

Invesco Mortgage Capital Inc.  
Form 10-Q  
October 31, 2013  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2013

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission file number 001-34385

INVESCO MORTGAGE CAPITAL INC.  
(Exact Name of Registrant as Specified in Its Charter)

Maryland 26-2749336  
(State or Other Jurisdiction of (I.R.S. Employer  
Incorporation or Organization) Identification No.)

1555 Peachtree Street, N.E., Suite 1800 30309  
Atlanta, Georgia (Zip Code)  
(Address of Principal Executive Offices)  
(404) 892-0896  
(Registrant's Telephone Number, Including Area Code)

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

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

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

Large Accelerated filer  Accelerated filer   
Non-Accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

As of October 29, 2013, there were 135,225,647 outstanding shares of common stock of Invesco Mortgage Capital Inc.



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## PART I

## ITEM 1. FINANCIAL STATEMENTS

## INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

\$ in thousands, except per share amounts	As of September 30, 2013 (Unaudited)	December 31, 2012
<b>ASSETS</b>		
Mortgage-backed securities, at fair value	18,811,679	18,470,563
Residential loans, held-for-investment, net of loan loss reserve	1,532,389	—
Commercial loans, held-for-investment, net of loan loss reserve	17,388	—
Cash and cash equivalents	199,095	286,474
Due from counterparties	8,119	—
Investment related receivable	8,912	41,429
Investments in unconsolidated ventures, at fair value	42,276	35,301
Accrued interest receivable	71,198	62,977
Derivative assets, at fair value	188,509	6,469
Deferred securitization and financing costs	14,033	—
Other investments	10,000	10,000
Other assets	1,883	1,547
Total assets <sup>(1)</sup>	20,905,481	18,914,760
<b>LIABILITIES AND EQUITY</b>		
<b>Liabilities:</b>		
Repurchase agreements	15,897,612	15,720,460
Asset-backed securities issued	1,411,897	—
Exchangeable senior notes	400,000	—
Derivative liability, at fair value	316,670	436,440
Dividends and distributions payable	71,037	79,165
Investment related payable	201,203	63,715
Accrued interest payable	19,554	15,275
Collateral held payable	21,045	—
Accounts payable and accrued expenses	3,885	877
Due to affiliate	11,457	9,308
Total liabilities <sup>(1)</sup>	18,354,360	16,325,240
<b>Equity:</b>		
Preferred Stock: par value \$0.01 per share, 50,000,000 shares authorized; 7.75% series A cumulative redeemable, \$25 liquidation preference, 5,600,000 shares issued and outstanding at September 30, 2013 and December 31, 2012, respectively	135,356	135,362
Common Stock: par value \$0.01 per share, 450,000,000 shares authorized; 135,224,162 and 116,195,500 shares issued and outstanding at September 30, 2013 and December 31, 2012, respectively	1,352	1,162
Additional paid in capital	2,712,790	2,316,290
Accumulated other comprehensive income (loss)	(315,469)	) 86,436
Retained earnings (distributions in excess of earnings)	(9,912)	) 18,848
Total shareholders' equity	2,524,117	2,558,098
Non-controlling interest	27,004	31,422
Total equity	2,551,121	2,589,520

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Total liabilities and equity 20,905,481 18,914,760

Our consolidated balance sheets include assets of consolidated variable interest entities (“VIEs”) that can only be used to settle obligations and liabilities of the VIEs for which creditors do not have recourse to the primary (1) beneficiary (IAS Asset I LLC, an indirect subsidiary of Invesco Mortgage Capital Inc.). At September 30, 2013 and December 31, 2012, total assets of the consolidated VIEs were \$1,540,150 and \$0, respectively, and total liabilities of the consolidated VIEs were \$1,415,784 and \$0, respectively. See Note 3 for further discussion. The accompanying notes are an integral part of these consolidated financial statements.

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INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
\$ in thousands, except per share data				
Interest Income				
Mortgage-backed securities	157,539	140,477	486,619	421,442
Residential loans	13,417	—	20,443	—
Commercial loans	372	—	432	—
Total interest income	171,328	140,477	507,494	421,442
Interest Expense				
Repurchase agreements	73,695	60,327	208,487	172,312
Exchangeable senior note	5,621	—	12,403	—
Asset-backed securities issued	10,266	—	15,722	—
Total interest expense	89,582	60,327	236,612	172,312
Net interest income	81,746	80,150	270,882	249,130
Provision for loan losses	87	—	751	—
Net interest income after provision for loan losses	81,659	80,150	270,131	249,130
Other Income (loss)				
Gain (loss) on sale of investments, net	(69,323 )	12,836	(56,919 )	24,978
Equity in earnings and fair value change in unconsolidated ventures	1,422	3,262	5,169	6,231
Realized and unrealized gain (loss) on interest rate derivative instruments	(6,887 )	(808 )	44,424	(2,851 )
Realized and unrealized credit default swap income	297	1,348	828	2,694
Total other income (loss)	(74,491 )	16,638	(6,498 )	31,052
Expenses				
Management fee – related party	10,945	9,053	32,106	26,372
General and administrative	2,259	959	6,845	3,132
Total expenses	13,204	10,012	38,951	29,504
Net income (loss)	(6,036 )	86,776	224,682	250,678
Net income (loss) attributable to non-controlling interest	(63 )	1,026	2,392	3,025
Net income (loss) attributable to Invesco Mortgage Capital Inc.	(5,973 )	85,750	222,290	247,653
Dividends to preferred shareholders	2,713	2,682	8,138	2,682
Net income (loss) attributable to common shareholders	(8,686 )	83,068	214,152	244,971
Earnings (loss) per share:				
Net income (loss) attributable to common shareholders				
Basic	(0.06 )	0.72	1.61	2.12
Diluted	(0.06 )	0.72	1.56	2.12
Dividends declared per common share	0.50	0.65	1.80	1.95
The accompanying notes are an integral part of these consolidated financial statements.				

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INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)  
(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
\$ in thousands, except per share data	2013	2012	2013	2012
Net income (loss)	(6,036	) 86,776	224,682	250,678
Other comprehensive income (loss)				
Unrealized gain (loss) on mortgage-back securities				
Change in fair value	(10,724	) 322,647	(846,292	) 603,710
Reclassification adjustments for (gain) loss included in gain (loss) on sale of investments	85,754	(5,824	) 140,195	(17,401
Unrealized gain (loss) on mortgage-backed securities, net	75,030	316,823	(706,097	) 586,309
Unrealized gain (loss) on derivatives				
Change in fair value	(74,098	) (60,716	) 183,391	(181,280
Reclassification adjustments for loss included in unrealized gain (loss) on interest rate derivative instruments	43,583	35,763	116,553	107,051
Unrealized gain (loss) on derivatives, net	(30,515	) (24,953	) 299,944	(74,229
Total Other comprehensive income (loss)	44,515	291,870	(406,153	) 512,080
Comprehensive income (loss)	38,479	378,646	(181,471	) 762,758
Less: Comprehensive income (loss) attributable to non-controlling interest	(402	) (4,585	) 1,856	(9,271
Less: Dividends to preferred shareholders	(2,713	) (2,682	) (8,138	) (2,682
Comprehensive income (loss) attributable to common shareholders	35,364	371,379	(187,753	) 750,805

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

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**INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF EQUITY**

For the nine months ended September 30, 2013

(Unaudited)

\$ in thousands, except per share amounts	Preferred Stock		Attributable to Common Shareholders				Retained Earnings (Distributions in excess of earnings)	Total Shareholders' Equity	Non- Controlling Interest	Total Equity
	Shares	Amount	Shares	Amount	Additional Paid in Capital	Accumulated Other Comprehensive Income (loss)				
Balance at January 1, 2013	5,600,000	135,362	116,195,500	1,162	2,316,290	86,436	18,848	2,558,098	31,422	2,589,520
Net income	—	—	—	—	—	—	222,290	222,290	2,392	224,682
Other comprehensive loss	—	—	—	—	—	(401,905)	—	(401,905)	(4,248)	(406,153)
Proceeds from issuance of common stock, net of offering costs	—	—	19,015,269	190	396,227	—	—	396,417	—	396,417
(Cost) proceeds from issuance of preferred stock, net of offering costs	—	(6)	—	—	—	—	—	(6)	—	(6)
Stock awards	—	—	13,393	—	—	—	—	—	—	—
Common stock dividends	—	—	—	—	—	—	(242,912)	(242,912)	—	(242,912)
Common unit dividends	—	—	—	—	—	—	—	—	(2,565)	(2,565)
Preferred stock dividends	—	—	—	—	—	—	(8,138)	(8,138)	—	(8,138)
Amortization of equity-based compensation	—	—	—	—	273	—	—	273	3	276
Balance at September 30, 2013	5,600,000	135,356	135,224,162	1,352	2,712,790	(315,469)	(9,912)	2,524,117	27,004	2,551,121

The accompanying notes are an integral part of this consolidated financial statement.



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INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

	Nine Months Ended September	
	30,	2012
\$ in thousands	2013	2012
Cash Flows from Operating Activities		
Net income	224,682	250,678
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of mortgage-backed securities premiums and discounts, net	145,112	94,722
Amortization of residential loan and asset-backed securities premiums	117	—
Amortization of commercial loan origination fees	(21)	)
Origination fee received	145	—
Provision for loan losses	751	—
Unrealized loss on interest rate derivative instruments	21,810	2,851
Unrealized (gain) loss on credit default swap	743	(406)
(Gain) loss on sale of mortgage-backed securities	56,919	(24,978)
Gain on termination of interest rate swaptions	(66,234)	)
Equity in earnings and fair value change in unconsolidated ventures	(5,169)	(6,231)
Amortization of equity-based compensation	276	257
Amortization of deferred securitization and financing costs	1,647	—
Changes in operating assets and liabilities:		
Increase in accrued interest receivable	(8,538)	(7,592)
Increase in other assets	(391)	(165)
Increase (decrease) in accrued interest payable	4,279	(568)
Increase in due to affiliate	2,149	428
Increase in accounts payable and accrued expenses	3,061	64
Net cash provided by operating activities	381,338	309,060
Cash Flows from Investing Activities		
Purchase of mortgage-backed securities	(6,923,130)	(6,354,428)
(Contributions) distributions from investment in unconsolidated ventures, net	(1,806)	) 19,370
Principal payments from mortgage-backed securities	2,309,117	1,827,398
Proceeds from sale of mortgage-backed securities	3,507,011	1,605,902
Payment of premiums for interest rate derivative instruments	(72,723)	) (2,140)
Proceeds from termination of interest rate swaptions	114,538	—
Purchase of residential loans	(1,562,818)	)
Principal payments from residential loans	28,464	—
Origination of commercial loans, net of origination fees	(17,195)	)
Net cash used in investing activities	(2,618,542)	) (2,903,898)
Cash Flows from Financing Activities		
Proceeds from issuance of common stock	396,417	103
(Cost) proceeds (of) from issuance of preferred stock	(6)	) 135,535
Due from counterparties	(8,182)	) 57,172
Collateral held payable	21,045	—
Proceeds from repurchase agreements	140,364,041	111,725,441
Principal repayments of repurchase agreements	(140,159,048)	) (109,101,978)
Proceeds from issuance of exchangeable senior notes	400,000	—
Proceeds from issuance of asset-backed securities	1,440,755	—

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Principal repayments of asset-backed securities	(27,778	) —
Payments of deferred costs	(15,676	) —
Payments of dividends and distributions	(261,743	) (227,811 )
Net cash provided by financing activities	2,149,825	2,588,462
Net change in cash	(87,379	) (6,376 )
Cash, beginning of period	286,474	197,224
Cash and cash equivalents, end of period	199,095	190,848
Supplement Disclosure of Cash Flow Information		
Interest paid	231,782	172,879
Non-cash Investing and Financing Activities Information		
Net change in unrealized gain (loss) on mortgage-backed securities and derivatives	(406,153	) 512,080
Net change in unconsolidated ventures	—	—
Net change in due from counterparties	63	3,851
Dividends and distributions declared not paid	71,037	78,628
(Receivable) / payable for mortgage-backed securities sold / purchased, net	150,733	(672,589 )
Repurchase agreements, not settled	(27,842	) —
The accompanying notes are an integral part of these consolidated financial statements.		

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INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(unaudited)

Note 1 – Organization and Business Operations

Invesco Mortgage Capital Inc. (the “Company”) is a Maryland corporation focused on investing in, financing and managing residential and commercial mortgage-backed securities and mortgage loans. The Company invests in residential mortgage-backed securities (“RMBS”) for which a U.S. Government Agency such as the Government National Mortgage Association (“Ginnie Mae”), the Federal National Mortgage Association (“Fannie Mae”) or the Federal Home Loan Mortgage Corporation (“Freddie Mac”) guarantees payments of principal and interest on the securities (collectively “Agency RMBS”). The Company’s Agency RMBS investments include mortgage pass-through securities and collateralized mortgage obligations (“CMOs”). The Company also invests in RMBS that are not issued or guaranteed by a U.S. government Agency (“non-Agency RMBS”), commercial mortgage-backed securities (“CMBS”), and residential and commercial mortgage loans. The Company is externally managed and advised by Invesco Advisers, Inc. (the “Manager”), a registered investment adviser and an indirect, wholly-owned subsidiary of Invesco Ltd. (“Invesco”), a leading independent global investment management firm.

The Company conducts its business through IAS Operating Partnership LP (the “Operating Partnership”) as its sole general partner. As of September 30, 2013, the Company owned 99% of the Operating Partnership, and Invesco Investments (Bermuda) Ltd., a direct, wholly-owned subsidiary of Invesco, owned the remaining 1.0%.

The Company finances its Agency RMBS, non-Agency RMBS and CMBS investments through short-term borrowings structured as repurchase agreements. The Company has secured commitments with a number of repurchase agreement counterparties. The Company finances its residential loans through the issuance of asset-backed securities. In addition, the Company may use other sources of financing including committed borrowing facilities and other private financing.

The Company is taxed as a real estate investment trust (“REIT”) for U.S. federal income tax purposes under the provisions of the Internal Revenue Code of 1986, as amended (“Code”). To maintain the Company’s REIT qualification, the Company is generally required to distribute at least 90% of its taxable income to its shareholders annually.

Note 2 – Summary of Significant Accounting Policies

Basis of Quarterly Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“U.S. GAAP”) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X, promulgated by the Securities and Exchange Commission (the “SEC”). In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the financial position and the results of operations of the Company for the interim periods presented have been included. Certain disclosures included in the Company’s annual report on Form 10-K are not required to be included on an interim basis in the company’s quarterly reports on Forms 10-Q. The Company has condensed or omitted these disclosures. The interim consolidated financial statements should be read in conjunction with the Company’s consolidated financial statements and related notes thereto included in the Company’s annual report on Form 10-K for the year ended December 31, 2012, which was filed with the SEC on March 1, 2013. The results of operations for the period ended September 30, 2013 are not necessarily indicative of the results to be expected for the full year or any other future period.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company, its subsidiaries and VIEs in which the Company is deemed the primary beneficiary. The underlying loans owned by the VIEs are shown under residential loans on our consolidated balance sheets. The asset-backed securities (“ABS”) issued to third parties by the VIEs are shown under asset-backed securities issued. In our consolidated statements of operations, we record interest income on the residential loans owned by the VIEs and interest expense on the ABS issued by the VIEs. All intercompany balances and transactions have been eliminated.

Variable Interest Entity

A VIE is an entity that lacks one or more of the characteristics of a voting interest entity. A VIE is defined as an entity in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. The determination of whether an entity is a VIE includes both a qualitative and quantitative analysis. The Company reassesses its initial evaluation of an entity as a VIE upon the occurrence of certain reconsideration events. The entity that consolidates a VIE is known as its primary

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beneficiary and is generally the entity with (i) the power to direct the activities that most significantly impact the VIE's economic performance, and (ii) the right to receive benefits from the VIE or the obligation to absorb losses of the VIE that could be significant to the VIE. For VIEs that do not have substantial ongoing activities, the power to direct the activities that most significantly impact the VIE's economic performance may be determined by an entity's involvement with the design of the VIE.

### Use of Estimates

The accounting and reporting policies of the Company conform to U.S. GAAP. The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Examples of estimates include, but are not limited to, estimates of the fair values of financial instruments, interest income on mortgage-backed securities ("MBS"), allowance for loan losses and other-than-temporary impairment charges. Actual results may differ from those estimates.

### Cash and Cash Equivalents

The Company considers all highly liquid investments that have original or remaining maturity dates of three months or less when purchased to be cash equivalents. At September 30, 2013, the Company had cash and cash equivalents, including amounts restricted, in excess of the FDIC deposit insurance limit of \$250,000 per institution. The Company mitigates its risk of loss by actively monitoring its counterparties.

### Underwriting Commissions and Offering Costs

Underwriting commissions and direct costs incurred in connection with the Company's initial public offering ("IPO") and subsequent stock offerings are reflected as a reduction of additional paid-in-capital.

### Deferred Costs

Included in deferred costs are costs associated with the issuance of beneficial interest by consolidated VIEs incurred by the Company and costs incurred in connection with the issuance by the Company of its exchangeable senior notes. These costs may include underwriting, rating agency, legal, accounting and other fees. These deferred costs are amortized as an adjustment to interest expense using the effective interest method, based upon actual repayments of the associated beneficial interest issued to third parties and over the stated legal maturity of the exchangeable senior notes.

### Repurchase Agreements

The Company finances its Agency RMBS, non-Agency RMBS and CMBS investment portfolio through the use of repurchase agreements. Repurchase agreements are treated as collateralized financing transactions and are carried at their contractual amounts, including accrued interest, as specified in the respective agreements.

In instances where the Company acquires Agency RMBS, non-Agency RMBS or CMBS through repurchase agreements with the same counterparty from whom such assets were purchased, the Company accounts for the purchase commitment and repurchase agreement on a net basis and records a forward commitment to purchase such assets as a derivative instrument if the transaction does not comply with the criteria for gross presentation. All of the following criteria must be met for gross presentation in the circumstance where the repurchase assets are financed with the same counterparty:

- the initial transfer of and repurchase financing cannot be contractually contingent;
- the repurchase financing entered into between the parties provides full recourse to the transferee and the repurchase price is fixed;
- the financial asset has an active market and the transfer is executed at market rates; and
- the repurchase agreement and financial asset do not mature simultaneously.

If the transaction complies with the criteria for gross presentation, the Company records the assets and the related financing on a gross basis on its consolidated balance sheets, and the corresponding interest income and interest expense in its consolidated statements of operations. Forward commitments are recorded at fair value with subsequent changes in fair value recognized in income. Additionally, the Company records the cash portion of its investment in Agency RMBS and non-Agency RMBS as a mortgage related receivable from the counterparty on its consolidated balance sheets.



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### Asset-Backed Debt Securities

Asset-backed debt securities are recorded at principal balance net of unamortized premiums or discounts.

### Fair Value Measurements

The Company discloses the fair value of its financial instruments according to a fair value hierarchy (Levels 1, 2, and 3, as defined). In accordance with U.S. GAAP, the Company is required to provide enhanced disclosures regarding instruments in the Level 3 category (which require significant management judgment), including a separate reconciliation of the beginning and ending balances for each major category of assets and liabilities.

To determine fair value of its financial instruments, the Company generally obtains one price per instrument from its primary valuation service. If this service cannot provide a price, the Company will seek a value from other vendors. The valuation services use various observable inputs which may include a combination of benchmark yields, trades, broker/dealer quotes, issuer spreads, bids, offers and benchmark securities to determine prices. Both the Company and the pricing vendor continuously monitor market indicators and economic events to determine if any may have an impact on the valuations.

Overrides of prices from pricing vendors are rare in the current market environment and with the assets the Company holds. Examples of instances that would cause an override would be if the Company recently traded the same security or there is an indication of market activity that would cause the vendor price to be unreliable. In the rare instance where a price is adjusted, the Company has a control process to monitor the reason for such adjustment.

To gain comfort that vendor prices are representative of current market information, the Company compares the transaction prices of security purchases and sales to the valuation levels provided by the vendors. Price differences exceeding pre-defined tolerance levels are identified and investigated and may be challenged. Trends are monitored over time and if there are indications that the valuations are not comparable to market activity, the vendors are asked to provide detailed information regarding their methodology and inputs. Transparency tools are also available from the vendors which help clients observe data points and/or market inputs used for pricing securities.

In addition, the Company performs due diligence procedures on all vendors on at least an annual basis. A questionnaire is sent to vendors which requests information such as changes in methodologies, business recovery preparedness, internal controls and confirmation that evaluations are generated based on market data. Physical visits are also made to each vendor's office.

As described in Note 11 - "Financial Instruments," the Company evaluates the source used to provide the market price for each security and makes a determination on its categorization within the fair value hierarchy. If the price of a security is obtained from quoted prices for similar instruments or model-derived valuations whose inputs are observable, the security is classified as a level 2 security. If the inputs appear to be unobservable, the security would be classified as a level 3 security.

Additionally, U.S. GAAP permits entities to choose to measure many financial instruments and certain other items at fair value (the "fair value option"). Unrealized gains and losses on items for which the fair value option has been elected are irrevocably recognized in earnings at each subsequent reporting date.

The Company elected the fair value option for its investments in unconsolidated ventures. The Company has the one-time option to elect fair value for these financial assets on the election date. The changes in the fair value of these instruments are recorded in equity in earnings and fair value change in unconsolidated ventures in the consolidated statements of operations.

For assets representing available-for-sale investment securities, any change in fair value is reported through consolidated other comprehensive income (loss) with the exception of impairment losses, which are recorded in the consolidated statements of operations.

### Securities

The Company designates securities as held-to-maturity, available-for-sale, or trading depending on its ability and intent to hold such securities to maturity. Trading and securities available-for-sale are reported at fair value, while securities held-to-maturity are reported at amortized cost. Although the Company generally intends to hold most of its RMBS and CMBS until maturity, the Company may, from time to time, sell any of its RMBS or CMBS as part of its overall management of its investment portfolio and therefore classifies its RMBS and CMBS as available-for-sale

securities.

All securities classified as available-for-sale are reported at fair value, based on market prices from third-party sources, with unrealized gains and losses excluded from earnings and reported as a separate component of shareholders' equity. When



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applicable, included with available-for-sale securities are forward purchase commitments on to-be-announced securities (“TBA”). The Company records TBA purchases on the trade date and the corresponding payable is recorded as an outstanding liability as a payable for investments purchased until the settlement date of the transaction. This payable is presented in the “Investment related payable” line item on the consolidated balance sheets.

The Company considers its portfolio of Agency RMBS to be of high credit quality under the accounting guidance. For non-Agency RMBS and CMBS, the Company does not rely on ratings from third party agencies to determine the credit quality of the investment. To determine expected future losses, the Company uses internal models that analyze the individual loans underlying each security and evaluates factors including, but not limited to, delinquency status, loan-to-value ratios, borrower credit scores, occupancy status and geographic concentration to estimate the expected future cash flows and an expected yield. The Company places reliance on this internal model in determining credit quality and the corresponding accounting treatment.

While non-Agency RMBS and CMBS with expected future losses are generally purchased at a discount to par, the potential for a significant adverse change in expected cash flows remains. The Company therefore considers each security for other-than-temporary impairment at least quarterly and more frequently when economic or market conditions warrant such evaluation.

The determination of whether a security is other-than-temporarily impaired involves judgments and assumptions based on subjective and objective factors. Consideration is given to (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of recovery in fair value of the security, and (iii) the Company’s intent and ability to retain its investment in the security for a period of time sufficient to allow for any anticipated recovery in fair value.

For debt securities, the amount of the other-than-temporary impairment related to a credit loss or impairments on securities that the Company has the intent or for which it is more likely than not that the Company will need to sell before recoveries are recognized in earnings and reflected as a reduction in the cost basis of the security. The amount of the other-than-temporary impairment on debt securities related to other factors is recorded consistent with changes in the fair value of all other available-for-sale securities as a component of consolidated shareholders’ equity in other comprehensive income or loss with no change to the cost basis of the security.

### Residential Loans Held-For-Investment

Loans held-for-investment include securitized residential mortgage loans held by VIEs in which the Company has determined it is the primary beneficiary and which are included in the Company's Consolidated Balance Sheets, and are carried at unpaid principal balance net of any allowance for loan losses. The Company expects that it will be required to continue to consolidate the VIEs in which such loans are held and generally does not have the authority to sell the residential loans held in the VIEs.

### Commercial Loans Held-For-Investment

Commercial loans held-for-investment include mezzanine loans owned by the Company carried at cost, net of any allowance for loan losses. An allowance for loan losses will be recognized only if past and current events indicate it is probable that all amounts due will not be collected according to the terms of the loan agreement.

### Interest Income Recognition

#### Securities

Interest income on available-for-sale MBS, which includes accretion of discounts and amortization of premiums on such MBS, is recognized over the life of the investment using the effective interest method. Management estimates, at the time of purchase, the future expected cash flows and determines the effective interest rate based on these estimated cash flows and the Company’s purchase price. As needed, these estimated cash flows are updated and a revised yield is computed based on the current amortized cost of the investment. In estimating these cash flows, there are a number of assumptions that are subject to uncertainties and contingencies, including the rate and timing of principal payments (prepayments, repurchases, defaults and liquidations), the pass through or coupon rate and interest rate fluctuations. In addition, management must use its judgment to estimate interest payment shortfalls due to delinquencies on the underlying mortgage loans. These uncertainties and contingencies are difficult to predict and are subject to future events that may impact management’s estimates and its interest income. Security transactions are recorded on the trade

date. Realized gains and losses from security transactions are determined based upon the specific identification method and recorded as gain (loss) on sale of available-for-sale securities in the consolidated statements of operations.

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### Residential Loans

Interest income from the Company's residential loans is recognized on an accrual basis with the related premiums being amortized into interest income using the effective interest method over the weighted average life of these loans. As needed, these estimated cash flows are updated and a revised yield is computed based on the current amortized cost of the investment. In estimating these cash flows, there are a number of assumptions that are subject to estimation, including the interest rate and timing of principal payments (prepayments, repurchases, defaults and liquidations), the timing and amount of expected credit losses, and other factors. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due or has been individually impaired, at which point the loan is placed on nonaccrual status. Interest previously accrued for loans that have been placed on non-accrual status is reversed against interest income in the period it becomes nonaccrual. Residential loans delinquent more than 90 days or in foreclosure are characterized as delinquent. Cash principal and interest that is advanced from servicers subsequent to a loan becoming greater than 90 days past due or individually impaired is recorded as a liability due to the servicer. When a delinquent loan previously placed on nonaccrual status has cured, meaning all delinquent principal and interest have been remitted by the borrower, the loan is placed back on accrual status. Alternately, nonaccrual loans may be placed back on accrual status if restructured and after the loan is considered re-performing. A restructured loan is considered re-performing when the loan has been current for at least 12 months.

### Commercial loans

Interest is recognized as revenue when earned and deemed collectible or until a loan becomes past due based on the terms of the loan agreement with the related originating fees, net of origination cost, being amortized into interest income using the effective interest method over the life of the loan. Interest received subsequent to a loan becoming past due or impaired is used to reduce the outstanding loan principal balance. When a delinquent loan previously placed on nonaccrual status has cured, meaning all delinquent principal and interest have been remitted by the borrower, the loan is placed back on accrual status. Alternately, loans that have been individually impaired may be placed back on accrual status if restructured and after the loan is considered re-performing. A restructured loan is considered re-performing when the loan has been current for at least 12 months.

### Allowance for Loan Losses

#### Residential Loans — Allowance for Loan Losses

For residential loans classified as held-for-investment, an allowance for loan losses is established based on the Company's estimate of credit losses. In calculating the allowance for loan losses, the Company assesses expected losses by estimating the probability of default and expected loss severities on the loans. Reviews are performed at least quarterly. The following factors are considered in evaluating the allowance for loan losses:

- Loan-to-value ratios, property values, credit scores, occupancy status, geographic concentration and other observable data available from third party providers;
- Historical prepayments, default rates and loss severities; and
- Trends in delinquencies, loan liquidations, foreclosure timelines, liquidation expenses, servicer advances of delinquent principal and interest, and other observable data related to the servicing of the loans.

#### Commercial Loans — Allowance for Loan Losses

For commercial loans classified as held-for-investment, we establish a specific allowance for loan losses for loans we have determined to be impaired at the reporting date. An individual loan is considered impaired when it is deemed probable that we will not be able to collect all amounts due according to the contractual terms of the loan.

The Company's methodology for assessing the adequacy of the allowance for loan losses begins with a formal review of each commercial loan in the portfolio to determine whether the loan is impaired. Reviews are performed at least quarterly. We consider the following factors in evaluating each loan:

- Loan to value ratios upon origination or acquisition of the loan;
- The most recent financial information available for each loan and associated properties, including net operating income, debt service coverage ratios, occupancy rates, rent rolls, as well as any other loss factors we consider relevant, such as, but not limited to, specific loan trigger events that would indicate an adverse change in expected

cash flows or payment delinquency;

Economic trends, both macroeconomic as well as those directly affecting the properties associated with our loans, and the supply and demand of competing projects in the sub-market in which the subject property is located; and

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The loan sponsor or borrowing entity's ability to ensure that properties associated with the loan are managed and operated sufficiently.

Where an individual commercial loan is deemed to be impaired, the Company records an allowance to reduce the carrying value of the loan to the current present value of expected future cash flows discounted at the loan's effective rate, with a corresponding charge to provision for loan losses on our consolidated statements of operations.

### Investments in Unconsolidated Ventures

The Company has investments in unconsolidated ventures. In circumstances where the Company has a non-controlling interest but is deemed to be able to exert significant influence over the affairs of the enterprise, the Company utilizes the equity method of accounting. Under the equity method of accounting, the initial investment is increased each period for additional capital contributions and a proportionate share of the entity's earnings and decreased for cash distributions and a proportionate share of the entity's losses.

The Company elected the fair value option for its investments in unconsolidated ventures. The election was made upon initial recognition in the financial statements. The Company has elected the fair value option for the purpose of enhancing the transparency of its financial condition. The Company measures the fair value on the basis of the net asset value per share of the investments.

### Dividends and Distributions Payable

Dividends and distributions payable represent dividends declared at the consolidated balance sheet date which are payable to common shareholders, preferred shareholders and distributions declared at the consolidated balance sheet date which are payable to non-controlling interest common unit holders of the Operating Partnership, respectively.

### Earnings (Loss) per Share

The Company calculates basic earnings (loss) per share by dividing net income attributable to common shareholders for the period by weighted-average shares of the Company's common stock outstanding for that period. Diluted earnings per share takes into account the effect of dilutive instruments, such as units of limited partnership interest in the Operating Partnership ("OP Units"), exchangeable debt, and unvested restricted stock, but use the average share price for the period in determining the number of incremental shares that are to be added to the weighted-average number of shares outstanding.

### Comprehensive Income (Loss)

Comprehensive income (loss) is comprised of net income, as presented in the consolidated statements of operations, adjusted for changes in unrealized gains or losses on available for sale securities and changes in the fair value of derivatives accounted for as cash flow hedges.

### Accounting for Derivative Financial Instruments

U.S. GAAP provides disclosure requirements for derivatives and hedging activities with the intent to provide users of financial statements with an enhanced understanding of: (i) how and why an entity uses derivative instruments; (ii) how derivative instruments and related hedged items are accounted for; and (iii) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. U.S. GAAP requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.

The Company records all derivatives on the consolidated balance sheets at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges.

Derivatives may also be designated as hedges of the foreign currency exposure of a net investment in a foreign operation. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are

attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into derivative contracts, such as credit default swaps,

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that are intended to economically hedge certain of its risk, even though hedge accounting does not apply or the Company elects not to apply hedge accounting under U.S. GAAP.

### Income Taxes

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

A REIT's dividend paid deduction for qualifying dividends to the Company's shareholders is computed using its taxable income as opposed to net income reported on the consolidated financial statements. Taxable income, generally, will differ from net income because the determination of taxable income is based on tax regulations and not financial accounting principles.

The Company may elect to treat certain of its future subsidiaries as taxable REIT subsidiaries ("TRS"). In general, a TRS may hold assets and engage in activities that the Company cannot hold or engage in directly and generally may engage in any real estate or non-real estate-related business. A TRS is subject to U.S. federal, state and local corporate income taxes.

If a TRS generates net income, the TRS can declare dividends to the Company which will be included in its taxable income and necessitate a distribution to its shareholders. Conversely, if the Company retains earnings at a TRS level, no distribution is required and the Company can increase book equity of the consolidated entity. The Company has no adjustments regarding its tax accounting treatment of any uncertainties. The Company currently has no uncertain tax positions.

### Share-Based Compensation

The Company has adopted an equity incentive plan under which its independent directors, as part of their compensation for serving as directors, are eligible to receive quarterly restricted stock awards. In addition, the Company may compensate the officers and employees of the Manager and its affiliates under this plan pursuant to the management agreement.

Share-based compensation arrangements include share options, restricted share awards, performance-based awards, share appreciation rights, and employee share purchase plans. Compensation costs relating to share-based payment transactions are recognized in the consolidated financial statements, based on the fair value of the equity or liability instruments issued on the date of grant, for awards to the Company's independent directors. Compensation related to stock awards to officers and employees of the Manager and its affiliates is recorded at the estimated fair value of the award during the vesting period. The Company makes an upward or downward adjustment to compensation expense for the difference in the fair value at the date of grant and the date the award is earned.

### Dividend Reinvestment and Share Purchase Plan

The Company has implemented a dividend reinvestment and share purchase plan (the "DRSPP"). Under the terms of the DRSPP, shareholders who participate in the DRSPP may purchase shares of common stock directly from the Company. DRSPP participants may also automatically reinvest all or a portion of their dividends for additional shares of common stock.

### Reclassifications

The presentation of certain prior period reported amounts has been reclassified to be consistent with the current presentation. Such reclassifications had no impact on net income or equity attributable to common shareholders.

### Recent Accounting Pronouncements

In January 2013, the FASB issued Accounting Standards Update 2013-01, "Clarifying the Scope of Disclosure about Offsetting Assets and Liabilities" ("ASU 2013-01"). ASU 2013-01 clarified Accounting Standard Update 2011-11,

“Disclosures about Offsetting Assets and Liabilities” which was issued in December 2011. Entities will be required to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transaction subject to an agreement similar to a master netting arrangement. This scope would include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements. The objective of this disclosure is to facilitate comparison between those entities that prepare their financial statements on a basis of U.S. GAAP basis and those entities that prepare their financial statements on the basis of International Financial Reporting Standards



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(IFRS). The guidance was effective for periods beginning on or after January 1, 2013, and interim periods within those annual periods. The additional disclosure requirements were incorporated into Note 10 “Offsetting Assets and Liabilities”.

In February 2013, the FASB issued Accounting Standards Update 2013-02, “Reporting of Amounts Reclassified out of Accumulated Other Comprehensive Income” (“ASU 2013-02”), which adds new disclosure requirements for items reclassified out of accumulated other comprehensive income. ASU 2013-02 does not amend any existing requirements for reporting net income or other comprehensive income in the financial statements and is effective prospectively for reporting periods beginning after December 15, 2012. ASU 2013-02 increased our disclosures related to items reclassified out of accumulated other comprehensive income, but did not have an effect on our consolidated financial statements.

Recent Accounting Pronouncements Not Yet Adopted

None

### Note 3 – Variable Interest Entities

During the nine months ended September 30, 2013, the Company purchased through its indirect subsidiary an interest in four securitization trusts (none during the quarter ended September 30, 2013) which the Company determined it is the primary beneficiary. The trusts initially held pools of 1,926 fixed rate residential mortgage loans having an initial aggregate principal balance of \$1.5 billion and issued a series of ABS having an aggregate original principal amount of \$1.5 billion payable from the cash flows generated by the pools of residential mortgage loans. \$1.4 billion of ABS was sold to unaffiliated third parties and the balance was purchased by the Company. The Company's interests in the trusts consist of classes of such ABS having an aggregate original principal balance of \$112.3 million, which are either subordinate in payment priority, pay interest only, or are payable from certain designated cash flows from the loans. The Company subsequently sold \$5.8 million of the original principal balance to a third party.

In determining if a securitized trust should be consolidated, the Company evaluated whether it was a VIE and, if so, whether the Company's direct involvement in the VIE reflects a controlling financial interest that would result in the Company being deemed the primary beneficiary. The Company concluded that its interest in the securitized trusts purchased during the nine months ended September 30, 2013 were VIEs because such interests included the power to direct the activities that most significantly impact the economic performance of the VIEs and the obligation to absorb losses or right to receive benefits that are potentially significant to the VIEs. Accordingly, for financial statement reporting purposes, the Company consolidated the underlying assets and liabilities of the securitization trusts at their fair value and, as such, no gain or loss was recorded upon consolidation. The securitizations are non-recourse financing of the residential mortgage loans held-for-investment. The senior securities issued by the securitization trusts and not purchased by the Company, which were sold to unaffiliated third parties, are presented in the consolidated balance sheets as “Asset-backed securities issued.”

The Company is not contractually required and has not provided any additional financial support to the VIEs for the period ended September 30, 2013. The following table presents a summary of the assets and liabilities of the VIEs. Intercompany balances have been eliminated for purposes of this presentation.

\$ in thousand	September 30, 2013	December 31, 2012
Residential loans, held-for-investment	1,532,389	—
Accrued interest receivable	4,696	—
Deferred costs	3,065	—
Total assets	1,540,150	—
Accrued interest and accrued expenses payable	3,887	—
Asset-backed securities issued	1,411,897	—
Total liabilities	1,415,784	—

### Note 4 – Mortgage-Backed Securities

All of the Company's MBS are classified as available-for-sale and, as such, are reported at fair value, which is determined by obtaining valuations from an independent source. If the fair value of a security is not available from a dealer or third-party pricing service, or such data appears unreliable, the Company may estimate the fair value of the security using a variety of methods including other pricing services, repurchase agreement pricing, discounted cash flow analysis, matrix pricing, option adjusted spread models and other fundamental analysis of observable market factors.

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The following tables present certain information about the Company's investment portfolio as of September 30, 2013 and December 31, 2012.

September 30, 2013

\$ in thousands	Principal Balance	Unamortized Premium (Discount)	Amortized Cost	Unrealized Gain/(Loss), net	Fair Value	Net Weighted Average Coupon (1)	Period-end Weighted Average Yield (2)	Quarterly Weighted Average Yield (3)
Agency RMBS:								
15 year fixed-rate	1,722,520	89,091	1,811,611	28,193	1,839,804	4.02 %	2.24 %	2.35 %
30 year fixed-rate	8,689,193	579,210	9,268,403	(246,644 )	9,021,759	3.95 %	2.64 %	2.84 %
ARM	197,033	(468 )	196,565	1,335	197,900	2.73 %	2.55 %	2.41 %
Hybrid ARM	977,583	(3,512 )	974,071	3,236	977,307	2.56 %	2.39 %	2.19 %
Total Agency pass-through	11,586,329	664,321	12,250,650	(213,880 )	12,036,770	3.82 %	2.56 %	2.73 %
Agency-CMO <sup>(4)</sup>	1,491,381	(1,004,321 )	487,060	(4,416 )	482,644	2.80 %	3.16 %	2.31 %
Non-Agency RMBS <sup>(5)</sup>	4,344,281	(646,859 )	3,697,422	11,589	3,709,011	3.67 %	3.76 %	4.63 %
CMBS <sup>(6)</sup>	4,585,928	(2,027,009 )	2,558,919	24,335	2,583,254	3.50 %	4.68 %	4.60 %
Total	22,007,919	(3,013,868 )	18,994,051	(182,372 )	18,811,679	3.66 %	3.10 %	3.34 %

(1) Net weighted average coupon ("WAC") as of September 30, 2013 is presented net of servicing and other fees.

(2) Average yield is based on amortized costs as of September 30, 2013 and incorporates future prepayment and loss assumptions.

(3) Average yield is based on average amortized costs for the three months ended September 30, 2013 and incorporates future prepayment and loss assumptions.

(4) Included in the Agency-CMO are interest-only securities which represent 16.4% of the balance based on fair value.

(5) The non-Agency RMBS held by the Company is 61.0% variable rate, 34.3% fixed rate, and 4.7% floating rate based on fair value.

(6) Included in the CMBS are interest-only securities and commercial real estate mezzanine loan pass-through certificates which represent 8.0% and 1.8% of the balance based on fair value, respectively.

December 31, 2012

\$ in thousands	Principal Balance	Unamortized Premium (Discount)	Amortized Cost	Unrealized Gain/(Loss), net	Fair Value	Net Weighted Average Coupon (1)	Period-end Weighted Average Yield (2)	Quarterly Weighted Average Yield (3)
Agency RMBS:								
15 year fixed-rate	1,964,999	102,058	2,067,057	63,839	2,130,896	4.09 %	2.37 %	2.37 %
30 year fixed-rate	9,168,196	601,592	9,769,788	238,949	10,008,737	4.21 %	2.89 %	2.88 %
ARM	109,937	3,464	113,401	2,365	115,766	3.15 %	2.06 %	2.02 %
Hybrid ARM	556,790	13,493	570,283	16,885	587,168	3.19 %	2.18 %	2.22 %
Total Agency pass-through	11,799,922	720,607	12,520,529	322,038	12,842,567	4.13 %	2.77 %	2.75 %
Agency-CMO <sup>(4)</sup>	1,322,043	(819,530 )	502,513	1,926	504,439	2.89 %	2.35 %	1.51 %
Non-Agency RMBS <sup>(5)</sup>	3,339,683	(308,885 )	3,030,798	48,238	3,079,036	4.20 %	4.61 %	4.80 %
CMBS <sup>(6)</sup>	1,868,928	24,070	1,892,998	151,523	2,044,521	5.27 %	4.96 %	4.82 %

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Total	18,330,576	(383,738 )	17,946,838	523,725	18,470,563	4.17	%	3.30	%	3.27	%
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(1) Net WAC as of December 31, 2012 is presented net of servicing and other fees.

(2) Average yield based on amortized cost as of December 31, 2012 incorporates future prepayment and loss assumptions.

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(3) Average yield based on average amortized cost for the three months ended December 31, 2012 incorporates future prepayment and loss assumptions.

(4) Included in Agency-CMO are interest-only securities which represent 14.1% of the balance based on fair value.

(5) The non-Agency RMBS held by the Company is 79.2% variable rate, 15.5% fixed rate, and 5.3% floating rate based on fair value.

(6) Included in the CMBS are interest-only securities and commercial real estate mezzanine loan pass-through certificates which represent 0% and 1.1% of the balance based on fair value, respectively.

The following table summarizes our non-Agency RMBS portfolio by asset type as of September 30, 2013 and December 31, 2012, respectively:

\$ in thousands	September 30, 2013	% of Non-Agency	December 31, 2012	% of Non-Agency
Re-REMIC Senior	1,475,475	39.8	% 1,844,209	59.9 %
Prime	1,383,923	37.3	% 754,161	24.5 %
Alt-A	822,815	22.2	% 468,181	15.2 %
Subprime	26,798	0.7	% 12,485	0.4 %
Total Non-Agency	3,709,011	100.0	% 3,079,036	100.0 %

The following table summarizes certain characteristics of our senior Re-REMIC holdings as of September 30, 2013 and December 31, 2012:

Re-REMIC Subordination <sup>(1)</sup>	Percentage of Re-REMIC holdings at Fair Value			
	September 30, 2013		December 31, 2012	
0-10	3.9	%	2.1	%
10-20	3.5	%	3.2	%
20-30	14.2	%	15.0	%
30-40	25.5	%	27.0	%
40-50	39.5	%	40.4	%
50-60	8.6	%	7.6	%
60-70	4.8	%	4.7	%
Total	100.0	%	100.0	%

Subordination refers to the credit enhancement provided to the senior Re-REMIC tranche by the junior Re-REMIC tranche or tranches in a resecuritization. This figure reflects the percentage of the balance of the underlying (1) security represented by the junior tranche or tranches at the time of resecuritization. Generally, principal losses on the underlying security in excess of the subordination amount would result in principal losses on the senior Re-REMIC tranche.

The components of the carrying value of the Company's investment portfolio at September 30, 2013 and December 31, 2012 are presented below:

\$ in thousands	September 30, 2013	December 31, 2012
Principal balance	22,007,919	18,330,576
Unamortized premium	758,256	788,716
Unamortized discount	(3,772,124)	(1,172,454)
Gross unrealized gains	284,631	563,093
Gross unrealized losses	(467,003)	(39,368)
Fair value	18,811,679	18,470,563



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The following table summarizes certain characteristics of the Company's investment portfolio, at fair value, according to estimated weighted average life classifications as of September 30, 2013 and December 31, 2012:

\$ in thousands	September 30, 2013	December 31, 2012
Less than one year	28,125	70,044
Greater than one year and less than five years	5,625,403	13,146,577
Greater than or equal to five years	13,158,151	5,253,942
Total	18,811,679	18,470,563

The following tables present the gross unrealized losses and estimated fair value of the Company's MBS by length of time that such securities have been in a continuous unrealized loss position at September 30, 2013 and December 31, 2012, respectively:

September 30, 2013

\$ in thousands	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Agency RMBS:						
15 year fixed-rate	155,656	(3,048 )	11,583	(319 )	167,239	(3,367 )
30 year fixed-rate	6,274,314	(308,170 )	79,392	(1,300 )	6,353,706	(309,470 )
ARM	34,431	(449 )	—	—	34,431	(449 )
Hybrid ARM	381,312	(2,818 )	—	—	381,312	(2,818 )
Total Agency pass-through	6,845,713	(314,485 )	90,975	(1,619 )	6,936,688	(316,104 )
Agency-CMO	228,820	(11,884 )	12,810	(4,263 )	241,630	(16,147 )
Non-Agency RMBS	1,434,914	(58,969 )	379,751	(9,708 )	1,814,665	(68,677 )
CMBS	1,127,151	(66,075 )	—	—	1,127,151	(66,075 )
Total	9,636,598	(451,413 )	483,536	(15,590 )	10,120,134	(467,003 )

December 31, 2012

\$ in thousands	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Agency RMBS:						
15 year fixed-rate	31,269	(279 )	—	—	31,269	(279 )
30 year fixed-rate	1,763,113	(6,469 )	78,640	(832 )	1,841,753	(7,301 )
Total Agency pass-through	1,794,382	(6,748 )	78,640	(832 )	1,873,022	(7,580 )
Agency-CMO	31,719	(7,796 )	10,770	(2,812 )	42,489	(10,608 )
Non-Agency RMBS	516,744	(6,005 )	490,503	(12,895 )	1,007,247	(18,900 )
CMBS	187,349	(1,267 )	52,813	(1,013 )	240,162	(2,280 )
Total	2,530,194	(21,816 )	632,726	(17,552 )	3,162,920	(39,368 )

Gross unrealized losses on the Company's Agency RMBS were \$316.1 million at September 30, 2013. Due to the inherent credit quality of Agency RMBS, the Company determined that at September 30, 2013, any unrealized losses on its Agency RMBS portfolio are temporary.

Gross unrealized losses on the Company's MBS-CMO, non-Agency RMBS, and CMBS were \$150.9 million at September 30, 2013. The Company does not consider these unrealized losses to be credit related, but rather due to non-credit related factors such as interest rate spreads, prepayment speeds, and market fluctuations. These investment securities are included in the Company's assessment for other-than-temporary impairment on at least a quarterly basis.





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The following table presents the impact of the Company's MBS on its accumulated other comprehensive income for the three and nine months ended September 30, 2013 and 2012.

\$ in thousands	Three Months ended September 30, 2013	Three Months ended September 30, 2012	Nine Months ended September 30, 2013	Nine Months ended September 30, 2012
Accumulated other comprehensive income from investment securities:				
Unrealized gain on MBS at beginning of period	(257,402	) 268,269	523,725	(1,217
Unrealized gain (loss) on MBS, net	75,030	316,823	(706,097	) 586,309
Balance at the end of period	(182,372	) 585,092	(182,372	) 585,092

During the three months ended September 30, 2013 and 2012, the Company reclassified \$85.8 million of net unrealized losses and \$5.8 million of net unrealized gains, respectively from other comprehensive income into gain (loss) on sale of investments as a result of the Company selling certain investments.

During the nine months ended September 30, 2013 and 2012, the Company reclassified \$140.2 million of net unrealized losses and \$17.4 million of net unrealized gains, respectively from other comprehensive income into gain on sale of investments as a result of the Company selling certain investments.

The Company assesses its investment securities for other-than-temporary impairment on at least a quarterly basis and more frequently when economic or market conditions warrant such evaluation. When the fair value of an investment is less than its amortized cost at the balance sheet date of the reporting period for which impairment is assessed, the impairment is designated as either "temporary" or "other-than-temporary." The Company evaluates each security that has had a fair value less than amortized cost for three or more consecutive months for other-than-temporary impairment. This analysis includes evaluating the individual loans in each security to determine estimated future cash flows. Individual loan characteristics reviewed include, but are not limited to, delinquency status, loan-to-value ratios, borrower credit scores, occupancy status and geographic concentration. To the extent a security is deemed impaired, the amount by which the amortized cost exceeds the security's market value would be considered other-than-temporary impairment.

The Company did not have other-than-temporary impairments for the three and nine months ended September 30, 2013 and 2012.

The following table presents components of interest income on the Company's MBS portfolio for the three and nine months ended September 30, 2013 and 2012.

For the three months ended September 30, 2013

\$ in thousands	Coupon Interest	Net (Premium Amortization)/Discount Accretion	Interest Income
Agency	126,685	(40,578	) 86,107
Non-Agency	39,479	2,895	42,374
CMBS	39,167	(10,050	) 29,117
Other	(59	) —	(59
Totals	205,272	(47,733	) 157,539

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For the nine months ended September 30, 2013

\$ in thousands	Coupon Interest	Net (Premium Amortization)/Discount Accretion	Interest Income
Agency	412,945	(132,648	) 280,297
Non-Agency	117,215	6,038	123,253
CMBS	101,487	(18,502	) 82,985
Other	84	—	84
Totals	631,731	(145,112	) 486,619

For the three months ended September 30, 2012

\$ in thousands	Coupon Interest	Net (Premium Amortization)/Discount Accretion	Interest Income
Agency	132,520	(42,479	) 90,041
Non-Agency	26,477	4,149	30,626
CMBS	20,330	(477	) 19,853
Other	(43	) —	(43
Totals	179,284	(38,807	) 140,477

For the nine months ended September 30, 2012

\$ in thousands	Coupon Interest	Net (Premium Amortization)/Discount Accretion	Interest Income
Agency	382,226	(109,717	) 272,509
Non-Agency	79,903	15,204	95,107
CMBS	54,146	(209	) 53,937
Other	(111	) —	(111
Totals	516,164	(94,722	) 421,442

## Note 5 – Residential Loans Held-for-Investment

The following table details the carrying value for residential loans held-for-investment at September 30, 2013 and December 31, 2012. These loans are held by the VIEs which the Company consolidates.

\$ in thousands	September 30, 2013	December 31, 2012
Principal balance	1,498,726	—
Unamortized premium, net	34,414	—
Recorded investment	1,533,140	—
Allowance for loan losses	(751	) —
Carrying value	1,532,389	—

We consider a number of factors when evaluating the credit risks associated with our residential loans held-for-investment portfolio, including but not limited to year of origination, delinquency status and geographic concentration.

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The following table displays certain characteristics of the Company's residential loans held-for-investment at September 30, 2013 by year of origination.

\$ in thousands	2013	2012	2011	2010	2009	Total
Portfolio Characteristics:						
Number of Loans	1,299	600	—	—	5	1,904
Current Principal Balance	992,778	503,747	—	—	2,201	1,498,726
Net Weighted Average Coupon Rate	3.48	% 3.50	% —	—	3.54	% 3.49
Weighted Average Maturity (years)	29.52	29.28	—	—	25.81	29.43
Current Performance:						
Current	991,339	502,918	—	—	2,201	1,496,458
30 Day Delinquent	1,439	829	—	—	—	2,268
60 Days Delinquent	—	—	—	—	—	—
90+ Days Delinquent	—	—	—	—	—	—
Bankruptcy/Foreclosure	—	—	—	—	—	—
Total	992,778	503,747	—	—	2,201	1,498,726

The following table presents the five largest geographic concentrations of the Company's residential loans at September 30, 2013 based on principal balance outstanding:

State	Percent
California	49.9 %
Illinois	5.9 %
Massachusetts	5.7 %
Virginia	4.3 %
Maryland	4.2 %
Other states (none greater than 4%)	30.0 %
Total	100.0 %

The following table presents future minimum annual principal payments under the residential loans held-for-investment at September 30, 2013:

\$ in thousands	September 30, 2013
Scheduled Principal	27,331
Within one year	57,835
One to three years	62,340
Three to five years	1,351,220
Greater than or equal to five years	1,498,726
Total	1,498,726

#### Allowance for Loan Losses on Residential Loans

For residential loans held-for-investment, the Company establishes an allowance for loan losses. The following table summarizes the activity in the allowance for loan losses for the nine months ended September 30, 2013:

\$ in thousands	September 30, 2013
Balance at beginning of period	—
Charge-offs, net	—
Provision for loan losses	751
Balance at end of period	751

During the quarter ended September 30, 2013 there were no charge-offs of residential loans.



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## Note 6 – Commercial Loans Held-for-Investment

Commercial loans held-for-investment includes mezzanine loans originated by the Company. These loans are secured by the borrower’s ownership interest in a single purpose entity that owns commercial property, rather than a lien on the commercial property. As of September 30, 2013, the Company had one outstanding commercial loan which was newly originated and was not delinquent on payment. The loan was not impaired and no allowance for loan loss has been recorded.

## Note 7 – Investments in Unconsolidated Ventures

The Company’s non-controlling, unconsolidated ownership interests in the following entities are accounted for under the equity method. Capital contributions, distributions, profits and losses of the entities are allocated in accordance with the terms of the entities’ operating agreements. Such allocations may differ from the stated percentage interests, if any, as a result of preferred returns and allocation formulas as described in such agreements. The Company has made the fair value election for its investments in all unconsolidated ventures. The fair value measurement for the investments in unconsolidated ventures is based on the net asset value per share of the investment, or its equivalent. Invesco Mortgage Recovery Feeder Fund, L.P. and Invesco Mortgage Recovery Loans AIV, L.P.

The Company invested in certain non-Agency RMBS, CMBS and residential and commercial mortgage loans by contributing equity capital to the Invesco Mortgage Recovery Feeder Fund L.P. managed by the Company’s Manager (“Invesco IMRF Fund”) that received financing under the U.S. government’s Public Private Investment Program (“PPIP”). In March 2012, Invesco IMRF Fund returned substantially all of its proceeds and repaid all financing under the PPIP. The Company is awaiting final distribution from the Invesco IMRF Fund. In addition, the Manager identified a whole loan transaction for the Company, which resulted in the Company’s admission into an alternative investment vehicle, the Invesco Mortgage Recovery Loans AIV, L.P. (“AIV”). The Company has a commitment to invest up to \$100.0 million in the Invesco IMRF Fund and AIV. As of September 30, 2013, \$87.7 million of the Company’s commitment has been called, and the Company is committed to fund \$12.3 million in additional capital. The Company realized approximately \$378,000 (2012: \$1.4 million) and \$1.3 million (2012: \$2.1 million) of equity in earnings for the three and nine months ended September 30, 2013 related to these investments. The Company also had an unrealized gain of \$250,000 (2012: \$464,000 loss) and an unrealized gain of \$1.7 million (2012: \$774,000 gain) from these investments for the three and nine months ended September 30, 2013, respectively.

## IMRF Loan Portfolio Member LLC

On September 30, 2011, the Company invested in a portfolio of commercial mortgage loans by contributing \$16.9 million, net of distributions, of equity capital to IMRF Loan Portfolio Member LLC (“IMRF LLC”), a limited liability company managed by AIV. The Company has fully funded its commitment to IMRF LLC. The Company realized approximately \$956,000 (2012: \$2.5 million) and \$1.0 million (2012: \$3.2 million) of equity in earnings for the three and nine months ended September 30, 2013, respectively. The Company also had \$163,000 (2012: \$191,000) of unrealized depreciation and \$1.1 million (2012: \$116,000) of unrealized appreciation from these investments for the three and nine months ended September 30, 2013, respectively.

## Note 8 – Borrowings

The Company has entered into repurchase agreements and issued exchangeable senior notes to finance the majority of its portfolio of investments. The following table summarizes certain characteristics of the Company’s borrowings as of September 30, 2013 and December 31, 2012:

	September 30, 2013			December 31, 2012		
	Amount Outstanding	Weighted Average Interest Rate	Weighted Average Remaining Maturity (days)	Amount Outstanding	Weighted Average Interest Rate	Weighted Average Remaining Maturity (days)
\$ in thousands						

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Agency RMBS	10,958,730	0.37	% 18	11,713,565	0.48	% 16
Non-Agency RMBS	2,995,413	1.55	% 33	2,450,960	1.75	% 23
CMBS	1,943,469	1.42	% 21	1,555,935	1.51	% 18
Exchangeable Senior Notes	400,000	5.00	% 1627	—	—	% 0
Total	16,297,612	0.83	% 60	15,720,460	0.78	% 17

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## Repurchase Agreements

The repurchase agreements bear interest at a contractually agreed rate. The repurchase obligations mature and typically reinvest every thirty days to one year. Repurchase agreements are being accounted for as secured borrowings since the Company maintains effective control of the financed assets. Under the repurchase agreements, the respective lender retains the right to mark the underlying collateral to fair value. A reduction in the value of pledged assets would require the Company to provide additional collateral or fund margin calls. In addition, the repurchase agreements are subject to certain financial covenants. The Company was in compliance with these covenants at September 30, 2013. The following tables summarize certain characteristics of the Company's repurchase agreements at September 30, 2013 and December 31, 2012:

September 30, 2013		Percent of Total	
\$ in thousands	Amount	Amount	Company MBS
Repurchase Agreement Counterparties	Outstanding	Outstanding	Held as Collateral
Credit Suisse Securities (USA) LLC	1,701,184	10.8	% 1,999,024
Citigroup Global Markets Inc.	1,260,176	7.9	% 1,413,843
Banc of America Securities LLC	1,195,313	7.5	% 1,324,343
South Street Securities LLC	1,167,095	7.3	% 1,224,850
Wells Fargo Securities, LLC	1,094,712	6.9	% 1,263,712
Morgan Stanley & Co. Incorporated	990,095	6.2	% 1,080,265
Pierpont Securities LLC	841,971	5.3	% 892,038
JP Morgan Securities Inc.	830,199	5.2	% 967,291
RBS Securities Inc.	805,749	5.1	% 931,688
ING Financial Market LLC	683,975	4.3	% 736,322
Nomura Securities International, Inc.	591,925	3.7	% 624,060
HSBC Securities (USA) Inc	519,350	3.3	% 537,185
Industrial and Commercial Bank of China Financial Services LLC	511,155	3.2	% 540,954
Mitsubishi UFJ Securities (USA), Inc.	489,904	3.1	% 522,000
Goldman, Sachs & Co.	482,523	3.0	% 516,843
Scotia Capital	452,067	2.8	% 476,569
Royal Bank of Canada	437,539	2.8	% 489,352
Daiwa Capital Markets America Inc	411,106	2.6	% 424,867
Deutsche Bank Securities Inc.	406,303	2.6	% 463,227
BNP Paribas Securities Corp.	368,794	2.3	% 392,547
KGS-Alpha Capital Markets, L.P.	168,750	1.1	% 180,511
Barclays Capital Inc.	163,548	1.0	% 174,961
TD Securities	151,918	1.0	% 165,137
Cantor Fitzgerald & Co.	70,332	0.4	% 74,077
Mizuho Securities USA Inc.	68,179	0.4	% 80,734
Guggenheim Liquidity Services, LLC	33,750	0.2	% 35,599
Total	15,897,612	100.0	% 17,531,999

  

December 31, 2012		Percent of Total	
\$ in thousands	Amount	Amount	Company MBS
Repurchase Agreement Counterparties	Outstanding	Outstanding	Held as Collateral
Credit Suisse Securities (USA) LLC	1,600,331	10.2	% 1,919,676
Morgan Stanley & Co. Incorporated	1,275,616	8.1	% 1,397,846
Nomura Securities International, Inc.	1,240,231	7.9	% 1,350,901
Mitsubishi UFJ Securities (USA), Inc.	941,671	6.0	% 990,057

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Wells Fargo Securities, LLC	941,556	6.0	% 1,079,194
HSBC Securities (USA) Inc	883,726	5.6	% 918,551
South Street Securities LLC	819,524	5.2	% 871,963
CitiGroup Global Markets Inc.	780,020	5.0	% 882,517



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Banc of America Securities LLC	728,609	4.6	% 838,216
Scotia Capital	708,750	4.5	% 744,692
Industrial and Commercial Bank of China Financial Services LLC	634,928	4.0	% 690,783
Deutsche Bank Securities Inc.	587,919	3.7	% 666,472
ING Financial Market LLC	573,116	3.6	% 622,944
JP Morgan Securities Inc.	561,426	3.6	% 697,602
Royal Bank of Canada	560,828	3.6	% 641,079
BNP Paribas Securities Corp.	488,375	3.1	% 516,770
Goldman, Sachs & Co.	468,806	3.0	% 509,660
Daiwa Capital Markets America Inc	456,098	2.9	% 479,354
Pierpont Securities LLC	437,095	2.8	% 463,466
Barclays Capital Inc.	350,688	2.3	% 372,708
RBS Securities Inc.	348,741	2.2	% 427,183
Mizuho Securities USA Inc.	101,962	0.6	% 122,836
Cantor Fitzgerald & Co.	80,466	0.5	% 86,961
KGS-Alpha Capital Markets, L.P.	79,052	0.5	% 86,241
Guggenheim Liquidity Services, LLC	43,245	0.3	% 45,437
TD Securities	27,681	0.2	% 33,129
Total	15,720,460	100.0	% 17,456,238

Company MBS held by counterparties as security for repurchase agreements was \$17.5 billion and \$17.5 billion at September 30, 2013 and December 31, 2012, respectively. This represents a collateral ratio (Company MBS Held as Collateral/Amount Outstanding) of 110% and 111% respectively.

No cash collateral was held by the counterparties at September 30, 2013 and December 31, 2012.

#### Asset-Backed Securities Issued

During the nine months ended September 30, 2013, the Company purchased controlling interests in four securitization trusts (none during the quarter ended September 30, 2013) which it determined to be VIEs. The securitization trusts securitized residential mortgage loans with an aggregate principal balance of \$1.5 billion, and issued \$1.5 billion aggregate principal amount of ABS, of which \$1.4 billion were sold to unaffiliated third parties and the balance was purchased by the Company. The Company subsequently sold \$5.8 million of the original principal balance to a third party. As a result, the ABS issued by the securitization trusts is recorded as a non-recourse liability in the Company's consolidated balance sheets. During the nine months ended September 30, 2013, ABS held by unaffiliated third parties was paid down by \$27.8 million.

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The carrying value of the ABS is based on its amortized cost, which is equal to the remaining principal balance net of unamortized premiums or discounts. The following table provides summary information of the carrying value of the ABS issued, along with other relevant information, at September 30, 2013.

	ABS	Residential loans
\$ in thousands	Outstanding	Held as Collateral
Principal balance	1,392,952	1,498,726
Interest-only securities	11,412	—
Unamortized premium	10,354	34,414
Unamortized discount	(2,821	) —
Loan loss reserve	—	(751
Carrying value	1,411,897	1,532,389
Range of weighted average interest rates	2.8% - 3.3%	
Number of series	4	

The following table presents the estimated principal repayment schedule of the VIE's ABS at September 30, 2013, based on estimated cash flows of the residential mortgage loans, as adjusted for projected losses on such loans.

\$ in thousands	September 30, 2013
Estimated principal repayment	
Within One Year	172,695
One to Three Years	290,454
Three to Five Years	227,926
Greater Than or Equal to Five Years	701,877
Total	1,392,952

The maturity of the VIEs' ABS is dependent upon cash flows received from the underlying residential mortgage loans. The estimated principal repayments may differ from actual amounts to the extent prepayments and/or loan losses vary. See Note 5 "Residential Loans Held-for-Investment" for a more detailed discussion of the residential loans collateralizing the VIEs' ABS.

## Exchangeable Senior Notes

In the first quarter of 2013, a wholly-owned subsidiary of the Company issued \$400.0 million in aggregate principal amount of Exchangeable Senior Notes (the "Notes") due 2018. The total net proceeds to the Company after deducting financing expenses was \$387.9 million.

The terms of the Notes are governed by an indenture (the "Indenture") by and among the wholly-owned subsidiary, as issuer, the Company, as guarantor, and The Bank of New York Mellon Trust Company, N.A., as trustee (the "Trustee"). The Notes bear interest at 5.00% per annum, payable semi-annually in arrears on March 15 and September 15 of each year, beginning September 15, 2013. The Notes may be exchanged for shares of the Company's common stock at the applicable exchange rate at any time prior to the close of business on the second scheduled trading day prior to the maturity date. The initial exchange rate for each \$1,000 aggregate principal amount of the Notes is 42.0893 shares of the Company's common stock, equivalent to an exchange price of approximately \$23.76 per share, and the maximum exchange rate is 48.4027 shares of the Company's common stock, equivalent to an exchange price of approximately \$20.66 per share. The initial and maximum exchange rates of the Notes are subject to adjustment in certain events. The Notes have not been registered under the Securities Act of 1933. Pursuant to the registration rights agreement between the Company and the initial purchasers of the Notes, the Company filed a prospectus supplement in August 2013 registering for resale 605,034 shares of common stock issuable upon exchange of the Notes. The Company may be required to register additional shares of common stock issuable upon exchange of the Notes from time to time at the request of holders as required by the registration rights agreement. Accrued interest payable on the Notes is approximately \$889,000 as of September 30, 2013.

Note 9 – Derivatives and Hedging Activities  
Risk Management Objective of Using Derivatives

The Company is exposed to certain risks arising from both its business operations and economic conditions. The Company principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity, and credit risk primarily by

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managing the amount, sources, and duration of its investments, debt funding, and the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Company's derivative financial instruments are used to manage differences in the amount, timing, and duration of the Company's known or expected cash receipts and its known or expected cash payments principally related to the Company's investments and borrowings.

The Company also utilizes credit derivatives such as credit default swaps ("CDS") to provide credit event protection based on a financial index or specific security in exchange for receiving a fixed-rate fee or premium over the term of the contract. These instruments enable the Company to synthetically assume the credit risk of a reference security, portfolio of securities or index of securities. The counterparty pays a premium to the Company and the Company agrees to make a payment to compensate the counterparty for losses upon the occurrence of a specified credit event. Although contract specific, credit events generally include bankruptcy, failure to pay, restructuring, obligation acceleration, obligation default, or repudiation/moratorium. Upon the occurrence of a defined credit event, the difference between the value of the reference obligation and the CDS's notional amount is recorded as a realized loss in the statement of operations.

The Company's only CDS contract was entered into in the fourth quarter of 2010. The Company sold protection against losses on a specific pool of non-Agency RMBS in the event they exceed a specified loss limit of 25% of the balance of the non-Agency RMBS on the trade date. The maximum exposure is the remaining unpaid principal balance of the underlying RMBS in excess of the specified loss threshold. In exchange, we are paid a stated fixed rate fee of 3% of the notional amount of the CDS. The remaining notional amount of the CDS at September 30, 2013 was \$57.5 million (\$79.8 million at December 31, 2012), and we estimated the fair market value of the CDS to be approximately \$776,000 at September 30, 2013 (\$1.5 million at December 31, 2012). As of September 30, 2013, the Company has not made any payments related to the CDS contract.

At September 30, 2013 and December 31, 2012, the open CDS sold by the Company is summarized as follows:

\$ in thousand	September 30, 2013	December 31, 2012
Fair value amount	776	1,519
Notional amount	57,450	79,806
Maximum potential amount of future undiscounted payments	57,450	79,806
Recourse provisions with third parties	—	—
Collateral held by counterparty	8,933	12,371

**Cash Flow Hedges of Interest Rate Risk**

The Company has purchased interest rate swaptions to help mitigate the potential impact of increases or decreases in interest rates on the performance of a portion of the Company's investment portfolio (referred to as "convexity risk"). The interest rate swaptions provide the Company the option to enter into interest rate swap agreements for a predetermined notional amount, stated term and pay and receive interest rates in the future. The premium paid for interest rate swaptions is reported as an asset in the Company's consolidated balance sheets. The premium is valued at an amount equal to the fair value of the swaption that would have the effect of closing the position adjusted for nonperformance risk, if any. The difference between the premium and the fair value of the swaption is reported in unrealized gain (loss) on interest rate swaps and swaptions, net in the Company's Consolidated Statements of Operations. If a swaption expires unexercised, the loss on the swaption would be equal to the premium paid. If we sell or exercise a swaption, the realized gain or loss on the swaption would be equal to the difference between the cash or the fair value of the underlying interest rate swap received and the premium paid. The Company sold swaptions during the three and nine months ended September 30, 2013, realizing a net gain of \$39.0 million and \$66.2 million, respectively. For the three and nine months ended September 30, 2013, the Company had \$42.9 million and \$19.0 million of unrealized loss, respectively, which represents the change in fair value of our interest rate swaptions that are recognized directly in earnings.



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As of September 30, 2013, the company had the following outstanding interest rate swaptions:

\$ in thousands	Option	Underlying Swap						
		Expiration	Cost	Fair Value	Average Months to Expiration	Notional Amount	Average Fixed Pay Rate	Average Receive rate
Swaptions Payer	< 6 Months	25,030	6,684	3.10	1,300,000	3.32	% 3M Libor	10.00
Swaptions Payer	> 6 Months	8,200	3,651	7.58	400,000	3.76	% 3M Libor	10.00
		33,230	10,335	4.15	1,700,000	3.42	%	10.00

The following table presents information with respect to our derivative instruments:

\$ in thousands	Notional Amount as of January 1, 2013	Additions	Settlement, Termination, Expiration or Exercise	Notional Amount as of September 30, 2013	Amount of Realized Gain, net on Interest Rate Derivative Instruments
Swaption Contracts	850,000	4,450,000	(3,600,000 )	1,700,000	66,234
Interest Rate Swap	8,000,000	5,100,000	(300,000 )	12,800,000	—
U.S. Treasury Futures Contracts	—	100,000	—	100,000	—
Total	8,850,000	9,650,000	(3,900,000 )	14,600,000	66,234

The Company finances its activities primarily through repurchase agreements, which are usually settled on a short-term basis, usually from one to twelve months. At each settlement date, the Company refinances each repurchase agreement at the market interest rate at that time. Since the interest rate on its repurchase agreements change on a one to twelve month basis, the Company is exposed to changing interest rates. The Company's objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps as part of its interest rate risk management strategy. Interest rate swaps, designated as cash flow hedges, involve the receipt of variable-rate amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the agreements without exchange of the underlying notional amount.

During the three months ended September 30, 2013, the Company recorded \$298,000 of unrealized swap gains (2012: \$319,000 of unrealized swap losses) in earnings as hedge ineffectiveness attributable primarily to differences in the reset dates on the Company's swaps versus the refinancing dates of certain of its repurchase agreements.

During the nine months ended September 30, 2013, the Company recorded \$591,000 of unrealized swap gains (2012: \$832,000 of unrealized swap losses) in earnings as hedge ineffectiveness attributable primarily to differences in the reset dates on the Company's swaps versus the refinancing dates of certain of its repurchase agreements.

Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest expense as interest is accrued and paid on the Company's repurchase agreements. During the next twelve months, the Company estimates that an additional \$197.6 million will be reclassified as an increase to interest expense.

The Company is hedging its exposure to the variability in future cash flows for forecasted transactions over a maximum period of 123 months.

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As of September 30, 2013, the Company had the following interest rate derivatives outstanding, which were designated as cash flow hedges of interest rate risk:

\$ in thousands		Notional	Maturity Date	Fixed Interest Rate in Contract	
Counterparty					
SunTrust Bank		100,000	7/15/2014	2.79	%
Deutsche Bank AG		200,000	1/15/2015	1.08	%
Deutsche Bank AG		250,000	2/15/2015	1.14	%
Credit Suisse International		100,000	2/24/2015	3.26	%
Credit Suisse International		100,000	3/24/2015	2.76	%
Wells Fargo Bank, N.A.		100,000	7/15/2015	2.85	%
Wells Fargo Bank, N.A.		50,000	7/15/2015	2.44	%
Morgan Stanley Capital Services, LLC		300,000	1/24/2016	2.12	%
The Bank of New York Mellon		300,000	1/24/2016	2.13	%
Morgan Stanley Capital Services, LLC		300,000	4/5/2016	2.48	%
Citibank, N.A.		300,000	4/15/2016	1.67	%
Credit Suisse International		500,000	4/15/2016	2.27	%
The Bank of New York Mellon		500,000	4/15/2016	2.24	%
JPMorgan Chase Bank, N.A.		500,000	5/16/2016	2.31	%
Goldman Sachs Bank USA		500,000	5/24/2016	2.34	%
Goldman Sachs Bank USA		250,000	6/15/2016	2.67	%
Wells Fargo Bank, N.A.		250,000	6/15/2016	2.67	%
JPMorgan Chase Bank, N.A.		500,000	6/24/2016	2.51	%
Citibank, N.A.		500,000	10/15/2016	1.93	%
Deutsche Bank AG		150,000	2/5/2018	2.90	%
ING Capital Markets LLC		350,000	2/24/2018	0.95	%
Morgan Stanley Capital Services, LLC		100,000	4/5/2018	3.10	%
ING Capital Markets LLC		300,000	5/5/2018	0.79	%
JPMorgan Chase Bank, N.A.		200,000	5/15/2018	2.93	%
UBS AG		500,000	5/24/2018	1.10	%
ING Capital Markets LLC		400,000	6/5/2018	0.87	%
The Royal Bank of Scotland Plc		500,000	9/5/2018	1.04	%
CME Clearing House	(5 ) (6)	300,000	2/5/2021	2.50	%
CME Clearing House	(5 ) (6)	300,000	2/5/2021	2.69	%
Wells Fargo Bank, N.A.		200,000	3/15/2021	3.14	%
Citibank, N.A.		200,000	5/25/2021	2.83	%
HSBC Bank USA, National Association	(3 )	550,000	2/24/2022	2.45	%
The Royal Bank of Scotland Plc	(4 )	400,000	3/15/2023	2.39	%
UBS AG	(4 )	400,000	3/15/2023	2.51	%
HSBC Bank USA, National Association		250,000	6/5/2023	1.91	%
HSBC Bank USA, National Association		250,000	7/5/2023	1.97	%
The Royal Bank of Scotland Plc		500,000	8/15/2023	1.98	%
CME Clearing House	(6 )	600,000	8/24/2023	2.88	%
UBS AG	(1 )	250,000	11/15/2023	2.23	%
HSBC Bank USA, National Association	(2 )	500,000	12/15/2023	2.20	%
Total		12,800,000		2.12	%

(1) Forward start date of November 2013





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(2) Forward start date of December 2013

(3) Forward start date of February 2015

(4) Forward start date of March 2015

(5) Forward start date of February 2016

Beginning June 10, 2013, regulations promulgated under The Dodd-Frank Wall Street Reform and Consumer Protection Act mandate that the Company clear new interest rate swap transactions through a central counterparty.

(6) Transactions that are centrally cleared result in the Company facing a clearing house, rather than a swap dealer, as counterparty. Central clearing requires the Company to post collateral in the form of initial and variation margin to the clearing house which reduces default risk.

At September 30, 2013, the Company's counterparties held \$8.1 million of cash margin deposits and approximately \$346.0 million in Agency RMBS as collateral against its swap, CDS and futures contracts. In addition, several counterparties posted securities of approximately \$171.0 million and \$21.0 million of cash as collateral with the Company. Cash margin posted by the Company is classified as due from counterparties, and cash margin posted by counterparties that are restricted in use, if any, is classified as restricted cash. The Agency RMBS collateral posted by the Company is included in the total mortgage-backed securities on the Company's consolidated balance sheets. Cash collateral that is not restricted for use by the Company is included in Cash and cash equivalents and the liability to return the collateral is included in Collateral held payable on the consolidated balance sheets. Non-cash collateral posted by counterparties to the Company would be recognized if any counterparty defaults or if the Company sold the pledged collateral. As of September 30, 2013, the Company did not recognize any non-cash collateral held as collateral.

#### U.S. Treasury Futures Contracts

The Company purchases or sells short U.S. Treasury futures contracts to help mitigate the potential impact of changes in interest rates on the performance of the Company's portfolio. Unrealized gains and losses associated with the short sales of the U.S. Treasury futures contracts are recognized in Realized and unrealized gain (loss) on interest rate derivative instruments in the Company's Consolidated Statements of Operations.

#### Tabular Disclosure of the Effect of Derivative Instruments on the Consolidated Balance Sheets

The table below presents the fair value of the Company's derivative financial instruments, as well as their classification on the consolidated balance sheets as of September 30, 2013 and December 31, 2012.

\$ in thousands

#### Asset Derivatives

As of September 30, 2013		As of December 31, 2012	
Balance Sheet	Fair Value	Balance Sheet	Fair Value
Interest rate swap asset	177,398	Interest rate swap asset	—
CDS	776	CDS	1,519
Swaption	10,335	Swaption	4,950

#### Liability Derivatives

As of September 30, 2013		As of December 31, 2012	
Balance Sheet	Fair Value	Balance Sheet	Fair Value
Interest rate swap liability	313,303	Interest rate swap liability	436,440
U.S. Treasury futures	3,367	U.S. Treasury futures	—

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## Tabular Disclosure of the Effect of Derivative Instruments on the Income Statement

The table below presents the effect of the Company's derivative financial instruments on the statement of operations for the three and nine months ended September 30, 2013 and 2012.

Three months ended September 30, 2013

\$ in thousands

Derivative type for cash flow hedge	Amount of gain (loss) recognized in OCI on derivative (effective portion)	Location of loss reclassified from accumulated OCI into income (effective portion)	Amount of loss reclassified from accumulated OCI into income (effective portion)	Location of gain recognized in income on derivative (ineffective portion)	Amount of gain (loss) recognized in income on derivative (ineffective portion)
Interest Rate Swap	(74,098	) Interest Expense	43,583	Realized and unrealized gain (loss) on interest rate derivative instruments	298

Nine months ended September 30, 2013

\$ in thousands

Derivative type for cash flow hedge	Amount of gain (loss) recognized in OCI on derivative (effective portion)	Location of loss reclassified from accumulated OCI into income (effective portion)	Amount of loss reclassified from accumulated OCI into income (effective portion)	Location of gain recognized in income on derivative (ineffective portion)	Amount of gain (loss) recognized in income on derivative (ineffective portion)
Interest Rate Swap	183,391	Interest Expense	116,553	Realized and unrealized gain (loss) on interest rate derivative instruments	591

Three months ended September 30, 2012

\$ in thousands

Derivative type for cash flow hedge	Amount of gain (loss) recognized in OCI on derivative (effective portion)	Location of loss reclassified from accumulated OCI into income (effective portion)	Amount of loss reclassified from accumulated OCI into income (effective portion)	Location of loss recognized in income on derivative (ineffective portion)	Amount of gain (loss) recognized in income on derivative (ineffective portion)
Interest Rate Swap	(60,716	) Interest Expense	35,763	Realized and unrealized gain (loss) on interest rate derivative instruments	(319

Nine months ended September 30, 2012

\$ in thousands

Derivative	Amount of gain	Location of loss	Amount of loss	Location of loss
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type for cash flow hedge	(loss) recognized in OCI on derivative (effective portion)	reclassified from accumulated OCI into income (effective portion)	reclassified from accumulated OCI into income (effective portion)	recognized in income on derivative (ineffective portion)	Amount of gain (loss) recognized in income on derivative (ineffective portion)
Interest Rate Swap	(181,280	) Interest Expense	107,051	Realized and unrealized gain (loss) on interest rate derivative instruments	(832 )

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Derivative not designated as hedging instrument	Location of unrealized gain (loss) recognized in income on derivative	Amount of gain (loss) recognized in income on derivative	
		Three months ended September 30, 2013	Three months ended September 30, 2012
CDS Contract	Realized and unrealized credit default swap income	(175	) 643
Swaption Contract	Realized and unrealized gain (loss) on interest rate derivative instruments	(42,891	) (489 )
Futures Contract	Realized and unrealized gain (loss) on interest rate derivative instruments	(3,369	) —
		Amount of gain (loss) recognized in income on derivative	
Derivative not designated as hedging instrument	Location of unrealized gain (loss) recognized in income on derivative	Three months	Three months
		ended September 30, 2013	ended September 30, 2012
CDS Contract	Realized and unrealized credit default swap income	(743	) 406
Swaption Contract	Realized and unrealized gain (loss) on interest rate derivative instruments	(19,032	) (2,019 )
Futures Contract	Realized and unrealized gain (loss) on interest rate derivative instruments	(3,369	) —

## Credit-risk-related Contingent Features

The Company has agreements with each of its derivative counterparties. Some of those agreements contain a provision whereby if the Company defaults on any of its indebtedness, including default whereby repayment of the indebtedness has not been accelerated by the lender, then the Company could also be declared in default on its derivative obligations.

The Company's agreements with certain of its derivative counterparties provide that if the Company's net asset value declines by certain percentages over specified time periods, then the Company could be declared in default on its derivative obligations with that counterparty. The Company's agreements with certain of its derivative counterparties provide that if the Company's shareholders' equity declines by certain percentages over specified time periods, then the Company could be declared in default on its derivative obligations with that counterparty.

The Company's agreements with certain of its derivative counterparties provide that if the Company fails to maintain a minimum shareholders' equity or market value of \$100 million and \$80 million, respectively, then the Company could be declared in default on its derivative obligations with that counterparty.

As of September 30, 2013, the fair value of derivatives in a net liability position, which includes accrued interest but excludes any adjustment for non-performance risk related to these agreements, was \$296.7 million. The Company has minimum collateral posting thresholds with certain of its derivative counterparties and has posted collateral of \$346.0 million of Agency RMBS and \$8.1 million of cash as of September 30, 2013. If the Company had breached any of these provisions at September 30, 2013, it could have been required to settle its obligations under the agreements at their termination value.

The Company was in compliance with all of the financial provisions of these agreements through September 30, 2013.



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Note 10 – Offsetting Assets and Liabilities

The following tables present information about certain assets and liabilities that are subject to master netting agreements (or similar agreements) and can potentially be offset on the Company’s consolidated balance sheets at September 30, 2013 and December 31, 2012.

Offsetting of Derivative Assets

As of September 30, 2013

	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Consolidated Balance Sheets	Net Amounts of Assets presented in the Consolidated Balance sheets	Gross Amounts Not Offset in the Consolidated Balance Sheets		
				Financial Instruments (1)	Cash	Collateral Received
\$ in thousands						
Description						Net Amount
Derivatives	188,509	—	188,509	(188,509 )	—	—
Total	188,509	—	188,509	(188,509 )	—	—

Offsetting of Derivative Liabilities and Repurchase agreements

As of September 30, 2013

	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Consolidated Balance Sheets	Net Amounts of Assets presented in the Consolidated Balance sheets	Gross Amounts Not Offset in the Consolidated Balance Sheets		
				Financial Instruments (2)	Cash	Collateral Posted (2)(4)
\$ in thousands						
Description						Net Amount
Derivatives	316,670	—	316,670	(316,670 )	—	—
Repurchase Agreements	15,897,612	—	15,897,612	(15,897,612 )	—	—
	16,214,282	—	16,214,282	(16,214,282 )	—	—

Offsetting of Derivative Assets

As of December 31, 2012

	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Consolidated Balance Sheets	Net Amounts of Assets presented in the Consolidated Balance sheets	Gross Amounts Not Offset in the Consolidated Balance Sheets		
				Financial Instruments (1)	Cash	Collateral Received
\$ in thousands						
Description						Net Amount
Derivatives	6,469	—	6,469	(6,469 )	—	—
Total	6,469	—	6,469	(6,469 )	—	—



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As of December 31, 2012

\$ in thousands Description	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Consolidated Balance Sheets	Net Amounts of Assets presented in the Consolidated Balance sheets	Gross Amounts Not Offset in the Consolidated Balance Sheets		Net Amount
				Financial Instruments (2)	Cash Collateral Posted (2)(4)	
Derivatives	436,440	—	436,440	(436,440 )	—	—
Repurchase Agreements	15,720,460	—	15,720,460	(15,720,460 )	—	—
	16,156,900	—	16,156,900	(16,156,900 )	—	—

Amounts represent interest rate derivatives in an asset position which could potentially be offset against interest rate derivatives in a liability position at September 30, 2013 and December 31, 2012, subject to a netting arrangement.

(2) Amounts represent collateral pledged that is available to be offset against liability balances associated with repurchase agreements and interest rate derivatives.

(3) The fair value of securities pledged against our borrowing under repurchase agreements was \$17.5 billion and \$17.5 billion at September 30, 2013 and December 31, 2012, respectively.

(4) Total cash received on our Derivatives was \$21.0 million and \$0 at September 30, 2013 and December 31, 2012, respectively. Total non-cash collateral received on our Derivatives was \$171.0 million and \$0 at September 30, 2013 and December 31, 2012, respectively. Total cash posted by the Company on our Derivatives was \$8.1 million at September 30, 2013.

In the Company's consolidated balance sheets, all balances associated with the repurchase agreement and derivatives transactions are presented on a gross basis.

Certain of the Company's repurchase agreement and derivative transactions are governed by underlying agreements that generally provide for a right of setoff in the event of default or in the event of a bankruptcy of either party to the transaction. For one repurchase agreement counterparty, the underlying agreement provide for an unconditional right of setoff.

## Note 11 – Financial Instruments

U.S. GAAP defines fair value, provides a consistent framework for measuring fair value under U.S. GAAP, and Accounting Standards Codification ("ASC") Topic 820 expands fair value financial statement disclosure requirements. ASC Topic 820 does not require any new fair value measurements and only applies to accounting pronouncements that already require or permit fair value measures, except for standards that relate to share-based payments.

Valuation techniques are based on observable and unobservable inputs. Observable inputs reflect readily obtainable data from independent sources, while unobservable inputs reflect the Company's market assumptions. The three levels are defined as follows:

Level 1 Inputs – Quoted prices for identical instruments in active markets.

Level 2 Inputs – Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.

Level 3 Inputs – Instruments with primarily unobservable value drivers.





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The fair values on a recurring basis of the Company's MBS and interest rate hedges based on the level of inputs at September 30, 2013 and December 31, 2012 are summarized below:

\$ in thousands	September 30, 2013			Total at Fair Value
	Fair Value Measurements Using:			
	Level 1	Level 2	Level 3	
Assets				
Mortgage-backed securities(1)	—	18,811,679	—	18,811,679
Investments in unconsolidated ventures	—	—	42,276	42,276
Derivatives	—	187,733	776	188,509
Total	—	18,999,412	43,052	19,042,464
Liabilities				
Derivatives	3,367	313,303	—	316,670
Total	3,367	313,303	—	316,670

  

\$ in thousands	December 31, 2012			Total at Fair Value
	Fair Value Measurements Using:			
	Level 1	Level 2	Level 3	
Assets				
Mortgage-backed securities(1)	—	18,470,563	—	18,470,563
Investments in unconsolidated ventures	—	—	35,301	35,301
Derivatives	—	4,950	1,519	6,469
Total	—	18,475,513	36,820	18,512,333
Liabilities				
Derivatives	—	436,440	—	436,440
Total	—	436,440	—	436,440

(1) For more detail about the fair value of our MBS and type of securities, see Note 4 in the consolidated financial statements.

The following table presents additional information about the Company's investments in unconsolidated ventures which are measured at fair value on a recurring basis for which the Company has utilized Level 3 inputs to determine fair value:

\$ in thousands	September 30, 2013	December 31, 2012
Beginning balance	35,301	68,793
Purchases	4,843	4,218
Sales and settlements	(3,037)	(44,879)
Total net gains / (losses) included in net income		
Realized gains/(losses), net	2,332	6,813
Unrealized gains/(losses), net	2,837	356
Unrealized gain/(losses), net included in other comprehensive income	—	—
Ending balance	42,276	35,301



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The following table presents additional information about the Company's CDS contract which is measured at fair value on a recurring basis for which the Company has utilized Level 3 inputs to determine fair value:

\$ in thousands	September 30, 2013	December 31, 2012
Beginning balance	1,519	1,339
Purchases	—	—
Sales and settlements	—	—
Total net gains / (losses) included in net income		
Realized gains/(losses), net	—	—
Unrealized gains/(losses), net	(743	) 180
Unrealized gain/(losses), net included in other comprehensive income	—	—
Ending balance	776	1,519

The following table summarizes quantitative information about Level 3 fair value measurements:

Fair Value at	Valuation	Unobservable	Weighted		
\$ in thousands	September 30, 2013	Technique	Input	Range	Average
CDS Contract	776	Discounted cash flow	Swap Rate		2.39 %
			Discount Rate		0.52 %
			Credit Spread		0.48 %
			Constant Prepayment Rate	1.0% - 20.0%	5.78 %
			Constant Default Rate	1.0% - 100.0%	4.86 %
			Loss Severity	7.3% - 63.2%	42.80 %

The significant inputs used in the fair value measurement of the CDS contract are the swap rate, discount rate, credit spread, constant prepayment rate, constant default rate, and loss severity in the event of default. These inputs change according to market conditions and security performance expectations. Significant increases (decreases) in swap rate, discount rate, credit spread, constant prepayment rate, constant default rate or loss severity in isolation would result in a lower (higher) fair value measurement. Generally, a change in the assumption used for the constant default rate would likely be accompanied by a directionally similar change in the assumptions used for swap rate, credit spread and loss severity and a directionally opposite change in the assumption used for discount rate and constant prepayment rate. If the inputs had not changed during the quarter, the fair value of the CDS contract would have been \$10,000 more than the actual fair value at September 30, 2013.

The following table presents the carrying value and estimated fair value of our financial instruments that are not carried at fair value on the consolidated balance sheets, at September 30, 2013 and December 31, 2012:

\$ in thousands	September 30, 2013		December 31, 2012	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
<b>Financial Assets</b>				
Residential loans, held-for-investment	1,532,389	1,414,816	—	—
Commercial loans, held-for-investment	17,388	17,388	—	—
Other investments	10,000	10,000	10,000	10,000
Total	1,559,777	1,442,204	10,000	10,000
<b>Financial Liabilities</b>				
Repurchase agreements	15,897,612	15,876,752	15,720,460	15,730,387
Asset-backed securities	1,411,897	1,321,675	—	—
Exchangeable senior notes	400,000	374,250	—	—
Total	17,709,509	17,572,677	15,720,460	15,730,387



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The following describes the Company's methods for estimating the fair value for financial instruments.

The fair value of the residential loans, held-for-investment and commercial loans, held-for-investment are a Level 3 fair value measurement based on an expected present value technique. This method discounts future estimated cash flows using rates the Company determined best reflect current market interest rates that would be offered for loans with similar characteristics and credit quality.

In December 2012, the Company acquired a \$10.0 million debt security from a repurchase lending counterparty that matures October 31, 2016. The debt security pays interest quarterly at the rate of 4.0% above the three-month LIBOR rate. The debt security is included in "Other Investments" and its fair value is a Level 3 fair value measurement based on an expected present value technique. This method discounts future estimated cash flows using rates the Company determined best reflect current market interest rates that would be offered for securities with similar characteristics and credit quality.

The fair value of the repurchase agreements is a Level 3 fair value measurement, based on an expected present value technique. This method discounts future estimated cash flows using rates the Company determined best reflect current market interest rates that would be offered for repurchase agreements with similar characteristics and credit quality.

The fair value of the asset-backed securities issued is a Level 3 fair value measurement based on an expected present value technique. This method discounts future estimated cash flows using rates the Company determined best reflect current market interest rates that would be offered for securities with similar characteristics and credit quality.

The fair value of the exchangeable senior notes issued is a Level 2 fair value measurement based on obtaining valuations from an independent source. The value was based on a value obtained from a third-party pricing service.

Note 12 – Related Party Transactions

The Company is externally managed and advised by the Manager. Pursuant to the terms of the management agreement, the Manager and its affiliates provide the Company with its management team, including its officers, along with appropriate support personnel. Each of the Company's officers is an employee of the Manager or one of its affiliates. The Company does not have any employees. With the exception of the Company's Chief Financial Officer, the Manager is not obligated to dedicate any of its employees exclusively to the Company, nor are the Manager or its employees obligated to dedicate any specific portion of its or their time to the Company's business. The Manager is at all times subject to the supervision and oversight of the Company's Board of Directors and has only such functions and authority as the Company delegates to it.

Management Fee

The Company pays the Manager a management fee equal to 1.50% of the Company's shareholders' equity per annum, which is calculated and payable quarterly in arrears. For purposes of calculating the management fee, shareholders' equity is equal to the sum of the net proceeds from all issuances of equity securities since inception (allocated on a pro rata daily basis for such issuances during the fiscal quarter of any such issuance), plus retained earnings at the end of the most recently completed calendar quarter (without taking into account any non-cash equity compensation expense incurred in current or prior periods), less any amount paid to repurchase common stock since inception, and excluding any unrealized gains, losses or other items that do not affect realized net income (regardless of whether such items are included in other comprehensive income or loss, or in net income). This amount will be adjusted to exclude one-time events pursuant to changes in U.S. GAAP, and certain non-cash items after discussions between the Manager and the Company's independent directors and approval by a majority of the Company's independent directors.

The Manager has agreed to reduce (but not below zero) the management fee payable by the Company under the management agreement with respect to any equity investment managed by the Manager. The fee reduction occurs at the equity investment level.

For the three months ended September 30, 2013, the Company incurred management fees of \$10.9 million (2012: \$9.1 million), of which \$10.9 million (2012: \$9.1 million), was accrued but has not been paid.

For the nine months ended September 30, 2013, the Company incurred management fees of \$32.1 million (2012: \$26.4 million), of which \$10.9 million (2012: \$9.1 million) was accrued but has not been paid.



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Expense Reimbursement

Pursuant to the management agreement, the Company is required to reimburse the Manager for operating expenses related to the Company incurred by the Manager, including directors and officers insurance, accounting services, auditing and tax services, filing fees, and miscellaneous general and administrative costs. The Company's reimbursement obligation is not subject to any dollar limitation.

The Company incurred costs, originally paid by Invesco, of approximately \$1.0 million (2012: \$1.7 million) and \$3.9 million (2012: \$3.1 million) for the three and nine months ended September 30, 2013, respectively. Approximately \$1.0 million (2012: \$1.5 million) and \$3.5 million (2012: \$2.9 million) was either prepaid or expensed for the three and nine months ended September 30, 2013, respectively, \$0 (2012: \$176,000) and \$418,000 (2012: \$218,000) was charged against equity as a cost of raising capital for the three and nine months ended September 30, 2013, respectively.

Termination Fee

A termination fee is due to the Manager upon termination of the management agreement by the Company equal to three times the sum of the average annual management fee earned by the Manager during the 24-month period prior to such termination, calculated as of the end of the most recently completed fiscal quarter.

Note 13 – Shareholders' Equity

Securities Convertible into Shares of Common Stock

The limited partner who holds OP Units has the right to cause the Operating Partnership to redeem their OP Units for cash equal to the market value of an equivalent number of shares of common stock, or at the Company's option, the Company may purchase their OP Units by issuing one share of common stock for each OP Unit redeemed. The Company has also adopted an equity incentive plan which includes the ability of the Company to grant securities convertible into the Company's common stock to the independent directors and the executive officers of the Company and the personnel of the Manager and its affiliates.

Exchangeable Senior Notes

In the first quarter of 2013, a wholly-owned subsidiary of the Company issued \$400.0 million in aggregate principal amount of the Notes due 2018. The total net proceeds to the Company after deducting financing expenses was \$387.9 million. The Notes may be exchanged for shares of the Company's common stock at the applicable exchange rate at any time prior to the close of business on the second scheduled trading day prior to the maturity date. The initial exchange rate for each \$1,000 aggregate principal amount of the Notes is 42.0893 shares of the Company's common stock, equivalent to an exchange price of approximately \$23.76 per share, and the maximum exchange rate is 48.4027 shares of the Company's common stock, equivalent to an exchange price of approximately \$20.66 per share. The initial and maximum exchange rates of the Notes are subject to adjustment in certain events.

Registration Rights

The Company entered into a registration rights agreement with regard to the common stock and OP Units owned by the Manager and Invesco Investments (Bermuda) Ltd., respectively, upon completion of the Company's IPO and any shares of common stock that the Manager may elect to receive under the management agreement or otherwise. Pursuant to the registration rights agreement, the Company has granted to the Manager and Invesco Investments (Bermuda) Ltd. (i) unlimited demand registration rights to have the shares purchased by the Manager or granted to it in the future and the shares that the Company may issue upon redemption of the OP Units purchased by Invesco Investments (Bermuda) Ltd. registered for resale and (ii) in certain circumstances, the right to "piggy-back" these shares in registration statements the Company might file in connection with any future public offering so long as the Company retains the Manager under the management agreement.

On March 12, 2013, in connection with the issuance and sale of the Notes, the Operating Partnership and the Company also entered into a registration rights agreement with the initial purchasers of the Notes. Pursuant to the registration rights agreement, the Company has designated its automatic shelf registration statement filed on April 2, 2013 to be used for resales of the common stock, if any, issuable upon exchange of the Notes. The Company has filed a supplement to the underlying prospectus in that shelf registration statement to cover resales of the common stock



and has agreed to file prospectus supplements if requested by noteholders to add such noteholders as selling securityholders. If the shelf registration statement ceases to be effective, then subject to certain exceptions, additional interest will accrue on the Notes.

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Common Stock Public Offerings

On January 28, 2013, the Company completed a public offering of 15,000,000 shares of its common stock and an issuance of an additional 2,250,000 shares of common stock pursuant to the underwriters' full exercise of their over-allotment option at \$21.00 per share, resulting in net proceeds of approximately \$359.0 million, after deducting underwriting discounts and estimated offering costs.

During the nine months ended September 30, 2013, the Company issued 1,766,995 shares of common stock at an average price of \$21.32 under the DRSP with total proceeds to the Company of approximately \$37.7 million, net of issuance costs of \$219,000.

Preferred Stock

Holders of the Company's Series A Preferred Stock are entitled to receive dividends at an annual rate of 7.75% of the liquidation preference of \$25 per share or \$1.9375 per share per annum. These dividends are cumulative and payable quarterly in arrears. The shares are not convertible into or exchangeable for any other property or any other securities of the Company at the election of the holders. However, the Company, at its option after July 26, 2017, may redeem the shares at a redemption price of \$25.00, plus any accrued unpaid distributions through the date of the redemption.

Share-Based Compensation

The Company established the 2009 Equity Incentive Plan for grants of restricted common stock and other equity based awards to the independent directors and the executive officers of the Company and personnel of the Manager and its affiliates (the "Incentive Plan"). Under the Incentive Plan, a total of 1,000,000 shares of common stock are currently reserved for issuance. Unless terminated earlier, the Incentive Plan will terminate in 2019, but will continue to govern the unexpired awards. The Company recognized compensation expense of approximately \$45,000 (2012: \$53,000) for the three months ended September 30, 2013. The Company recognized compensation expense of approximately \$120,000 (2012: \$128,000) for the nine months ended September 30, 2013. During the three months ended September 30, 2013, the Company issued 2,361 shares (2012: 2,568 shares) of restricted stock pursuant to the Incentive Plan to the Company's non-executive directors. During the nine months ended September 30, 2013, the Company issued 5,970 shares (2012: 6,831 shares) of restricted stock pursuant to the Incentive Plan to the Company's non-executive directors. The fair market value of the shares granted was determined by the closing stock market price on the date of the grant.

The Company recognized compensation expense of approximately \$45,000 (2012: \$49,000) for the three months ended September 30, 2013 related to awards to officers and employees of the Manager and its affiliates which is reimbursed by the Manager under the management agreement.

The Company recognized compensation expense of approximately \$156,000 (2012: \$129,000) for the nine months ended September 30, 2013 related to awards to officers and employees of the Manager and its affiliates which is reimbursed by the Manager under the management agreement.

During March 2013, the Company issued 5,697 shares of common stock (net of tax withholding) in exchange for 8,783 restricted stock units that vested under the Incentive Plan. In addition, during the nine months ended September 30, 2013, the Company awarded 16,835 restricted stock units to officers and employees of the Manager and its affiliates.

Dividends

On September 16, 2013, the Company declared a dividend of \$0.50 per share of common stock. The dividend was paid on October 28, 2013 to shareholders of record as of the close of business on September 26, 2013.

On September 16, 2013, the Company declared a dividend of \$0.4844 per share of Series A Preferred Stock. The dividend was paid on October 25, 2013 to shareholders of record as of the close of business on October 1, 2013.

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## Note 14 – Earnings per Common Share

Earnings per share for the three and nine months ended September 30, 2013 and 2012 is computed as follows:

\$ and share amounts in thousands	Three Months Ended		Nine Months Ended	
	September 30, 2013	2012	September 30, 2013	2012
Numerator (Income)				
Basic Earnings				
Net income (loss) available to common shareholders	(8,686 )	83,068	214,152	244,971
Effect of dilutive securities:				
Income allocated to exchangeable senior debt	—	—	12,403	—
Income allocated to non-controlling interest	—	1,026	2,392	3,025
Dilutive net income (loss) available to shareholders	(8,686 )	84,094	228,947	247,996
Denominator (Weighted Average Shares)				
Basic Earnings:				
Shares available to common shareholders	135,220	115,412	133,094	115,405
Effect of dilutive securities:				
Restricted Stock Awards	—	31	12,519	28
OP Units	—	1,425	34	1,425
Exchangeable senior notes	—	—	1,425	—
Dilutive Shares	135,220	116,868	147,072	116,858

The following potential common shares (in thousands) were excluded from diluted earnings per common share for the three months ended September 30, 2013 as the Company had a net loss for the period: 16,836 for the Notes, 1,425 for OP Units and 38 for Restricted Stock Awards.

## Note 15 – Non-controlling Interest—Operating Partnership

Non-controlling interest represents the aggregate OP Units in the Operating Partnership held by limited partners (the “Unit Holders”). Income allocated to the non-controlling interest is based on the Unit Holders’ ownership percentage of the Operating Partnership. The ownership percentage is determined by dividing the number of OP Units held by the Unit Holders by the total number of dilutive shares of common stock. The issuance of common stock (“Share” or “Shares”) or OP Units changes the percentage ownership of both the Unit Holders and the holders of common stock. Since an OP unit is generally redeemable for cash or Shares at the option of the Company, it is deemed to be equivalent to a Share. Therefore, such transactions are treated as capital transactions and result in an allocation between shareholders’ equity and non-controlling interest in the accompanying consolidated balance sheets to account for the change in the ownership of the underlying equity in the Operating Partnership. As of September 30, 2013, non-controlling interest related to the outstanding 1,425,000 OP Units represented a 1.0% interest (2012: 1.2%) in the Operating Partnership. Loss allocated to the Operating Partnership non-controlling interest for the three months ended September 30, 2013 was approximately \$63,000 (2012: \$1.0 million income). Income allocated to the Operating Partnership non-controlling interest for the nine months ended September 30, 2013 was \$2.4 million (2012: \$3.0 million). For the three months ended September 30, 2013, distributions paid to the non-controlling interest were \$926,000 (2012: \$926,000). For the nine months ended September 30, 2013, distributions paid to the non-controlling interest were \$2.8 million (2012: \$2.8 million). As of September 30, 2013, distributions payable to the non-controlling interest were approximately \$713,000 (2012: \$926,000).

## Note 16 – Subsequent Events

The Company has reviewed subsequent events occurring through the date that these consolidation financial statements were issued, and determined that no subsequent events occurred that would require accrual or additional disclosure.



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

In this quarterly report on Form 10-Q, or this “Report,” we refer to Invesco Mortgage Capital Inc. and its consolidated subsidiaries as “we,” “us,” “our Company,” or “our,” unless we specifically state otherwise or the context indicates otherwise. We refer to our external manager, Invesco Advisers, Inc., as our “Manager,” and we refer to the indirect parent company of our Manager, Invesco Ltd. (NYSE:IVZ) together with its consolidated subsidiaries (which does not include us), as “Invesco.”

The following discussion should be read in conjunction with our consolidated financial statements and the accompanying notes to our consolidated financial statements, which are included in Item 1 of this Report, as well as the information contained in our most recent Form 10-K filed with the Securities and Exchange Commission (the “SEC”).

Forward-Looking Statements

We make forward-looking statements in this Report and other filings we make with the SEC within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and such statements are intended to be covered by the safe harbor provided by the same. Forward-looking statements are subject to substantial risks and uncertainties, many of which are difficult to predict and are generally beyond our control. These forward-looking statements include information about possible or assumed future results of our business, investment strategies, financial condition, liquidity, results of operations, plans and objectives. When we use the words “believe,” “expect,” “anticipate,” “estimate,” “plan,” “continue,” “intend,” “should,” “may,” “will,” “could,” “would,” and any other similar expressions and future or conditional verbs such as “will,” “may,” “could,” “should,” and “would,” and any other statement that necessarily depends on future events, we intend to identify forward-looking statements. Factors that could cause actual results to differ from those expressed in our forward-looking statements include, but are not limited to:

- our business and investment strategy;
- our investment portfolio;
- our projected operating results;
- actions and initiatives of the U.S. government, including the impact of Congressional debate on the U.S. debt ceiling and budget deficit, and changes to U.S. government policies, including the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) and mortgage loan modification programs and our ability to respond to and comply with such actions, initiatives and changes;
- our ability to obtain additional financing arrangements and the terms of such arrangements;
- financing and advance rates for our target assets;
- changes to our expected leverage;
- general volatility of the markets in which we invest;
- general volatility of foreign financial markets and their governments’ responses;
- our expected investments;
- our expected book value per share of common stock;
- interest rate mismatches between our target assets and our borrowings used to fund such investments;
- the adequacy of our cash flow from operations and borrowings to meet our short-term liquidity needs;
- our ability to maintain sufficient liquidity to meet any margin calls;
- changes in the credit rating of the U.S. government;
- changes in interest rates and interest rate spreads and the market value of our target assets;
- changes in prepayment rates on our target assets;
- the impact of any deficiencies in foreclosure practices of third parties and related uncertainty in the timing of collateral disposition;
- effects of hedging instruments on our target assets;
- rates of default or decreased recovery rates on our target assets;



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- modifications to whole loans or loans underlying securities;
- the degree to which our hedging strategies may or may not protect us from interest rate volatility;
- counterparty defaults;
- changes in governmental regulations, tax law and rates, and similar matters and our ability to respond to such changes;
- our ability to maintain our qualification as a real estate investment trust (“REIT”) for U.S. federal income tax purposes;
- our ability to maintain our exception from the definition of “investment company” under the Investment Company Act of 1940, as amended (the “1940 Act”);
- availability of investment opportunities in mortgage-related, real estate-related and other securities;
- availability of U.S. Government Agency guarantees with regard to payments of principal and interest on securities;
- availability of qualified personnel;
- estimates relating to our ability to continue to make distributions to our shareholders in the future;
- our understanding of our competition;
- changes to accounting principles generally accepted in the United States of America (“U.S. GAAP”); and
- market trends in our industry, interest rates, real estate values, the debt securities markets or the general economy.

These forward-looking statements are based upon information presently available to our management and are inherently subjective, uncertain and subject to change. There can be no assurance that actual results will not differ materially from our expectations. We caution investors not to rely unduly on any forward-looking statements and urge you to carefully consider the risks identified under the captions “Risk Factors,” “Forward-Looking Statements” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in this Report and our most recent Form 10-K and subsequent Form 10-Qs, which are available on the SEC’s website at [www.sec.gov](http://www.sec.gov).

All written or oral forward-looking statements that we make, or that are attributable to us, are expressly qualified by this cautionary notice. We expressly disclaim any obligation to update the information in any public disclosure if any forward-looking statement later turns out to be inaccurate, except as may otherwise be required by law.

The following discussion should be read in conjunction with our consolidated financial statements and the accompanying notes to our consolidated financial statements, which are included in this Report.

Overview

We are a Maryland corporation primarily focused on investing in, financing and managing residential and commercial mortgage-backed securities and mortgage loans, which we collectively refer to as our target assets. We are externally managed and advised by Invesco Advisers, Inc., which is an indirect, wholly-owned subsidiary of Invesco Ltd. We are a REIT for U.S. federal income tax purposes. Accordingly, we generally will not be subject to U.S. federal income taxes on our taxable income to the extent that we annually distribute all of our net income to our shareholders and maintain our qualification as a REIT. We operate our business in a manner that permits us to maintain our exclusion from the definition of “Investment Company” under the 1940 Act.

Our objective is to provide attractive risk-adjusted returns to our shareholders, primarily through dividends and secondarily through capital appreciation. To achieve this objective, we primarily invest in the following:

- Agency RMBS, which are residential mortgage-backed securities (“RMBS”), for which a U.S. government Agency such as the Government National Mortgage Association (“Ginnie Mae”) or a federally chartered corporation such as the Federal National Mortgage Association (“Fannie Mae”) or the Federal Home Loan Mortgage Corporation (“Freddie Mac”) guarantees payments of principal and interest on the securities;

- Non-Agency RMBS, which are RMBS that are not issued or guaranteed by a U.S. government agency or a federally chartered corporation;

- Commercial mortgage-backed securities (“CMBS”); and

- Residential and commercial mortgage loans.





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We finance the majority of our investments in Agency RMBS, non-Agency RMBS and CMBS through short-term borrowings structured as repurchase agreements. Our Manager has secured commitments for us with a number of repurchase agreement counterparties.

### Recent Developments

On September 16, 2013, we declared a dividend of \$0.50 per share of common stock. The dividend was paid on October 28, 2013 to shareholders of record as of the close of business on September 26, 2013.

On September 16, 2013, we declared a dividend of \$0.4844 per share of Series A Preferred Stock. The dividend was paid on October 25, 2013 to shareholders of record as of the close of business on October 1, 2013.

### Factors Impacting Our Operating Results

Our operating results can be affected by a number of factors and primarily depend on, among other things, the level of our net interest income, the market value of our assets and the supply of, and demand for, the target assets in which we invest. Our net interest income, which includes the amortization of purchase premiums and accretion of purchase discounts, varies primarily as a result of changes in market interest rates and prepayment speeds, as measured by the constant prepayment rate (“CPR”) on our target assets. Interest rates and prepayment speeds vary according to the type of investment, conditions in the financial markets, competition and other factors, none of which can be predicted with any certainty.

### Market Conditions

Beginning in the summer of 2007, significant adverse changes in financial market conditions resulted in a deleveraging of the entire global financial system. As part of this process, residential and commercial mortgage markets in the United States experienced a variety of difficulties, including loan defaults, credit losses and reduced liquidity. As a result, many lenders tightened their lending standards, reduced lending capacity, liquidated significant portfolios or exited the market altogether, and therefore, financing with attractive terms was generally unavailable. In response to these unprecedented events, the U.S. government has taken a number of actions to stabilize the financial markets and encourage lending. Significant measures include the enactment of the Emergency Economic Stabilization Act of 2008 to, among other things, establish the Troubled Asset Relief Program (“TARP”), the enactment of the Housing and Economic Recovery Act of 2008 (“HERA”), which established a new regulator for Fannie Mae and Freddie Mac and the establishment of the Term Asset-Backed Securities Loan Facility (“TALF”) and the PPIP. Some of these programs have expired and the impact of the wind-down of these programs on the financial sector and on the economic recovery is unknown. Continuing volatility in the RMBS markets may have an adverse effect on the market value and performance of the RMBS in which we invest. Moreover, we rely on financing to acquire, on a leveraged basis, the target assets in which we invest. If market conditions deteriorate, our lenders may exit the repurchase market, further tighten lending standards, or increase the amount of equity capital required to obtain financing making it more difficult and costly for us to obtain financing.

The Dodd-Frank Act, enacted in July 2010, contains numerous provisions affecting the financial and mortgage industries, many of which may have an impact on our operating environment and the target assets in which we invest. Consequently, the Dodd-Frank Act may affect our cost of doing business, may limit our investment opportunities and may affect the competitive balance within our industry and market areas.

The Federal Housing Finance Agency (“FHFA”) and the Department of the Treasury introduced the Home Affordable Refinance Program (“HARP”) in early 2009. HARP provides borrowers, who may not otherwise qualify for refinancing because of declining home values or reduced access to mortgage insurance, the ability to refinance their mortgages into a lower interest rate and/or more stable mortgage product. On October 24, 2011, the FHFA announced a series of changes to the rules regarding HARP with the intent of increasing the number of borrowers eligible to refinance their mortgage under this program. The FHFA announced changes to the guidelines related to loan-to-value, appraisals, and certain fees, among other things, subject to a variety of qualifications and the extension of the end date for HARP until December 31, 2015. It does not change the time period in which these loans were originated, maintaining the requirement that the loans must have been guaranteed by Fannie Mae or Freddie Mac on or before May 31, 2009. We do not expect the current HARP or future modifications to have a material impact on our results of operations in future periods.

“Operation Twist,” was a program conducted by the Board of Governors of the Federal Reserve System (the “Federal Reserve”) in 2011 and 2012. Pursuant to the first Operation Twist, instituted between September 2011 and June 2012, the Federal Reserve purchased \$400 billion of U.S. Treasury securities with remaining maturities between 6 and 30 years and sold an equal amount of U.S. Treasury securities with remaining maturities of 3 years or less. From July 2012 through December 2012, the Federal Reserve deployed \$267 billion to purchase Treasury securities with remaining maturities of 6 years to 30 years and sold or redeemed an equal amount of Treasury securities with remaining maturities of approximately 3 years or less.

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While it is difficult to identify the specific impact Operation Twist had on our business, the program generally reduced asset values and lowered the interest income we received.

In December 2012, the Federal Reserve announced that it would replace “Operation Twist” with another round of long-term asset purchases, or quantitative easing (“QE”), pursuant to which the Federal Reserve will continue to purchase \$40 billion of Agency MBS as well as \$45 billion of longer-term Treasury securities per month. We expect that during these large scale purchases of Agency MBS, yields on Agency MBS values will be lower and refinancing volumes will be higher. As a result, returns on our Agency MBS may be adversely affected.

Although the Federal Reserve has communicated that the QE program may be reduced, or “tapered,” depending on positive economic data, the Federal Reserve has maintained its level of purchasing under the QE program. Initial talk of the tapering of the QE program was the major catalyst behind the increase in interest rates on Treasury securities and the increase in yield premium investors demand to own Agency MBS, which reduced the value of each asset class during the second quarter of 2013. Chairman Ben Bernanke has communicated that the Federal Open Market Committee, which is the policy making body of the Federal Reserve, will focus on the unemployment rate as the key metric for determining when to commence tapering the purchase of Agency MBS. The expected timing and degree of the reduction in QE has the potential to adversely impact Treasury and Agency MBS valuations going forward by reducing overall demand for these assets and potentially increasing price volatility.

On July 31, 2013, the Federal Reserve announced that it would keep the target range for the federal funds rate at 0 to 0.25% as long as the unemployment rate remains above 6.5% or until inflation reaches 2.5%. Low levels of federal funds rates may reduce our borrowing costs. However, there can be no assurance that federal funds rates will remain near zero percent, or that such low levels will reduce our cost of funds.

In addition, U.S. lawmakers recently reached a short-term agreement on a national debt ceiling. The absence of a long-term agreement could negatively impact the trading market for U.S. government securities and could result in limited economic growth. This may negatively affect the value of our investment portfolio, which could cause our repurchase counterparties to make margin calls on our borrowings and swaps if our collateral is insufficient to cover the debt secured by our assets, which could, in turn, require us to sell our assets at reduced prices to cover such margin calls.

#### Investment Activities

As of September 30, 2013, 52.8% (2012: 51.9%) of our equity was invested in Agency RMBS, 29.1% (2012: 26.8%) in non-Agency RMBS, 26.2% (2012: 19.1%) in CMBS, 4.9% (2012: 0%) in residential loans, held-for-investment, 1.6% (2012: 2.2%) in unconsolidated joint ventures, and 0.7% (2012: 0%) in commercial loans, held-for-investment. Refer to the allocation of equity and debt/equity ratio table in the “Liquidity and Capital Resources” section for more details. We use leverage on our target assets to achieve our return objectives. With respect to our mortgage-backed securities (“MBS”) portfolio, we focus on securities we believe provide attractive returns when levered approximately 3 to 7 times. The leverage on classes of assets may periodically exceed the stated ranges as we adjust our borrowings to obtain the best available source and minimize total interest expense, while maintaining our overall portfolio leverage guidelines.

The change in allocations between our classes of assets reflects our views on the current risk/return opportunities in the market for our target assets.

As of September 30, 2013, we held \$9.0 billion (2012: \$10.4 billion) in 30-year fixed rate Agency RMBS securities that offered higher coupons and call protection based on the collateral attributes. In addition, we held \$1.8 billion (2012: \$2.3 billion) in 15-year fixed rate Agency RMBS securities, \$977.3 million (2012: \$651.3 million) in hybrid adjustable-rate mortgages Agency RMBS (“ARMs”) and approximately \$197.9 million (2012: \$126.0 million) in Agency ARM RMBS we believe to have similar durations based on prepayment speeds. As of September 30, 2013, we held \$3.7 billion (2012: \$2.6 billion) non-Agency RMBS.

As of September 30, 2013, we owned \$2.6 billion (2012: \$1.7 billion) in CMBS and \$482.6 million (2012: \$520.6 million) in collateralized mortgage obligations (“CMOs”). Additionally, we held \$1.5 billion of residential loans held-for-investment and \$17.4 million in commercial loans held for investment, both of which were \$0 for 2012.

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During the nine months ended September 30, 2013, we purchased \$7.1 billion (2012: \$7.0 billion) of MBS. The average yield on these purchases as of September 30, 2013 was 2.6% (2012: 3.2%).

During the nine months ended September 30, 2013, we purchased interests in four securitization trusts totaling \$1.5 billion which we considered VIEs. The VIEs initially held 1,926 residential mortgage loans paying interest at an aggregate weighted average fixed rate of 3.76% and having an original stated maturity of 30 years.

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## Portfolio Characteristics

The table below represents the vintage of our credit assets as of September 30, 2013:

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total
Re-REMIC Senior (1)	— %	— %	— %	— %	0.3 %	— %	0.6 %	3.0 %	26.7 %	9.2 %	— %	39.8 %
Prime	0.4 %	0.9 %	4.8 %	4.3 %	9.7 %	2.3 %	— %	— %	0.2 %	— %	14.7 %	37.3 %
Alt-A	— %	0.3 %	9.0 %	5.9 %	7.0 %	— %	— %	— %	— %	— %	— %	22.2 %
Subprime	— %	0.1 %	— %	0.1 %	0.5 %	— %	— %	— %	— %	— %	— %	0.7 %
Total Non-Agency CMBS	0.4 %	1.3 %	13.6 %	10.3 %	17.5 %	2.3 %	0.6 %	3.0 %	26.9 %	9.2 %	14.7 %	100.0 %

For Re-REMIC Seniors, the table reflects the year in which the resecuritizations were issued. The vintage (1) distribution of the securities that collateralize the Company's Re-REMIC Senior investments is 9.7% 2005, 38.8% 2006 and 51.5% 2007. Additionally, 7.7% of our Re-REMIC holdings are not senior classes.

The tables below represent the geographic concentration of the underlying collateral for our MBS portfolio as of September 30, 2013:

Non-Agency RMBS State	Percentage	CMBS State	Percentage
California	47.7	California	15.0 %
Florida	7.0	New York	12.6 %
New York	6.1	Texas	9.4 %
Virginia	3.7	Florida	6.0 %
New Jersey	3.3	Illinois	5.0 %
Maryland	3.3	Pennsylvania	3.8 %
Washington	3.1	Ohio	3.0 %
Illinois	2.4	New Jersey	2.9 %
Massachusetts	2.2	Virginia	2.8 %
Arizona	2.2	North Carolina	2.7 %
Other	19.0	Other	36.8 %
Total	100.0	Total	100.0 %

The vintage and geographic concentrations have not significantly changed since June 30, 2013.

## Financing and Other Liabilities.

We enter into repurchase agreements to finance the majority of our Agency RMBS, non-Agency RMBS and CMBS. These agreements are secured by our Agency RMBS, non-Agency RMBS and CMBS and bear interest at rates that have historically moved in close relationship to the London Interbank Offer Rate ("LIBOR"). As of September 30, 2013, we had entered into repurchase agreements totaling \$15.9 billion. (2012: \$14.9 billion). The increase in the amount of the repurchase agreement balance was due to leveraging additional equity received during the year.

We also have a commitment to invest up to \$100.0 million in the Invesco IMRF Fund and Invesco Mortgage Recovery Loans AIV, L.P. ("AIV Fund"), which, in turn, invests in our target assets. As of September 30, 2013, \$87.7 million (2012: \$82.9 million) of our commitment to the Invesco IMRF Fund and AIV Fund has been called and we are committed to fund \$12.3 million (2012: \$17.1 million) in additional capital.

The Company records the liability for mortgage-backed securities purchased for which settlement has not taken place as an investment-related payable. As of September 30, 2013 and December 31, 2012, the Company had investment related payables of \$201.2 million and \$63.7 million, respectively, of which no items were outstanding greater than thirty days. The change in balance was primarily due to an increase in unsettled mortgage-backed security purchases at the quarter ended September 30, 2013. The Company records a receivable for mortgage-backed securities sold for

which settlement has not taken place as an investment-related receivable. As of September 30, 2013 and December 31, 2012, the Company had investment related receivables of \$8.9 million and \$41.4 million, respectively, of which no items were outstanding greater than thirty days.

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Hedging Instruments. We generally hedge as much of our interest rate risk as we deem prudent in light of market conditions. No assurance can be given that our hedging activities will have the desired beneficial impact on our results of operations or financial condition. Our investment policies do not contain specific requirements as to the percentages or amount of interest rate risk that we are required to hedge.

Interest rate hedging may fail to protect or could adversely affect us because, among other things:

- available interest rate hedging may not correspond directly with the interest rate risk for which protection is sought;
- the duration of the hedge may not match the duration of the related liability;
- the party owing money in the hedging transaction may default on its obligation to pay;
- the credit quality of the party owing money on the hedge may be downgraded to such an extent that it impairs our ability to sell or assign our side of the hedging transaction; and
- the value of derivatives used for hedging may be adjusted from time to time in accordance with accounting rules to reflect changes in fair value. Downward adjustments or mark-to-market losses would reduce our shareholders' equity.

As of September 30, 2013, we have entered into interest rate swap agreements designed to mitigate the effects of increases in interest rates under a portion of our repurchase agreements. These swap agreements provide for fixed interest rates indexed off of one-month LIBOR and effectively fix the floating interest rates on \$12.8 billion (2012: \$7.8 billion) of borrowings under our repurchase agreements. As of September 30, 2013, included in this amount we had forward starting swaps with a total notional amount of \$2.7 billion, with starting dates ranging from November 15, 2013 to February 5, 2016. The increase in the amount of interest rate swaps was due to our view of interest rate risk and the expected duration of our investment portfolio and liabilities.

As of September 30, 2013, we held \$1.7 billion in interest rate swaptions with an unrealized loss of \$19.0 million. During the nine months ended September 30, 2013, we sold interest rate swaptions with a notional amount of \$3.6 billion and recognized a realized gain of \$66.2 million.

As of September 30, 2013, we held \$100.0 million (2012: \$0) in notional amount of short U.S. Treasury futures to help mitigate the potential impact of change in interest rates on the performance of our portfolio.

### Book Value per Share

Our book value per common share was \$17.64 and \$20.83 as of September 30, 2013 and December 31, 2012, respectively, on a fully diluted basis, after giving effect to our units of limited partnership interest in our operating partnership, which may be converted to common shares at our sole election. The change in our book value was primarily due to the change in valuation of our investment portfolio and our interest rate hedges that are recorded in Other Comprehensive Income (Loss) on our consolidated balance sheets. Refer to Note 4 – “Mortgage-Backed Securities” for information regarding the impact of changes in accumulated other comprehensive income on our investment portfolio. The value of our assets and liabilities change daily based on market conditions. Refer to Item 3. “Quantitative and Qualitative Disclosures About Market Risks” for interest rate risk and its impact on fair value.

### Critical Accounting Policies

Our consolidated financial statements are prepared in accordance with U.S. GAAP, which requires the use of estimates and assumptions that involve the exercise of judgment and use of assumptions as to future uncertainties. Accounting estimates and assumptions discussed in this section are those that we consider to be the most critical to an understanding of our financial statements because they involve significant judgments and uncertainties. All of these estimates reflect our best judgment about current, and for some estimates, future economic and market conditions and their effects based on information available as of the date of these financial statements. If conditions change from those expected, it is possible that the judgments and estimates described below could change, which may result in a change in valuation of our investment portfolio, future impairments of our mortgage-backed securities, change in our interest income recognition, allowance for loan losses, inclusion of the change in derivative values in our income rather than other comprehensive income and an increase in our tax liability among other effects.

Securities. We record our mortgage-backed securities as available-for-sale and report them at fair value based on prices received from third-party sources. The valuation service uses various observable inputs which may change with market conditions. It is possible that changes in these inputs could change the valuation estimate and lead to

impairment of our MBS portfolio. Further information is provided in Note 2 - "Summary of Significant Accounting Policies" and Note 4 - "Mortgage-Backed Securities."



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**Other-than-temporary Impairment.** We regularly review our available-for-sale portfolio for other-than-temporary impairment. This determination involves both qualitative and quantitative data. It is possible that estimates may be incorrect, economic conditions may change or we are forced to sell the investment before recovery of our amortized cost. Further information is provided in Note 2 - "Summary of Significant Accounting Policies" and Note 4 - "Mortgage-Backed Securities."

**Allowance for Loan Losses.** For residential and commercial loans held-for-investment, an allowance for loan losses is established based on credit losses inherent in the portfolio. These estimates require consideration of various observable inputs including, but not limited to, historical loss experience, delinquency status, borrower credit scores, geographic concentrations and loan-to-value ratios are adjusted for current economic conditions as deemed necessary by management. In addition, since we have not incurred any direct losses on our portfolio, we use national historical credit performance information from a third party vendor to assist in our analysis. Changes in our estimates can significantly impact the allowance for loan losses and provision expense. It is also possible that we will experience credit losses that are different from our current estimates or that the timing of those losses may differ from our estimates. Further information on the allowance for loan losses is provided in Note 2 - "Summary of Significant Accounting Policies".

**Interest Income Recognition.** Interest income on available-for-sale securities, which includes accretion of discounts and amortization of premiums, is recognized over the life of the investment using the effective interest method. Management estimates, at the time of purchase, the future expected cash flows and determines the effective interest rate based on these estimated cash flows and the Company's purchase price. As needed, these estimated cash flows are updated and a revised yield is computed based on the current amortized cost of the investment. In estimating these cash flows, there are a number of assumptions that are subject to uncertainties and contingencies, including the rate and timing of principal payments (prepayments, repurchases, defaults and liquidations), the pass through or coupon rate and interest rate fluctuations. In addition, management must use its judgment to estimate interest payment shortfalls due to delinquencies on the underlying mortgage loans. These uncertainties and contingencies are difficult to predict and are subject to future events that may impact management's estimates and its interest income.

**Accounting for Derivative Financial Instruments.** We use derivatives to manage interest rate risk. Accounting for derivatives as hedges requires that, at inception and over the term of the arrangement, the derivative meet the requirements for hedge accounting. The rules and interpretations related to hedge accounting are complex. Failure to apply this complex guidance correctly will result in changes in the fair value of the derivative being reported in earnings rather than other comprehensive income. Further information is provided in Note 9 - "Derivatives and Hedging Activities".

**Income Taxes.** We have elected to be taxed as a REIT. Accordingly, we generally will not be subject to U.S. federal and applicable state and local corporate income tax to the extent that the we make qualifying distributions and provided we satisfy on a continuing basis, through actual investment and operating results, the REIT requirements including certain asset, income, distribution and stock ownership tests. The REIT qualifications rules are complex and failure to apply them correctly could subject the Company to U.S. federal, state and local income taxes.

**Expected Impact of New Authoritative Guidance on Future Financial Information**  
None.

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## Results of Operations

The table below presents certain information from our Consolidated Statements of Operations for the three and nine month periods ending September 30, 2013 and 2012.

\$ in thousands, except per share data	Three Months Ended		Nine Months Ended	
	September 30, 2013	2012	September 30, 2013	2012
Interest Income				
Mortgage-backed securities	157,539	140,477	486,619	421,442
Residential loans	13,417	—	20,443	—
Commercial loans	372	—	432	—
Total interest income	171,328	140,477	507,494	421,442
Interest Expense				
Repurchase agreements	73,695	60,327	208,487	172,312
Exchangeable senior notes	5,621	—	12,403	—
Asset-backed securities issued	10,266	—	15,722	—
Total interest expense	89,582	60,327	236,612	172,312
Net interest income	81,746	80,150	270,882	249,130
Provision for loan losses	87	—	751	—
Net interest income after provision for loan losses	81,659	80,150	270,131	249,130
Other income (loss)	(74,491 )	16,638	(6,498 )	31,052
Expenses				
Management fee – related party	10,945	9,053	32,106	26,372
General and administrative	2,259	959	6,845	3,132
Total expenses	13,204	10,012	38,951	29,504
Net income (loss)	(6,036 )	86,776	224,682	250,678
Net income (loss) attributable to non-controlling interest	(63 )	1,026	2,392	3,025
Net income (loss) attributable to Invesco Mortgage Capital Inc.	(5,973 )	85,750	222,290	247,653
Dividends to preferred shareholders	2,713	2,682	8,138	2,682
Net income (loss) attributable to common shareholders	(8,686 )	83,068	214,152	244,971
Earnings per share:				
Net income (loss) attributable to common shareholders (basic)	(0.06 )	0.72	1.61	2.12
Net income (loss) attributable to common shareholders (diluted)	(0.06 )	0.72	1.56	2.12
Dividends declared per common share	0.50	0.65	1.80	1.95
Weighted average number of shares of common stock:				
Basic	135,220	115,412	133,094	115,405
Diluted	135,220	116,868	147,072	116,858

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The table below presents certain information for our portfolio for the three and nine month periods ending September 30, 2013 and 2012.

\$ in thousands	Three Months Ended		Nine Months Ended		
	September 30,		September 30,		
	2013	2012	2013	2012	
Average Balances*:					
Agency RMBS:					
15 year fixed-rate, at amortized cost	1,849,443	2,262,090	1,947,324	2,365,084	
30 year fixed-rate, at amortized cost	9,679,520	9,244,544	10,894,824	7,969,201	
ARM, at amortized cost	102,828	136,990	89,832	161,715	
Hybrid ARM, at amortized cost	578,696	796,446	518,079	1,175,280	
MBS-CMO, at amortized cost	494,089	502,646	500,781	450,419	
Non-Agency RMBS, at amortized cost	3,662,796	2,496,031	3,574,810	2,391,076	
CMBS, at amortized cost	2,533,174	1,516,371	2,362,370	1,329,005	
Residential Loans, at amortized cost	1,538,830	—	793,814	—	
Commercial Loans, at amortized cost	13,312	—	8,971	—	
Average MBS and Residential Loans portfolio	20,452,688	16,955,118	20,690,805	15,841,780	
Average Portfolio Yields (1):					
Agency RMBS:					
15 year fixed-rate	2.35	% 2.40	% 2.23	% 2.60	%
30 year fixed-rate	2.84	% 2.92	% 2.82	% 3.22	%
ARM	2.41	% 2.75	% 2.31	% 2.63	%
Hybrid ARM	2.19	% 2.61	% 2.30	% 2.67	%
MBS—CMO	2.31	% 2.22	% 1.87	% 2.21	%
Non-Agency RMBS	4.63	% 4.91	% 4.60	% 5.30	%
CMBS	4.60	% 5.24	% 4.68	% 5.41	%
Residential Loans	3.46	% n/a	3.31	% n/a	
Commercial loans	10.76	% n/a	10.97	% n/a	
Average MBS portfolio	3.35	% 3.31	% 3.27	% 3.55	%
Average Borrowings*:					
Agency RMBS	11,378,486	11,452,398	12,502,114	10,884,302	
Non-Agency RMBS	2,990,502	1,842,351	2,776,819	1,767,130	
CMBS	1,963,525	1,145,575	1,876,043	980,341	
Exchangeable senior notes	400,000	—	294,815	—	
Asset-backed securities issued	1,418,084	—	727,533	—	
Total borrowed funds	18,150,597	14,440,324	18,177,324	13,631,773	
Maximum borrowings during the period (2)	18,460,059	14,890,062	19,710,901	14,890,062	
Average Cost of Funds (3):					
Agency RMBS	0.39	% 0.41	% 0.40	% 0.37	%
Non-Agency RMBS	1.58	% 1.77	% 1.61	% 1.78	%
CMBS	1.47	% 1.59	% 1.46	% 1.57	%
Exchangeable senior notes	5.62	% n/a	5.61	% n/a	
Asset-backed securities issued	2.90	% n/a	2.88	% n/a	
Unhedged cost of funds	1.01	% 0.68	% 0.88	% 0.64	%
Hedged cost of funds	1.97	% 1.67	% 1.74	% 1.69	%
Average Equity (4):	2,426,259	2,329,921	2,636,580	2,198,633	
Average debt/equity ratio (average during period)	7.48x	6.20x	6.89x	6.20x	

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Debt/equity ratio (as of period end)	6.94x	5.75x	6.95x	5.75x
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\* Average amounts for each period are based on weighted month-end balances; all percentages are annualized. For the three and nine months ended September 30, 2013 the average balances are presented on an amortized cost basis.

(1) Average portfolio yield for the period was calculated by dividing interest income, including amortization of premiums and discounts, by our average of the amortized cost of the investments. All yields are annualized.

(2) Amount represents the maximum borrowings at month-end during each of the respective periods.

(3) Average cost of funds is calculated by dividing annualized interest expense by our average borrowings.

(4) Average equity is calculated based on a weighted balance basis.

#### Net Income (Loss) Summary

For the three months ended September 30, 2013, our net loss attributable to common shareholders was \$8.6 million (2012: \$83.1 million net income) or \$0.06 (2012: \$0.72 net income) basic loss per weighted average share available to common shareholders and \$0.06 (2012: \$0.72 basic income) diluted loss per weighted average share available to common shareholders.

For the nine months ended September 30, 2013, our net income attributable to common shareholders was \$214.2 million (2012: \$245.0 million) or \$1.61 (2012: \$2.12) basic income per weighted average share available to common shareholders and \$1.56 (2012: \$2.12) diluted income per weighted average share available to common shareholders.

#### Non-GAAP Financial Measures

Core earnings is a non-GAAP financial measure. We calculate core earnings as GAAP net income attributable to common shareholders excluding gain/loss on sale of investments and realized and unrealized gain/loss on interest rate derivative instruments. We record changes in the valuation of our investment portfolio and certain interest rate swaps in other comprehensive income. In addition, we use swaptions that do not qualify under GAAP for inclusion in other comprehensive income, and, as such, the changes in valuation are recorded in the period in which they occur. For internal portfolio analysis, our management deducts these gains and losses from GAAP net income to provide a consistent view of investment portfolio performance across reporting periods.

We believe the presentation of core earnings allows investors to evaluate and compare our performance to that of our peers because core earnings measures investment portfolio performance over multiple reporting periods by removing realized and unrealized gains and losses. As such, we believe that the disclosure of core earnings is useful and meaningful to our investors.

However, we caution that core earnings should not be considered as an alternative to net income (determined in accordance with GAAP), or an indication of our cash flow from operating activities (determined in accordance with GAAP), a measure of our liquidity, or an indication of amounts available to fund our cash needs, including our ability to make cash distributions. In addition, our methodology for calculating core earnings may differ from those employed by other companies for a similarly described measure and, therefore, may not be comparable.

The table below provides a reconciliation of GAAP Net income attributable to common shareholders to Core Earnings for this period:

#### Reconciliation of Net Income Attributable to Common Shareholders to Core Earnings

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
\$ in thousands, except per share data	2013	2012	2013	2012
Net income (loss) attributable to common shareholders	(8,686 )	83,068	214,152	244,971
Adjustments				
(Gain) loss on sale of investments, net	69,323	(12,836 )	56,919	(24,978 )
Realized gain on interest rate derivative instruments	(39,075 )	—	(66,234 )	—
Unrealized loss on interest rate derivative instruments <sup>(1)</sup>	45,962	808	21,810	2,851
Total adjustments	76,210	(12,028 )	12,495	(22,127 )
Core earnings	67,524	71,040	226,647	222,844
Basic earnings per common share	(0.06 )	0.72	1.61	2.12
Core earnings per share attributable to common shareholders	0.50	0.62	1.70	1.93



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<sup>(1)</sup> Unrealized (gain) loss on interest rate derivative instruments for the three and nine months ended September 30, 2013 include adjustments for unrealized losses of \$3.4 million attributed to short U.S. Treasury futures contracts we began purchasing during the three months ended September 30, 2013.

**Interest Income and Average Earning Asset Yield**

Our primary source of income is interest earned on our investment portfolio. During the three months ended September 30, 2013, we had average earning assets of approximately \$20.5 billion (2012: \$17.0 billion) and earned interest income of \$171.3 million (2012: \$140.5 million). The yield on our average investment portfolio was 3.35% (2012: 3.31%). Our average investment portfolio increased \$3.5 billion for the three months ended September 30, 2013 versus September 30, 2012.

We had average earning assets of \$20.7 billion (2012: \$15.8 billion) and earned interest income of \$507.5 million (2012: \$421.4 million) for the nine months ended September 30, 2013. The yield on our average investment portfolio was 3.27% (2012: 3.55%) for the respective period. Our average investment portfolio increased \$4.8 billion for the nine months ended September 30, 2013 versus September 30, 2012.

The change in our average assets and portfolio yield during the three and nine months ended September 30, 2013 compared to 2012 was primarily attributable to investing capital from our stock offerings and by changing our portfolio composition. We continue to evaluate our investment portfolio and make adjustments based on our views of the market opportunities. Refer to the average balance table in the “Results of Operations” section above for changes in average portfolio balance and asset mix.

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

The CPR of our portfolio impacts the amount of premium and discount on the purchase of securities that is recognized into income. Our Agency and non-Agency RMBS had a weighted average CPR of 13.1 and 12.6 for the three months ended September 30, 2013 and June 30, 2013, respectively. The table below shows the three month CPR for our RMBS compared to bonds with similar characteristics (“Cohorts”).

	September 30, 2013		June 30, 2013	
	Company	Cohorts	Company	Cohorts
15 year Agency RMBS	15.9	23.9	19.5	27.8
30 year Agency RMBS	10.1	14.2	9.5	15.8
Agency Hybrid ARM RMBS	18.1	NA	22.8	NA
Non-Agency RMBS	17.3	NA	15.5	NA
Weighted average	13.1	NA	12.6	NA

**Interest Expense and the Cost of Funds**

Our largest expense is the interest expense on borrowed funds. For the three months ended September 30, 2013, we had average borrowed funds of \$18.2 billion (2012: \$14.4 billion) and total interest expense of \$89.6 million (2012: \$60.3 million). The increase in average borrowed funds and interest expense was primarily the result of increasing the size of our investment portfolio, hedging costs from additional interest rate swaps, the issuance of our exchangeable senior notes and costs attributed to ABS issued.

We had average borrowed funds of \$18.2 billion (2012: \$13.6 billion) and total interest expense of \$236.6 million (2012: \$172.3 million) for the nine months ended September 30, 2013. The increase in average borrowed funds and interest expense was primarily the result of increasing the size of our investment portfolio, hedging costs from additional interest rate swaps, the issuance of our exchangeable senior notes and costs attributed to ABS.

For the three months ended September 30, 2013, our average cost of funds was 1.97% (2012: 1.67%). Since a substantial portion of our repurchase agreements are short term, changes in market rates are directly reflected in our interest expense. Interest expense includes borrowing costs under repurchase agreements, borrowing costs on our exchangeable senior notes, borrowing costs under our ABS issued, as well as any hedging costs.

Our average cost of funds was 1.74% (2012: 1.69%) for the nine months ended September 30, 2013. Since a substantial portion of our repurchase agreements are short term, changes in market rates are directly reflected in our

interest expense.



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## Net Interest Income

Our net interest income, which equals interest income less interest expense for the three months ended September 30, 2013 totaled \$81.8 million (2012: \$80.2 million). Our net interest rate margin, which equals the yield on our average assets for the period less the average cost of funds for the three months ended September 30, 2013, was 1.38% (2012: 1.64%). The increase in net interest income was primarily the result of increasing our investment portfolio. The decrease in net interest rate margin was primarily due to higher hedged cost of funds related to the increase in average borrowings and interest rate swaps and a decrease in portfolio yield.

Our net interest income totaled \$270.9 million (2012: \$249.1 million) for the nine months ended September 30, 2013. Our net interest rate margin was 1.53% (2012: 1.86%) for the nine months ended September 30, 2013. The increase in net interest income was primarily the result of increasing our investment portfolio, while the decrease in our net interest rate margin was a direct result of our change in asset mix in our portfolio composition. Refer to the average balance table in the “Results of Operations” section above for changes in average portfolio balance and asset mix.

## Provision for Loan Losses

We evaluated our residential and commercial loans, held-for-investment to determine if it is probable that all amounts due will not be collected according to the terms of the loan agreements. Based upon this analysis, we recorded a loan loss reserve of \$87,000 and \$751,000 for the three and nine months ended September 30, 2013, respectively.

## Gain (loss) on Sale of Investments

As part of our investment process, all of our MBS are continuously reviewed to determine if they continue to meet our risk and return targets. This process involves looking at changing market assumptions and the impact those assumptions will have on the individual securities. We sold securities and recognized net loss of approximately \$69.3 million for the three months ended September 30, 2013 (2012: \$12.8 million net gain).

As a result of our change in market assumptions, we sold securities and recognized net loss of \$56.9 million (2012: \$25.0 million net gain) for the nine months ended September 30, 2013.

## Equity in Earnings and Change in Fair Value of Unconsolidated Ventures

For the three months ended September 30, 2013, we recognized equity in earnings and unrealized gain on the change in fair value of our investment in the Invesco IMRF Fund of approximately \$378,000 (2012: \$1.4 million), and approximately \$250,000 (2012: \$464,000 loss), respectively. The decrease in equity in earnings and increase in unrealized income on the change in fair value was primarily the result of realizing gains on investments sold in the Invesco IMRF Fund.

For the nine months ended September 30, 2013, we recognized equity in earnings of approximately \$1.3 million (2012: \$2.1 million), and unrealized gain on the change in fair value of our investment in the Invesco IMRF Fund of \$1.7 million (2012: \$774,000). The decrease in equity in earnings and increase in unrealized income on the change in fair value was primarily the result of realizing gains on investments sold in the Invesco IMRF Fund.

In 2011, we invested in a portfolio of commercial mortgage loans by contributing \$16.9 million, net of distributions, of equity capital to IMRF Loan Portfolio Member LLC (“IMRF LLC”). For the three months ended September 30, 2013, we recognized equity in earnings and unrealized depreciation on the change in fair value of our investment in the IMRF LLC of approximately \$956,000 (2012: \$2.5 million) and \$163,000 (2012: \$191,000), respectively.

For the nine months ended September 30, 2013, we recognized equity in earnings and unrealized appreciation on the change in fair value of our investment in the IMRF LLC of approximately \$1.0 million (2012: \$3.2 million) and \$1.1 million (2012: \$116,000), respectively.

## Other Income (Loss)

We finance our activities primarily through repurchase agreements, which are generally settled on a short-term basis, usually from one to twelve months. At each settlement date, we refinance each repurchase agreement at the market interest rate at that time. Since the interest rate on repurchase agreements change on a one to twelve month basis, we are continuously exposed to changing interest rates. Our objectives in using interest rate derivatives are to add stability to interest expense and to manage our exposure to interest rate movements. To accomplish these objectives, we primarily use derivative instruments, including interest rate swaps, swaptions and U.S. Treasury futures, as part of our interest rate risk management strategy. Interest rate swaps designated as cash flow hedges involve the receipt of

variable-rate amounts from a counterparty in exchange for us making fixed-rate payments over the life of the agreements without exchange of the underlying notional amount. The interest rate swaption provides us the option to enter into an interest rate swap agreement for a predetermined notional amount, stated

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term and pay and receive interest rates in the future. The premium paid for interest rate swaptions is reported as an asset in our consolidated balance sheets. The premium is valued at an amount equal to the fair value of the swaption that would have the effect of closing the position adjusted for nonperformance risk, if any.

For the three months ended September 30, 2013, our realized and unrealized gain (loss) on interest rate derivative instruments of \$6.9 million loss (2012: \$808,000 loss) consists of approximately \$298,000 gain (2012: \$319,000 loss) which represents the ineffective portion of the change in fair value of our interest rate swaps, \$42.9 million of unrealized loss (2012: \$489,000 of unrealized loss) which represents the change in fair value of our interest rate swaptions that are recognized directly in earnings, \$39.0 million of net realized gain (2012: \$0) on sold swaptions contracts and \$3.4 million (2012: \$0) of unrealized loss on U.S. Treasury futures contracts.

For the nine months ended September 30, 2013, our realized and unrealized gain (loss) on interest rate derivative instruments of \$44.4 million gain (2012: \$2.9 million loss) consists of approximately \$591,000 gain (2012: \$832,000 loss) which represents the ineffective portion of the change in fair value of our interest rate swaps, \$19.0 million of unrealized loss (2012: \$2.1 million of unrealized loss) which represents the change in fair value of our interest rate swaptions that are recognized directly in earnings \$66.2 million of net realized gain (2012: \$0) on sold swaptions contracts and \$3.4 million (2012: \$0) of unrealized loss on U.S. Treasury futures contracts.

In 2010 we entered into a credit default swap (“CDS”) contract. For the three months ended September 30, 2013, we recognized income of \$297,000 (2012: \$1.3 million) on our investment in the CDS of which \$472,000 (2012: \$704,000) represents premium payments we receive for providing protection and \$175,000 (2012: \$643,000 unrealized gain) is an unrealized loss based on change in the fair market value of the CDS. The change in income was primarily due to the decline in the notional amount of the CDS.

For the nine months ended September 30, 2013, we recognized income of \$828,000 (2012: \$2.7 million) on our investment in a CDS of which \$743,000 (2012: \$406,000 unrealized gain) is an unrealized loss based on change in the fair market value of the CDS and \$1.6 million (2012: \$2.3 million) represents premium payments we receive for providing protection. The decline in income was due to lower notional amount of the CDS and a mark-to-market adjustment recorded in 2012 that did not repeat in 2013.

Expenses

For the three months ended September 30, 2013, we incurred management fees of \$10.9 million (2012: \$9.1 million), which are payable to our Manager under our management agreement. The increase in management fees is attributable to an increase in shareholders’ equity resulting from our follow-on common stock and preferred stock offerings in 2012 and 2013. See Note 12 – “Related Party Transactions” for a discussion of the management fee and our relationship with our Manager.

We incurred management fees of \$32.1 million (2012: \$26.4 million) for the nine months ended September 30, 2013, which are payable to our Manager under our management agreement. The increase in management fees is attributable to an increase in shareholders’ equity resulting from our follow-on common stock and preferred stock offerings in 2012 and 2013.

For the three months ended September 30, 2013, our general and administrative expense of approximately \$2.2 million (2012: \$959,000) include operating expenses not covered under our management agreement. These expenses primarily consist of directors and officers insurance, accounting services, auditing and tax services, filing fees, and miscellaneous general and administrative costs. The increase in general and administrative costs is primarily attributable to costs related to the operations of four consolidated VIEs acquired during 2013.

Our general and administrative expenses were \$6.8 million (2012: \$3.1 million) for the nine months ended September 30, 2013. The increase in general and administrative costs is primarily attributable to acquisition and operating costs of four consolidated VIEs acquired during the nine months ended September 30, 2013.

Net Income (loss) after Preferred Dividends and Return on Average Equity

For the three months ended September 30, 2013, our net loss after preferred dividends was \$8.8 million (2012: \$84.1 million net income) and our annualized return on average equity was (1.44)% (2012: 14.44%). The change in net income after preferred dividends and return on average equity was primarily the result of increasing our investment portfolio from the proceeds of our common and preferred stock offerings and our exchangeable senior notes offering,

the changes in our portfolio composition in 2013 and 2012 and the increase in realized and unrealized losses on sale of MBS and derivative instruments. The decrease in return on average equity was the result of realized and unrealized gains on interest rate swaptions offset by a lower asset yields on the portfolio as a result of the interest rate environment.

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Our net income after preferred dividends was \$216.5 million (2012: \$248.0 million) for the nine months ended September 30, 2013. Our annualized return on average equity was 10.95% (2012: 15.04%) for the nine months ended September 30, 2013. The change in net income after preferred dividends and return on average equity was primarily the result of increasing our investment portfolio from the proceeds of our common and preferred stock offerings and our exchangeable notes offering, the changes in our portfolio composition in 2013 and 2012 and the increase in realized and unrealized losses on sale of MBS and derivative instruments. The decrease in return on average equity was the result of realized and unrealized gains on interest rate swaptions offset by lower asset yields on the portfolio as a result of the interest rate environment.

**Liquidity and Capital Resources**

Liquidity is a measurement of our ability to meet potential cash requirements, including ongoing commitments to pay dividends, fund investments, repayment of borrowings and other general business needs. Our primary sources of funds for liquidity consist of the net proceeds from our common and preferred equity offerings, net cash provided by operating activities, cash from repurchase agreements and other financing arrangements and future issuances of equity and/or debt securities. We also have sought, and may continue to finance our assets under, and may otherwise participate in, programs established by the U.S. government.

We currently believe that we have sufficient liquidity and capital resources available for the acquisition of additional investments, repayments on borrowings, margin requirements and the payment of cash dividends as required for continued qualification as a REIT. We generally maintain liquidity to pay down borrowings under repurchase arrangements to reduce borrowing costs and otherwise efficiently manage our long-term investment capital. Because the level of these borrowings can be adjusted on a daily basis, the level of cash and cash equivalents carried on our consolidated balance sheets is significantly less important than our potential liquidity available under borrowing arrangements. However, there can be no assurance that we will maintain sufficient levels of liquidity to meet any margin calls.

We held cash and cash equivalents of \$199.1 million (2012: \$190.8 million) at September 30, 2013. Our cash and cash equivalents increased due to normal fluctuations in cash balances related to the timing of principal and interest payments, repayments of debt, and asset purchases and sales.

Our operating activities provided net cash of approximately \$381.3 million (2012: \$309.1 million) for the nine month period ended September 30, 2013. The cash provided by operating activities increased due to the increase in net interest income earned by our portfolio, which increase in net income resulted from the increase in average interest earning assets of \$20.8 billion in investments at September 30, 2013 as compared to \$15.8 billion at September 30, 2012.

Our investing activities used net cash of \$2.6 billion (2012: \$2.9 billion) for the nine month period ended September 30, 2013. During the nine month period ended September 30, 2013, we utilized cash to purchase \$6.9 billion (2012: \$6.4 billion) in securities and \$1.6 billion (2012: \$0) in residential loans which were offset by proceeds from asset sales of \$3.5 billion (2012: \$1.6 billion) and principal payments on securities of \$2.3 billion (2012: \$1.8 billion) and principal repayments on residential loans of \$28.5 million (2012: \$0). In addition, we originated a commercial loan of \$17.2 million. The increase in principal payments resulted from the larger portfolio for the nine months ended September 30, 2013 as compared to September 30, 2012.

Our financing activities for the nine months ended September 30, 2013 consisted of net proceeds from our common stock offering and our dividend reinvestment and share purchase plan (“DRSPP”) in which we raised approximately \$396.4 million (2012: \$103,000) in equity, net proceeds from our preferred stock offering in which we raised \$0 (2012: \$135.4 million), net proceeds from our repurchase agreements of \$205.0 million (2012: \$2.6 billion), net proceeds from the issuance of our exchangeable senior notes of \$400.0 million (2012: \$0), and net proceeds from our issuance of asset-backed securities of \$1.4 billion (2012: \$0), offset by principal repayments of asset-backed securities of \$27.8 million (2012: \$0).

The table below shows the allocation of our equity and debt-to-equity ratio as of September 30, 2013. The leverage on each class of assets may periodically exceed the stated ranges as we adjust our borrowings to obtain the best available source and minimize total interest expense while maintaining our overall portfolio leverage guidelines.



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\$ in millions	Agency	Non-Agency	CMBS	Residential Loans	Commercial Loans	Unconsolidated Ventures	Corporate Liability	Total
Repurchase agreements	10,960	2,995	1,943	—	—	—	—	15,898
Asset-backed securities	—	—	—	1,412	—	—	—	1,412
Exchangeable notes	—	—	—	—	—	—	400	400
Equity allocation	1,347	743	668	124	17	42	(390)	2,551
Debt / Equity Ratio	8.1	4.0	2.9	11.4	—	—	(1.0)	6.9
% of Total Equity	52.8	% 29.1	% 26.2	% 4.9	% 0.7	% 1.6	% (15.3)	% 100.0

As of September 30, 2013, the weighted average margin requirement, or the percentage amount by which the collateral value must exceed the loan amount, which we also refer to as the “haircut,” under our repurchase agreements for Agency RMBS was approximately 4.51% (weighted by borrowing amount), under our repurchase agreements for non-Agency RMBS was approximately 17.72% and under our repurchase agreements for CMBS was approximately 18.26%. Across our repurchase facilities for Agency RMBS, the haircuts range from a low of 3% to a high of 10%, for non-Agency RMBS range from a low of 10% to a high of 50% and for CMBS range from a low of 10% to a high of 30%. Our hedged cost of funds was approximately 1.74% and 1.70% as of September 30, 2013 and December 31, 2012, respectively. Declines in the value of our securities portfolio can trigger margin calls by our lenders under our repurchase agreements. An event of default or termination event would give some of our counterparties the option to terminate all repurchase transactions existing with us and require any amount due by us to the counterparties to be payable immediately.

As discussed above under “Market Conditions,” the residential mortgage market in the United States, though improving, remains weak and is subject to the following conditions:

- increased volatility of many financial assets, including agency securities and other high-quality RMBS assets, due to potential security liquidations; and
- continued volatility in the broader residential mortgage and RMBS markets.

If these conditions persist, then our lenders may be forced to exit the repurchase market, become insolvent or further tighten lending standards or increase the amount of required equity capital or haircut, any of which could make it more difficult or costly for us to obtain financing. In addition, because Fannie Mae and Freddie Mac are in conservatorship of the U.S. government, if the U.S.’s credit rating is further downgraded, it may impact the credit risk associated with Agency RMBS and other assets, and, therefore, decrease the value of the Agency RMBS, non-Agency RMBS and CMBS in our portfolio, which could cause our repurchase counterparties to make margin calls on our borrowings and swaps if our collateral is insufficient to cover the debt secured by our assets.

In 2011, we implemented the DRSP. We have registered and reserved for issuance 15,000,000 shares of our common stock under the DRSP. Under the terms of the DRSP, shareholders who participate in the DRSP may purchase shares of our common stock directly from us, in cash investments up to \$10,000, or greater than \$10,000 if we grant a request for waiver. At our sole discretion, we may accept optional cash investments in excess of \$10,000 per month, which may qualify for a discount from the market price of 0% to 3%. The DRSP participants may also automatically reinvest all or a portion of their dividends for additional shares of our stock. During the nine months ended September 30, 2013, we issued 1,766,995 shares of common stock at an average price of \$21.32 under the DRSP with total proceeds of approximately \$37.7 million, of which 1,752,503 shares of common stock were issued at an average offering price of \$21.35 (2012: 0 shares) under the waiver feature of the DRSP.

In 2011, we announced a share repurchase program that was approved by our Board of Directors for up to 7 million shares of our common stock. The shares may be repurchased from time to time through privately negotiated transactions or open market transactions, including pursuant to a trading plan in accordance with Rules 10b5-1 and 10b-18 under the Exchange Act or by any combination of such methods. The manner, price, number and timing of share repurchases will be subject to a variety of factors, including market conditions and applicable SEC rules. As of September 30, 2013, we have not repurchased any shares under this program.

Effects of Margin Requirements, Leverage and Credit Spreads

Our securities have values that fluctuate according to market conditions and, as discussed above, the market value of our securities will decrease as prevailing interest rates or credit spreads increase. When the value of the securities pledged to secure a repurchase loan decreases to the point where the positive difference between the collateral value and the loan amount is less than the haircut, our lenders may issue a “margin call,” which means that the lender will require us to pay the margin call in cash or pledge additional collateral to meet that margin call. Under our repurchase facilities, our lenders have full discretion to



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determine the value of the securities we pledge to them. Most of our lenders will value securities based on recent trades in the market. Lenders also issue margin calls as the published current principal balance factors change on the pool of mortgages underlying the securities pledged as collateral when scheduled and unscheduled paydowns are announced monthly.

We experience margin calls in the ordinary course of our business. In seeking to effectively manage the margin requirements established by our lenders, we maintain a position of cash and unpledged securities. We refer to this position as our “liquidity.” The level of liquidity we have available to meet margin calls is directly affected by our leverage levels, our haircuts and the price changes on our securities. If interest rates increase as a result of a yield curve shift or for another reason or if credit spreads widen, then the prices of our collateral (and our unpledged assets that constitute our liquidity) will decline, we will experience margin calls, and we will use our liquidity to meet the margin calls. There can be no assurance that we will maintain sufficient levels of liquidity to meet any margin calls. If our haircuts increase, our liquidity will proportionately decrease. In addition, if we increase our borrowings, our liquidity will decrease by the amount of additional haircut on the increased level of indebtedness.

We intend to maintain a level of liquidity in relation to our assets that enables us to meet reasonably anticipated margin calls but that also allows us to be substantially invested in securities. We may misjudge the appropriate amount of our liquidity by maintaining excessive liquidity, which would lower our investment returns, or by maintaining insufficient liquidity, which would force us to liquidate assets into unfavorable market conditions and harm our results of operations and financial condition.

**Forward-Looking Statements Regarding Liquidity**

Based upon our current portfolio, leverage rate and available borrowing arrangements, we believe that cash flow from operations and available borrowing capacity, will be sufficient to enable us to meet anticipated short-term (one year or less) liquidity requirements to fund our investment activities, pay fees under our management agreement, fund our distributions to shareholders and for other general corporate expenses.

Our ability to meet our long-term (greater than one year) liquidity and capital resource requirements will be subject to obtaining additional debt financing. We may increase our capital resources by obtaining long-term credit facilities or through public or private offerings of equity or debt securities, possibly including classes of preferred stock, common stock, and senior or subordinated notes. Such financing will depend on market conditions for capital raises and our ability to invest such offering proceeds. If we are unable to renew, replace or expand our sources of financing on substantially similar terms, it may have an adverse effect on our business and results of operations.

**Contractual Obligations**

We have entered into an agreement with our Manager pursuant to which our Manager is entitled to receive a management fee and the reimbursement of certain expenses. The management fee is calculated and payable quarterly in arrears in an amount equal to 1.50% of our shareholders’ equity, per annum. Our Manager uses the proceeds from its management fee in part to pay compensation to its officers and personnel who, notwithstanding that certain of those individuals are also our officers, receive no cash compensation directly from us. We are required to reimburse our Manager for operating expenses related to us incurred by our Manager, including certain salary expenses and other expenses relating to legal, accounting, due diligence and other services. Expense reimbursements to our Manager are made in cash on a monthly basis following the end of each month. Our reimbursement obligation is not subject to any dollar limitation. Refer to Note 12 – “Related Party Transactions” for details of our reimbursements to our Manager.

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## Contractual Commitments

As of September 30, 2013, we had the following contractual commitments and commercial obligations:

\$ in thousands	Payments Due by Period				
	Total	Less than 1 year	1-3 years	3-5 years	After 5 years
Obligations of Invesco Mortgage Capital Inc.					
Repurchase agreements	15,897,612	15,897,612	—	—	—
Invesco IMRF Fund and AIV Fund	12,297	12,297	—	—	—
Commercial loans	23,988	—	23,988	—	—
Exchangeable senior notes	400,000	—	—	400,000	—
Total contractual obligations	16,333,897	15,909,909	23,988	400,000	—
Obligations of entities consolidated for financial reporting purposes					
Consolidated ABS <sup>(1)</sup>	1,392,952	172,695	290,454	227,926	701,877
Anticipated interest payments on ABS <sup>(2)</sup>	733,628	41,552	80,740	77,388	533,948
Total obligations of entities consolidated for financial reporting purposes	2,126,580	214,247	371,194	305,314	1,235,825
Total consolidated obligations and commitments	18,460,477	16,124,156	395,182	705,314	1,235,825

All consolidated ABS issued by VIEs are collateralized by residential mortgage loans. The ABS obligations will (1) pay down as the principal balances of these residential mortgage loans pay down. The amounts shown are the estimated principal repayments, adjusted for projected prepayments and losses.

(2) The anticipated interest payments on consolidated ABS issued by VIEs are calculated based on estimated principal balances, adjusted for projected prepayments and losses.

As of September 30, 2013, we have approximately \$16.1 million in contractual interest payments related to our repurchase agreements and \$91.2 million in anticipated interest payments related to our exchangeable senior notes.

## Off-Balance Sheet Arrangements

We committed to invest up to \$100.0 million in the Invesco IMRF Fund, which, in turn, invests in our target assets. As of September 30, 2013 and 2012, approximately \$87.7 million and \$82.9 million of the commitment has been called, respectively. In March 2012, Invesco IMRF Fund returned substantially all of its proceeds and repaid all financing under the PPIP. The Company is awaiting final distribution from the Invesco IMRF Fund.

We also utilize credit derivatives, such as credit default swaps, to provide credit event protection based on a financial index or specific security in exchange for receiving a fixed-rate fee or premium over the term of the contract. These instruments enable us to synthetically assume the credit risk of a reference security, portfolio of securities or index of securities. The counterparty pays a premium to us and we agree to make a payment to compensate the counterparty for losses upon the occurrence of a specified credit event. Although contract specific, credit events generally include bankruptcy, failure to pay, restructuring, obligation acceleration, obligation default, or repudiation/moratorium. Upon the occurrence of a defined credit event, the difference between the value of the reference obligation and the CDS's notional amount is recorded as realized loss in the statement of operations.

Our only CDS contract was entered into in December 2010. We sold protection against losses on a specific pool of non-Agency RMBS in the event they exceed a specified loss limit of 25% of the balance of the non-Agency RMBS on the trade date. The maximum exposure is the remaining unpaid principal balance of the underlying RMBS in excess of the specified loss threshold. In exchange, we are paid a stated fixed rate fee of 3%. The remaining notional amount of the CDS at September 30, 2013 is \$57.5 million (2012: \$87.1 million), and we estimated the fair market value of the CDS to be approximately \$776,000 (2012: \$1.7 million) at September 30, 2013. As of September 30, 2013, we have not made any payments related to the CDS contract.



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### Shareholders' Equity

On January 28, 2013, we completed a public offering of 15,000,000 shares of our common stock and an issuance of an additional 2,250,000 shares of common stock pursuant to the underwriters' full exercise of their over-allotment option at \$21.00 per share, resulting in net proceeds of approximately \$359.0 million, after deducting underwriting discounts and offering costs.

During the nine months ended September 30, 2013, we issued 1,766,995 shares of common stock at an average price of \$21.32 under the DRSP with total proceeds of approximately \$37.7 million, of which 1,752,503 shares of common stock were issued at an average offering price of \$21.35 (2012: 0 shares) under the waiver feature of the DRSP.

### Unrealized Gains and Losses

Since we account for our investment securities as "available-for-sale," unrealized fluctuations in market values of assets do not impact our U.S. GAAP income, but rather are reflected on our consolidated balance sheets by changing the carrying value of the asset and shareholders' equity under "Accumulated Other Comprehensive Income (Loss)." In addition, unrealized fluctuations in market values of our cash flow hedges that qualify for hedge accounting are also reflected in "Accumulated Other Comprehensive Income (Loss)."

For the three months ended September 30, 2013, net unrealized gain included in shareholders' equity was \$44.5 million (2012: \$291.9 million gain).

For the nine months ended September 30, 2013, net unrealized loss included in shareholders' equity was \$406.2 million (2012: \$512.1 million gain).

The decrease in net unrealized gain is primarily attributable to changes in the market values of our RMBS portfolio and our cash flow hedges that qualify for hedge accounting. Refer to Note 4 – "Mortgage-Backed Securities" and Note 9 – "Derivative and Hedging Activities" for more details on the unrealized gains and losses in both our investment securities and our cash flow hedges.

As a result of this mark-to-market accounting treatment, our book value and book value per share are likely to fluctuate far more than if we used historical amortized cost accounting. As a result, comparisons with companies that use historical cost accounting for some or all of their balance sheet may not be meaningful.

### Share-Based Compensation

We established the 2009 Equity Incentive Plan for grants of restricted common stock and other equity based awards to our independent, non-executive directors, and to the officers and employees of the Manager and its affiliates (the "Incentive Plan"). Under the Incentive Plan, a total of 1,000,000 shares are currently reserved for issuance. Unless terminated earlier, the Incentive Plan will terminate in 2019, but will continue to govern the unexpired awards. Effective July 1, 2011, our three independent, non-executive directors are each eligible to receive \$50,000 in restricted common stock annually. For the three months ended September 30, 2013, we recognized compensation expense of approximately \$45,000 (2012: \$53,000) and issued 2,361 shares (2012: 2,568 shares) of restricted stock to our independent, non-executive directors pursuant to the Incentive Plan. For the nine months ended September 30, 2013, we recognized compensation expense of approximately \$120,000 (2012: \$128,000) and issued 5,970 shares (2012: 6,831 shares) of restricted stock to our independent, non-executive directors pursuant to the Incentive Plan. The number of shares issued was determined based on the closing price of our common stock on the New York Stock Exchange on the actual date of grant.

During March 2013, we issued 16,835 restricted stock units to non-executive employees of the Manager. The restricted stock units vest equally in four installments on the anniversary date of each award. Compensation related to stock awards to employees of the Manager is recorded at the estimated fair value of the award during the vesting period. We make an upward or downward adjustment to compensation expense for the difference in fair value at the date of grant and date the award was earned.

During the nine month period ending September 30, 2013, we issued 5,697 shares of common stock (net of tax withholding) in exchange for 8,783 restricted stock units that vested under the Incentive Plan and 509 restricted stock units were forfeited.

### Dividends

We intend to continue to make regular quarterly distributions to holders of our common stock and preferred stock. U.S. federal income tax law generally requires that a REIT distribute annually at least 90% of its REIT taxable income, determined without regard to the deduction for dividends paid and excluding net capital gains, and that it pay tax at regular

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corporate rates to the extent that it annually distributes less than 100% of its taxable income. We intend to pay regular quarterly dividends to our shareholders in an amount equal at least 90% of our net taxable income. Before we pay any dividend, whether for U.S. federal income tax purposes or otherwise, we must first meet both our operating requirements and debt service on our repurchase agreements and other debt payable. If our cash available for distribution is less than our net taxable income, we could be required to sell assets or borrow funds to make cash distributions, or we may make a portion of the required distribution in the form of a taxable stock distribution or distribution of debt securities.

**Inflation**

Virtually all of our assets and liabilities are interest rate sensitive in nature. As a result, interest rates and other factors influence our performance far more than inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates.

**Unrelated Business Taxable Income**

We have not engaged in transactions that would result in a portion of our income being treated as unrelated business taxable income.

**Other Matters**

We believe that we satisfied each of the asset tests in Section 856(c)(4) of the Internal Revenue Code of 1986, as amended (the "Code") for the period ended September 30, 2013. We also believe that our revenue qualifies for the 75% source of income test and for the 95% source of income test rules for the period ended September 30, 2013.

Consequently, we believe we met the REIT income and asset test as of September 30, 2013. We also met all REIT requirements regarding the ownership of our common stock and the distribution of dividends of our net income as of September 30, 2013. Therefore, as of September 30, 2013, we believe that we qualified as a REIT under the Code. At all times, we intend to conduct our business so that neither we nor our Operating Partnership nor the subsidiaries of our Operating Partnership are required to register as an investment company under the 1940 Act. If we were required to register as an investment company, then our use of leverage would be substantially reduced. Because we are a holding company that conducts our business through our Operating Partnership and the Operating Partnership's wholly-owned or majority-owned subsidiaries, the securities issued by these subsidiaries that are excepted from the definition of "investment company" under Section 3(c)(1) or Section 3(c)(7) of the 1940 Act, together with any other investment securities the Operating Partnership may own, may not have a combined value in excess of 40% of the value of the Operating Partnership's total assets (exclusive of U.S. government securities and cash items) on an unconsolidated basis, which we refer to as the 40% test. This requirement limits the types of businesses in which we are permitted to engage in through our subsidiaries. In addition, we believe neither we nor the Operating Partnership are considered an investment company under Section 3(a)(1)(A) of the 1940 Act because they do not engage primarily or hold themselves out as being engaged primarily in the business of investing, reinvesting or trading in securities. Rather, through the Operating Partnership's wholly-owned or majority-owned subsidiaries, we and the Operating Partnership are primarily engaged in the non-investment company businesses of these subsidiaries. IAS Asset I LLC and certain of the Operating Partnership's other subsidiaries that we may form in the future rely upon the exclusion from the definition of "investment company" under the 1940 Act provided by Section 3(c)(5)(C) of the 1940 Act, which is available for entities "primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." This exclusion generally requires that at least 55% of each subsidiary's portfolio be comprised of qualifying assets and at least 80% be comprised of qualifying assets and real estate-related assets (and no more than 20% comprised of miscellaneous assets). Qualifying assets for this purpose generally include mortgage loans fully secured by real estate and other assets, such as whole pool Agency and non-Agency RMBS, that the SEC or its staff in various no-action letters has determined are the functional equivalent of mortgage loans fully secured by real estate. We treat as real estate-related assets CMBS, debt and equity securities of companies primarily engaged in real estate businesses, Agency partial pool certificates and securities issued by pass-through entities of which substantially all of the assets consist of qualifying assets and/or real estate-related assets. Additionally, unless certain mortgage securities represent all the certificates issued with respect to an underlying pool of mortgages, the MBS may be treated as securities separate from the underlying mortgage loans and, thus, may not be considered qualifying

interests for purposes of the 55% requirement. We calculate that as of September 30, 2013, we conducted our business so as not to be regulated as an investment company under the 1940 Act.

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**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

The primary components of our market risk are related to interest rate, principal prepayment and market value. While we do not seek to avoid risk completely, we believe the risk can be quantified from historical experience and we seek to actively manage that risk, to earn sufficient compensation to justify taking those risks and to maintain capital levels consistent with the risks we undertake.

**Interest Rate Risk**

Interest rate risk is highly sensitive to many factors, including governmental, monetary and tax policies, domestic and international economic and political considerations, and other factors beyond our control. We are subject to interest rate risk in connection with our investments and our repurchase agreements. Our repurchase agreements are typically of limited duration and will be periodically refinanced at current market rates. We mitigate this risk through utilization of derivative contracts, primarily interest rate swap agreements, interest rate caps and interest rate floors.

**Interest Rate Effect on Net Interest Income**

Our operating results depend in large part upon differences between the yields earned on our investments and our cost of borrowing and interest rate hedging activities. Most of our repurchase agreements provide financing based on a floating rate of interest calculated on a fixed spread over LIBOR. The fixed spread will vary depending on the type of underlying asset which collateralizes the financing. Accordingly, the portion of our portfolio which consists of floating interest rate assets are match-funded utilizing our expected sources of short-term financing, while our fixed interest rate assets are not match-funded. During periods of rising interest rates, the borrowing costs associated with our investments tend to increase while the income earned on our fixed interest rate investments may remain substantially unchanged. This increase in borrowing costs results in the narrowing of the net interest spread between the related assets and borrowings and may even result in losses. Further, during this portion of the interest rate and credit cycles, defaults could increase and result in credit losses to us, which could adversely affect our liquidity and operating results. Such delinquencies or defaults could also have an adverse effect on the spread between interest-earning assets and interest-bearing liabilities.

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

**Interest Rate Effects on Fair Value**

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

We primarily assess our interest rate risk by estimating the duration of our assets and the duration of our liabilities. Duration measures the market price volatility of financial instruments as interest rates change. We generally calculate duration using various financial models and empirical data. Different models and methodologies can produce different duration numbers for the same securities.

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

**Prepayment Risk**

As we receive prepayments of principal on our investments, premiums paid on these investments are amortized against interest income. In general, an increase in prepayment rates will accelerate the amortization of purchase premiums, thereby reducing the interest income earned on the investments. Conversely, discounts on such investments are accreted into interest income. In general, an increase in prepayment rates will accelerate the accretion of purchase discounts, thereby increasing the interest income earned on the investments.





Table of Contents**Extension Risk**

We compute the projected weighted-average life of our investments based upon assumptions regarding the rate at which the borrowers will prepay the underlying mortgages. In general, when a fixed-rate or hybrid adjustable-rate security is acquired with borrowings, we may, but are not required to, enter into an interest rate swap agreement or other hedging instrument that effectively fixes our borrowing costs for a period close to the anticipated average life of the fixed-rate portion of the related assets. This strategy is designed to protect us from rising interest rates, because the borrowing costs are fixed for the duration of the fixed-rate portion of the related target asset.

However, if prepayment rates decrease in a rising interest rate environment, then the life of the fixed-rate portion of the related assets could extend beyond the term of the swap agreement or other hedging instrument. This could have a negative impact on our results from operations, as borrowing costs would no longer be fixed after the end of the hedging instrument, while the income earned on the hybrid adjustable-rate assets would remain fixed. This situation may also cause the market value of our hybrid adjustable-rate assets to decline, with little or no offsetting gain from the related hedging transactions. In extreme situations, we may be forced to sell assets to maintain adequate liquidity, which could cause us to incur losses.

**Market Risk****Market Value Risk**

Our available-for-sale securities are reflected at their estimated fair value with unrealized gains and losses excluded from earnings and reported in other comprehensive income pursuant to ASC Topic 320. The estimated fair value of these securities fluctuates primarily due to changes in interest rates and other factors. Generally, in a rising interest rate environment, the estimated fair value of these securities would be expected to decrease; conversely, in a decreasing interest rate environment, the estimated fair value of these securities would be expected to increase.

The sensitivity analysis table presented below shows the estimated impact of an instantaneous parallel shift in the yield curve, up and down 50 and 100 basis points, on the market value of our interest rate-sensitive investments and net interest income, at September 30, 2013, assuming a static portfolio. When evaluating the impact of changes in interest rates, prepayment assumptions and principal reinvestment rates are adjusted based on our Manager's expectations. The analysis presented utilized assumptions, models and estimates of our Manager based on our Manager's judgment and experience.

Change in Interest Rates	Percentage Change in Projected Net Interest Income	Percentage Change in Projected Portfolio Value
+1.00%	12.93	% (1.26 )%
+0.50%	18.66	% (0.69 )%
-0.50%	(25.34	)% 0.42 %
-1.00%	(58.95	)% 0.60 %

**Real Estate Risk**

Residential and commercial property values are subject to volatility and may be affected adversely by a number of factors, including, but not limited to: national, regional and local economic conditions (which may be adversely affected by industry slowdowns and other factors); local real estate conditions (such as the supply of housing stock); changes or continued weakness in specific industry segments; construction quality, age and design; demographic factors; and retroactive changes to building or similar codes. In addition, decreases in property values reduce the value of the collateral and the potential proceeds available to a borrower to repay our loans, which could also cause us to suffer losses.

**Credit Risk**

We believe that our investment strategy will generally keep our credit losses and financing costs low. However, we retain the risk of potential credit losses on all of the residential and commercial mortgage loans, as well as the loans underlying the non-Agency RMBS and CMBS in our portfolio. We seek to manage this risk through our pre-acquisition due diligence process. In addition, with respect to any particular asset, our Manager's investment team evaluates, among other things, relative valuation, supply and demand trends, shape of yield curves, prepayment rates,

delinquency and default rates, recovery of various sectors and vintage of collateral.

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Risk Management

To the extent consistent with maintaining our REIT qualification, we seek to manage risk exposure to protect our investment portfolio against the effects of major interest rate changes. We generally seek to manage this risk by:

- monitoring and adjusting, if necessary, the reset index and interest rate related to our target assets and our financings;
- attempting to structure our financing agreements to have a range of different maturities, terms, amortizations and interest rate adjustment periods;
- using hedging instruments, primarily interest rate swap agreements but also financial futures, options, interest rate cap agreements, floors and forward sales to adjust the interest rate sensitivity of our target assets and our borrowings; and
- actively managing, on an aggregate basis, the interest rate indices, interest rate adjustment periods, and gross reset margins of our target assets and the interest rate indices and adjustment periods of our financings.

ITEM 4. CONTROLS AND PROCEDURES.

Our management is responsible for establishing and maintaining disclosure controls and procedures that are designed to ensure that information we are required to disclose in the reports that we file or submit under the Securities Exchange Act of 1934, as amended (the "Exchange Act") is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include controls and procedures designed to ensure that the required information is accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required disclosure.

We have evaluated, with the participation of our principal executive officer and principal financial officer, the effectiveness of our disclosure controls and procedures as of September 30, 2013. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives. Based upon our evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the applicable rules and forms, and that it is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

No change occurred in our internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) of the Exchange Act) during the quarter ended September 30, 2013 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II – OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

From time to time, we may be involved in various claims and legal actions arising in the ordinary course of business. As of September 30, 2013, we were not involved in any such legal proceedings.

ITEM 1A. RISK FACTORS.

There were no material changes during the period covered by this Report to the risk factors previously disclosed in our annual report on Form 10-K for the year ended December 31, 2012, as filed with the SEC on March 1, 2013, and our quarterly report on Form 10-Q for the period ended March 31, 2013, as filed with the SEC on May 8, 2013. Additional risks not presently known, or that we currently deem immaterial, also may have a material adverse effect on our business, financial condition and results of operation.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

None.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION.

None.

ITEM 6. EXHIBITS.

A list of exhibits to this Form 10-Q is set forth on the Exhibit Index and 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.

INVESCO MORTGAGE CAPITAL INC.

October 31, 2013

By: /s/ Richard J. King  
Richard J. King  
President and Chief Executive Officer

October 31, 2013

By: /s/ Donald R. Ramon  
Donald R. Ramon  
Chief Financial Officer

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EXHIBIT INDEX

Item 6. Exhibits

Exhibit No.	Description
3.1	Articles of Amendment and Restatement of Invesco Mortgage Capital Inc., incorporated by reference to Exhibit 3.1 to our Quarterly Report on Form 10-Q, filed with the Securities and Exchange Commission on August 12, 2009.
3.2	Amended and Restated Bylaws of Invesco Mortgage Capital Inc., incorporated by reference to Exhibit 3.2 to Amendment No. 8 to our Registration Statement on Form S-11 (No. 333-151665), filed with the Securities and Exchange Commission on June 18, 2009.
31.1	Certification of Richard J. King pursuant to Rule 13a-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Donald R. Ramon pursuant to Rule 13a-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Richard J. King pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Donald R. Ramon pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
	The following series of unaudited XBRL-formatted documents are collectively included herewith as Exhibit 101. The financial information is extracted from Invesco Mortgage Capital Inc.'s unaudited consolidated interim financial statements and notes that are included in this Form 10-Q Report.
	101.INS XBRL Instance Document
	101.SCH XBRL Taxonomy Extension Schema Document
101	101.CAL XBRL Taxonomy Calculation Linkbase Document
	101.LAB XBRL Taxonomy Label Linkbase Document
	101.PRE XBRL Taxonomy Presentation Linkbase Document
	101.DEF XBRL Taxonomy Definition Linkbase Document