internal control over financial reporting that has materially affected, or was reasonably likely to materially affect, the Company's internal control over financial reporting.

Notwithstanding the foregoing, a control system, no matter how well designed and operated, can provide only reasonable, not absolute assurance that it will detect or uncover failures within the Company to disclose material information otherwise required to be set forth in the Company's periodic reports.



Table of Contents

**PART II OTHER INFORMATION**

**ITEM 1. Legal Proceedings**

From time to time, the Company may be involved in various claims and legal actions arising in the ordinary course of business. As of September 30, 2012, the Company was not involved in any legal proceedings.

**ITEM 1A. Risk Factors**

See the Registration Statement on Form S-11, as originally filed on and declared effective on September 28, 2012 with the Securities and Exchange Commission. There have been no material changes to the Company's risk factors for the period from May 15, 2012 (commencement of operations) through September 30, 2012.

**ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

**ITEM 3. Defaults Upon Senior Securities**

None.

**ITEM 4. Mine Safety Disclosures**

Not Applicable.

**ITEM 5. Other Information**

None.

Table of Contents

**ITEM 6. Exhibits**

(a) The following exhibits are filed as part of this report.

<b>Exhibit No.</b>	<b>Description</b>
10.2*	Form of Unit Purchase Agreement between Western Asset Mortgage Capital Corporation and certain institutional accredited investors, incorporated by reference to Exhibit 10.1 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.
10.3*	Form of Warrant, incorporated by reference to Exhibit 10.2 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.
10.4*	Management Agreement, dated May 9, 2012, between Western Asset Mortgage Capital Corporation and Western Asset Management Company, incorporated by reference to Exhibit 10.4 to the Quarterly Report on Form 10-Q, filed August 14, 2012.
10.5*	Registration Rights Agreement, dated May 15, 2012, among Western Asset Mortgage Capital Corporation, Western Asset Management Company and certain individual holders named therein, incorporated by reference to Exhibit 10.5 to the Quarterly Report on Form 10-Q, filed August 14, 2012.
10.6*	Western Asset Mortgage Capital Corporation Equity Plan, incorporated by reference to Exhibit 10.5 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.
10.7*	Western Asset Mortgage Capital Corporation Manager Equity Plan, incorporated by reference to Exhibit 10.6 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.
10.8*	Form of Indemnification Agreement between Western Asset Mortgage Capital Corporation and a director, incorporated by reference to Exhibit 10.7 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.
10.9*	Restricted Stock Award Agreement, dated May 15, 2012, for Western Asset Management Company, incorporated by reference to Exhibit 10.9 to the Quarterly Report on Form 10-Q, filed August 14, 2012.
10.10*	Form of Restricted Stock Award Agreement for independent directors, incorporated by reference to Exhibit 10.2 to the Form S-8 dated May 15, 2012 (File No. 1-35543).
10.11	Underwriting Agreement, dated September 27, 2012, between Western Asset Mortgage Capital Corporation, Western Asset Management Company, Deutsche Bank Securities Inc. and Citigroup Global Markets Inc.
31.1	Rule 13a-14(a) / 15d-14(a) Certification of Chief Executive Officer.
31.2	Rule 13a-14(a) / 15d-14(a) Certification of Chief Financial Officer.
32.1	Section 1350 Certifications of Chief Executive Officer and Chief Financial Officer
101.INS**	XBRL Instance Document
101.SCH**	XBRL Taxonomy Extension Schema Document
101.CAL**	XBRL Taxonomy Extension Calculation Linkbase Document

Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-Q

101.DEF\*\* XBRL Taxonomy Extension Definition Linkbase Document  
101.LAB\*\* XBRL Taxonomy Extension Label Linkbase Document  
101.PRE\*\* XBRL Taxonomy Extension Presentation Linkbase Document

\*Fully or partly previously filed.

\*\*These interactive data files are furnished and not deemed filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act, and are not deemed filed for purposes of Section 18 of the Exchange Act, and otherwise are not subject to liability under those sections.

Table of Contents

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

WESTERN ASSET MORTGAGE CAPITAL CORPORATION

November 14, 2012

By: /s/ GAVIN L. JAMES

**Gavin L. James**  
**President, Chief Executive Officer and Director**

By: /s/ STEVEN M. SHERWYN

**Steven M. Sherwyn**  
**Chief Financial Officer and Treasurer**