MFA FINANCIAL, INC.
Form 10-Q
November 07, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2011

OR

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

For the transition period from to

Commission File Number: 1-13991

MFA FINANCIAL, INC.

(Exact name of registrant as specified in its charter)

Maryland	**13-3974868**
(State or other jurisdiction of	(I.R.S. Employer
incorporation or organization)	Identification No.)
350 Park Avenue, 20th Floor, New York, New York	**10022**
(Address of principal executive offices)	(Zip Code)

(212) 207-6400

(Registrant s telephone number, including area code)

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

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

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

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o	Smaller reporting company o

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

356,209,321 shares of the registrant s common stock, $0.01 par value, were outstanding as of October 28, 2011.

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MFA FINANCIAL, INC.

CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Per Share Amounts)		September 30, 2011 (Unaudited)		December 31, 2010
Assets:				
Mortgage-backed securities (MBS):				
Agency MBS, at fair value ($6,892,716 and $5,519,879 pledged as collateral, respectively)	$	7,519,002	$	5,980,623
Non-Agency MBS, at fair value ($1,069,870 and $867,655 pledged as collateral, respectively)		1,431,102		1,372,383
Non-Agency MBS transferred to consolidated variable interest entities (VIEs) *(1)*		2,458,208		705,704
Cash and cash equivalents		421,026		345,243
Restricted cash		22,498		41,927
MBS linked transactions, net (Linked Transactions), at fair value		64,494		179,915
Interest receivable		44,340		38,215
Derivative hedging instruments, at fair value		81		
Real estate held-for-sale as of September 30, 2011, net		10,651		10,732
Goodwill		7,189		7,189
Prepaid and other assets		16,172		5,476
Total Assets	$	11,994,763	$	8,687,407
Liabilities:				
Repurchase agreements	$	8,017,663	$	5,992,269
Securitized debt *(2)*		958,406		220,933
Accrued interest payable		7,478		8,007
Derivative hedging instruments, at fair value		134,712		139,142
Dividends and dividend equivalents rights (DERs) payable		90,200		67,040
Accrued expenses and other liabilities		145,080		9,569
Total Liabilities	$	9,353,539	$	6,436,960
Commitments and contingencies (Note 9)				
Stockholders Equity:				
Preferred stock, $.01 par value; series A 8.50% cumulative redeemable; 5,000 shares authorized; 3,840 shares issued and outstanding ($96,000 aggregate liquidation preference)	$	38	$	38
Common stock, $.01 par value; 895,000 and 370,000 shares authorized; 355,591 and 280,481 issued and outstanding, respectively		3,556		2,805
Additional paid-in capital, in excess of par		2,792,491		2,184,493
Accumulated deficit		(214,785)		(191,569)
Accumulated other comprehensive income		59,924		254,680
Total Stockholders Equity	$	2,641,224	$	2,250,447
Total Liabilities and Stockholders Equity	$	11,994,763	$	8,687,407

(1) Non-Agency MBS transferred to consolidated VIEs included in the Consolidated Balance Sheet at September 30, 2011 and December 31, 2010 represent assets of the consolidated VIEs that can be used only to settle the obligations of each respective VIE.

(2) Securitized Debt included in the Consolidated Balance Sheet at September 30, 2011 and December 31, 2010, represents third-party liabilities of consolidated VIEs and excludes liabilities of the VIEs acquired by the Company that eliminate on consolidation. The third-party beneficial interest holders in the VIEs have no recourse to the general credit of the Company. (See Notes 9 and 14 for further discussion.)

The accompanying notes are an integral part of the consolidated financial statements.

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MFA FINANCIAL, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

(In Thousands, Except Per Share Amounts)	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Interest Income:				
Agency MBS	$ 59,957	$ 60,390	$ 186,114	$ 193,598
Non-Agency MBS	24,379	36,906	76,098	99,857
Non-Agency MBS transferred to consolidated VIEs	46,405		110,435	
Cash and cash equivalent investments	25	121	106	286
Interest Income	130,766	97,417	372,753	293,741
Interest Expense:				
Repurchase agreements	34,924	35,464	102,513	109,656
Securitized debt	3,828		8,087	
Total Interest Expense	38,752	35,464	110,600	109,656
Net Interest Income	92,014	61,953	262,153	184,085
Other-Than-Temporary Impairments:				
Total other-than-temporary impairment losses	(14,913)		(15,550)	(184)
Portion of loss recognized in/(reclassified from) other comprehensive income	10,922		9,167	(5,228)
Net Impairment Losses Recognized in Earnings	(3,991)		(6,383)	(5,412)
Other Income, net:				
Unrealized net gains and net interest income from Linked Transactions	733	21,307	9,970	41,304
Gains on sale of MBS	4,196		4,196	33,739
Revenue from operations of real estate held-for-sale	390	369	1,146	1,100
Loss on termination of repurchase agreements				(26,815)
Other, net	(898)		(886)	
Other Income, net	4,421	21,676	14,426	49,328
Operating and Other Expense:				
Compensation and benefits	5,477	4,106	15,591	12,527
Other general and administrative expense	3,031	2,003	7,981	5,995
Real estate held-for-sale operating expense, mortgage interest and prepayment penalty	237	306	774	1,298
Operating and Other Expense	8,745	6,415	24,346	19,820
Net Income	83,699	77,214	245,850	208,181
Less: Preferred Stock Dividends	2,040	2,040	6,120	6,120
Net Income Available to Common Stock and Participating Securities	$ 81,659	$ 75,174	$ 239,730	$ 202,061
Earnings per Common Share - Basic and Diluted	$ 0.23	$ 0.27	$ 0.71	$ 0.72

Dividends Declared per share of Common Stock	$	0.25	$	0.19	$	0.74	$	0.43 *(1)*

(1) A dividend of $0.225 per share for the quarter ended September 30, 2010 was declared on October 1, 2010. See Note 10.

The accompanying notes are an integral part of the consolidated financial statements.

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MFA FINANCIAL, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS)/INCOME

(UNAUDITED)

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	**2011**	**2010**	**2011**	**2010**
Net Income	$ 83,699	$ 77,214	$ 245,850	$ 208,181
Other Comprehensive Income:				
Unrealized gain on Agency MBS, net	12,035	5,899	50,092	(1,465)
Unrealized loss on Non-Agency MBS, net	(109,294)	42,162	(250,845)	99,560
Reclassification adjustment for MBS sales	(4,525)		(4,869)	(41,459)
Reclassification adjustment for net losses included in net income for other-than-temporary impairments	3,991		6,383	5,412
Unrealized (loss)/gain on derivative hedging instruments, net	(10,255)	(7,624)	4,483	(22,840)
Comprehensive (loss)/income before preferred dividends	$ (24,349)	$ 117,651	$ 51,094	$ 247,389
Dividends declared on preferred stock	(2,040)	(2,040)	(6,120)	(6,120)
Comprehensive (Loss)/Income Available to Common Stock and Participating Securities	$ (26,389)	$ 115,611	$ 44,974	$ 241,269

The accompanying notes are an integral part of the consolidated financial statements.

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MFA FINANCIAL, INC.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY

(UNAUDITED)

(In Thousands, Except Per Share Amounts)		**Nine Months Ended September 30, 2011 Dollars**	**Shares**
Preferred Stock, Series A 8.50% Cumulative Redeemable Liquidation Preference $25.00 per Share:			
Balance at September 30, 2011 and December 31, 2010	$	38	3,840
Common Stock, Par Value $.01:			
Balance at December 31, 2010		2,805	280,481
Issuance of common stock		751	75,110
Balance at September 30, 2011		3,556	355,591
Additional Paid-in Capital, in excess of Par:			
Balance at December 31, 2010		2,184,493	
Issuance of common stock, net of expenses		605,015	
Equity-based compensation expense and other		2,983	
Balance at September 30, 2011		2,792,491	
Accumulated Deficit:			
Balance at December 31, 2010		(191,569)	
Net income		245,850	
Dividends declared on common stock		(261,750)	
Dividends declared on preferred stock		(6,120)	
Dividends attributable to DERs		(1,196)	
Balance at September 30, 2011		(214,785)	
Accumulated Other Comprehensive Income:			
Balance at December 31, 2010		254,680	
Change in unrealized gains on MBS, net		(199,239)	
Change in unrealized losses on derivative hedging instruments		4,483	
Balance at September 30, 2011		59,924	
Total Stockholders Equity at September 30, 2011	$	2,641,224	

The accompanying notes are an integral part of the consolidated financial statements.

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MFA FINANCIAL, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	Nine Months Ended September 30,	
(In Thousands)	**2011**	**2010**
Cash Flows From Operating Activities:		
Net income	$ 245,850	$ 208,181
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sales of MBS	(4,196)	(33,739)
Losses on termination of repurchase agreements		26,815
Other-than-temporary impairment charges	6,383	5,412
Net (accretion of purchase discounts)/amortization of purchase premiums	(6,380)	5,404
(Increase)/decrease in interest receivable	(6,125)	7,478
Depreciation and amortization on real estate and other assets	2,263	483
Unrealized losses/(gains) and other on Linked Transactions	4,831	(25,909)
Increase in prepaid and other assets and other	(47)	(53)
Increase/(decrease) in accrued expenses and other liabilities	37	(3,593)
Decrease in accrued interest payable	(529)	(5,877)
Equity-based compensation expense and other	2,983	2,190
Net cash provided by operating activities	$ 245,070	$ 186,792
Cash Flows From Investing Activities:		
Principal payments on MBS	$ 1,688,520	$ 2,524,021
Proceeds from sale of MBS	76,495	939,119
Purchases of MBS	(4,430,941)	(2,492,909)
Net additions to leasehold improvements, furniture, fixtures and real estate investment	(2,004)	(276)
Net cash (used in)/provided by investing activities	$ (2,667,930)	$ 969,955
Cash Flows From Financing Activities:		
Principal payments on repurchase agreements	$ (43,843,055)	$ (39,524,402)
Proceeds from borrowings under repurchase agreements	45,821,751	38,324,022
Proceeds from issuance of securitized debt	963,255	
Principal payments on securitized debt	(225,782)	
Payments to terminate repurchase agreements		(26,815)
Payments made for resecuritization related costs	(6,981)	
Cash disbursements on financial instruments underlying Linked Transactions	(2,051,908)	(1,088,668)
Cash received from financial instruments underlying Linked Transactions	1,464,965	962,012
Payments made for margin calls on repurchase agreements and interest rate swaps (Swaps)	(8,460)	(435,507)
Proceeds from reverse margin calls on repurchase agreements and Swaps	25,914	461,850
Payment made to purchase interest rate swaptions (Swaptions)	(915)	
Proceeds from issuances of common stock	605,765	370
Dividends paid on preferred stock	(6,120)	(6,120)
Dividends paid on common stock and DERs	(239,786)	(196,881)
Principal amortization and prepayment on mortgage loan		(9,143)
Net cash provided by/(used in) financing activities	$ 2,498,643	$ (1,539,282)
Net increase/(decrease) in cash and cash equivalents	$ 75,783	$ (382,535)
Cash and cash equivalents at beginning of period	$ 345,243	$ 653,460
Cash and cash equivalents at end of period	$ 421,026	$ 270,925

Non-cash Investing and Financing Activities:				
MBS recorded upon de-linking of Linked Transactions	$	744,231	$	112,835
Repurchase agreements recorded upon de-linking of Linked Transactions	$	46,698	$	
Dividends and DERs declared and unpaid	$	90,200	$	538

The accompanying notes are an integral part of the consolidated financial statements.

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MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2011

1. Organization

MFA Financial, Inc. (the Company) was incorporated in Maryland on July 24, 1997 and began operations on April 10, 1998. The Company has elected to be treated as a real estate investment trust (REIT) for federal income tax purposes. In order to maintain its qualification as a REIT, the Company must comply with a number of requirements under federal tax law, including that it must distribute at least 90% of its annual REIT taxable income to its stockholders. (See Note 10(b))

2. Summary of Significant Accounting Policies

(a) Basis of Presentation and Consolidation

The interim unaudited financial statements of the Company have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and note disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) have been condensed or omitted according to these SEC rules and regulations. Management believes that the disclosures included in these interim financial statements are adequate to make the information presented not misleading. The accompanying financial statements should be read in conjunction with the financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2010. In the opinion of management, all normal and recurring adjustments necessary to present fairly the financial condition of the Company at September 30, 2011 and results of operations for all periods presented have been made. The results of operations for the nine months ended September 30, 2011 should not be construed as indicative of the results to be expected for the full year.

The consolidated financial statements of the Company have been prepared on the accrual basis of accounting in accordance with GAAP. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although the Company s estimates contemplate current conditions and how it expects them to change in the future, it is reasonably possible that actual conditions could be worse than anticipated in those estimates, which could materially impact the Company s results of operations and its financial condition. Management has made significant estimates in several areas, including other-than-temporary impairment (OTTI) on Agency and Non-Agency MBS (Note 3), valuation of Agency and Non-Agency MBS (Notes 3 and 13) and derivative hedging instruments (Notes 4 and 13), and income recognition on certain Non-Agency MBS purchased at a discount (Note 3). Actual results could differ from those estimates. The consolidated financial statements of the Company include the accounts of all subsidiaries; significant intercompany accounts and transactions have been eliminated. Certain prior period amounts have been reclassified to conform to the current period presentation.

(b) Agency and Non-Agency MBS (including Non-Agency MBS transferred to a consolidated VIE)

The Company has investments in residential MBS that are issued or guaranteed as to principal and/or interest by a federally chartered corporation, such as Fannie Mae or Freddie Mac, or any agency of the U.S. Government, such as Ginnie Mae (collectively, Agency MBS), and residential MBS that are not guaranteed by any U.S. Government agency or any federally chartered corporation (Non-Agency MBS), as described in Note 3.

Designation

The Company generally intends to hold its MBS until maturity; however, from time to time, it may sell any of its securities as part of the overall management of its business. As a result, all of the Company s MBS are designated as available-for-sale and, accordingly, are carried at their fair value with unrealized gains and losses excluded from earnings (except when an OTTI is recognized, as discussed below) and reported in accumulated other comprehensive income, a component of stockholders equity.

Upon the sale of an investment security, any unrealized gain or loss is reclassified out of accumulated other comprehensive income to earnings as a realized gain or loss using the specific identification method.

Revenue Recognition, Premium Amortization and Discount Accretion

Interest income on securities is accrued based on the outstanding principal balance and their contractual terms. Premiums and discounts associated with Agency MBS and Non-Agency MBS rated AA and higher at the time of purchase are amortized into interest income over the life of such securities using the effective yield method. Adjustments to premium amortization are made for actual prepayment activity.

Interest income on the Non-Agency MBS that were purchased at a discount to par value and/or were rated below AA at the time of purchase is recognized based on the security s effective interest rate. The effective interest

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NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2011

rate on these securities is based on management s estimate from each security of the projected cash flows, which are estimated based on the Company s observation of current information and events and include assumptions related to fluctuations in interest rates, prepayment speeds 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, 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 these securities or in the recognition of OTTI impairments. (See Note 3)

Based on the projected cash flows from the Company s Non-Agency MBS purchased at a discount to par value, a portion of the purchase discount may be designated as non-accretable purchase discount (Credit Reserve), which effectively provides credit protection against future credit losses and is not expected to be accreted into interest income. The amount designated as Credit Reserve 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 Reserve is more favorable than forecasted, a portion of the amount designated as Credit Reserve may be accreted into interest income over time. Conversely, if the performance of a security with a Credit Reserve is less favorable than forecasted, the amount designated as Credit Reserve may be increased, or impairment charges and write-downs of such securities to a new cost basis could result.

Determination of MBS Fair Value

The Company determines the fair value of its Agency MBS based upon prices obtained from a third-party pricing service, which are indicative of market activity. In determining the fair value of its Non-Agency MBS, management considers a number of observable market data points including prices obtained from third-party pricing services and brokers as well as dialogue with market participants. (See Note 13)

Impairments

When the fair value of an investment security is less than its amortized cost at the balance sheet date, the security is considered impaired. The Company assesses its impaired securities on at least a quarterly basis and designates such impairments as either temporary or other-than-temporary. If the Company intends to sell an impaired security, or it is more likely than not that it will be required to sell the impaired security before its anticipated recovery, then the Company must recognize an OTTI through charges to earnings equal to the entire difference between the investment s amortized cost and its fair value at the balance sheet date. If the Company does not expect to sell an other-than-temporarily impaired security, only the portion of the OTTI related to credit losses is recognized through charges to earnings with the remainder recognized through other accumulated comprehensive income on the consolidated balance sheet. Impairments recognized through other comprehensive income do not impact earnings. Following the recognition of an OTTI through earnings, a new cost basis is established for the security and may not be adjusted for subsequent recoveries in fair value through earnings. However, other-than-temporary impairments recognized through charges to earnings may be accreted back to the amortized cost basis of the security on a prospective basis through interest income. The determination as to whether an OTTI exists and, if so, the amount considered other-than-temporarily impaired is subjective, as such determinations are based on both factual and subjective information available at the time of assessment. As a result, the timing and amount of OTTIs constitute material estimates that are susceptible to significant change. (See Note 3)

Non-Agency MBS on which impairments are recognized have experienced, or are expected to experience, credit-related adverse cash flow changes. The Company s estimate of cash flows for its Non-Agency MBS is based on its review of the underlying mortgage loans securing the MBS. The Company considers information available about the performance of underlying mortgage loans, including prepayment rates, default rates, loss severities, delinquency rates, percentage of non-performing loans, Fair Isaac Corporation (FICO) scores at loan origination, year of origination, loan-to-value ratios, geographic concentrations, as well as reports by credit rating agencies, such as Moody s Investors Services, Inc. (Moody s), Standard & Poor s Corporation (S&P), or Fitch, Inc. (collectively, Rating Agencies), general market assessments, and dialogue with market participants. As a result, significant judgment is used in the Company s analysis to determine the expected cash flows for its Non-Agency MBS. In determining the other-than-temporary impairment related to credit losses, 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.

Balance Sheet Presentation

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

MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2011

sales of securities are recorded on the trade date or when all significant uncertainties regarding the securities are removed. However, if a repurchase agreement is determined to be linked to the purchase of an MBS, then the MBS and linked repurchase borrowing will be reported net, as Linked Transactions. (See Notes 2(m) and 4)

(c) Cash and Cash Equivalents

Cash and cash equivalents include cash on deposit with financial institutions and investments in money market funds, all of which have original maturities of three months or less. Cash and cash equivalents may also include cash pledged as collateral to the Company by its repurchase agreement and/or Swap counterparties as a result of reverse margin calls (i.e., margin calls made by the Company). The Company did not hold any cash pledged by its counterparties at September 30, 2011 or December 31, 2010. At September 30, 2011 and December 31, 2010, all of the Company s cash investments were comprised of overnight money market funds, which are not bank deposits and are not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. (See Notes 8 and 13)

(d) Restricted Cash

Restricted cash represents the Company s cash held by its counterparties as collateral against the Company s Swaps and/or repurchase agreements. Restricted cash, which earns interest, is not available to the Company for general corporate purposes, but may be applied against amounts due to counterparties to the Company s repurchase agreements and/or Swaps, or returned to the Company when the collateral requirements are exceeded or at the maturity of the Swap or repurchase agreement. The Company had aggregate restricted cash held as collateral against its Swaps and repurchase agreements of $22.5 million and $41.9 million at September 30, 2011 and December 31, 2010, respectively. (See Notes 4, 7, 8 and 13)

(e) Goodwill

At September 30, 2011 and December 31, 2010, the Company had goodwill of $7.2 million, which represents the unamortized portion of the excess of the fair value of its common stock issued over the fair value of net assets acquired in connection with its formation in 1998. Goodwill is tested for impairment at least annually, or more frequently under certain circumstances, at the entity level. Through September 30, 2011, the Company had not recognized any impairment against its goodwill.

(f) Depreciation

Real Estate/Real Estate Held-for-Sale

The Company has 100% of the ownership interest in Lealand Place, a 191-unit apartment property located in Lawrenceville, Georgia, through Lealand Place, LLC (Lealand), an indirect, wholly-owned subsidiary. This property was acquired through a tax-deferred exchange under Section 1031 of the Internal Revenue Code of 1986, as amended (the Code). (See Note 6)

The property, capital improvements and other assets held in connection with this investment are carried at cost, net of accumulated depreciation and amortization. Maintenance, repairs and minor improvements are expensed in the period incurred, while real estate assets, except land, and capital improvements are depreciated over their useful life using the straight-line method. The estimated life is 27.5 years for buildings and five to seven years for furniture and fixtures.

On March 31, 2011, the Company classified its investment in Lealand as held-for-sale and accordingly ceased depreciating assets related to this investment as of such date. The Company reviewed the carrying value of its investment in Lealand as of September 30, 2011, and it determined that Lealand s fair value less cost to sell was in excess of its carrying value. Lealand s historical results of operations are not material to the Company.

Leasehold Improvements and Other Depreciable Assets

Depreciation is computed on the straight-line method over the estimated useful life of the related assets or, in the case of leasehold improvements, over the shorter of the useful life or the lease term. Furniture, fixtures, computers and related hardware have estimated useful lives ranging from five to eight years at the time of purchase.

(g) Resecuritization Related Costs

Resecuritization related costs are costs associated with the issuance of beneficial interests by consolidated VIEs and incurred by the Company in connection with the resecuritization transactions that were completed in October 2010, February 2011 and June 2011. These costs include underwriting, rating agency, legal, accounting and other fees. Such costs, which reflect deferred charges, are included on the Company s consolidated balance sheet in prepaid and other assets. These deferred charges are amortized as an adjustment to interest expense using the effective interest method, based upon the actual repayments of the associated beneficial interests.

MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2011

(h) Repurchase Agreements

The Company finances the acquisition of a significant portion of its MBS with repurchase agreements. Under repurchase agreements, the Company sells securities to a lender and agrees to repurchase the same securities in the future for a price that is higher than the original sale price. The difference between the sale price that the Company receives and the repurchase price that the Company pays represents interest paid to the lender. Although legally structured as a sale and repurchase, the Company accounts for its repurchase agreements as secured borrowings, with the exception of those repurchase agreements accounted for as components of Linked Transactions. (See Note 2(m) below.) Under its repurchase agreements, the Company pledges its securities as collateral to secure the borrowing, which is equal in value to a specified percentage of the fair value of the pledged collateral, while the Company retains beneficial ownership of the pledged collateral. At the maturity of a repurchase financing, unless the repurchase financing is renewed with the same counterparty, the Company is required to repay the loan including any accrued interest and concurrently receives back its pledged collateral from the lender. With the consent of the lender, the Company may renew a repurchase financing at the then prevailing financing terms. Margin calls, whereby a lender requires that the Company pledge additional securities or cash as collateral to secure borrowings under its repurchase financing with such lender, are routinely experienced by the Company when the value of the MBS pledged as collateral declines as a result of principal amortization or due to changes in market interest rates, spreads or other market conditions. The Company also may make margin calls on counterparties when collateral values increase.

The Company s repurchase financings typically have terms ranging from one month to six months at inception, but may also have longer or shorter terms. Should a counterparty decide not to renew a repurchase financing at maturity, the Company must either refinance elsewhere or be in a position to satisfy the obligation. If, during the term of a repurchase financing, a lender should file for bankruptcy, the Company might experience difficulty recovering its pledged assets which could result in an unsecured claim against the lender for the difference between the amount loaned to the Company plus interest due to the counterparty and the fair value of the collateral pledged to such lender. The Company enters into repurchase agreements with multiple counterparties with a maximum loan from any lender of no more than three times the Company s stockholders equity. (See Notes 2(m), 4, 7, 8 and 13)

(i) Equity-Based Compensation

Compensation expense for equity based awards is recognized ratably over the vesting period of such awards, based upon the fair value of such awards at the grant date. With respect to awards granted in 2009 and prior years, the Company has applied a zero forfeiture rate for these awards, as they were granted to a limited number of employees, and historical forfeitures have been minimal. Forfeitures, or an indication that forfeitures are expected to occur, may result in a revised forfeiture rate and would be accounted for prospectively as a change in estimate.

During 2010, the Company granted certain restricted stock units (RSUs) that vest after either two or four years of service and provided that certain criteria are met, which are based on a formula that includes changes in the Company s closing stock price over a two- or four-year period and dividends declared on the Company s common stock during those periods. During 2011, the Company granted certain RSUs that vest annually over a three year period, provided that certain criteria are met, which are based on a formula that includes changes in the Company s closing stock price over the annual vesting period and dividends declared on the Company s common stock during those periods. Such criteria constitute a market condition which impacts the amount of compensation expense recognized for these awards. Specifically, the uncertainty regarding whether the market condition will be achieved is reflected in the grant date fair valuation of the RSUs, which in addition to estimates regarding the amount of RSUs expected to be forfeited during the associated service period, determines the amount of compensation expense that is recognized. Compensation expense is not reversed should the market condition not be achieved, while differences in actual forfeiture experience relative to estimated forfeitures will result in adjustments to the timing and amount of compensation expense recognized.

Payments pursuant to DERs, which are attached to certain equity based awards, are charged to stockholders equity when declared to the extent the underlying equity award is expected to vest. Compensation expense is recognized for DERs to the extent that associated equity awards do not or are not expected to vest and grantees are not required to return payments of dividends or DERs to the Company. (See Notes 2(j) and 12)

(j) Earnings per Common Share (EPS)

Basic EPS is computed using the two-class method, which includes the weighted-average number of shares of common stock outstanding during the period and other securities that participate in dividends, such as the Company s unvested restricted stock and RSUs that have non-forfeitable rights to dividends and DERs attached to vested stock options to arrive at total common equivalent shares. In applying the two-class method, earnings are allocated to both shares of common stock and securities that participate in dividends based on their respective

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weighted-average shares outstanding for the period. For the diluted EPS calculation, common equivalent shares are further adjusted for the effect of dilutive unexercised stock options and RSUs outstanding that are unvested and have dividends that are subject to forfeiture using the treasury stock method. Under the treasury stock method, common equivalent shares are calculated assuming that all dilutive common stock equivalents are exercised and the proceeds, along with future compensation expenses associated with such instruments, are used to repurchase shares of the Company s outstanding common stock at the average market price during the reported period. (See Note 11)

(k) Comprehensive Income

The Company s comprehensive income includes net income, the change in net unrealized gains/(losses) on its MBS and its derivative hedging instruments, which are comprised of Swaps and Swaptions, (to the extent that such changes are not recorded in earnings), adjusted by realized net gains/(losses) reclassified out of accumulated other comprehensive income for MBS and is reduced by dividends declared on the Company s preferred stock.

(l) U.S. Federal Income Taxes

The Company has elected to be taxed as a REIT under the provisions of the Code and the corresponding provisions of state law. The Company expects to operate in a manner that will enable it to continue to be taxed as a REIT. A REIT is not subject to tax on its earnings to the extent that it distributes at least 90% of its annual REIT taxable income to its stockholders. As such, no provision for current or deferred income taxes has been made in the accompanying consolidated financial statements. To the extent that the Company incurs interest and/or penalties in connection with its tax obligations, such amounts shall be classified as income tax expense on the Company s consolidated statements of operations.

(m) Derivative Financial Instruments

Hedging Activity

As part of the Company s interest rate risk management, it periodically hedges a portion of its interest rate risk using derivative financial instruments, currently comprised of Swaps and Swaptions, and does not enter into derivative transactions for speculative or trading purposes and, accordingly, accounts for its Swaps and Swaptions as hedging instruments.

The Company documents its risk-management policies, including objectives and strategies, as they relate to its hedging activities and the relationship between the hedging instrument and the hedged liability. The Company assesses, both at inception of a hedge and on a quarterly basis thereafter, whether or not the hedge is highly effective.

The Company discontinues hedge accounting on a prospective basis and recognizes changes in the fair value through earnings when: (i) it is determined that the derivative is no longer effective in offsetting cash flows of a hedged item (including forecasted transactions); (ii) it is no longer probable that the forecasted transaction will occur; or (iii) it is determined that designating the derivative as a hedge is no longer appropriate.

Although permitted under certain circumstances, the Company does not offset cash collateral receivables or payables against its net derivative positions. (See Notes 4, 8 and 13)

Swaps

Swaps are carried on the Company s balance sheet at fair value, as assets, if their fair value is positive, or as liabilities, if their fair value is negative. Changes in the fair value of the Company s Swaps are recorded in other comprehensive income provided that the hedge remains effective. Changes in fair value for any ineffective amount of a Swap are recognized in earnings. The Company has not recognized any change in the value of its existing Swaps through earnings as a result of hedge ineffectiveness, except that all gains and losses realized on Swaps that were terminated early were recognized, as the borrowings that such Swaps hedged were repaid.

Swaptions

As part of its strategy to hedge its exposure to increases in interest rates, the Company has purchased Swaptions, which give it the right, but not the obligation, to enter into a Swap at a future date. Swaptions are carried as assets on the Company s balance sheet at fair value. Changes in the intrinsic value of the Swap underlying the Swaption are recorded in other comprehensive income, a component of stockholders equity, provided that the hedge remains effective, while changes in the time value of the Swaption are recorded as gains/losses through earnings as a component of other income/loss during the option period. The Company uses the cumulative dollar-offset ratio to assess the hedge effectiveness of its Swaptions.

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Non-Hedging Activity/Linked Transactions

It is presumed that the initial transfer of a financial asset (i.e., the purchase of an MBS by the Company) and contemporaneous repurchase financing of such MBS with the same counterparty are considered part of the same arrangement, or a linked transaction, unless certain criteria are met. The two components of a linked transaction (MBS purchase and repurchase financing) are not reported separately but are evaluated on a combined basis and reported as a forward (derivative) contract and are presented as Linked Transactions on the Company s consolidated balance sheet. Changes in the fair value of the assets and liabilities underlying Linked Transactions and associated interest income and expense are reported as unrealized net gains and net interest income from Linked Transactions on the Company s consolidated statements of operations and are not included in other comprehensive income. However, if certain criteria are met, the initial transfer (i.e., the purchase of a security by the Company) and repurchase financing will not be treated as a linked transaction and will be evaluated and reported separately, as an MBS purchase and repurchase financing. When or if a transaction is no longer considered to be linked, the MBS and repurchase financing will be reported on a gross basis. In this case, the fair value of the MBS at the time the transactions are no longer considered linked will become the cost basis of the MBS, and the income recognition yield for such MBS will be calculated prospectively using this new cost basis. (See Notes 4 and 13)

(n) Fair Value Measurements and the Fair Value Option for Financial Assets and Financial Liabilities

The Company s presentation of fair value for its financial assets and liabilities is determined within a framework that stipulates that the fair value of a financial asset or liability is an exchange price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability. The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. This definition of fair value is based on a consistent definition of fair value which focuses on exit price and prioritizes the use of market-based inputs over entity-specific inputs when determining fair value. In addition, the framework for measuring fair value establishes a three-level hierarchy for fair value measurements based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. (See Note 13)

Although permitted under GAAP to measure many financial instruments and certain other items at fair value, the Company has not elected the fair value option for any of its assets or liabilities. If the fair value option is elected, unrealized gains and losses on such items for which fair value is elected would be recognized in earnings at each subsequent reporting date. A decision to elect the fair value option for an eligible financial instrument, which may be made on an instrument by instrument basis, is irrevocable.

(o) Variable Interest Entities

An entity is referred to as a VIE if it meets at least one of the following criteria: (1) the entity has equity that is insufficient to permit the entity to finance its activities without additional subordinated financial support of other parties; or (2) as a group, the holders of the equity investment at risk lack (a) the power to direct the activities of an entity that most significantly impact the entity s economic performance; (b) the obligation to absorb the expected losses; or (c) the right to receive the expected residual returns; or (3) have disproportional voting rights and the entity s activities are conducted on behalf of the investor that has disproportionally few voting rights.

The Company consolidates a VIE when it has both the power to direct the activities that most significantly impact the economic performance of the VIE and a right to receive benefits or absorb losses of the entity that could be potentially significant to the VIE. The Company is required to reconsider its evaluation of whether to consolidate a VIE each reporting period, based upon changes in the facts and circumstances pertaining to the VIE.

The Company has entered into resecuritization transactions which result in the Company consolidating the VIEs that were created to facilitate the transactions and to which the underlying assets in connection with the resecuritizations were transferred. In determining the accounting treatment to be applied to these resecuritization transactions, the Company evaluated whether the entities used to facilitate these transactions were VIEs and, if so, whether they should be consolidated. Based on its evaluation, the Company concluded that the VIEs should be consolidated. If the Company had determined that consolidation was not required, it would have then assessed whether the transfer of the underlying assets would qualify as a sale or should be accounted for as secured financings under GAAP.

Prior to the completion of its initial resecuritization transaction in October 2010, the Company had not transferred assets to VIEs or Qualifying Special Purpose Entities (QSPEs) and other than acquiring MBS issued by such entities, had no other involvement with VIEs or QSPEs. (See Note 14)

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(p) New and Proposed Accounting Standards and Interpretations

Fair Value

For fiscal years beginning after December 15, 2010 (and for interim periods within those fiscal years), Accounting Standards Update (ASU) 2010-06 requires separate disclosure of purchases, sales, issuances, and settlements in the Level 3 roll-forward. The Company s adoption of the additional disclosure provisions of ASU 2010-06 beginning on January 1, 2011 did not have an impact on its consolidated financial statements.

Recent Accounting Standards

Transfers and Servicing

In April 2011, the Financial Accounting Standards Board (FASB) issued ASU 2011-03, *Reconsideration of Effective Control for Repurchase Agreements,* (ASU 2011-03), which changes the assessment of whether repurchase agreement transactions should be accounted for as sales or secured financings. In a typical repurchase agreement transaction, an entity transfers financial assets to the counterparty in exchange for cash with an agreement for the counterparty to return the same or equivalent financial assets for a fixed price in the future. Prior to this update, one of the factors in determining whether sale treatment could be used was whether the transferor maintained effective control of the transferred assets and in order to do so, the transferor must have the ability to repurchase such assets. This ASU changes the assessment of effective control by focusing on a transferor s contractual rights and obligations with respect to transferred financial assets, rather than whether the transferor has the practical ability to perform in accordance with those rights or obligations. ASU 2011-03 is effective for the first interim or annual period beginning on or after December 15, 2011. With the exception of Linked Transactions, the Company records repurchase agreements as secured borrowings and not sales, and accordingly, this update is not expected to have a significant impact on the Company s consolidated financial statements.

Fair Value Measurements and Disclosures

In May 2011, FASB issued ASU 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*, (ASU 2011-04) further converging US GAAP and International Financial Reporting Standards by providing common fair value measurement and disclosure requirements. The amendments in this update change the wording used to describe many of the requirements in US GAAP for measuring fair value and for disclosing information about fair value measurements. These include those that clarify the FASB s intent about the application of existing fair value measurement and disclosure requirements and those that change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. ASU 2011-04 is effective for interim and annual reporting periods beginning after December 15, 2011. While this update may result in certain additional disclosures, it is not expected to have a material impact on the Company s consolidated financial statements.

Comprehensive Income

In June 2011, FASB issued ASU 2011-05, *Presentation of Comprehensive Income*, (ASU 2011-05) which allows an entity to present the total of comprehensive income, the components of net income, and the components of other comprehensive income (OCI) either in a single continuous statement of comprehensive income or in two separate but consecutive statements.   Either presentation requires the presentation on the face of the financial statements any reclassification adjustments for items that are reclassified from OCI to net income in the statement(s) where the components of net income and the components of OCI are presented. There is no change in what must be reported in OCI or when an item of OCI must be reclassified to net income. ASU 2011-05 requires retrospective application and is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The FASB recently announced that it will consider deferring certain aspects of this ASU. While this update may require additional disclosure, it is not expected to have a material impact on the Company s consolidated financial statements.

Intangibles Goodwill and Other

In September 2011, FASB issued ASU 2011-08, *Testing Goodwill for Impairment*, (ASU 2011-08) which simplifies how entities test goodwill for impairment. Under ASU 2011-08, an entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads the entity to determine that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines that it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. If the entity concludes otherwise, then it is required to test goodwill for impairment under the currently prescribed two-step process. ASU 2011-08 is effective for annual and interim goodwill impairment tests performed for fiscal years

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beginning after December 15, 2011. The adoption of ASU 2011-08 is not expected to have a material impact on the Company s consolidated financial statements.

Proposed Accounting Standards

FASB has recently issued or discussed a number of proposed standards on such topics as consolidation, financial statement presentation, revenue recognition, leases, financial instruments, hedging, contingencies, measurement of credit impairment and fair value measurement. Some of the proposed changes are potentially significant and could have a material impact on the Company s reporting. The Company has not yet fully evaluated the potential impact of these proposals but will make such an evaluation as the standards are finalized.

3. MBS

The Company s MBS are comprised of Agency MBS and Non-Agency MBS. These MBS are secured by: (i) hybrid mortgages (Hybrids), which have interest rates that are fixed for a specified period of time and, thereafter, generally adjust annually to an increment over a specified interest rate index; (ii) adjustable-rate mortgages (ARMs); (iii) mortgages that have interest rates that reset more frequently (collectively, ARM-MBS); and (iv) 15-year and longer-term fixed rate mortgages. MBS do not have a single maturity date, and further, the mortgage loans underlying ARM-MBS do not all reset at the same time.

The Company pledges a significant portion of its MBS as collateral against its borrowings under repurchase agreements and Swaps. Non-Agency MBS that are accounted for as components of Linked Transactions are not reflected in the tables set forth in this note, as they are accounted for as derivatives. (See Notes 4 and 8)

Agency MBS: Agency MBS are guaranteed as to principal and/or interest by a federally chartered corporation, such as Fannie Mae or Freddie Mac, or an agency of the U.S. Government, such as Ginnie Mae. The payment of principal and/or interest on Ginnie Mae MBS is backed by the full faith and credit of the U.S. Government. Since the third quarter of 2008, Fannie Mae and Freddie Mac have been under the conservatorship of the Federal Housing Finance Agency, which significantly strengthened the backing for these government-sponsored entities.

Non-Agency MBS (including Non-Agency MBS transferred to VIEs): The Company s Non-Agency MBS are secured by pools of residential mortgages, which are not guaranteed by an agency of U.S. Government or any federally chartered corporation. Non-Agency MBS may be rated by one or more Rating Agencies or may be unrated (i.e., not assigned a rating by any Rating Agency). The rating indicates the opinion of the

Rating Agency as to the creditworthiness of the investment, indicating the obligor s ability to meet its full financial commitment on the obligation. A rating of D is assigned when a security has defaulted on any of its contractual terms. The Company s Non-Agency MBS are primarily comprised of the senior-most tranches from the MBS structure.

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The following tables present certain information about the Company s MBS at September 30, 2011 and December 31, 2010:

September 30, 2011

(In Thousands)	Principal/ Current Face	Purchase Premiums	Accretable Purchase Discounts	Discount Designated as Credit Reserve and OTTI (1)	Amortized Cost (2)	Carrying Value/ Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Net Unrealized Gain/(Loss)
Agency MBS:									
Fannie Mae	$ 6,293,420	$ 159,120	$ (140)	$	$ 6,452,400	$ 6,635,600	$ 186,548	$ (3,348)	$ 183,200
Freddie Mac	813,340	24,387			842,199	866,468	24,447	(178)	24,269
Ginnie Mae	16,291	282			16,573	16,934	361		361
Total Agency MBS	7,123,051	183,789	(140)		7,311,172	7,519,002	211,356	(3,526)	207,830
Non-Agency MBS *(3)*									
Rated AAA	13,356	267			13,623	13,623			
Rated AA	48	1			49	35		(14)	(14)
Rated A	34,059	797	(885)	(594)	33,377	29,494	399	(4,282)	(3,883)
Rated BBB	58,681	42	(7,736)	(1,111)	49,876	49,199	2,255	(2,932)	(677)
Rated BB	87,402	33	(6,290)	(2,532)	78,613	73,845	211	(4,979)	(4,768)
Rated B	442,396	18	(38,165)	(30,335)	373,914	364,068	7,887	(17,733)	(9,846)
Rated CCC	1,195,769		(80,268)	(229,354)	886,147	893,583	43,414	(35,978)	7,436
Rated CC	1,295,750		(47,184)	(267,554)	981,012	961,899	32,853	(51,966)	(19,113)
Rated C	1,386,314		(35,893)	(362,101)	988,320	989,877	44,666	(43,109)	1,557
Unrated and D-rated *(4)*	823,734		(23,288)	(302,820)	497,626	513,687	35,279	(19,218)	16,061
Total Non-Agency MBS	5,337,509	1,158	(239,709)	(1,196,401)	3,902,557	3,889,310	166,964	(180,211)	(13,247)
Total MBS	$ 12,460,560	$ 184,947	$ (239,849)	$ (1,196,401)	$ 11,213,729	$ 11,408,312	$ 378,320	$ (183,737)	$ 194,583

December 31, 2010

(In Thousands)	Principal/ Current Face	Purchase Premiums	Accretable Purchase Discounts	Discount Designated as Credit Reserve and OTTI (1)	Amortized Cost (2)	Carrying Value/ Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Net Unrealized Gain/(Loss)
Agency MBS:									
Fannie Mae	$ 5,083,076	$ 88,654	$ (210)	$	$ 5,171,520	$ 5,323,475	$ 157,365	$ (5,410)	$ 151,955
Freddie Mac	602,921	16,171			628,355	638,582	12,744	(2,517)	10,227
Ginnie Mae	17,830	311			18,141	18,566	425		425
Total Agency MBS	5,703,827	105,136	(210)		5,818,016	5,980,623	170,534	(7,927)	162,607
Non-Agency MBS *(3)*									
Rated AAA	2,157	52			2,209	1,994		(215)	(215)
Rated AA	33,257	905	(446)		33,716	30,805	334	(3,245)	(2,911)
Rated A	26,761	43	(6,441)	(1,632)	18,731	22,968	4,773	(536)	4,237
Rated BBB	44,313	27	(2,329)	(840)	41,171	39,468	438	(2,141)	(1,703)
Rated BB	44,305		(3,671)	(2,250)	38,384	42,441	4,057		4,057

Rated B	93,552		(15,108)	(7,173)	71,271	80,976	9,753	(48)	9,705
Rated CCC	764,579		(69,899)	(192,503)	502,177	565,043	67,382	(4,516)	62,866
Rated CC	620,114		(54,361)	(196,106)	369,647	432,542	63,179	(284)	62,895
Rated C	1,004,627		(60,308)	(281,070)	663,249	745,292	88,388	(6,345)	82,043
Unrated and D-rated *(4)*	187,824		(16,403)	(65,104)	106,317	116,558	13,131	(2,890)	10,241
Total Non-Agency MBS	2,821,489	1,027	(228,966)	(746,678)	1,846,872	2,078,087	251,435	(20,220)	231,215
Total MBS	$ 8,525,316	$ 106,163	$ (229,176)	$ (746,678)	$ 7,664,888	$ 8,058,710	$ 421,969	$ (28,147)	$ 393,822

(1) Discount designated as Credit Reserve and amounts related to OTTI are generally not expected to be accreted into interest income. Amounts disclosed at September 30, 2011 reflect Credit Reserve of $1.146 billion and OTTI of $50.7 million. Amounts disclosed at December 31, 2010 reflect Credit Reserve of $700.3 million and OTTI of $46.4 million.

(2) Includes principal payments receivable of $4.5 million and $9.3 million at September 30, 2011 and December 31, 2010, respectively, which are not included in the Principal/Current Face.

(3) Non-Agency MBS, including Non-Agency MBS transferred to consolidated VIEs, are reported based on the lowest rating issued by a Rating Agency, if more than one rating is issued on the security, at the date presented.

(4) Includes 52 Non-Agency MBS that were D-rated and had an aggregate amortized cost and fair value of $483.2 million and $498.5 million, respectively, at September 30, 2011 and 13 Non-Agency MBS that were D-rated and had an aggregate amortized cost and fair value of $98.6 million and $105.9 million, respectively, at December 31, 2010.

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Unrealized Losses on MBS and Impairments

The following table presents information about the Company s MBS that were in an unrealized loss position at September 30, 2011:

Unrealized Loss Position For:

	Less than 12 Months			12 Months or more			Total	
(In Thousands)	**Fair Value**	**Unrealized Losses**	**Number of Securities**	**Fair Value**	**Unrealized Losses**	**Number of Securities**	**Fair Value**	**Unrealized Losses**
Agency MBS:								
Fannie Mae	$ 535,456	$ 1,572	39	$ 154,717	$ 1,776	18	$ 690,173	$ 3,348
Freddie Mac	22,526	117	2	3,003	61	1	25,529	178
Total Agency MBS	557,982	1,689	41	157,720	1,837	19	715,702	3,526
Non-Agency MBS:								
Rated AA				35	14	1	35	14
Rated A	2,842	282	1	24,933	4,000	3	27,775	4,282
Rated BBB	36,422	2,509	5	1,499	423	2	37,921	2,932
Rated BB	62,485	3,957	7	10,270	1,022	2	72,755	4,979
Rated B	245,293	15,497	17	14,392	2,236	2	259,685	17,733
Rated CCC	600,747	31,975	48	18,012	4,003	3	618,759	35,978
Rated CC	727,495	51,424	50	3,516	542	2	731,011	51,966
Rated C	653,817	36,562	50	81,490	6,547	2	735,307	43,109
Unrated and other	290,904	15,118	23	18,202	4,100	2	309,106	19,218
Total Non-Agency MBS	2,620,005	157,324	201	172,349	22,887	19	2,792,354	180,211
Total MBS	$ 3,177,987	$ 159,013	242	$ 330,069	$ 24,724	38	$ 3,508,056	$ 183,737

At September 30, 2011, the Company did not intend to sell any of its MBS that were in an unrealized loss position, and it is more likely than not that the Company will not be required to sell these MBS before recovery of their amortized cost basis, which may be at their maturity. With respect to Non-Agency MBS held by consolidated VIEs, the ability of any entity to cause the sale by the VIE prior to the maturity of these Non-Agency MBS is either specifically precluded, or is limited to specified events of default, none of which have occurred to date.

Gross unrealized losses on the Company s Agency MBS were $3.5 million at September 30, 2011. Given the credit quality inherent in Agency MBS, the Company does not consider any of the current impairments on its Agency MBS to be credit related. In assessing whether it is more likely than not that it will be required to sell any impaired security before its anticipated recovery, which may be at their maturity, the Company considers the significance of each investment, the amount of impairment, the projected future performance of such impaired securities, as well as the Company s current and anticipated leverage capacity and liquidity position.Based on these analyses, the Company determined that at September 30, 2011 any unrealized losses on its Agency MBS were temporary.

Unrealized losses on the Company s Non-Agency MBS (including Non-Agency MBS transferred to consolidated VIEs) were $180.2 million at September 30, 2011. The Company does not consider these unrealized losses to be credit related, but are rather due to non-credit related factors, including supply and demand imbalances and widening of interest rate spreads.

The Company recognized credit-related OTTI losses of $4.0 million on 14 Non-Agency MBS during the three months ended September 30, 2011 and $6.4 million on 20 Non-Agency MBS in earnings during the nine months ended September 30, 2011, respectively. The Company recognized credit-related OTTI losses of $5.4 million through earnings during the nine months ended September 30, 2010, all of which were recognized in connection with six Non-Agency MBS during the second quarter of 2010.

MBS on which OTTI is recognized have experienced, or are expected to experience, credit-related adverse cash flow changes. The Company s estimate of cash flows for its Non-Agency MBS is based on its review of the underlying mortgage loans securing these MBS. The Company considers information available about the structure of the securitization, including structural credit enhancement, if any, and the performance of underlying mortgage loans, including prepayment rates, default rates, loss severities, delinquency rates, percentage of non-performing, FICO scores at loan origination, year of origination, loan-to-value ratios, geographic concentrations, as well as Rating Agency reports, general market assessments, and dialogue with market participants. Significant judgment is

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used in both the Company s analysis of the expected cash flows for its Non-Agency MBS and any determination of the credit component of OTTI.

The following table presents the composition of OTTI charges recorded by the Company for the three and nine months ended September 30, 2011 and 2010:

(In Thousands)	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
OTTI included in earnings	$ 3,991	$	$ 6,383	$ 5,412
OTTI recognized in/(reclassified from) other comprehensive income	10,922		9,167	(5,228)
Total OTTI losses	$ 14,913	$	$ 15,550	$ 184

The following table presents a roll-forward of the credit loss component of OTTI on the Company s Non-Agency MBS for which a non-credit component of OTTI was previously recognized in other comprehensive income. Changes in the credit loss component of OTTI are presented based upon whether the current period is the first time OTTI was recorded on a security or a subsequent OTTI charge was recorded.

(In Thousands)	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2011
Credit loss component of OTTI at beginning of period	$ 26,739	$ 24,347
Additions for credit related OTTI not previously recognized	3,991	3,991
Subsequent additional credit related OTTI recorded		2,392
Credit loss component of OTTI at end of period	$ 30,730	$ 30,730

The significant inputs considered and assumptions made at time of impairment in determining the measurement of the component of OTTI recorded in earnings with respect to the Company s Non-Agency MBS at September 30, 2011 are summarized as follows:

	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2011
Credit enhancement *(1) (2)*		
Weighted average *(3)*	2.70%	3.02%
Range *(4)*	0.00-10.40%	0.00-13.30%
Projected CPR *(2) (5)*		

Weighted average *(3)*	11.00%	10.90%
Range *(4)*	6.90-12.20%	1.90-12.20%
Projected Loss Severity *(2) (6)*		
Weighted average *(3)*	56.10%	53.60%
Range *(4)*	46.10-70.00%	41.90-70.00%
60+ days delinquent *(2) (7)*		
Weighted average *(3)*	21.40%	21.30%
Range *(4)*	9.10-36.70%	7.30-36.70%

(1) Represents a level of protection for these securities, expressed as a percentage of total current underlying loan balance.

(2) Information provided is based on loans for all groups that provide credit enhancement for MBS with credit enhancement. If an MBS no longer has credit enhancement, information provided is based on loans for the individual group owned by the Company.

(3) Calculated by weighting the relevant input/assumptions for each individual security by current outstanding face of the security.

(4) Represents the range of inputs/assumptions based on individual securities.

(5) CPR - conditional prepayment rate.

(6) Projected loss severity represents the projected amount of loss realized on liquidated properties as a percentage of the principal balance.

(7) Includes, for each security, underlying loans 60 or more days delinquent, foreclosed loans and other real estate owned.

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The following table presents the impact on accumulated other comprehensive income of the Company s MBS for the three and nine months ended September 30, 2011 and September 30, 2010:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	**2011**	**2010**	**2011**	**2010**
Accumulated other comprehensive income on MBS:				
Unrealized gain on MBS at beginning of period	$ 292,376	$ 353,457	$ 393,822	$ 339,470
Unrealized gain/(loss) on Agency MBS, net	12,035	5,899	50,092	(1,465)
Unrealized (loss)/gain on Non-Agency MBS, net	(109,294)	42,162	(250,845)	99,560
Reclassification adjustment for MBS sales included in net income	(4,525)		(4,869)	(41,459)
Reclassification adjustment for OTTI included in net income	3,991		6,383	5,412
Balance at end of period	$ 194,583	$ 401,518	$ 194,583	$ 401,518

Purchase Discounts on Non-Agency MBS

The following tables present the changes in the components of the Company s purchase discount on its Non-Agency MBS between purchase discount designated as Credit Reserve and OTTI, and accretable purchase discount for the three and nine months ended September 30, 2011 and September 30, 2010:

	Three Months Ended September 30, 2011		Nine Months Ended September 30, 2011	
(In Thousands)	**Discount Designated as Credit Reserve and OTTI (1)**	**Accretable Discount (1) (2)**	**Discount Designated as Credit Reserve and OTTI (1)**	**Accretable Discount (1)**
Balance at beginning of period	$ (1,174,890)	$ (222,930)	$ (746,678)	$ (228,966)
Accretion of discount		10,785		33,107
Realized credit losses	10,735		20,612	
Purchases	(29,141)	(16,198)	(360,655)	(19,035)
Reclass discount for OTTI			101	(101)
Net impairment losses recognized in earnings	(3,991)		(6,383)	
Unlinking of Linked Transactions	(10,419)	(61)	(116,489)	(11,623)
Transfers/release of credit reserve	11,305	(11,305)	13,091	(13,091)
Balance at end of period	$ (1,196,401)	$ (239,709)	$ (1,196,401)	$ (239,709)

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	Three Months Ended September 30, 2010		Nine Months Ended September 30, 2010	
(In Thousands)	**Discount Designated as Credit Reserve and OTTI (3)**	**Accretable Discount (2) (3)**	**Discount Designated as Credit Reserve and OTTI (3)**	**Accretable Discount (3)**
Balance at beginning of period	$ (604,785)	$ (208,938)	$ (472,710)	$ (149,319)
Accretion of discount		9,355		27,138
Realized credit losses	2,019		3,153	
Purchases	(67,547)	(10,694)	(266,593)	(19,483)
Sales			7,856	683
Reclass discount for OTTI			520	(520)
Net impairment losses recognized in earnings			(5,412)	
Unlinking of Linked Transactions	(23,639)	241	(26,379)	(2,922)
Transfers/release of credit reserve	5,145	(5,145)	70,758	(70,758)
Balance at end of period	$ (688,807)	$ (215,181)	$ (688,807)	$ (215,181)

(1) In addition, the Company reallocated $1.3 million and $474,000 of purchase discount designated as accretable purchase discount to Credit Reserve on Non-Agency MBS underlying Linked Transactions during the three and nine months ended September 30, 2011, respectively.

(2) Together with coupon interest, accretable purchase discount is recognized as interest income over the life of the security.

(3) In addition, the Company reallocated $1.1 million and $18.3 million of purchase discount designated as Credit Reserve to accretable purchase discount on Non-Agency MBS underlying Linked Transactions during the three and nine months ended September 30, 2010, respectively.

Sales of MBS

During the first nine months of 2011, the Company sold seven Agency MBS for $76.5 million, realizing gross gains of $4.2 million; all of these sales occurred during the third quarter of 2011. During the nine months ended September 30, 2010, the Company sold $931.9 million of Agency MBS, realizing gross gains of $33.1 million, and sold one Non-Agency MBS for $7.2 million, realizing a gain of $654,000; all of these sales occurred during the first quarter of 2010. The Company has no continuing involvement with any of these MBS sales.

MBS Interest Income

The following table presents components of interest income on the Company s Agency MBS for the three and nine months ended September 30, 2011 and 2010:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	**2011**	**2010**	**2011**	**2010**
Coupon interest	$ 70,654	$ 68,887	$ 212,703	$ 226,010
Effective yield adjustment *(1)*	(10,697)	(8,497)	(26,589)	(32,412)
Agency MBS interest income	$ 59,957	$ 60,390	$ 186,114	$ 193,598

(1) Includes amortization of premium paid net of accretion of purchase discount. For Agency MBS, interest income is recorded at an effective yield, which reflects net premium amortization and discount accretion based on actual prepayment activity.

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The following table presents components of interest income for the Company s Non-Agency MBS (including MBS transferred to consolidated VIEs) for the three and nine months ended September 30, 2011 and 2010:

(In Thousands)	**Three Months Ended September 30, 2011**	**Three Months Ended September 30, 2010**	**Nine Months Ended September 30, 2011**	**Nine Months Ended September 30, 2010**
Coupon interest	$ 60,038	$ 27,605	$ 153,563	$ 72,849
Effective yield adjustment *(1)*	10,746	9,301	32,970	27,008
Non-Agency MBS interest income	$ 70,784	$ 36,906	$ 186,533	$ 99,857

(1) The effective yield adjustment is the difference between the net income calculated using the net yield, which is based on management s estimates of future cash flows for Non-Agency MBS, less the current coupon yield.

4. Derivatives

The Company s derivatives are comprised of Swaps and Swaptions, which are designated as cash flow hedges against the interest rate risk associated with its borrowings, and Linked Transactions, which are not designated as hedging instruments. The following table presents the fair value of the Company s derivative instruments and their balance sheet location at September 30, 2011 and December 31, 2010:

Derivative Instrument (In Thousands)	**Designation**	**Balance Sheet Location**	**September 30, 2011**	**December 31, 2010**
Swaps, at fair value ($125.0 million notional)	Hedging	Assets	$ 53	$
Swaptions, at fair value ($100.0 million notional)	Hedging	Assets	$ 28	$
Linked Transactions, at fair value	Non-Hedging	Assets	$ 64,494	$ 179,915
Swaps, at fair value ($3.379 billion notional)	Hedging	Liabilities	$ (134,712)	$ (139,142)

Linked Transactions

The Company s Linked Transactions are evaluated on a combined basis, reported as forward (derivative) instruments and presented as assets on the Company s consolidated balance sheets at fair value. The fair value of Linked Transactions reflect the value of the underlying Non-Agency MBS, linked repurchase agreement borrowings and accrued interest receivable/payable on such instruments. The Company s Linked Transactions are not designated as hedging instruments and, as a result, the change in the fair value and net interest income from Linked Transactions is reported in Other (Loss)/Income on the Company s consolidated statements of operations.

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The following tables present certain information about the Non-Agency MBS and repurchase agreements underlying the Company s Linked Transactions at September 30, 2011 and December 31, 2010:

Linked Transactions at September 30, 2011

Linked Repurchase Agreements			Linked MBS				
Maturity or Repricing (Dollars in Thousands)	**Balance**	**Weighted Average Interest Rate**	**Non-Agency MBS (Dollars in Thousands)**	**Fair Value**	**Amortized Cost**	**Par/Current Face**	**Weighted Average Coupon Rate**
Within 30 days	$ 113,013	1.67%	Rated AAA	$ 30,553	$ 30,682	$ 31,507	3.32%
>30 days to 90 days	64,647	1.64	Rated AA	19,193	18,361	18,816	5.00
>90 days to 180 days	15,300	1.35	Rated BBB	27,141	26,602	30,795	3.07
Total	$ 192,960	1.63%	Rated CCC	32,509	33,075	41,841	4.51
			Rated CC	79,891	82,143	107,837	5.89
			Rated C	35,912	38,739	49,970	5.97
			Rated D	31,170	31,325	41,013	5.44
			Total	$ 256,369	$ 260,927	$ 321,779	5.09%

Linked Transactions at December 31, 2010

Linked Repurchase Agreements			Linked MBS				
Maturity or Repricing (Dollars in Thousands)	**Balance**	**Weighted Average Interest Rate**	**Non-Agency MBS (Dollars in Thousands)**	**Fair Value**	**Amortized Cost**	**Par/Current Face**	**Weighted Average Coupon Rate**
Within 30 days	$ 289,522	1.62%	Rated AAA	$ 46,710	$ 46,367	$ 47,151	4.13%
>30 days to 90 days	277,765	1.62	Rated AA	57,634	54,176	61,389	3.51
Total	$ 567,287	1.62%	Rated A	36,440	34,620	41,984	2.53
			Rated BBB	69,397	66,848	78,741	3.38
			Rated BB	14,536	14,456	17,513	2.51
			Rated B	129,962	121,198	139,763	4.28
			Rated CCC	216,398	211,302	255,667	4.98
			Rated CC	89,833	86,509	110,518	5.45
			Rated C	78,181	78,038	100,204	5.77
			Unrated	5,278	5,220	10,350	6.00
			Total	$ 744,369	$ 718,734	$ 863,280	4.56%

The following table presents certain information about the components of the unrealized net gains and net interest income from Linked Transactions included in the Company s consolidated statements of operations for the three and nine months ended September 30, 2011 and 2010:

Components of Unrealized Net Gains and Net Interest Income from Linked Transactions	**Three Months Ended September 30,**	**Nine Months Ended September 30,**

(In Thousands)	2011	2010	2011	2010
Interest income attributable to MBS underlying Linked Transactions	$ 4,631	$ 9,520	$ 21,475	$ 24,748
Interest expense attributable to linked repurchase agreement borrowings underlying Linked Transactions	(864)	(1,722)	(3,938)	(4,392)
Change in fair value of Linked Transactions included in earnings	(3,034)	13,509	(7,567)	20,948
Unrealized net gains and net interest income from Linked Transactions	$ 733	$ 21,307	$ 9,970	$ 41,304

Derivative Hedging Instruments

Consistent with market practice, the Company has agreements with its Swap and Swaption counterparties that provide for the posting of collateral based on the fair values of its derivative contracts. Through this margining process, either the Company or its derivative counterparty may be required to pledge cash or securities as collateral. Collateral requirements vary by counterparty and change over time based on the market value, notional amount and remaining term of the derivative contract. Certain derivative contracts provide for cross collateralization with repurchase agreements with the same counterparty.

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A number of the Company s derivative contracts include financial covenants, which, if breached, could cause an event of default or early termination event to occur under such agreements. If the Company were to cause an event of default or trigger an early termination event pursuant to one of its derivative contracts, the counterparty to such agreement may have the option to terminate all of its outstanding derivative contracts with the Company and, if applicable, any close-out amount due to the counterparty upon termination of the derivative contracts would be immediately payable by the Company. The Company was in compliance with all of its financial covenants through September 30, 2011. At September 30, 2011, the aggregate fair value of assets needed to immediately settle derivative contracts that were in a liability position to the Company, if so required, was approximately $134.7 million.

The following table presents the assets pledged as collateral against the Company s derivative contracts at September 30, 2011 and December 31, 2010:

(In Thousands)		**September 30, 2011**		**December 31, 2010**
Agency MBS, at fair value	$	146,380	$	153,534
Restricted cash		22,498		35,083
Total assets pledged against derivative contracts	$	168,878	$	188,617

The use of derivative hedging instruments exposes the Company to counterparty credit risk. In the event of a default by a derivative counterparty, the Company may not receive payments to which it is entitled under its derivative agreements, and may have difficulty recovering its assets pledged as collateral against such agreements. If, during the term of a derivative contract, a counterparty should file for bankruptcy, the Company may experience difficulty recovering its assets pledged as collateral which could result in the Company having an unsecured claim against such counterparty s assets for the difference between the fair value of the derivative and the fair value of the collateral pledged to such counterparty. At September 30, 2011, all of the Company s derivative counterparties were rated A or better by a Rating Agency.

The Company s derivative hedging instruments, or a portion thereof, could become ineffective in the future if the associated repurchase agreements or securitized debt that such derivatives hedge fail to exist or fail to have terms that match those of the derivatives that hedge such borrowings. At September 30, 2011, all of the Company s derivatives were deemed effective for hedging purposes and no derivatives were terminated during the three and nine months ended September 30, 2011 and September 30, 2010.

Swaps

The Company s Swaps have the effect of modifying the repricing characteristics of the Company s repurchase agreements and cash flows for such liabilities. To date, no cost has been incurred at the inception of a Swap, pursuant to which the Company agrees to pay a fixed rate of interest and receive a variable interest rate, generally based on one-month or three-month London Interbank Offered Rate (LIBOR), on the notional amount of the Swap. The Company has not recognized any change in the value of its derivative hedging instruments in earnings as a result of the hedge or a portion thereof being ineffective during the three and nine months ended September 30, 2011 and September 30, 2010.

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At September 30, 2011, the Company had Swaps with an aggregate notional amount of $3.504 billion, which had gross unrealized losses of $134.7 million, gross unrealized gains of $53,000 and extended 24 months on average with a maximum term of approximately 53 months. During the three and nine months ended September 30, 2011, the Company entered into Swaps with an aggregate notional amount of $20.0 million and $1.215 billion, respectively, and had Swaps expire with an aggregate notional amount of $131.4 million and $516.5 million, respectively. The following table presents information about the Company s Swaps at September 30, 2011 and December 31, 2010:

	September 30, 2011			December 31, 2010		
Maturity (1) (Dollars in Thousands)	**Notional Amount**	**Weighted Average Fixed-Pay Interest Rate**	**Weighted Average Variable Interest Rate (2)**	**Notional Amount**	**Weighted Average Fixed-Pay Interest Rate**	**Weighted Average Variable Interest Rate (2)**
Within 30 days	$ 36,696	4.06%	0.25%	$ 55,267	3.90%	0.28%
Over 30 days to 3 months	89,402	4.16	0.29	160,589	4.35	0.27
Over 3 months to 6 months	154,057	4.35	0.26	169,258	4.02	0.28
Over 6 months to 12 months	463,094	3.30	0.25	257,482	4.09	0.28
Over 12 months to 24 months	1,281,452	3.18	0.25	833,302	4.40	0.27
Over 24 months to 36 months	598,371	2.16	0.24	849,351	3.10	0.26
Over 36 months to 48 months	830,892	2.17	0.24	360,042	3.32	0.27
Over 48 months to 60 months	50,000	2.13	0.24	120,170	2.87	0.27
Total Swaps	$ 3,503,964	2.85%	0.25%	$ 2,805,461	3.74%	0.27%

(1) Each maturity category reflects contractual amortization and/or maturity of notional amounts.

(2) Reflects the benchmark variable rate due from the counterparty at the date presented, which rate adjusts monthly or quarterly based on one-month or three-month LIBOR, respectively.

The following table presents the net impact of the Company s Swaps on its interest expense and the weighted average interest rate paid and received for such Swaps for the three and nine months ended September 30, 2011 and 2010:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in Thousands)	**2011**	**2010**	**2011**	**2010**
Interest expense attributable to Swaps	$ 24,322	$ 27,758	$ 73,091	$ 85,474
Weighted average Swap rate paid	2.88%	3.84%	3.24%	4.02%

Weighted average Swap rate received	0.21%	0.36%	0.24%	0.30%

Swaptions

In June 2011, the Company purchased a Swaption, for which it paid a premium of $915,000, that provides the Company with the right to enter into a fixed-pay Swap at termination of the option period in January 2012. The terms of the Swap that the Company may enter into are as follows: $100.0 million notional; four-year term; fixed strike rate 1.90%; variable index equal to one month LIBOR. Swaptions are used as a hedge against the risk of changes in the interest component above a specified level on a portion of forecasted one-month fixed rate borrowings. At September 30, 2011, the Company s Swaption had a fair value of $28,000. During the three months ended September 30, 2011, the Company s Swaptions decreased in value by $227,000, which was reflected in other comprehensive income, reflecting changes in the intrinsic value component of the Swaption, and $899,000 of expense in other income, reflecting changes in the time-value component of the Swaption. For the nine months ended September 30, 2011, the Company recognized $887,000 of expense in other income, reflecting changes in the time-value component of the Swaption.

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Impact of Derivative Hedging Instruments on Accumulated Other Comprehensive Income/(Loss)

The following table presents the impact of the Company s Swaps on its accumulated other comprehensive income for the three and nine months ended September 30, 2011 and 2010:

	Three Months Ended September 30,	Nine Months Ended September 30,