HOLLY ENERGY PARTNERS LP
Form 4
January 04, 2017

FORM 4

Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. *See* Instruction 1(b).

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

OMB APPROVAL

OMB Number:	3235-0287
Expires:	January 31, 2005
Estimated average burden hours per response...	0.5

(Print or Type Responses)

1. Name and Address of Reporting Person *
Jennings Michael

(Last) (First) (Middle)

2828 N. HARWOOD, SUITE 1300

(Street)

DALLAS, TX 75201

(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
HOLLY ENERGY PARTNERS LP [HEP]

3. Date of Earliest Transaction (Month/Day/Year)
01/02/2017

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

__X__ Director _____ 10% Owner
_____ Officer (give title below) _____ Other (specify below)

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			
Common Units	01/02/2017		A		2,473	A	$ 0 (1)	32,421	D	

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

Persons who respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control number.

SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Nu Deriv Secur Bene Own Follo Repo Trans (Instr
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares		

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
Jennings Michael 2828 N. HARWOOD SUITE 1300 DALLAS, TX 75201	X			

Signatures

Walter W. Zimmerman, attorney-in-fact	01/04/2017
**Signature of Reporting Person	Date

Explanation of Responses:

- * If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).
- ** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).
- **(1)** Restricted Units granted under the Holly Energy Partners, L.P. Long-Term Incentive Plan.

Remarks:

Mr. Jennings is an outside director of Holly Logistic Services, L.L.C. Holly Logistic Services, L.L.C. is the general partner of

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.

Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. >

$

(45,756

)

Accretion of discount

826

2,737

Realized credit losses

1,002

499

Purchases

(74,809

)

4,892

Explanation of Responses:

Unlinking of Linked Transactions

38,662

2,419

116,489

34,190

Transfers/release of credit reserve

(575
)

575

(309
)

309

Balance at the end of period

$
(6,646
)
$
(2,386
)

Explanation of Responses:

$

(57,224

)

$

(3,628

)

Non-GAAP Basis (In Thousands)	Nine Months Ended September 30, 2012 Discount Designated as Credit Reserve and OTTI	Nine Months Ended September 30, 2012 Accretable Discount (1)	Nine Months Ended September 30, 2011 Discount Designated as Credit Reserve and OTTI	Nine Months Ended September 30, 2011 Accretable Discount (1)
Balance at beginning of period	$ (1,274,501)	$ (256,685)	$ (845,772)	$ (274,722)
Accretion of discount		28,933		35,844
Realized credit losses	108,231		21,111	
Purchases	(370,649)	(3,883)	(435,464)	(14,143)
Reclass discount for OTTI	866	(866)	101	(101)
Net impairment losses recognized in earnings	(1,200)		(6,383)	
Unlinking of Linked Transactions		(7,005)		22,567
Transfers/release of credit reserve	70,956	(70,956)	12,782	(12,782)
Balance at the end of period	$ (1,466,297)	$ (310,462)	$ (1,253,625)	$ (243,337)

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

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The following table presents information with respect to the yield components of our Non-Agency MBS: (i) excluding Linked Transactions and reported in accordance with GAAP; (ii) underlying our Linked Transactions and (iii) combined with the securities underlying Linked Transactions (Non-GAAP) for the three months ended September 30, 2012 and 2011:

	Three Months Ended September 30,	
	2012	**2011**
Non-Agency MBS (GAAP - excluding Linked Transactions)		
Coupon Yield *(1)*	5.90%	6.15%
Effective Yield Adjustment *(2)*	0.75	1.10
Net Yield	6.65%	7.25%
Non-Agency MBS Underlying Linked Transactions		
Coupon Yield *(1)*	5.00%	6.37%
Effective Yield Adjustment *(2)*	1.34	0.05
Net Yield	6.34%	6.42%
Combined Non-Agency MBS and MBS Underlying Linked Transactions (Non-GAAP)		
Coupon Yield *(1)*	5.89%	6.17%
Effective Yield Adjustment *(2)*	0.76	1.03
Net Yield	6.65%	7.20%

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(1) Reflects the annualized coupon interest income divided by the average amortized cost. The discounted purchase price on Non-Agency MBS causes the coupon yield to be higher than the pass-through coupon interest rate.

(2) The effective yield adjustment is the difference between the net yield, calculated utilizing management s estimates of future cash flows for Non-Agency MBS, less the current coupon yield.

The information in the above tables, on pages 45-48, includes certain underlying Non-Agency MBS and the associated repurchase agreement borrowings that are disclosed both separately and/or on a combined basis with our Non-Agency MBS portfolio. However, for GAAP financial reporting purposes, these items are required to be accounted for by us as Linked Transactions. Consequently, the presentation of this information in the above tables constitutes Non-GAAP financial measures within the meaning of Regulation G, as promulgated by the SEC.

In assessing the performance of the Non-Agency MBS portfolio, we do not view these transactions as linked, but rather view the performance of the linked Non-Agency MBS and the related repurchase agreement borrowings as we would any other Non-Agency MBS that is not part of a linked transaction. Accordingly, we consider that the Non-GAAP information disclosed in the above tables enhances the ability of investors to analyze the performance of our Non-Agency MBS in the same way that we assess such assets.

In addition, in connection with our financing strategy for Non-Agency MBS, we have entered into contemporaneous repurchase agreement and reverse repurchase agreement transactions with a single counterparty. The transactions effectively result in us pledging Non-Agency MBS as collateral to the counterparty in connection with the repurchase agreement financing and obtaining U.S. Treasury securities as collateral in connection with the reverse repurchase agreement. Both the repurchase agreement and the reverse repurchase agreement have a contractual maturity of January 2016 with no net exchange of cash at inception. The U.S. Treasury collateral obtained is pledged as collateral in a subsequent repurchase agreement transaction with a different counterparty for cash. This subsequent repurchase transaction had a term of 90

days at inception. For purposes of presentation of its repurchase agreement financing liabilities in the Non-GAAP Asset Allocation table on page 42, we offset our reverse repurchase agreement receivable that is secured by U.S. Treasuries received from the first counterparty against the repurchase agreement liability with the second counterparty for which we pledged those U.S. Treasury securities as collateral, as we believe net presentation is consistent with the economic substance of the transactions. However, GAAP prohibits offsetting of this asset and liability for a number of reasons, including the fact that the counterparties to these transactions are different, and there is no legal right of offset. For GAAP presentation purposes, the repurchase agreement liability against which we have pledged U.S. Treasuries is reported based on its legal contractual maturity. However, based on an evaluation of the economic substance of these collateralized financing arrangements, management considers that the Non-GAAP Asset Allocation table presented on page 42

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more appropriately reflects the effective economic term of the financing obtained. Consequently, this presentation constitutes a Non-GAAP financial measure within the meaning of Regulation G, as promulgated by the SEC.

Exposure to Financial Counterparties

We finance the acquisition of a significant portion of our MBS with repurchase agreements. In connection with these financing arrangements, we pledge our securities as collateral to secure the borrowing. The amount of collateral pledged will typically exceed the amount of the financing with the extent of over-collateralization ranging from 1 - 6% of the amount borrowed (U.S. Treasury and Agency MBS collateral) to up to 63% (Non-Agency MBS collateral). Consequently, while repurchase agreement financing results in us recording a liability to the counterparty in our consolidated balance sheet, we are exposed to the counterparty, if during the term of the repurchase agreement financing, a lender should default on its obligation and we are not able to recover our pledged assets. The amount of this exposure is the difference between the amount loaned to us plus interest due to the counterparty and the fair value of the collateral pledged by us to the lender including accrued interest receivable on such collateral.

In addition, we use interest rate swaps to manage interest rate risk exposure in connection with our repurchase agreement financings. We will make cash payments or pledge securities as collateral as part of a margin arrangement in connection with interest rate swaps that are in an unrealized loss position. In the event that a counterparty were to default on its obligation, we would be exposed to a loss to a swap counterparty to the extent that the amount of cash or securities pledged exceeded the unrealized loss on the associated swaps and we were not able to recover the excess collateral.

During the past several years, certain of our repurchase agreement counterparties in the United States and Europe have experienced financial difficulty and have been either rescued by government assistance or otherwise benefitted from accommodative monetary policy of Central Banks.

The table below summarizes our exposure to our financial counterparties at September 30, 2012:

Country (Dollars in Thousands)	Number of Counterparties	Repurchase Agreement Financing	Swaps at Fair Value	Exposure (1)	Exposure as a Percentage of MFA Total Assets
European Countries: *(2)*					
Germany	1	$ 554,345	$ (18,313)	$ 217,732	1.58%
Switzerland	3	1,411,410		899,084	6.53
France	1	418,823		23,467	0.17
Holland	1	346,611		17,003	0.12
United Kingdom	2	1,017,474	(25,809)	62,942	0.46
Total	8	3,748,663	(44,122)	1,220,228	8.86%
Other Countries:					
United States	11	$ 4,264,033	$ (34,047)	$ 631,781	4.59%
Japan	4	788,047		53,167	0.39
Other	3	568,006		158,742	1.17
Total	18	5,620,086	(34,047)	843,690	6.15%

Total Counterparty Exposure	26	$	9,368,749 *(3)(4)*	$	(78,169)	$	2,063,918	15.01%

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(1) Represents for each counterparty the amount of cash and/or securities pledged as collateral less the aggregate of repurchase agreement financing, Swaps at fair value, and net interest receivable/payable on all such instruments.

(2) Includes European-based counterparties as well as U.S.-domiciled subsidiaries of the European parent entity.

(3) Includes $500.0 million of repurchase agreements entered into in connection with contemporaneous repurchase and reverse repurchase agreements with a single counterparty.

(4) Includes $36.4 million of repurchase agreements which are a component of our Linked Transactions.

At September 30, 2012, we did not use credit default swaps or other forms of credit protection to hedge the exposures summarized in the table above.

If the European credit crisis continues to impact our major European financial counterparties, there is the possibility that it will also impact the operations of their U.S. domiciled subsidiaries. This could adversely affect our financing and operations as well as those of the entire mortgage sector in general. Management monitors our exposure to our repurchase agreement and swap counterparties on a regular basis, using various methods, including review of recent rating agency actions or other developments and by monitoring the amount of cash and securities

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collateral pledged and the associated loan amount under repurchase agreements and/or the fair value of swaps with our counterparties. We intend to make reverse margin calls on our counterparties to recover excess collateral as permitted by the agreements governing our financing arrangements, or take other necessary actions to reduce the amount of our exposure to a counterparty when such actions are considered necessary.

Tax Considerations

Variances between GAAP and Tax Income

Due to the potential timing differences in the recognition of GAAP net income compared to REIT taxable income on our investments, our net income and the unamortized amount of purchase discounts and premiums calculated in accordance with GAAP may differ significantly from such amounts calculated for purposes of determining our REIT taxable income. At September 30, 2012, net premiums on our Agency MBS portfolio (excluding net premiums on MBS purchased but not yet settled) were $217.7 million compared to $214.4 million for tax purposes. In accordance with GAAP, a portion of the purchase discounts on our Non-Agency MBS are allocated to a Credit Reserve and, as such, are not expected to be accreted into interest income. In addition, under GAAP, certain Non-Agency MBS underlying our Linked Transactions are not reported as MBS; however, for purposes of determining our REIT taxable income, all Non-Agency MBS, including those underlying Linked Transactions, are treated as being owned and the purchase discounts associated with these securities are accreted into taxable income over the life of the applicable security. Under GAAP, we had net purchase discounts on our Non-Agency MBS portfolio of $1.767 billion, which when combined with purchase discounts of $9.0 million related to securities underlying our Linked Transactions, resulted in total net purchase discounts on Non-Agency MBS of $1.776 billion at September 30, 2012. Our total Non-Agency MBS portfolio for tax differs from our portfolio reported for GAAP. These differences are primarily due to the fact that for tax purposes; (i) certain of the MBS contributed to the VIEs used to facilitate resecuritization transactions were deemed to be sold; (ii) the tax portfolio includes certain securities issued by these VIEs; and (iii) Non-Agency MBS underlying Linked Transactions are included in our tax portfolio. In addition, for bonds common to both tax and GAAP reported portfolios, potential timing differences arise with respect to the accretion of market discount into income for tax purposes as compared to GAAP. These differences result in net purchase discounts for tax on our Non-Agency MBS at September 30, 2012 of $1.507 billion. We currently anticipate that our REIT taxable income and GAAP net income will trend closer during the remainder of 2012.

Resecuritizations

For tax purposes, depending on the transaction structure, a resecuritization transaction may be treated either as a sale or a financing of the underlying MBS. Income recognized from resecuritization transactions will differ for tax and GAAP. For tax purposes, we own and may in the future acquire interests in resecuritization trusts, in which several of the classes of securities are or will be issued with Original Issue Discount (or OID). As the holder of the retained interests in the trust, we generally will be required to include OID in our current gross interest income over the term of the applicable securities as the OID accrues. The rate at which the OID is recognized into taxable income is calculated using a constant rate of yield to maturity, without a loss assumption provision. For tax purposes, REIT taxable income may be recognized in excess of economic income (i.e., OID) or in advance of the corresponding cash flow from these assets, thereby effecting our dividend distribution requirement to stockholders.

Regulatory Developments

The U.S. Congress, Board of Governors of the Federal Reserve System, U.S. Treasury, Federal Deposit Insurance Corporation, SEC and other governmental and regulatory bodies have taken and continue to consider additional actions in response to the financial crisis. In particular, the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (or the Dodd-Frank Act) created a new regulator housed within the Federal Reserve System, an independent bureau known as the Consumer Financial Protection Bureau (or the CFPB), which has broad authority over a wide range of consumer financial products and services, including mortgage lending. Another portion of the Dodd-Frank Act, the Mortgage Reform and Anti-Predatory Lending Act (or the Mortgage Reform Act), contains new underwriting and servicing standards for the mortgage industry, as well as restrictions on compensation for mortgage originators. In addition, the Mortgage Reform Act grants broad discretionary regulatory authority to the CFPB to prohibit or condition terms, acts or practices relating to residential mortgage loans that the CFPB finds abusive, unfair, deceptive or predatory, as well as to take other actions that the CFPB finds are necessary or proper to ensure responsible affordable mortgage credit remains available to consumers. The Dodd-Frank Act also affects the securitization of mortgages (and other assets) with requirements for risk retention by securitizers and requirements for regulating credit rating agencies.

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The implementation of the Dodd-Frank Act requires implementing numerous regulations, many of which (including those mentioned above regarding underwriting and risk retention requirements) have been proposed for public comment. However, a large number of the Dodd-Frank Act rulemakings have yet to be finalized. Thus, we are unable to fully predict at this time how the Dodd-Frank Act, as well as other laws that may be adopted in the future, will impact our business, results of operations and financial condition, or the environment for repurchase financing and other forms of borrowing, the investing environment for Agency MBS, Non-Agency MBS and/or residential mortgage loans, the securitization industry, Swaps and other derivatives. However, at a minimum, we believe that the Dodd-Frank Act and the regulations to be promulgated thereunder are likely to increase the economic and compliance costs for participants in the mortgage and securitization industries, including us.

In addition to the regulatory actions being implemented under the Dodd-Frank Act, on August 31, 2011, the SEC issued a concept release under which it is reviewing interpretive issues related to Section 3(c)(5)(C) of the Investment Company Act. Section 3(c)(5)(C) excludes from the definition of investment company entities that are primarily engaged in, among other things, purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. Many companies that engage in the business of acquiring mortgages and mortgage-related instruments, including us, seek to rely on an existing interpretation of the SEC Staff with respect to Section 3(c)(5)(C) so as not to become an investment company for the purpose of regulation under the Investment Company Act. The SEC has requested comments on, among other things, whether it should reconsider its existing interpretation of Section 3(c)(5)(C) on which we rely.

The potential timetable and outcome of the SEC s review are unclear. However, if the SEC determines to narrow or eliminate the interpretive exemption under Section 3(c)(5)(C) upon which we rely, we could be required to significantly restructure our operations in order to maintain our investment company exemption. Under these circumstances, our ability to use leverage could be substantially reduced, which would require us to change the way we conduct our business. For additional discussion of the SEC s concept release and its potential impact on us, please see Other Matters below.

Results of Operations

Quarter Ended September 30, 2012 Compared to the Quarter Ended September 30, 2011

For the third quarter of 2012, we had net income available to common stock and participating securities of $76.1 million, or $0.21 per basic and diluted common share, compared to net income available to common stock and participating securities of $81.7 million, or $0.23 per basic and diluted common share, for the third quarter of 2011. The decrease in net income available to our common stock and participating securities, and the decrease of this item on a per share basis, were generally influenced by the impact of declining net interest spreads on interest bearing assets and liabilities. These declining spreads were primarily attributable to lower net yields on both Agency and Non-Agency MBS. Yields on Agency MBS were impacted by the lower interest rate environment and higher CPRs, while yields on Non-Agency MBS were primarily impacted by the addition of lower yielding assets and changes in expected future interest rates. In addition, we have also increased the amount of higher cost longer-term financing for our Non-Agency MBS portfolio consistent with our overall financing strategy.

Interest income on our Agency MBS for the third quarter of 2012 decreased $12.8 million, or 21.3%, to $47.2 million from $60.0 million for the third quarter of 2011. This change primarily reflects a decrease in the net yield on our Agency MBS to 2.66% for the third quarter of 2012 from 3.37% for the third quarter of 2011, and, to a lesser extent, a decrease of $12.5 million in the average amortized cost of our Agency MBS portfolio to $7.094 billion for the third quarter of 2012 from $7.106 billion for the third quarter of 2011. During the third quarter of 2012, our Agency MBS portfolio experienced a 21.6% CPR and we recognized $14.8 million of net premium amortization compared to a CPR of 19.3% and $10.7 million of net premium amortization for the third quarter of 2011. At the end of the third quarter of 2012, the average coupon on

mortgages underlying our Agency MBS was lower compared to the end of the third quarter of 2011, due to acquisition of assets in the marketplace at generally lower coupons reflecting current market conditions and as a result of prepayments on higher yielding assets and resets on Hybrid and ARM-MBS within the portfolio. As a result, the coupon yield on our Agency MBS portfolio declined 49 basis points to 3.49% for the third quarter of 2012 from 3.98% for the third quarter of 2011. At September 30, 2012, we had net purchase premiums on our Agency MBS of $225.4 million, or 3.2% of current par value, compared to net purchase premiums of $177.7 million and 2.6% of par value at December 31, 2011.

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Interest income on our Non-Agency MBS (which includes Non-Agency MBS transferred to consolidated VIEs) increased $7.1 million, or 10.1%, for the third quarter of 2012 to $77.9 million compared to $70.8 million for the third quarter of 2011, principally due to the increase in the amortized cost of our Non-Agency MBS portfolio. For the third quarter of 2012, the average amortized cost of our Non-Agency MBS increased by $780.8 million, or 20.0%, to $4.685 billion, from $3.904 billion for the third quarter of 2011. The growth in our Non-Agency MBS has primarily been funded with longer term forms of repurchase agreement financings. In addition, certain of our Non-Agency MBS underlying Linked Transactions became delinked during the third quarter of 2012, due to the repayment of the repurchase agreement financing. These delinkings resulted in Non-Agency MBS of $16.8 million, previously included as a component of Linked Transactions, being recognized as Non-Agency MBS on our consolidated balance sheet at September 30, 2012. Our Non-Agency MBS portfolio yielded 6.65% for the third quarter of 2012 compared to 7.25% for the third quarter of 2011. The decrease in the yield on our Non-Agency MBS is primarily due to the flattening (downward movement in the later years) of the forward yield curve, which causes us to lower the projected future coupons and therefore the expected yields on our Hybrid Non-Agency MBS and the addition of newly acquired assets at yields less than our overall portfolio yield. During the third quarter of 2012, we recognized net purchase discount accretion of $8.8 million on our Non-Agency MBS compared to $10.7 million for the third quarter of 2011. At September 30, 2012, we had net purchase discounts of $1.767 billion, including Credit Reserve and previously recognized OTTI of $1.460 billion, on our Non-Agency MBS, or 27.4% of par value.

The following table presents the components of the coupon yield and net yields earned on our Agency MBS and Non-Agency MBS and weighted average CPRs experienced for such MBS for the quarterly periods presented:

	Agency MBS (1)			**Non-Agency MBS (1)**			**Total MBS (1)**		
Quarter Ended	**Coupon Yield (2)**	**Net Yield (3)**	**Weighted Average CPR**	**Coupon Yield (2)**	**Net Yield (3)**	**Weighted Average CPR**	**Coupon Yield (2)**	**Net Yield (3)**	**Weighted Average CPR**
September 30, 2012	3.49%	2.66%	21.62%	5.90%	6.65%	15.42%	4.45%	4.25%	19.08%
June 30, 2012	3.68	2.95	20.39	5.89	6.77	14.87	4.57	4.47	18.20
March 31, 2012	3.78	3.15	17.90	6.02	6.95	14.05	4.62	4.57	16.48
December 31, 2011	3.79	3.14	19.35	6.07	7.02	13.07	4.60	4.51	17.19
September 30, 2011	3.98	3.37	19.29	6.15	7.25	14.66	4.75	4.75	17.97

(1) Yields presented throughout this Quarterly Report on Form 10-Q are calculated using average amortized cost data. For GAAP reporting purposes, MBS purchases and sales are reported on the trade date. Average amortized cost data used to determine yields is calculated based on the settlement date of the associated purchase or sale as interest income is not earned on purchased bonds and continues to be earned on sold bonds until settlement date.

(2) Reflects the annualized coupon interest income divided by the average amortized cost. The discounted purchase price on Non-Agency MBS causes the coupon yield to be higher than the pass-through coupon interest rate. (Does not include MBS underlying our Linked Transactions. See Note 4 to the accompanying consolidated financial statements, included under Item 1 of this Quarterly Report on Form 10-Q.)

(3) Reflects annualized interest income divided by average amortized cost.

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The following table presents information about average balances of our MBS portfolio by category and associated income for the quarters ended September 30, 2012 and September 30, 2011:

MBS Category (Dollars in Thousands)		Average Amortized Cost (1)		Interest Income	Weighted Average Coupon	Coupon Yield (2)	Net Asset Yield (3)
Quarter Ended September 30, 2012							
Agency MBS	$	7,093,871	$	47,198	3.68%	3.49%	2.66%
Non-Agency MBS, including transfers to consolidated VIEs		4,685,068		77,899	4.34	5.90	6.65
Total	$	11,778,939	$	125,097	4.00%	4.45%	4.25%
Quarter Ended September 30, 2011							
Agency MBS	$	7,106,377	$	59,957	4.15%	3.98%	3.37%
Non-Agency MBS, including transfers to consolidated VIEs		3,904,309		70,784	4.60	6.15	7.25
Total	$	11,010,686	$	130,741	4.34%	4.75%	4.75%

(1) Includes principal payments receivable.

(2) Reflects the annualized coupon interest income divided by the average amortized cost. The discounted purchase price on Non-Agency MBS causes the coupon yield to be higher than the pass-through coupon interest rate. (Does not include MBS underlying our Linked Transactions. See Note 4 to the accompanying consolidated financial statements, included under Item 1 of this Quarterly Report on Form 10-Q.)

(3) Reflects annualized interest income divided by the average amortized cost.

Interest income from our cash investments, which are comprised of money market investments and are not a material source of income as the yields on such funds remain at historically low levels, increased to $38,000 for the third quarter of 2012 from $25,000 for the 2011 period. Our average cash investments were $406.5 million and yielded 0.04% for the third quarter of 2012 compared to average cash investments of $548.3 million that yielded 0.02% for the third quarter of 2011. In general, we manage our cash investments relative to our investing, financing and operating requirements, investment opportunities and current and anticipated market conditions.

At September 30, 2012, we had repurchase agreement borrowings of $8.832 billion and securitized debt of $749.5 million, of which $2.761 billion was hedged with Swaps. At September 30, 2012, our Swaps had a weighted average fixed-pay rate of 2.64% and extended 16 months on average with a maximum remaining term of approximately 40 months.

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Our interest expense for the third quarter of 2012 increased by $7.0 million, or 18.2%, to $45.8 million from $38.8 million for the third quarter of 2011. This increase primarily reflects the combined impact of an increase in our average borrowings and the higher effective interest rate paid on such borrowings. The following table presents information regarding the components of our interest expense for the quarters ended September 30, 2012 and September 30, 2011:

(Dollars in Thousands)	Average Balance	Interest Expense	Average Cost of Funds (1)
Quarter Ended September 30, 2012			
Agency Repurchase Agreements	$ 6,398,410	$ 24,651	1.53%
Non-Agency Repurchase Agreements	2,342,610	14,666	2.49
Total Repurchase Agreements	8,741,020	39,317	1.78
Securitized Debt	819,361	4,477	2.17
Senior Notes *(2)*	100,000	2,007	8.03
Total	$ 9,660,381	$ 45,801	1.89%
Quarter Ended September 30, 2011			
Agency Repurchase Agreements	$ 6,416,498	$ 28,127	1.74%
Non-Agency Repurchase Agreements	1,590,845	6,797	1.69
Total Repurchase Agreements	8,007,343	34,924	1.73
Securitized Debt	1,026,701	3,828	1.48
Total	$ 9,034,044	$ 38,752	1.70%

(1) Reflects the annualized interest expense divided by the average balance and includes the cost of Swaps designated as hedges against repurchase agreements.

(2) We did not have any Senior Notes during the 2011 period.

The following table presents information about our securitized debt at September 30, 2012:

Benchmark Interest Rate (Dollars in Thousands)	At September 30, 2012 Securitized Debt	Interest Rate
30 Day LIBOR + 100 basis points	$ 266,632	1.21%
30 Day LIBOR + 125 basis points	327,714	1.46
Fixed	155,125	2.85
Total	$ 749,471	1.66%

The effective interest rate paid on our borrowings increased to 1.89% for the quarter ended September 30, 2012 from 1.70% for the quarter ended September 30, 2011. This increase reflects additional higher cost longer-term financing associated with our Non-Agency MBS portfolio, the issuance of fixed-rate securitized debt in February 2012, the issuance of our Senior Notes in April 2012 partially offset by the maturity of Swaps with higher fixed-pay rates. Payments made and/or received on our Swaps are a component of our borrowing costs and accounted for interest expense of $18.1 million, or 75 basis points, for the third quarter of 2012, compared to interest expense of $24.3 million, or 107 basis points, for the third quarter of 2011. Certain of our Swaps have fixed interest rates that are significantly higher than current market interest rates. As these Swaps continue to amortize and/or expire, the Swap component of our borrowing costs is expected to continue to decrease. The weighted average fixed-pay rate on our Swaps decreased to 2.72% for the quarter ended September 30, 2012 from 2.88% for the quarter ended September 30, 2011. The weighted average variable interest rate received on our Swaps increased to 0.27% for the quarter ended September 30, 2012 from 0.21% for the quarter ended September 30, 2011. During the quarter ended September 30, 2012, we did not enter into any new Swaps and had Swaps with an aggregate notional amount of $187.7 million and a weighted average fixed-pay rate of 4.41% amortize and/or

expire.

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We expect that our interest expense and funding costs for the remainder of 2012 will be impacted by market interest rates, the amount of our borrowings, our existing and future interest rates on our hedging instruments and the extent to which we execute additional financing transactions, such as resecuritizations. As a result of these variables, our future borrowing costs cannot be predicted with any certainty. (See Notes 4, 7 and 15 to the accompanying consolidated financial statements, included under Item 1 of this Quarterly Report on Form 10-Q.)

The following table presents our leverage multiples, as measured by debt-to-equity, at the dates presented:

At the Period Ended	GAAP Leverage Multiple (1)	Non-GAAP Leverage Multiple (2)
September 30, 2012	3.2*(3)*	3.2
June 30, 2012	3.6*(4)*	3.6
March 31, 2012	3.4*(5)*	3.5
December 31, 2011	3.6*(6)*	3.7
September 30, 2011	3.4	3.5

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(1) Represents the sum of borrowings under repurchase agreements, securitized debt, payable for unsettled MBS purchases, obligation to return securities obtained as collateral, and Senior Notes, divided by stockholders equity.

(2) The Non-GAAP Leverage Multiple reflects the sum of our borrowings under repurchase agreements, securitized debt, payable for unsettled MBS purchases, obligation to return securities obtained as collateral, Senior Notes and borrowings that are reported on our consolidated balance sheet as a component of Linked Transactions of $36.4 million, $51.2 million, $84.8 million, $170.9 million, and $193.0 million at September 30, 2012, June 30, 2012, March 31, 2012, December 31, 2011, and September 30, 2011, respectively. We present a Non-GAAP leverage multiple since repurchase agreement borrowings that are a component of Linked Transactions may not be linked in the future and, if no longer linked, will be reported as repurchase agreement borrowings, which will increase our leverage multiple. (See Note 4 to the accompanying consolidated financial statements, included under Item 1 of this Quarterly Report on Form 10-Q.)

(3) The decrease in our leverage multiple from 3.6x at June 30, 2012 to 3.2x at September 30, 2012 primarily reflects an increase in the market value of our Non-Agency MBS.

(4) The increase in our leverage multiple from 3.4x at March 31, 2012 to 3.6x to June 30, 2012 primarily reflects a higher use of financing structures and the issuance of Senior Notes during the quarter.

(5) The decrease in our leverage multiple from 3.6x at December 31, 2011 to 3.4x at March 31, 2012 primarily reflects an increase in the market value of our Non-Agency MBS.

(6) The increase in our leverage multiple from 3.4x at September 30, 2011 to 3.6x at December 31, 2011 primarily reflects a decline in the market value of our Non-Agency MBS and increased use of structured financing to acquire Non-Agency MBS.

For the third quarter of 2012, our net interest income decreased by $12.7 million, or 13.8%, to $79.3 million from $92.0 million for the third quarter of 2011. This decrease primarily reflects the impact of additional lower yielding MBS and increases in our average borrowings and the higher effective interest rate paid on such borrowings. Our net interest spread and margin for the third quarter of 2012 were 2.22% and 2.61%, respectively, compared to a net interest spread and margin of 2.83% and 3.20%, respectively, for the third quarter of 2011.

Explanation of Responses:

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The following table presents information regarding our average balances, interest income and expense, yields on average interest-earning assets, average cost of funds and net interest income for the quarters presented:

Quarter Ended (Dollars in Thousands)	Average Amortized Cost of MBS (1)	Interest Income on MBS	Average Interest Earning Cash (2)	Total Interest Income	Yield on Average Interest-Earning Assets (3)	Average Balance of Financing Arrangements (4)	Interest Expense	Average Cost of Funds	Net Interest Income
September 30, 2012	$ 11,778,939	$ 125,097	$ 406,488	$ 125,135	4.11%	$ 9,660,381	$ 45,801	1.89%	$ 79,334
June 30, 2012	11,219,055	125,504	292,302	125,531	4.36	8,981,553	42,688	1.91	82,843
March 31, 2012	10,819,531	123,504	424,691	123,523	4.39	8,721,868	40,127	1.85	83,396
December 31, 2011	11,000,704	123,964	402,958	123,994	4.35	8,899,013	38,811	1.73	85,183
September 30, 2011	11,010,686	130,741	548,339	130,766	4.53	9,034,044	38,752	1.70	92,014

(1) Unrealized gains and losses are not reflected in the average amortized cost of MBS.

(2) Includes average interest-earning cash, cash equivalents and restricted cash.

(3) Reflects annualized interest income divided by average amortized cost of interest-earning assets.

(4) Includes repurchase agreements, securitized debt and Senior Notes.

The following table presents our net interest spread and net interest margin for the quarters presented:

	Total Interest-Earning Assets and Interest-Bearing Liabilities	
Quarter Ended	Net Interest Spread (1)	Net Interest Margin (2)
September 30, 2012	2.22%	2.61%
June 30, 2012	2.45	2.87
March 31, 2012	2.54	2.96
December 31, 2011	2.62	3.00
September 30, 2011	2.83	3.20

(1) Reflects the difference between the yield on average interest-earning assets and average cost of funds.

(2) Annualized net interest income divided by average interest-earning assets.

The following table presents the components of the net interest spread earned on our Agency MBS and Non-Agency MBS for the quarters presented:

Agency MBS	Non-Agency MBS	Total MBS

Quarter Ended	Net Yield (1)	Cost of Funding (2)	Net Interest Spread (3)	Net Yield (1)	Cost of Funding (2)	Net Interest Spread (3)	Net Yield (1)	Cost of Funding (2)	Net Interest Spread (3)
September 30, 2012	2.66%	1.53%	1.13%	6.65%	2.41%	4.24%	4.25%	1.82%	2.43%
June 30, 2012	2.95	1.63	1.32	6.77	2.32	4.45	4.47	1.85	2.62
March 31, 2012	3.15	1.71	1.44	6.95	2.17	4.78	4.57	1.85	2.72
December 31, 2011	3.14	1.71	1.43	7.02	1.78	5.24	4.51	1.73	2.78
September 30, 2011	3.37	1.74	1.63	7.25	1.61	5.64	4.75	1.70	3.05

(1) Annualized interest income on MBS divided by average amortized cost of MBS.

(2) Annualized interest expense divided by average balance of repurchase agreements and securitized debt.

(3) Reflects the difference between the net yield on average MBS and average cost of funds on MBS.

During the third quarter of 2012, we did not recognize any OTTI charges through earnings against our Non-Agency MBS compared to $4.0 million during the third quarter of 2011. The impairment charges for the 2011 period reflected changes in our estimated cash flows for such securities based on an updated assessment of the estimated future performance of the underlying collateral, including the expected principal loss over the term of the

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security and changes in the expected timing of receipt of cash flows. At September 30, 2012, we had 51 Non-Agency MBS with a gross unrealized loss of $13.2 million and 34 Agency MBS with a gross unrealized loss of $961,000. Impairments on Agency MBS in an unrealized loss position at September 30, 2012 are considered temporary and not credit related. Unrealized losses on Non-Agency MBS for which no OTTI was recorded during the quarter are considered temporary based on an assessment of changes in the expected cash flows for such MBS, which considers recent bond performance and expected future performance of the underlying collateral. Significant judgment is used both in the Company s analysis of expected cash flows for its Non-Agency MBS and any determination of the credit component of OTTI.

For the third quarter of 2012, we had other income, net of $7.5 million. This income primarily reflects net gains of $3.2 million on our Linked Transactions and $4.3 million of gains realized on the sale of certain Agency MBS. The gains on Linked Transactions for the three months ended September 30, 2012 included interest income of $812,000 on the underlying Non-Agency MBS, interest expense of $168,000 on the borrowings under repurchase agreements and an increase of $2.5 million in the fair value of the underlying securities. The gains on our Linked Transactions of $733,000 for the three months ended September 30, 2011 included interest income of $4.6 million on the underlying Non-Agency MBS, interest expense of $864,000 on the borrowings under repurchase agreements and a decline of $3.0 million in the fair value of the underlying securities. Changes in the market value of the securities underlying our Linked Transactions, the amount of bond purchases recorded as Linked Transactions in the future and the amount of Linked Transactions that become unlinked in the future, none of which can be predicted with any certainty, will impact future gains/(losses) on our Linked Transactions. During the three months ended September 30, 2012, certain of our Linked Transactions became unlinked, resulting in our recording Non-Agency MBS with a fair value of $16.8 million on our consolidated balance sheet.

During the quarter ended September 30, 2012 we realized $4.3 million of gains on the sale of certain Agency MBS for proceeds of $66.0 million. During the quarter ended September 30, 2011, we realized $4.2 million of gains on the sale of certain Agency MBS for proceeds of $76.5 million.

For the third quarter of 2012, we had compensation and benefits and other general and administrative expense of $8.7 million, or 1.15% of average equity, compared to $8.5 million, or 1.23% of average equity, for the third quarter of 2011. The increase in our compensation and benefits expense to $6.0 million for the third quarter of 2012 compared to $5.5 million for the third quarter of 2011, primarily reflects vesting of equity-based compensation awards. Our other general and administrative expenses decreased by $365,000 to $2.7 million for the quarter ended September 30, 2012 compared to $3.0 million for the quarter ended September 30, 2011. The decrease was primarily comprised of lower recruitment and legal costs.

Nine-Month Period Ended September 30, 2012 Compared to the Nine-Month Period Ended September 30, 2011

For the nine months ended September 30, 2012, we had net income available to common stock and participating securities of $231.5 million, or $0.65 per basic and diluted common share, compared to net income available to common stock and participating securities of $239.7 million, or $0.71 per basic and diluted common share, for the nine months ended September 30, 2011. The decrease in net income available to our common stock and participating securities, and the decrease of this item on a per share basis were generally influenced by the impact of declining net interest spreads on interest bearing assets and liabilities. These declining spreads were primarily attributable to lower net yields on both Agency and Non-Agency MBS. Yields on Agency MBS were impacted by the lower interest rate environment and higher CPRs, while yields on Non-Agency MBS were primarily impacted by the addition of lower yielding assets and changes in expected future interest rates. In addition, we have also increased the amount of higher cost longer-term financing for our Non-Agency MBS portfolio, consistent with our overall financing strategy.

Interest income on our Agency MBS for the first nine months of 2012 decreased $36.1 million, or 19.4%, to $150.0 million from $186.1 million, for the first nine months of 2011. This change reflects a decrease in the net yield on our Agency MBS to 2.91% for the first nine months of 2012 from 3.62% for the first nine months of 2011, which was partially offset by an increase in the average amortized cost of our Agency MBS portfolio to $6.868 billion for the first nine months of 2012 from $6.855 billion for the first nine months of 2011. During the first nine months of 2012, our Agency MBS portfolio experienced a 20.0% CPR and we recognized $37.9 million of net premium amortization compared to a CPR of 18.8% and $26.6 million of net premium amortization for the first nine months of 2011. At the end of the third quarter of 2012, the average coupon on mortgages underlying our Agency MBS was lower compared to the end of the third quarter of 2011, due to acquisition of assets in the marketplace at generally lower coupons reflecting current market conditions and as a result of prepayments on higher yielding

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assets and resets on Hybrid and ARM-MBS within the portfolio. As a result, the coupon yield on our Agency MBS portfolio declined 49 basis points to 3.65% for the first nine months of 2012 from 4.14% for the first nine months of 2011. At September 30, 2012 we had net purchase premiums on our Agency MBS of $225.4 million, or 3.2% of current par value, compared to net purchase premiums of $177.7 million and 2.6% of par value at December 31, 2011.

Interest income on our Non-Agency MBS (which includes Non-Agency MBS transferred to consolidated VIEs) increased $37.5 million, or 20.1%, to $224.1 million for the first nine months of 2012 compared to $186.5 million for the first nine months of 2011, principally due to the increase in the amortized cost of our Non-Agency portfolio. Certain of our Non-Agency MBS are reported as a component of Linked Transactions, rather than as MBS. (See Note 4 to the accompanying consolidated financial statements, included under Item 1 of this Quarterly Report on Form 10-Q.) For the first nine months of 2012, the average amortized cost of our Non-Agency MBS increased by $1.204 billion, or 37.6%, to $4.406 billion, from $3.202 billion for the first nine months of 2011. The growth in our Non-Agency MBS has primarily been funded with longer term forms of repurchase agreement financings and securitized debt in connection with our resecuritization transactions. In addition, certain of our Non-Agency MBS underlying Linked Transactions became delinked during the first nine months of 2012, primarily in connection with our amended multi-year financing arrangement with one of our counterparties in January 2012. These delinkings resulted in Non-Agency MBS of $175.2 million, previously included as a component of Linked Transactions, being recognized as Non-Agency MBS on our consolidated balance sheet at September 30, 2012. Our Non-Agency MBS portfolio yielded 6.78% for the first nine months of 2012 compared to 7.77% for the first nine months of 2011. The decrease in the yield on our Non-Agency MBS is primarily due to the flattening (downward movement in the later years) of the forward yield curve, which causes us to lower the projected future coupons and therefore the expected yields on our Hybrid Non-Agency MBS and the addition of newly acquired assets at yields less than our overall portfolio yield. During the first nine months of 2012, we recognized net purchase discount accretion of $27.9 million on our Non-Agency MBS, compared to $33.0 million for the first nine months of 2011. At September 30, 2012, we had net purchase discounts of $1.767 billion, including Credit Reserve and previously recognized OTTI of $1.460 billion, on our Non-Agency MBS, or 27.4% of par value.

The following table presents information about average balances of our MBS portfolio by category and associated income for the nine months ended September 30, 2012 and September 30, 2011:

MBS Category (Dollars in Thousands)		Average Amortized Cost (1)		Interest Income	Weighted Average Coupon	Coupon Yield (2)	Net Asset Yield (3)
Nine Months Ended September 30, 2012							
Agency MBS	$	6,867,940	$	150,048	3.82%	3.65%	2.91%
Non-Agency MBS, including transfers to consolidated VIEs		4,406,416		224,057	4.36	5.94	6.78
Total	$	11,274,356		374,105	4.08%	4.54%	4.42%
Nine Months Ended September 30, 2011							
Agency MBS	$	6,854,773		186,114	4.31%	4.14%	3.62%
Non-Agency MBS, including transfers to consolidated VIEs		3,202,455		186,533	4.70	6.39	7.77
Total	$	10,057,228		372,647	4.34%	4.86%	4.94%

(1) Includes principal payments receivable.

(2) Reflects the annualized coupon interest income divided by the average amortized cost. The discounted purchase price on Non-Agency MBS causes the coupon yield to be higher than the pass-through coupon interest rate. (Does not include MBS underlying our Linked Transactions. See Note 4 to the accompanying consolidated financial statements, included under Item 1 of this Quarterly Report on Form 10-Q.)

(3) Reflects annualized interest income divided by the average amortized cost.

Interest income from our cash investments, which are comprised of money market investments and are not a material source of income as the yields on such funds are at historically low levels, decreased to $84,000 for the first nine months of 2012 from $106,000 for the 2011 period. Our average cash investments were $374.6 million and yielded 0.03% for the first nine months of 2012 compared to average cash investments of $478.4 million that yielded 0.03% for the first nine months of 2011. In general, we manage our cash investments relative to our investing, financing and operating requirements, investment opportunities and current and anticipated market conditions.

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At September 30, 2012, we had repurchase agreements of $8.832 billion and securitized debt of $749.5 million, of which $2.761 billion was hedged with Swaps. At September 30, 2012, our Swaps had a weighted average fixed-pay rate of 2.64% and extended 16 months on average with a maximum term of approximately 40 months. We expect interest expense and funding costs for the remainder of 2012 will be impacted by market interest rates, the amount of our borrowings, our existing and future interest rates on our hedging instruments and the extent to which we execute additional financing transactions, such as resecuritizations. As a result of these variables, our borrowing costs cannot be predicted with any certainly. (See Notes 4, 7 and 15 to the accompanying consolidated financial statements, included under Item 1 of this Quarterly Report on Form 10-Q.)

Our interest expense for the first nine months of 2012 increased by $18.0 million, or 16.3%, to $128.6 million from $110.6 million for the first nine months of 2011. This increase primarily reflects the $933.0 million increase in our average borrowings. The following table presents information regarding the components of our interest expense for the first nine months ended September 30, 2012 and September 30, 2011:

(Dollars in Thousands)	Average Balance	Interest Expense	Average Cost of Funds (1)
Nine Months Ended September 30, 2012			
Agency Repurchase Agreements	$ 6,175,813	$ 75,011	1.62%
Non-Agency Repurchase Agreements	1,984,486	36,628	2.47
Total Repurchase Agreements	8,160,299	111,639	1.83
Securitized Debt	899,797	13,186	1.96
Senior Notes *(2)*	63,139	3,791	8.00
Total	$ 9,123,235	$ 128,616	1.88%
Nine Months Ended September 30, 2011			
Agency Repurchase Agreements	$ 6,089,385	$ 85,453	1.87%
Non-Agency Repurchase Agreements	1,365,820	17,060	1.67
Total Repurchase Agreements	7,455,205	102,513	1.84
Securitized Debt	735,015	8,087	1.47
Total	$ 8,190,220	$ 110,600	1.81%

(1) Reflects the annualized interest expense divided by the average balance and includes the cost of Swaps designated as hedges against repurchase agreements.

(2) We did not have any Senior Notes during the 2011 period.

The effective interest rate paid on our borrowings increased slightly to 1.88% for the nine months ended September 30, 2012 compared to 1.81% for the first nine months of 2011. The increase reflects additional higher cost longer-term financing associated with our Non-Agency MBS portfolio, the issuance of fixed-rate securitized debt in February 2012, the issuance of our Senior Notes in April 2012, partially offset by the maturity of Swaps with fixed-pay rates higher than the overall average for our Swaps, which positively impacted the funding cost for our Agency MBS portfolio. Payments made and/or received on our Swaps are a component of our borrowing costs and accounted for interest expense of $58.3 million, or 85 basis points, for the nine months ended September 30, 2012, compared to interest expense of $73.1 million, or 119 basis points, for the first nine months of 2011. Certain of our Swaps have fixed interest rates that are significantly higher than current market interest rates. As these Swaps continue to amortize and/or expire, the Swap component of our borrowing costs is expected to continue to decrease. The weighted average fixed-pay rate on our Swaps decreased to 2.74% for the first nine months of 2012 from 3.24% for the first nine months of 2011. The weighted average variable interest rate received on our Swaps increased to 0.29% for the first nine months of 2012 from

0.24% for the first nine months of 2011. During the nine months ended September 30, 2012, we did not enter into any new Swaps and had Swaps with a notional amount of $617.2 million and a weighted average fixed-pay rate of 3.56% amortize and/or expire.

For the first nine months of 2012, our net interest income decreased by $16.6 million, or 6.3%, to $245.6 million from $262.2 million for the first nine months of 2011. This decrease primarily reflects an increase in our average borrowings and the higher effective rate paid on such borrowings partially offset by a $1.217 billion increase in the average amortized cost of our MBS portfolio. Our net interest spread and margin for the first nine months of 2012 were 2.40% and 2.81%, respectively, compared to a net interest spread and margin of 2.91% and 3.31%, respectively, for the first nine months of 2011.

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During the first nine months of 2012, we recognized OTTI charges through earnings of $1.2 million compared to $6.4 million during the first nine months of 2011. These impairment charges reflect changes in our estimated cash flows for such securities based on an updated assessment of the estimated future performance of the underlying collateral, including the expected principal loss over the term of the security and changes in the expected timing of receipt of cash flows.

For the nine months ended September 30, 2012, we had other income, net of $18.7 million. This income primarily reflects $11.4 million of net gains on our Linked Transactions and $7.2 million of gains realized on the sale of certain Agency MBS. The gains on our Linked Transactions for the nine months of 2012 included interest income of $4.4 million on the underlying Non-Agency MBS, interest expense of $965,000 on the underlying repurchase agreement borrowings and an increase of $8.0 million in the fair value of the underlying securities. The gains on our Linked Transactions of $10.0 million for the nine months ended September 30, 2011 included interest income of $21.5 million on the underlying Non-Agency MBS, interest expense of $3.9 million on the underlying repurchase financings and a decline of $7.6 million in the fair value of the underlying MBS. Changes in the market value of the securities underlying our Linked Transactions, the amount of bond purchases recorded as Linked Transactions in the future and the amount of Linked Transactions that become unlinked in the future, none of which can be predicted with any certainty, will impact future gains/(losses) on our Linked Transactions. During the nine months ended September 30, 2012, certain of our Linked Transactions became unlinked, resulting in our recording Non-Agency MBS with a fair value of $175.2 million on our consolidated balance sheet.

During the nine months ended September 30, 2012, we realized $7.2 million of gains on the sale of certain Agency MBS for proceeds of $137.1 million. During the nine months ended September 30, 2011, we realized $4.2 million of gains on the sale of certain Agency MBS for proceeds of $76.5 million.

During the first nine months of 2012, we had compensation and benefits and other general and administrative expense of $25.4 million, or 1.20% of average equity compared to $23.6 million, or 1.15% of average equity, for the first nine months of 2011. The $1.2 million increase in our compensation expense to $16.8 million for the first nine months of 2012, compared to $15.6 million for the first nine months of 2011, primarily reflects vesting of equity-based compensation awards, additional salary expense for new hires, and salary increases. Our other general and administrative expenses increased by $698,000 to $8.7 million for the first nine months of 2012, compared to $8.0 million for the first nine months of 2011. The increase was primarily comprised of increases in office rent and related occupancy costs, expenses related to director stock awards, shareholder services and the cost of data and analytical systems, which primarily reflects expenses to expand our investment analytic capability, associated primarily with our investments in Non-Agency MBS, and data system upgrades.

Liquidity and Capital Resources

General

Our principal sources of cash generally consist of borrowings under repurchase agreements, payments of principal and interest we receive on our MBS portfolio, cash generated from our operating results and, depending on market conditions, proceeds from capital market and resecuritization transactions. Our most significant uses of cash are generally to pay principal and interest on our borrowings under repurchase agreements and securitized debt, to purchase MBS, to make dividend payments on our capital stock, to fund our operations and to make other investments that we consider appropriate.

We seek to employ a diverse capital raising strategy under which we may issue capital stock. To the extent we raise additional equity through capital market transactions, we currently anticipate using the proceeds from such transactions to purchase additional MBS, to make scheduled payments of principal and interest on our repurchase agreement and other borrowings, for working capital and for other general corporate purposes. We may also acquire other investments consistent with our investment strategies and operating policies. There can be no assurance, however, that we will be able to raise additional equity capital at any particular time or on any particular terms. We have available for issuance an unlimited amount (subject to the terms and limitations of our charter) of common stock, preferred stock, depositary shares representing preferred stock, warrants, debt securities, rights and/or units pursuant to our automatic shelf registration statement and, at September 30, 2012, we had 9.4 million shares of common stock available for issuance pursuant to our DRSPP shelf registration statement. During the nine months ended September 30, 2012, we issued 596,079 shares of common stock through our DRSPP, raising net proceeds of $4.4 million.

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Our borrowings under repurchase agreements are uncommitted and renewable at the discretion of our lenders and, as such, our lenders could determine to reduce or terminate our access to future borrowings at virtually any time. The terms of the repurchase transaction borrowings under our master repurchase agreements as such terms relate to repayment, margin requirements and the segregation of all securities that are the subject of repurchase transactions generally conform to the terms in the standard master repurchase agreement as published by the Securities Industry and Financial Markets Association (or SIFMA) or the global master repurchase agreement published by SIFMA and the International Capital Market Association. In addition, each lender typically requires that we include supplemental terms and conditions to the standard master repurchase agreement. Typical supplemental terms and conditions, which differ by lender, may include changes to the margin maintenance requirements, required haircuts (as defined below), purchase price maintenance requirements, requirements that all controversies related to the repurchase agreement be litigated in a particular jurisdiction and cross default and setoff provisions.

With respect to margin maintenance requirements for repurchase agreements with Non-Agency MBS as collateral, margin calls are typically determined by our counterparties based on their assessment of changes in the fair value of the underlying collateral and in accordance with the agreed upon haircuts specified in the transaction confirmation with the counterparty. We address margin call requests in accordance with the required terms specified in the applicable repurchase agreement and such requests are typically satisfied by posting additional cash or collateral on the same business day. We review margin calls made by counterparties and assess them for reasonableness by comparing the counterparty valuation against our valuation determination. When we believe that a margin call is unnecessary based on an inappropriate counterparty valuation, we typically hold discussions with the counterparty and are able to resolve the matter. In the unlikely event that resolution cannot be reached, we will look to resolve the dispute based on the remedies available to us under the terms of the repurchase agreement, which in some instances may include the engagement of a third party to review collateral valuations. For other agreements that do not include such provisions, we could resolve the matter by substituting collateral as permitted in accordance with the agreement or otherwise request the counterparty to return the collateral in exchange for cash to unwind the financing.

The following table presents information regarding the margin requirements, or the percentage amount by which the collateral value is contractually required to exceed the loan amount (this difference is referred to as the haircut), on our repurchase agreements at September 30, 2012 and December 31, 2011:

	Weighted Average Haircut	Low	High
September 30, 2012			
Repurchase agreement borrowings secured by:			
Agency MBS	4.77%	3.00%	6.00%
Non-Agency MBS	30.38	10.00	63.00
U.S. Treasury securities	1.59	1.00	2.00
December 31, 2011			
Repurchase agreement borrowings secured by:			
Agency MBS	4.78%	3.00%	7.00%
Non-Agency MBS	30.97	10.00	63.00
U.S. Treasury securities	2.00	2.00	2.00

The weighted average haircut requirements for the respective underlying collateral types for our repurchase agreements have not significantly changed since December 31, 2011.

Explanation of Responses:

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During the first nine months of 2012, the financial market environment was impacted by continued accommodative monetary policy. Repurchase agreement funding for both Agency MBS and Non-Agency MBS has been available to us at attractive market terms from multiple counterparties. Typically, due to the credit risk inherent to Non-Agency MBS, repurchase agreement funding involving Non-Agency MBS is available from fewer counterparties, at terms requiring higher collateralization and higher interest rates, than does repurchase agreement funding secured by Agency MBS and U.S. Treasury securities. Therefore, we generally expect to be able to finance our acquisitions of Agency MBS (which we expect will continue to comprise the majority of our assets) on more favorable terms than financing for Non-Agency MBS.

We maintain cash and cash equivalents, unpledged Agency MBS and collateral in excess of margin requirements held by our counterparties (or collectively, our Cushion) to meet routine margin calls and protect against unforeseen reductions in our borrowing capabilities. Our ability to meet future margin calls will be impacted by our Cushion, which varies based on the market value of our securities, our cash position and margin requirements. Our cash position fluctuates based on the timing of our operating, investing and financing activities and is managed based on our anticipated cash needs. (See our consolidated statements of cash flows, included under Item 1 of this Quarterly Report on Form 10-Q and Interest Rate Risk included under Item 3 of this Quarterly Report on Form 10-Q.)

At September 30, 2012, we had a total of $10.629 billion of MBS and U.S. Treasury securities and $7.0 million of restricted cash pledged against our repurchase agreements and Swaps. At September 30, 2012, we had a Cushion of $1.071 billion available to meet potential margin calls, comprised of cash and cash equivalents of $450.4 million, unpledged Agency MBS of $568.6 million and excess collateral on Agency MBS of $51.9 million. In addition, at September 30, 2012, we had unpledged Non-Agency MBS with a fair value of $255.0 million and Non-Agency MBS with a fair value of $281.4 million pledged in excess of contractual requirements.

During the nine months ended September 30, 2012, we entered into a resecuritization transaction that resulted in us consolidating as a VIE, the SPE that was created to facilitate this transaction, and to which the underlying assets in connection with the resecuritization was transferred. As part of this resecuritization transaction, we sold Non-Agency MBS to Wells Fargo Mortgage Loan Trust, LLC (or WFMLT), who subsequently transferred the underlying certificates to a separate trust established under the laws of the State of New York, which we consolidate as a VIE. (See Note 15 to the accompanying consolidated financial statements, included under Item 1 of this Quarterly Report on Form 10-Q.)

The following table summarizes the key details of the resecuritization transactions we have been involved in to date:

(Dollars in Thousands)	**February 2012**	**June 2011**	**February 2011**	**October 2010**
Name of Trust (Consolidated as a VIE)	WFMLT Series 2012-RR1	CSMC Series 2011-7R	CSMC Series 2011-1R	DMSI 2010-RS2
Principal value of Non-Agency MBS sold	$ 433,347	$ 1,283,422	$ 1,319,969	$ 985,228
Face amount of Senior Bonds issued by the VIE and purchased by 3rd party investors	$ 186,691	$ 474,866	$ 488,389	$ 246,307
Outstanding amount of Senior Bonds at September 30, 2012	$ 155,125	$ 275,189	$ 266,632	$ 52,525
Pass-through rate for Senior Bonds issued	2.85%	One-month LIBOR plus 125 basis points	One-month LIBOR plus 100 basis points	One-month LIBOR plus 125 basis points
Face amount of Senior Support Certificates received by the Company *(1)*	$ 246,656	$ 808,556	$ 831,580	$ 738,921
Cash received	$ 186,691	$ 474,866	$ 488,389	$ 246,307
Notional amount acquired of non-rated, interest only senior certificates	$ 186,691	$ 474,866	$ 488,389	$ 246,307

Expenses incurred *(2)*	$	1,814	$	3,230	$	3,527	$	3,562

(1) Provides credit support for the sequential Senior Non-Agency MBS sold to third-party investors in resecuritization transactions (or Senior Bonds).

(2) Amortized to interest expense based upon the actual repayments of the associated beneficial interests issued to third parties.

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For financial statement reporting purposes, we consolidate the underlying trusts in our resecuritization transactions and, as such, no gain or loss is recorded. Since the underlying trusts are consolidated, we take the view that the resecuritization is effectively a financing of the Non-Agency MBS sold resulting in the Senior Bonds being presented in our consolidated financial statements as securitized debt.

During the nine months ended September 30, 2012, we issued $100.0 million aggregate principal amount of Senior Notes in an underwritten public offering. The total net proceeds to us from the offering of the Senior Notes were approximately $96.6 million, after deducting offering expenses and the underwriting discount. The Senior Notes bear interest at the rate of 8.00% per year, paid quarterly in arrears on January 15, April 15, July 15 and October 15 of each year and will mature on April 15, 2042. We may redeem the Senior Notes, in whole or in part, at any time on or after April 15, 2017 at a redemption price equal to 100% of the principal amount redeemed plus accrued and unpaid interest. (See Note 9 to the accompanying consolidated financial statements, included under Item 1 of this Quarterly Report on Form 10-Q.)

The table below presents certain information about our borrowings under repurchase agreements and securitized debt:

	Repurchase Agreements			Securitized Debt		
Quarter Ended (In Thousands)	**Quarterly Average Balance**	**End of Period Balance**	**Maximum Balance at Any Month-End**	**Quarterly Average Balance**	**End of Period Balance**	**Maximum Balance at Any Month-End**
September 30, 2012 *(1)*	$ 8,741,020	$ 8,832,326	$ 8,832,326	$ 819,361	$ 749,471	$ 821,256
June 30, 2012 *(1)*	7,961,497	8,368,407	8,368,407	931,045	861,255	935,051
March 31, 2012	7,772,000	7,908,932	7,908,932	949,868	967,422*(2)*	1,000,787
December 31, 2011	7,969,178	7,813,159	7,996,749	929,836	875,520	932,239
September 30, 2011	8,007,343	8,017,663	8,084,098	1,026,701	958,406	1,027,701

(1) The information presented in the table above excludes Senior Notes issued in April 2012. The quarterly average balance, end of period balance and maximum balance at any month-end for Senior Notes was $100.0 million.

(2) The higher end of the period balance reflects the securitized debt from our resecuritization transaction in February 2012.

Cash Flows and Liquidity For the Nine Months Ended September 30, 2012

Our cash and cash equivalents increased by $56.4 million during the nine months ended September 30, 2012, reflecting: $606.1 million provided by our financing activities; $782.3 million used through our investing activities, primarily to purchase MBS; and $232.6 million provided by our operating activities.

At September 30, 2012, our debt-to-equity multiple was 3.2x compared to 3.6x at December 31, 2011. At September 30, 2012, we had borrowings under repurchase agreements of $8.832 billion with 26 counterparties, of which $6.460 billion was secured by Agency MBS, $1.869 billion was secured by Non-Agency MBS and $503.1 million was secured by U.S. Treasuries. In addition, at such date, we had $36.4 million of borrowings under repurchase agreements that were a component of our Linked Transactions. (See Note 4 to the consolidated financial

statements, included under Item 1 of this Quarterly Report on Form 10-Q.) We continue to have available capacity under our repurchase agreement credit lines. At December 31, 2011, we had borrowings under repurchase agreements of $7.813 billion with 25 counterparties and had borrowings under repurchase agreements of $170.9 million that were a component of our Linked Transactions.

At September 30, 2012, we had aggregate securitized debt of $749.5 million, resulting from our resecuritization transactions. During the nine months ended September 30, 2012, we used cash of $312.7 million to make principal payments on our securitized debt, which had a weighted average expected remaining term of 1.22 years at September 30, 2012. During the nine months ended September 30, 2012, we increased the financing obtained under multi-year collateralized financing arrangements by approximately $200.0 million. At September 30, 2012, approximately $500.0 million of financing had been obtained under these arrangements.

During the nine months ended September 30, 2012, we issued $100.0 million aggregate principal amount of Senior Notes in an underwritten public offering. The total net proceeds from the offering of the Senior Notes were approximately $96.6 million, after deducting offering expenses and the underwriting discount.

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During the nine months ended September 30, 2012 we used $782.3 million through our investing activities. During this period, we received cash of $1.977 billion from prepayments and scheduled amortization on our MBS portfolio, of which $1.434 billion was attributable to Agency MBS and $543.4 million was from Non-Agency MBS. During the nine months ended September 30, 2012, we purchased $1.774 billion of Agency MBS and $1.123 billion of Non-Agency MBS funded with cash and repurchase agreement borrowings. While we generally intend to hold our MBS as long-term investments, we may sell certain MBS in order to manage our interest rate risk and liquidity needs, meet other operating objectives and adapt to market conditions. During the nine months ended September 30, 2012 we sold certain of our Agency MBS for proceeds of $137.1 million, realizing gross gains of $7.2 million.

In connection with our repurchase agreement borrowings and Swaps, we routinely receive margin calls from our counterparties and make margin calls to our counterparties. Margin calls and reverse margin calls, which requirements vary over time, may occur daily between us and any of our counterparties when the value of collateral pledged changes from the amount contractually required. The value of securities pledged as collateral fluctuates reflecting changes in: (i) the face (or par) value of our MBS; (ii) market interest rates and/or other market conditions; and (iii) the market value of our Swaps. Margin calls/reverse margin calls are satisfied when we pledge/receive additional collateral in the form of additional securities and/or cash. We have maintained compliance with all of our financial covenants to date.

The table below summarizes our margin activity with respect to our repurchase agreement financings (including underlying Linked Transactions) and derivative hedging instruments for the quarterly periods presented:

	Collateral Pledged to Meet Margin Calls				
For the Quarter Ended (In Thousands)	**Fair Value of Securities Pledged**	**Cash Pledged**	**Aggregate Assets Pledged For Margin Calls**	**Cash and Securities Received For Reverse Margin Calls**	**Net Assets Received/ (Pledged) For Margin Activity**
September 30, 2012	$ 429,201	$	$ 429,201	$ 461,123	$ 31,922
June 30, 2012	334,536	800	335,336	318,723	(16,613)
March 31, 2012	277,415	1,590	279,005	333,753	54,748
December 31, 2011	451,838	10,901	462,739	463,791	1,052
September 30, 2011	719,639	2,660	722,299	657,785	(64,514)

During the nine months ended September 30, 2012, we paid $265.5 million for cash dividends on our common stock and DERs, and paid cash dividends of $6.1 million on our preferred stock. On September 28, 2012, we declared our third quarter 2012 dividend on our common stock of $0.21 per share; on October 31, 2012, we paid this dividend which totaled $75.3 million, including DERs of approximately $324,000.

We believe that we have adequate financial resources to meet our current obligations, including margin calls, as they come due, to fund dividends we declare and to actively pursue our investment strategies. However, should the value of our MBS suddenly decrease, significant margin calls on our repurchase agreement borrowings could result and our liquidity position could be materially and adversely affected. Further, should market liquidity tighten, our repurchase agreement counterparties may increase our margin requirements on new financings, reducing our ability to use leverage. Access to financing may also be negatively impacted by the ongoing volatility in the world financial markets, potentially adversely impacting our current or potential lenders ability or willingness to provide us with financing. In addition, there is no assurance that favorable market conditions will continue to permit us to consummate additional securitization transactions if we determine to seek that form of financing.

Off-Balance Sheet Arrangements

We do not have any material off-balance-sheet arrangements. Our Linked Transactions are comprised of MBS, associated repurchase agreements and interest receivable/payable on such accounts. The extent to which these transactions become unlinked in the future, the underlying MBS and the borrowings under repurchase agreements and associated interest income and expense will be presented on a gross basis on our consolidated balance sheet and statement of operations, prospectively. (See page 55 for information about our leverage multiple and Note 4 to the accompanying consolidated financial statements, included under Item 1 of this Quarterly Report on Form 10-Q.)

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Inflation

Substantially all of our assets and liabilities are financial in nature. As a result, changes in interest rates and other factors impact our performance far more than does inflation. Our financial statements are prepared in accordance with GAAP and dividends declared are based upon net ordinary income as calculated for tax purposes. In each case, our results of operations and reported assets, liabilities and equity are measured with reference to historical cost or fair value without considering inflation.

Other Matters

Our objective has been to conduct our business so as not to become regulated as an investment company under the Investment Company Act. Section 3(c)(5)(C) of the Investment Company Act exempts from the definition of investment company entities that are primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. Under current interpretations of the SEC staff, this exemption generally means that at least 55% of our assets must be comprised of qualifying real estate assets and at least 80% of our portfolio must be comprised of qualifying real estate assets and real estate-related assets under the Investment Company Act. We primarily rely on an existing interpretation of the SEC Staff that whole pool certificates that are issued or guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae (or Agency Whole Pool Certificates) are considered qualifying real estate assets under Section 3(c)(5)(C). We treat as real estate-related assets MBS that do not represent all of the certificates issued with respect to the entire pool of mortgages. Compliance with this exemption inherently limits the types of assets we may acquire from time to time.

On August 31, 2011, the SEC issued a concept release under which it is reviewing interpretive issues related to the Section 3(c)(5)(C) exemption, including requesting comments on whether it should reconsider whether Agency Whole Pool Certificates may be treated as interests in real estate (and presumably Qualifying Real Estate Assets) and whether companies, such as us, whose primary business consists of investing in Agency Whole Pool Certificates, are the type of entities that Congress intended to be covered by the exclusion provided by Section 3(c)(5)(C).

The potential timetable and outcome of the SEC s review are unclear. However, if the SEC determines that Agency Whole Pool Certificates are not interests in real estate (and therefore not Qualifying Real Estate Assets), adopts an otherwise adverse interpretation with respect to Agency Whole Pool Certificates, issues different guidance regarding any of the matters bearing upon the exemption under Section 3(c)(5)(C) or otherwise believes we do not satisfy an Investment Company Act exemption, we would be required to significantly restructure our operations in order to maintain our investment company exemption. Under these circumstances, our ability to use leverage and our access to more favorable methods of financing would be substantially reduced, and we would be unable to conduct our business as we currently conduct it. We may also be required to sell certain of our assets and/or limit the types of assets we acquire. Under the circumstances described above, it is likely that our net interest income would be significantly reduced, which would materially and adversely affect our business.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk.

We seek to manage our risks related to interest rates, liquidity, prepayment speeds, market value and the credit quality of our assets while, at the same time, seeking to provide an opportunity to stockholders to realize attractive total returns through ownership of our capital stock. While we do not seek to avoid risk, we seek, consistent with our investment policies, to: assume risk that can be quantified from historical experience and actively manage such risk; earn sufficient returns to justify the taking of such risks; and maintain capital levels consistent with the risks that we undertake.

Interest Rate Risk

We primarily invest in residential ARM-MBS on a leveraged basis. We take into account both anticipated coupon resets on our ARM-MBS and expected prepayments on all of our MBS when measuring the sensitivity of our MBS portfolio to changes in interest rates. Our Repricing Gap measures the difference between: (a) the weighted average months until the next coupon adjustment or projected prepayment on our MBS portfolio, including Non-Agency MBS underlying our Linked Transactions; and (b) the months remaining to repricing for our repurchase financings (reflecting the impact of Swaps), including repurchase financings underlying our Linked Transactions and securitized debt. A CPR is applied in order to reflect, to a certain extent, the prepayment characteristics inherent in our interest-earning assets and interest-bearing liabilities. Over the last consecutive eight quarters, ending with September 30, 2012, the monthly fair value weighted average CPR on our MBS portfolio ranged from a high of 23.9% experienced during the quarter ended December 31, 2010 to a low of 15.2% experienced during the quarter ended June 30, 2011, with an average CPR over such quarters of 18.1%.

The following table presents information at September 30, 2012 about our Repricing Gap based on contractual maturities (i.e., 0 CPR), and applying CPRs of 15%, 20% and 25% to our MBS portfolio, including MBS underlying our Linked Transactions:

CPR Assumptions	Estimated Months to Asset Reset or Expected Prepayment	Estimated Months to Liabilities Reset (1)	Repricing Gap in Months (1)
0%*(2)*	60	6	54
15%	30	6	24
20%	25	6	19
25%	22	6	16

(1) Reflects the effect of our Swaps.

(2) 0% CPR reflects only scheduled amortization and contractual maturities.

At September 30, 2012, our financing obligations under repurchase agreements and repurchase agreement borrowings underlying our Linked Transactions had a weighted average remaining contractual term of 73 days and a weighted average term to interest rate reset of 29 days, or an effective repricing period of six months, including the impact of our Swaps. Upon contractual maturity or an interest reset date, these borrowings are typically refinanced at prevailing market rates. We use Swaps as part of our overall interest rate risk management strategy. Our Swaps are intended to act as a hedge against future interest rate increases on our repurchase financings, which rates are typically LIBOR based.

While our Swaps do not extend the maturities of our borrowings under repurchase agreements, they do, however, in effect, lock in a fixed rate of interest over their term for a corresponding amount of our repurchase agreements that such Swaps hedge. For the quarter ended September 30, 2012, our Swaps accounted for $18.1 million, or 75 basis points, of our borrowing costs. At September 30, 2012, we had borrowings under repurchase agreements of $8.832 billion and borrowings under repurchase agreements of $36.4 million underlying Linked Transactions. At such date, we had Swaps with a notional amount of $2.761 billion with a weighted average fixed-pay rate of 2.64%, which extended 16 months on average with a maximum term of approximately 40 months.

At September 30, 2012, our Swaps were in an unrealized loss position of $78.2 million, compared to a net unrealized loss position of $114.2 million at December 31, 2011. We expect that over time the unrealized losses on our Swaps will continue to decrease, as our Swaps with higher fixed-pay rates amortize and their remaining term shortens. (See Note 4 to the accompanying consolidated financial statements, included under Item 1 of this Quarterly Report on Form 10-Q.)

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The interest rates for most of our ARM-MBS, once in their adjustable rate period, primarily reset based on LIBOR and the one-year constant maturity treasury rate (or CMT) while our borrowings, comprised of repurchase agreements and securitized debt, are generally priced off of LIBOR. While LIBOR and CMT generally move together, there can be no assurance that the movement of one index will match that of the other index and, in fact, have at times moved inversely. The returns on our Non-Agency MBS, a significant portion of which were purchased at a discount, are impacted by the timing and amount of prepayments, credit performance and the benchmark rate to which the underlying mortgages are indexed.

Loans underlying Agency ARM-MBS generally reset based on the same benchmark index, Non-Agency MBS may be collateralized by mortgage loans that reset based on various benchmark indices and may contain fixed-rate mortgages. The ARMs collateralizing our Agency MBS are primarily comprised of Hybrids; which have interest rates that are typically fixed for three to ten years at origination and, thereafter, generally adjust annually to an increment over a specified interest rate index; and, to a lesser extent, ARMs, which have interest rates that generally adjust annually (although some may adjust more frequently) to an increment over a specified interest rate index.

Because the expected yields on our Non-Agency MBS are significantly greater than those on non-credit sensitive assets, we believe that changes in Non-Agency MBS prices are generally not correlated to changes in market interest rates and are impacted by general economic conditions and housing specific performance. The extent to which the yield on our Non-Agency MBS is impacted by the accretion of purchase discounts will vary over time, by security, based upon the amount of purchase discount, the actual credit performance and CPRs experienced on each MBS.

The amount by which our Agency ARM-MBS can reset is limited by the interim and lifetime caps on the underlying mortgages. The following table presents information about the interim and lifetime caps on our Agency ARM-MBS portfolio at September 30, 2012:

Lifetime Interest Rate Caps on Agency ARMs (1)		**Interim Interest Rate Caps on Agency ARMs (2)**	
Maximum Lifetime Interest Rate	**% of Total**	**Maximum Interim Change in Rate**	**% of Total**
6.0% to 8.0%	15.6%	≤1.0%	1.3%
>8.0% to 10.0 %	53.2	>1.0% and ≤3.0%	17.6
>10.0% to 12.0%	28.8	>3.0% and ≤5.0%	78.5
>12.0%	2.4	>5.0%	0.1
	100.0%	No interim caps	2.5
			100.0%

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(1) Lifetime interest rate caps limit the amount interest rates can adjust upward from inception through maturity of a particular ARM.

(2) Interim interest rate caps limit the amount interest rates on a particular ARM can adjust during the next adjustment period.

We generally acquire interest-rate sensitive assets and fund them with interest-rate sensitive liabilities, a portion of which are hedged with Swaps. Our adjustable-rate assets reset on various dates that are not matched to the reset dates on our repurchase agreement borrowings. In general, the repricing of our repurchase agreements occurs more quickly, including the impact of Swaps, than the repricing of our assets. Therefore, on average, our cost of borrowings generally rises or falls more quickly in response to changes in market interest rates than would the yield on our interest-earning assets.

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At September 30, 2012, MFA s $12.723 billion of Agency MBS and Non-Agency MBS, which includes MBS underlying Linked Transactions, were backed by Hybrid, adjustable and fixed-rate mortgages. Additional information about these MBS, including months to reset and three-month average CPR, is presented below:

	Agency MBS			Non-Agency MBS (1)			Total		
(Dollars in Thousands)	**Fair Value**	**Average Months to Reset (2)**	**Average CPR (3)**	**Fair Value**	**Average Months to Reset (2)**	**Average CPR (3)**	**Fair Value**	**Average Months to Reset (2)**	**Average CPR (3)**
Time to Reset:									
< 2 years *(4)*	$ 1,621,052	7	20.6%	$ 2,955,601	5	14.3%	$ 4,576,653	6	16.6%
2-5 years	2,414,580	38	30.4	664,114	47	18.7	3,078,694	40	28.0
> 5 years	1,279,614	75	16.2				1,279,614	75	16.2
ARM-MBS Total	$ 5,315,246	37	24.0%	$ 3,619,715	13	15.1%	$ 8,934,961	28	20.5%
15-year fixed	$ 2,161,602		14.4%	$ 12,165		28.0%	$ 2,173,767		14.5%
30-year fixed				1,607,696		16.0	1,607,696		16.0
40-year fixed				6,457		13.3	6,457		13.3
Fixed Rate Total	$ 2,161,602		14.4%	$ 1,626,318		16.1%	$ 3,787,920		15.2%
MBS Total	$ 7,476,848		21.6%	$ 5,246,033		15.4%	$ 12,722,881		19.1%

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(1) Information presented based on data available at time of loan origination.

(2) Months to reset is the number of months remaining before the coupon interest rate resets. At reset, the MBS coupon will adjust based upon the underlying benchmark interest rate index, margin and periodic or lifetime caps. The months to reset do not reflect scheduled amortization or prepayments.

(3) Average CPR weighted by positions as of the beginning of each month in the quarter.

(4) Includes floating rate MBS that may be collateralized by fixed-rate mortgages.

The information presented in the following Shock Table projects the potential impact of sudden parallel changes in interest rates on our net interest income and portfolio value, including the impact of derivative hedging instruments, over the next 12 months based on the assets in our investment portfolio at September 30, 2012. All changes in income and value are measured as the percentage change from the projected net interest income and portfolio value at the base interest rate scenario at September 30, 2012.

Shock Table

Change in Interest Rates (Dollars in Thousands)	**Estimated Value of MBS (1)**	**Estimated Value of Derivative Hedging Instruments**	**Estimated Value of Financial Instruments Carried at Fair Value (2)**	**Estimated Change in Fair Value**	**Percentage Change in Net Interest Income (3)**	**Percentage Change in Portfolio Value**
+100 Basis Point Increase	$ 12,649,286	$ (43,183)	$ 12,606,103	$ (38,609)	(7.44)%	(0.31)%
+ 50 Basis Point Increase	$ 12,689,166	$ (60,676)	$ 12,628,490	$ (16,222)	(4.06)%	(0.13)%
Actual at September 30, 2012	$ 12,722,881	$ (78,169)	$ 12,644,712	$		

- 50 Basis Point Decrease	$	12,750,432	$	(95,662)	$	12,654,770	$	10,058	0.10%	0.08%
-100 Basis Point Decrease	$	12,771,819	$	(113,155)	$	12,658,664	$	13,952	(5.52)%	0.11%

(1) Includes linked MBS that are reported as a component of our Linked Transactions on our consolidated balance sheet. Such MBS may not be linked in future periods.

(2) Does not include cash investments, which typically have overnight maturities and are not expected to change in value as interest rates change.

(3) Includes underlying interest income and interest expense associated with MBS and repurchase agreement borrowings underlying our Linked Transactions. Such MBS and repurchase agreements may not be linked in future periods.

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Certain assumptions have been made in connection with the calculation of the information set forth in the Shock Table 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 management s judgment and experience. Furthermore, while we generally expect to retain such assets and the associated interest rate risk to maturity, future purchases and sales of assets could materially change our interest rate risk profile. It should be specifically noted that the information set forth in the above table and all related disclosure constitute forward-looking statements within the meaning of Section 27A of the 1933 Act and Section 21E of the 1934 Act. Actual results could differ significantly from those estimated in the Shock Table above.

The Shock Table quantifies the potential changes in net interest income and portfolio value, which includes the value of our derivative hedging instruments (which are carried at fair value), should interest rates immediately change (i.e., shocked). The Shock Table presents the estimated impact of interest rates instantaneously rising 50 and 100 basis points, and falling 50 and 100 basis points. The cash flows associated with our portfolio of MBS for each rate shock are calculated based on assumptions, including, but not limited to, prepayment speeds, yield on replacement assets, the slope of the yield curve and composition of our portfolio. Assumptions made on the interest rate sensitive liabilities, which are assumed to be repurchase financings and securitized debt, include anticipated interest rates, collateral requirements as a percent of the repurchase agreement, amount and term of borrowing. Given the low level of interest rates at September 30, 2012, we applied a floor of 0% for all anticipated interest rates included in our assumptions. Due to this floor, it is anticipated that any hypothetical interest rate shock decrease would have a limited positive impact on our funding costs; however, because prepayments speeds are unaffected by this floor, it is expected that any increase in our prepayment speeds (occurring as a result of any interest rate shock decrease or otherwise) could result in an acceleration of our premium amortization on our Agency MBS and discount accretion on our Non-Agency MBS and the reinvestment of principal repayments in lower yielding assets. As a result, because the presence of this floor limits the positive impact of interest rate decrease on our funding costs, hypothetical interest rate shock decreases could cause the fair value of our financial instruments and our net interest income to decline.

At September 30, 2012, the impact on portfolio value was approximated using the calculated effective duration (i.e., the price sensitivity to changes in interest rates), including the effect of derivative hedging instruments, of 0.21 which is the weighted average of 0.82 for our Agency MBS, (1.30) for our derivative hedging instruments and zero for our Non-Agency MBS, and expected convexity (i.e., the approximate change in duration relative to the change in interest rates) of (0.19), which is the weighted average of (0.33) for our Agency MBS, zero for our derivative hedging instruments and zero for our Non-Agency MBS. Because the expected yields on our Non-Agency MBS are significantly greater than those on non-credit sensitive assets, we believe that changes in Non-Agency MBS prices are generally not correlated to changes in market interest rates and are impacted by general economic conditions and housing specific performance. The impact on our net interest income is driven mainly by the difference between portfolio yield and cost of funding of our repurchase agreements (including those underlying our Linked Transactions), which includes the cost and/or benefit from derivative hedging instruments. Our asset/liability structure is generally such that an increase in interest rates would be expected to result in a decrease in net interest income, as our borrowings are generally shorter in term than our interest-earning assets. When interest rates are shocked, prepayment assumptions are adjusted based on management s expectations along with the results from the prepayment model.

Market Value Risk

Our MBS are designated as available-for-sale and, as such, are reported at their fair value. The difference between amortized cost and fair value of our MBS is reflected in accumulated other comprehensive income/(loss), a component of Stockholders Equity, except that credit related impairments that are identified as other-than-temporary are recognized through earnings. Changes in the fair value of our Linked Transactions are reported in earnings. At September 30, 2012, our investment portfolio was comprised of Agency MBS and Non-Agency MBS. While changes in the fair value of our Agency MBS are generally not credit-related, changes in the fair value of our Non-Agency MBS and Linked Transactions may reflect both market and interest rate conditions as well as credit risk. At September 30, 2012, our Non-Agency MBS had a fair value of $5.197 billion and an amortized cost of $4.690 billion, comprised of gross unrealized losses of $13.2 million and gross unrealized gains of $519.9 million. At September 30, 2012, our Linked Transactions included MBS with a fair value of $49.1 million, including net unrealized gains of $3.4 million, which have been reflected through earnings to date as a component of unrealized net gains and net interest income from Linked Transactions.

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Generally, in a rising interest rate environment, the fair value of our MBS would be expected to decrease; conversely, in a decreasing interest rate environment, the fair value of such MBS would be expected to increase. If the fair value of MBS collateralizing our repurchase agreements decreases, we may receive margin calls from our repurchase agreement counterparties for additional MBS collateral or cash due to such decline. If such margin calls are not met, our lender could liquidate the securities collateralizing our repurchase agreements with such lender, potentially resulting in a loss to us. To avoid forced liquidations, we could apply a strategy of reducing borrowings and assets, by selling assets or not replacing securities as they amortize and/or prepay. Such an action would likely reduce our interest income, interest expense and net income, the extent of which would be dependent on the level of reduction in assets and liabilities as well as the price at which such assets are sold. Such a decrease in our net interest income could negatively impact cash available for dividend distributions, which in turn could reduce the market price of our issued and outstanding common stock and preferred stock.

In evaluating our asset/liability management and Non-Agency MBS credit performance, we consider the credit characteristics underlying our Non-Agency MBS, including those that are a component of our Linked Transactions. The following table presents certain information about our Non-Agency MBS portfolio and Non-Agency MBS underlying our Linked Transactions at September 30, 2012. Information presented with respect to weighted average loan to value, weighted average FICO scores and other information aggregated based on information reported at the time of mortgage origination are historical and, as such, does not reflect the impact of the general decline in home prices or changes in a borrower s credit score or the current use of the mortgaged property.

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The information in the table below is presented as of September 30, 2012.

Year of Securitization (2) (Dollars in Thousands)	Securities with Average Loan FICO of 715 or Higher (1) 2007	2006	2005 and Prior	Securities with Average Loan FICO Below 715 (1) 2007	2006	2005 and Prior	Total
Number of securities	93	94	102	15	26	47	377
MBS current face	$ 2,137,267	$ 1,484,937	$ 1,450,098	$ 204,645	$ 580,940	$ 653,874	$ 6,511,761
Total purchase discount, net	$ (557,384)	$ (440,559)	$ (293,602)	$ (90,448)	$ (230,028)	$ (163,829)	$ (1,775,850)
Purchase discount designated as Credit Reserve and OTTI *(3)*	$ (499,327)	$ (333,638)	$ (206,133)	$ (74,341)	$ (227,720)	$ (125,138)	$ (1,466,297)
Purchase discount designated as Credit Reserve and OTTI as percentage of current face	23%	22%	14%	36%	39%	19%	23%
MBS amortized cost	$ 1,579,883	$ 1,044,378	$ 1,156,496	$ 114,197	$ 350,912	$ 490,045	$ 4,735,911
MBS fair value	$ 1,733,628	$ 1,181,858	$ 1,233,317	$ 140,326	$ 397,832	$ 559,072	$ 5,246,033
Weighted average fair value to current face	81.1%	79.6%	85.1%	68.6%	68.5%	85.5%	80.6%
Weighted average coupon *(4)*	4.80%	4.39%	3.66%	3.71%	4.42%	4.43%	4.35%
Weighted average loan age (months) *(4) (5)*	67	75	88	68	77	90	77
Weighted average current loan size *(4) (5)*	$ 547	$ 537	$ 362	$ 466	$ 293	$ 306	$ 454
Percentage amortizing *(6)*	38.2%	44.9%	66.0%	44.0%	55.9%	65.7%	50.4%
Weighted average FICO score at origination *(4) (7)*	734	730	728	702	704	706	725
Owner-occupied loans	89.2%	89.3%	86.3%	82.9%	83.5%	85.0%	87.5%
Rate-term refinancings	26.6%	19.1%	15.9%	18.7%	15.9%	13.8%	20.0%
Cash-out refinancings	33.0%	32.8%	26.1%	40.6%	39.6%	37.7%	32.7%
3 Month CPR *(5)*	18.1%	16.4%	13.9%	14.8%	15.6%	14.1%	16.0%
3 Month CRR *(5) (8)*	9.1%	7.3%	7.6%	4.3%	5.3%	8.0%	7.8%
3 Month CDR *(5) (8)*	8.3%	8.7%	5.9%	11.0%	10.7%	5.3%	7.8%
3 Month loss severity	49.6%	50.3%	47.1%	56.2%	63.3%	56.4%	51.8%
60+ days delinquent *(7)*	20.1%	19.7%	16.0%	29.5%	26.5%	19.8%	20.0%
Percentage of always current borrowers (Lifetime) *(9)*	52.8%	50.9%	56.8%	35.6%	34.1%	43.0%	50.1%
Percentage of always current borrowers (12M) *(10)*	68.1%	68.0%	74.3%	55.5%	55.5%	64.7%	67.6%
Weighted average credit enhancement *(7) (11)*	1.1%	2.0%	6.9%	1.1%	2.0%	9.1%	3.5%

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(1) FICO score is used by major credit bureaus to indicate a borrower s creditworthiness at time of loan origination.

(2) Information presented based on the initial year of securitization of the underlying collateral. Certain of our Non-Agency MBS have been resecuritized. The historical information presented in the table is based on the initial securitization date and data available at the time of original securitization (and not the date of resecuritization). No information has been updated with respect to any MBS that have been resecuritized.

(3) Purchase discounts designated as Credit Reserve and OTTI are not expected to be accreted into interest income.

(4) Weighted average is based on MBS current face at September 30, 2012.

(5) Information provided is based on loans for individual groups owned by us.

(6) Percentage of face amount for which the original mortgage note contractually calls for principal amortization in the current period.

(7) Information provided is based on loans for all groups that provide credit enhancement for MBS with credit enhancement.

(8) CRR represents voluntary prepayments and CDR represents involuntary prepayments.

(9) Percentage of face amount of loans for which the borrower has not been delinquent since origination.

(10) Percentage of face amount of loans for which the borrower has not been delinquent in the last twelve months.

(11) Credit enhancement for a particular security is expressed as a percentage of all outstanding mortgage loan collateral. A particular security will not be subject to principal loss as long as its credit enhancement is greater than zero. As of September 30, 2012, a total of 153 Non-Agency MBS in our portfolio representing approximately $2.815 billion or 43% of the current face amount of the portfolio had no credit enhancement.

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The mortgages securing our Non-Agency MBS are located in many geographic regions across the United States. The following table presents the six largest geographic concentrations of the mortgages collateralizing our Non-Agency MBS, including Non-Agency MBS underlying our Linked Transactions, at September 30, 2012:

Property Location	Percent
Southern California	28.3%
Northern California	18.0%
Florida	7.9%
New York	5.3%
Virginia	3.7%
New Jersey	3.2%

Liquidity Risk

The primary liquidity risk for us arises from financing long-maturity assets, including ARM-MBS that are subject to interim and lifetime interest rate adjustment caps, with shorter-term borrowings primarily in the form of repurchase agreements. We pledge MBS and cash to secure our repurchase agreements, including repurchase agreements that are reported as a component to our Linked Transactions, and Swaps. At September 30, 2012, we had a Cushion of $1.071 billion available to meet potential margin calls, comprised of cash and cash equivalents of $450.4 million, unpledged Agency MBS of $568.6 million and excess collateral on Agency MBS of $51.9 million. In addition, at September 30, 2012, we had unpledged Non-Agency MBS with a fair value of $255.0 million and Non-Agency MBS with a fair value of $281.4 million pledged in excess of contractual requirements. Should the value of our MBS pledged as collateral suddenly decrease, margin calls relating to our repurchase agreements could increase, causing an adverse change in our liquidity position. As such, we cannot be assured that we will always be able to roll over our repurchase agreements. Further, should market liquidity tighten, our repurchase agreement counterparties may increase our margin requirements on new financings, including repurchase agreement borrowings that we roll with the same counterparty, reducing our ability to use leverage.

Credit Risk

Although we do not believe that we are exposed to credit risk in our Agency MBS portfolio, we are exposed to credit risk in our Non-Agency MBS portfolio. In the event of the return of less than 100% of par on our Non-Agency MBS, credit support contained in the MBS deal structures and the discount purchase prices we paid mitigate our risk of loss on these investments. Over time, we expect the level of credit support remaining in MBS deal structures to decrease, which will result in an increase in the amount of realized credit loss experienced by our Non-Agency MBS portfolio. Our Non-Agency investment process involves analysis focused primarily on quantifying and pricing credit risk. When we purchase Non-Agency MBS, we assign certain assumptions to each of the MBS, including but not limited to, future interest rates, voluntary prepayment rates, mortgage modifications, default rates and loss severities, and generally allocate a portion of the purchase discount as a Credit Reserve which provides credit protection for such securities. As part of our surveillance process, we review our Non-Agency MBS by tracking their actual performance compared to the security s expected performance at purchase or, if we have modified our original purchase assumptions, compared to our revised performance expectations. To the extent that actual performance of a Non-Agency MBS is less favorable than the expected performance of the security, we may revise our performance expectations. As a result, we could reduce the accretable discount on such security and/or recognize an other-than-temporary impairment through earnings, which could have a material adverse impact on our operating results. In addition, as discussed in Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations, of this Quarterly Report on Form 10-Q, we are potentially exposed to repurchase agreement counterparties should they default on their obligations, and we are unable to recover any excess collateral pledged to them.

Prepayment and Reinvestment Risk

Premiums arise when we acquire MBS at a price in excess of the principal balance of the mortgages securing such MBS (i.e., par value). Conversely, discounts arise when we acquire MBS at a price below the principal balance of the mortgages securing such MBS. Premiums paid on our MBS are amortized against interest income and accretable purchase discounts on our MBS are accreted to interest income. Purchase premiums on our MBS, which are primarily carried on our Agency MBS, are amortized against interest income over the life of each security using the effective yield method, adjusted for actual prepayment activity. An increase in the prepayment rate, as measured by the CPR, will typically accelerate the amortization of purchase premiums, thereby reducing the yield/interest income earned on such assets. Generally, if prepayments on our Non-Agency MBS are less than anticipated, we expect that the income recognized on such assets would be reduced and impairments could result.

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Item 4. Controls and Procedures

A review and evaluation was performed by our management, including our Chief Executive Officer (or CEO) and Chief Financial Officer (or CFO), of the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the 1934 Act) as of the end of the period covered by this Quarterly Report. Based on that review and evaluation, the CEO and CFO have concluded that our disclosure controls and procedures, as designed and implemented, were effective as of September 30, 2012. Notwithstanding the foregoing, a control system, no matter how well designed, implemented 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 our periodic reports.

There have been no changes in our internal control over financial reporting that occurred during the quarter ended September 30, 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

There are no material pending legal proceedings to which we are a party or any of our assets are subject.

Item 1A. Risk Factors

For a discussion of the Company s risk factors, see Part I, Item 1A. Risk Factors of the Company s Annual Report on Form 10-K for the year ended December 31, 2011, and Part II, Item 1A. Risk Factors of the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2012. There are no material changes from the risk factors set forth in such Annual Report and such Quarterly Report. However, the risks and uncertainties that the Company faces are not limited to those set forth in such Annual Report and Quarterly Report. Additional risks and uncertainties not presently known to the Company or that it currently believes to be immaterial may also adversely affect the Company s business and the trading price of its securities.

Item 6. Exhibits

The list of exhibits required to be filed as exhibits to this report are listed on page E-1 hereof, under Exhibit Index, which is incorporated herein by reference.

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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.

Date: November 6, 2012	MFA FINANCIAL, INC. (Registrant)		
	By:	/s/	Stewart Zimmerman Stewart Zimmerman Chairman and Chief Executive Officer
	By:	/s/	Stephen D. Yarad Stephen D. Yarad Chief Financial Officer (Principal Financial Officer)

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EXHIBIT INDEX

The following exhibits are filed as part of this Quarterly Report:

Exhibit	Description
10.1	Amendment No.1, dated October 19, 2012, to Second Amended and Restated Employment Agreement, dated as of June 7, 2010, between MFA Financial, Inc. and Stewart Zimmerman (incorporated herein by reference to Exhibit 10.1 to the Company s Form 8-K, dated October 22, 2012, as amended by the Company s Form 8-K/A (Amendment No. 1), dated October 22, 2012 (Commission File No. 1-13991)).
10.2	Third Amended and Restated 2003 Non-Employee Directors Deferred Compensation Plan (as amended through November 1, 2012)
31.1	Certification of the Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of the Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of the Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema Document
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document

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*These interactive data files are furnished and deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.