MFA FINANCIAL, INC.
Form 10-Q
November 04, 2009

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

FORM 10-Q

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

For the quarterly period ended September 30, 2009

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: 1-13991

MFA FINANCIAL, INC.
(Exact name of registrant as specified in its charter)

Maryland (State or other jurisdiction of incorporation or organization)	13-3974868 (I.R.S. Employer Identification No.)
350 Park Avenue, 21st Floor, New York, New York (Address of principal executive offices)	10022 (Zip Code)

(212) 207-6400
(Registrant’s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T 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.

Large accelerated filer [ü]	Accelerated filer [ ]
Non-accelerated filer [ ]	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 ü

280,371,277 shares of the registrant’s common stock, $0.01 par value, were outstanding as of November 2, 2009.

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MFA FINANCIAL, INC.

CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Per Share Amounts)	September 30, 2009 (Unaudited)	December 31, 2008
Assets:		
Mortgage-backed securities ("MBS") at fair value (including pledged MBS of $8,347,435 and $10,026,638, respectively) (Notes 2(b), 3, 4, 7, 8 and 13)	$9,349,052	$10,122,583
Cash and cash equivalents (Notes 2(c), 7 and 8)	486,695	361,167
Restricted cash (Notes 2(d), 4 and 8)	44,009	70,749
Forward contracts to repurchase MBS ("MBS Forwards"), at fair value (Notes 2(l), 4, and 13)	53,459	-
Interest receivable (Note 5)	44,646	49,724
Real estate, net (Notes 2(f) and 6)	11,074	11,337
Securities held as collateral, at fair value (Notes 7, 8 and 13)	-	17,124
Goodwill (Note 2(e))	7,189	7,189
Prepaid and other assets	2,878	1,546
Total Assets	$9,999,002	$10,641,419
Liabilities:		
Repurchase agreements (Notes 2(g), 7 and 8)	$7,575,287	$9,038,836
Accrued interest payable	12,722	23,867
Mortgage payable on real estate (Note 6)	9,184	9,309
Interest rate swap agreements ("Swaps"), at fair value (Notes 2(l), 4, 8 and 13)	178,353	237,291
Obligations to return cash and security collateral, at fair value (Notes 8 and 13)	-	22,624
Dividends and dividend equivalents rights ("DERs") payable (Notes 10(b) and 12(a))	205	46,385
Accrued expenses and other liabilities	7,978	6,030
Total Liabilities	$7,783,729	$9,384,342
Commitments and contingencies (Note 9)		
Stockholders' Equity:		
Preferred stock, $.01 par value; series A 8.50% cumulative redeemable; 5,000 shares authorized; 3,840 shares issued and outstanding ($96,000 aggregate liquidation preference) (Note 10)	$38	$38
Common stock, $.01 par value; 370,000 shares authorized; 280,000 and 219,516 issued and outstanding, respectively (Note 10)	2,800	2,195
Additional paid-in capital, in excess of par	2,179,942	1,775,933
Accumulated deficit	(132,400)	(210,815)
Accumulated other comprehensive income/(loss) (Note 10(h))	164,893	(310,274)
Total Stockholders' Equity	$2,215,273	$1,257,077
Total Liabilities and Stockholders' Equity	$9,999,002	$10,641,419

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

MFA FINANCIAL, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS

(In Thousands, Except Per Share Amounts)	Three Months Ended September 30, 2009	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
	(Unaudited)			
Interest Income:				
MBS (Note 3)	$124,399	$139,419	$383,029	$383,026
Cash and cash equivalent investments	149	1,529	1,020	6,711
Interest Income	124,548	140,948	384,049	389,737
Interest Expense (Notes 4 and 7)	52,976	85,033	183,119	255,166
Net Interest Income	71,572	55,915	200,930	134,571
Other-Than-Temporary Impairments: (Note 3)				
Total other-than-temporary impairment losses	-	(183)	(78,135)	(5,051)
Portion of loss recognized in other comprehensive income	-	-	69,126	-
Net Impairment Losses Recognized in Earnings	-	(183)	(9,009)	(5,051)
Other Income/(Loss):				
Gain on MBS Forwards, net (Note 4)	754	-	754	-
Net gain/(loss) on sale of MBS (Note 3)	-	-	13,495	(24,530)
Revenue from operations of real estate (Note 6)	378	407	1,145	1,219
Loss on early termination of Swaps, net (Note 4)	-	(986)	-	(92,467)
Miscellaneous other income, net	-	68	43	247
Other Income/(Loss)	1,132	(511)	15,437	(115,531)
Operating and Other Expense:				
Compensation and benefits (Note 12)	3,710	3,264	10,824	8,595
Real estate operating expense and mortgage interest (Note 6)	444	439	1,359	1,312
New business initiative	-	-	-	998
Other general and administrative expense	1,713	1,465	5,559	3,936
Operating and Other Expense	5,867	5,168	17,742	14,841
Net Income/(Loss) Before Preferred Stock Dividends	66,837	50,053	189,616	(852)
Less: Preferred Stock Dividends (Note 10(a))	2,040	2,040	6,120	6,120
Net Income/(Loss) to Common Stockholders	$64,797	$48,013	$183,496	$(6,972)
Income/(Loss) Per Share of Common Stock:	$0.25	$0.24	$0.78	$(0.04)

Basic and Diluted (Note 11)				
Dividends Declared Per Share of Common Stock (Note 10(b))	$0.25	$0.20	$0.47	$0.38

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

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MFA FINANCIAL, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

(In Thousands, Except Per Share Amounts)	For the Nine Months Ended September 30, 2009 (Unaudited)
Preferred Stock, Series A 8.50% Cumulative Redeemable – Liquidation Preference $25.00 per Share:	
Balance at December 31, 2008 and September 30, 2009 (3,840 shares)	$38
Common Stock, Par Value $0.01:	
Balance at December 31, 2008 (219,516 shares)	2,195
Issuance of common stock (60,484 shares)	605
Balance at September 30, 2009 (280,000 shares)	2,800
Additional Paid-in Capital, in excess of Par:	
Balance at December 31, 2008	1,775,933
Issuance of common stock, net of expenses	402,577
Shares issued for common stock option exercises, net of shares withheld	116
Equity-based compensation expense	1,316
Balance at September 30, 2009	2,179,942
Accumulated Deficit:	
Balance at December 31, 2008	(210,815)
Net income	189,616
Dividends declared on common stock	(104,688)
Dividends declared on preferred stock	(6,120)
Dividends attributable to DERs	(393)
Balance at September 30, 2009	(132,400)
Accumulated Other Comprehensive (Loss)/Income:	
Balance at December 31, 2008	(310,274)
Unrealized gains on MBS, net	416,229
Unrealized gains on Swaps	58,938
Balance at September 30, 2009	164,893
Total Stockholders' Equity at September 30, 2009	$2,215,273

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

MFA FINANCIAL, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands)	Nine Months Ended September 30, 2009 (Unaudited)	2008
Cash Flows From Operating Activities:		
Net income/(loss)	$189,616	$(852)
Adjustments to reconcile net income/(loss) to net cash provided by operating activities:		
Losses on sale of MBS	-	25,101
Gains on sales of MBS	(13,495)	(571)
Losses on early termination of Swaps	-	92,467
Other-than-temporary impairment charges	9,009	5,051
Amortization of purchase premium on MBS, net of accretion of discounts	8,468	15,335
Decrease/(increase) in interest receivable	5,078	(7,708)
Depreciation and amortization on real estate	353	355
Increase in prepaid and other assets and other	(1,021)	(206)
Increase in accrued expenses and other liabilities	1,948	1,988
(Decrease)/increase in accrued interest payable	(11,145)	252
Equity-based compensation expense	1,316	944
Negative amortization and principal accretion on MBS	(12)	(493)
Net cash provided by operating activities	$190,115	$131,663
Cash Flows From Investing Activities:		
Principal payments on MBS and other investments securities	$1,413,711	$1,119,414
Proceeds from sale of MBS	438,507	1,851,019
Purchases of MBS	(666,428)	(5,188,932)
Net additions to leasehold improvements, furniture, fixtures and real estate investment	(549)	(113)
Net cash provided/(used) by investing activities	$1,185,241	$(2,218,612)
Cash Flows From Financing Activities:		
Principal payments on repurchase agreements	$(50,186,109)	$(44,159,270)
Proceeds from borrowings under repurchase agreements	48,722,560	46,012,730
Principal payments on MBS Forwards	(219,916)	-
Proceeds from MBS Forwards	166,547	-
Payments made on termination of Swaps	-	(91,868)
Payments made for margin calls on repurchase agreements and Swaps	(114,570)	(173,610)
Cash received for reverse margin calls on repurchase agreements and Swaps	135,868	178,127
Proceeds from issuances of common stock	403,298	616,376
Dividends paid on preferred stock	(6,120)	(6,120)
Dividends paid on common stock and DERs	(151,261)	(85,181)
Principal payments on mortgage loan	(125)	(115)
Net cash (used)/provided by financing activities	$(1,249,828)	$2,291,069
Net Increase in cash and cash equivalents	$125,528	$204,120
Cash and cash equivalents at beginning of period	$361,167	$234,410
Cash and cash equivalents at end of period	$486,695	$438,530

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

MFA FINANCIAL, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME/(LOSS)

(In Thousands)	Three Months Ended September 30, 2009	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
	(Unaudited)			
Net income/(loss) before preferred stock dividends	$66,837	$50,053	$189,616	$(852)
Other Comprehensive Income/(Loss):				
Unrealized gain/(loss) on MBS arising during the period, net	173,536	(152,191)	410,397	(208,886)
Reclassification adjustment for MBS sales	-	-	(3,033)	(8,241)
Reclassification adjustment for net losses included in net income for other-than-temporary impairments	-	96	8,865	1,500
Unrealized (loss)/gain on Swaps arising during the period, net	(4,943)	(10,448)	58,938	321
Reclassification adjustment for net losses included in earnings from Swaps	-	773	-	48,972
Comprehensive income/(loss) before preferred stock dividends	$235,430	$(111,717)	$664,783	$(167,186)
Dividends declared on preferred stock	(2,040)	(2,040)	(6,120)	(6,120)
Comprehensive Income/(Loss) to Common Stockholders	$233,390	$(113,757)	$658,663	$(173,306)

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

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MFA FINANCIAL, INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. Organization

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

2. Summary of Significant Accounting Policies

(a) Basis of Presentation and Consolidation
The interim unaudited financial statements of the Company have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and note disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles ("GAAP") have been condensed or omitted according to such SEC rules and regulations. Management believes, however, that the disclosures included in these interim financial statements are adequate to make the information presented not misleading. The accompanying financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2008. In the opinion of management, all normal and recurring adjustments necessary to present fairly the financial condition of the Company at September 30, 2009 and results of operations for all periods presented have been made. The results of operations for the nine-month period ended September 30, 2009 should not be construed as indicative of the results to be expected for the full year.

The consolidated financial statements of the Company have been prepared on the accrual basis of accounting in accordance with GAAP. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The consolidated financial statements of the Company include the accounts of all subsidiaries; significant intercompany accounts and transactions have been eliminated.

Hierarchy of GAAP
In June 2009, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("FAS") No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles - a replacement of FASB Statement No. 162 ("FAS 168"). FAS 168 identified the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of non-governmental entities that are presented in conformity with GAAP in the United States. FAS 168 established the FASB Accounting Standards Codification (the "Codification") as the source of authoritative accounting principles recognized by the FASB. All non-grandfathered, non-SEC accounting literature not included in the Codification, except as noted in FAS 168, is superseded and deemed non-authoritative for interim and annual periods ending after September 15, 2009. FAS 168 revised the framework for selecting the accounting principles to be used in the preparation of financial statements that are presented in conformity with GAAP. The Company's adoption of the Codification at September 30, 2009, resulted in the Company eliminating references to prior sources of GAAP which are integrated into the Codification.

(b) MBS
Designation

The Company generally intends to hold its MBS until maturity; however, from time to time, it may sell any of its securities as part of the overall management of its business. As a result, all of the Company's MBS are designated as "available-for-sale" and, accordingly are carried at their fair value with unrealized gains and losses excluded from earnings (except when an other-than-temporary impairment is recognized, as discussed below) and reported in other comprehensive income/(loss), a component of Stockholders' Equity. (See Note 2(j))

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

MFA FINANCIAL, INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

Revenue Recognition, Premium Amortization and Discount Accretion

Interest income on securities is accrued based on the outstanding principal balance and their contractual terms. Premiums and discounts associated with MBS that are issued or guaranteed as to principal and/or interest by a federally chartered corporation, such as Fannie Mae or Freddie Mac, or an agency of the U.S. Government, such as Ginnie Mae (collectively, "Agency MBS") and non-Agency MBS rated AA and higher at the time of purchase, are amortized into interest income over the life of such securities using the effective yield method. Amortization and adjustments to premium amortization are made for actual prepayment activity.

Interest income on the non-Agency MBS that were purchased at a discount to par value and/or were rated below AA at the time of purchase is recognized based on the security's effective interest rate. The effective interest rate on these securities is based on the projected cash flows from each security, which are estimated based on the Company's observation of current information and events and include assumptions related to interest rates, prepayment rates and the timing and amount of credit losses. On at least a quarterly basis, the Company reviews and, if appropriate, makes adjustments to its cash flow projections based on input and analysis received from external sources, internal models, and its judgment about interest rates, prepayment rates, the timing and amount of credit losses, and other factors. Changes in cash flows from those originally projected, or from those estimated at the last evaluation, may result in a prospective change in the yield/interest income recognized on such securities. (See Notes 2(n) and 3)

Based on the projected cash flows from the Company's non-Agency MBS purchased at a discount to par value, a portion of the purchase discount may be designated as credit protection against future credit losses and, therefore, may not be accreted into interest income. The amount designated as credit discount may be adjusted over time, based on the actual performance of the security, its underlying collateral, actual and projected cash flow from such collateral, economic conditions and other factors. If the performance of a security with a credit discount is more favorable than forecasted, a portion of the amount designated as credit discount may be accreted into interest income over time. Conversely, if the performance of a security with a credit discount is less favorable than forecasted, additional amounts of the purchase discount may be designated as credit discount, or impairment charges and write-downs of such securities to a new cost basis could result.

Determination of MBS Fair Value
The Company determines the fair value of its Agency MBS based upon prices obtained from a third-party pricing service, which are indicative of market activity. In determining the fair value of its non-Agency MBS, management judgment is used to arrive at fair value that considers prices obtained from a third-party pricing service, broker quotes received and other applicable market based data. If listed prices or quotes are not available, then fair value is based upon internally developed models that are primarily based on observable market-based inputs. (See Note 13)

Impairments
When the fair value of an investment security is less than its amortized cost at the balance sheet date, the security is considered impaired. The Company assesses its impaired securities on at least a quarterly basis, and designates such impairments as either "temporary" or "other-than-temporary." If the Company intends to sell an impaired security, or it is more likely than not that it will be required to sell the impaired security before its anticipated recovery, then it must recognize an other-than-temporary impairment through earnings equal to the entire difference between the investment's amortized cost and its fair value at the balance sheet date. If the Company does not expect to sell an other-than-temporarily impaired security, only the portion of the other-than-temporary impairment related to credit losses is recognized through earnings with the remainder recognized as a component of other comprehensive income/(loss) on the consolidated balance sheet. The amount of credit impairment is determined by comparing the amortized cost of an impaired security to the present value of cash flows expected to be collected, discounted at the

security's yield prior to recognizing the impairment. (See Note 2(n))

Impairments recognized through other comprehensive income/(loss) do not impact earnings. Following the recognition of an other-than-temporary impairment through earnings, a new cost basis is established for the security and may not be adjusted for subsequent recoveries in fair value through earnings. However, other-than-temporary impairments recognized through earnings may be accreted back to the amortized cost basis of the security on a prospective basis through interest income. The determination as to whether an other-than-temporary impairment exists and, if so, the amount considered other-than-temporarily impaired is subjective, as such determinations are based on both factual and subjective information available at the time of assessment. As a result, the timing and amount of other-than-temporary impairments constitute material estimates that are susceptible to significant change. (See Note 3)

MFA FINANCIAL, INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

Balance Sheet Presentation
The Company's MBS pledged as collateral against repurchase agreements and Swaps are included in MBS on the consolidated balance sheets with the fair value of the MBS pledged disclosed parenthetically. Purchases and sales of securities are recorded on the trade date or when all significant uncertainties regarding the securities are removed. However, if a repurchase agreement is determined to be linked to the purchase of an MBS, then the MBS and linked repurchase borrowing will be reported net, as an MBS Forward. (See Note 2(l))

(c) Cash and Cash Equivalents
Cash and cash equivalents include cash on deposit with financial institutions and investments in high quality money market funds, all of which have original maturities of three months or less. Cash and cash equivalents may also include cash pledged as collateral to the Company by its repurchase agreement and/or Swap counterparties as a result of reverse margin calls (i.e., margin calls made by the Company). (See Note 8) The Company did not hold any cash pledged by its counterparties at September 30, 2009 and held $5.5 million of cash pledged by its counterparties at December 31, 2008. At September 30, 2009, all of the Company's cash investments were in high quality overnight money market funds.

(d) Restricted Cash
Restricted cash represents the Company's cash held by counterparties as collateral against the Company's Swaps and/or repurchase agreements. Restricted cash, which earns interest, is not available to the Company for general corporate purposes, but may be applied against amounts due to counterparties to the Company's repurchase agreements and/or Swaps, or returned to the Company when the collateral requirements are exceeded or at the maturity of the Swap or repurchase agreement. The Company had restricted cash held as collateral against its Swaps of $44.0 million and $70.7 million at September 30, 2009 and December 31, 2008, respectively. (See Notes 4 and 8)

(e) Goodwill
At September 30, 2009 and December 31, 2008, the Company had goodwill of $7.2 million, which represents the unamortized portion of the excess of the fair value of its common stock issued over the fair value of net assets acquired in connection with its formation in 1998. Goodwill is tested for impairment at least annually, or more frequently under certain circumstances, at the entity level. Through September 30, 2009, the Company had not recognized any impairment against its goodwill.

(f) Real Estate
At September 30, 2009, the Company indirectly held 100% of the ownership interest in Lealand Place, a 191-unit apartment property located in Lawrenceville, Georgia ("Lealand"), which is consolidated with the Company. This property was acquired through a tax-deferred exchange under Section 1031 of the Internal Revenue Code of 1986, as amended (the "Code"). (See Note 6)

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

(g) Repurchase Agreements
The Company finances the acquisition of a significant portion of its MBS with repurchase agreements. Under repurchase agreements, the Company sells securities to a lender and agrees to repurchase the same securities in the future for a price that is higher than the original sale price. The difference between the sale price that the Company receives and the repurchase price that the Company pays represents interest paid to the lender. Although structured as

a sale and repurchase, under its repurchase agreements, the Company pledges its securities as collateral to secure the borrowing, which is equal in value to a specified percentage of the fair value of the pledged collateral, while the Company retains beneficial ownership of the pledged collateral. At the maturity of a repurchase agreement, the Company is required to repay the loan and concurrently receives back its pledged collateral from the lender. With the consent of the lender, the Company may renew a repurchase agreement at the then prevailing financing terms. Margin calls, whereby a lender requires that the Company pledge additional securities or cash as collateral to secure borrowings under its repurchase agreements with such lender, are routinely experienced by the Company when the value of the MBS pledged as collateral declines as a result of principal amortization or due to changes in market interest rates, spreads or other market conditions. To date, the Company had satisfied all of its margin calls and has never sold assets in response to a margin call. (See Notes 2(l), 7 and 8)

MFA FINANCIAL, INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

The Company's repurchase agreements typically have terms ranging from one month to three months at inception, with some having longer terms. Should a counterparty decide not to renew a repurchase agreement at maturity, the Company must either refinance elsewhere or be in a position to satisfy the obligation. If, during the term of a repurchase agreement, a lender should file for bankruptcy, the Company might experience difficulty recovering its pledged assets which could result in an unsecured claim against the lender for the difference between the amount loaned to the Company plus interest due to the counterparty and the fair value of the collateral pledged to such lender. The Company enters into repurchase agreements with multiple counterparties with a maximum loan from any lender of no more than three times the Company's stockholders' equity. At September 30, 2009, the Company had outstanding balances under repurchase agreements with 18 separate lenders with a maximum amount at risk (the difference between the amount loaned to the Company, including interest payable, and the fair value of securities pledged by the Company as collateral, including accrued interest on such securities) to any single lender of $123.0 million, or 5.6% of stockholders' equity, related to repurchase agreements. (See Notes 4 and 7)

(h) Equity Based Compensation
Compensation expense for equity based awards is recognized over the vesting period of such awards, based upon the fair value of such awards at the grant date. Payments pursuant to DERs, which are attached to certain equity based awards, are charged to stockholders' equity when declared. Equity based awards for which there is no risk of forfeiture are expensed upon grant or at such time that there is no longer a risk of forfeiture. The Company applies a zero forfeiture rate for its equity based awards, as such awards have been granted to a limited number of employees and historical forfeitures have been minimal. Forfeitures, or an indication that forfeitures may occur, would result in a revised forfeiture rate and are accounted for prospectively as a change in estimate.

Forfeiture provisions for dividends and DERs on unvested equity instruments on the Company's equity based awards vary by award. To the extent that equity awards do not vest and grantees are not required to return payments of dividends or DERs to the Company, additional compensation expense is recorded at the time an award is forfeited. (See Note 2(i) and 12)

(i) Earnings per Common Share ("EPS")
Basic EPS is computed by dividing net income/(loss) allocable to common stockholders by the weighted average number of shares of common stock outstanding during the period, which also includes participating securities representing unvested share-based payment awards that contain nonforfeitable rights to dividends or DERs. Diluted EPS is computed by dividing net income available to holders of common stock by the weighted average shares of common stock and common equivalent shares outstanding during the period. For the diluted EPS calculation, common equivalent shares outstanding includes the weighted average number of shares of common stock outstanding adjusted for the effect of dilutive unexercised stock options and restricted stock units ("RSUs") outstanding using the treasury stock method. Under the treasury stock method, common equivalent shares are calculated assuming that all dilutive common stock equivalents are exercised and the proceeds, along with future compensation expenses for unvested stock options and RSUs, are used to repurchase shares of the Company's outstanding common stock at the average market price during the reported period. No common share equivalents are included in the computation of any diluted per share amount for a period in which a net operating loss is reported.

(j) Comprehensive Income/Loss
The Company's comprehensive income/(loss) includes net income/(loss), the change in net unrealized gains/(losses) on its MBS and hedging instruments, adjusted by realized net gains/(losses) included in net income/(loss) for the period and is reduced by dividends declared on the Company's preferred stock.

(k) U.S. Federal Income Taxes
The Company has elected to be taxed as a REIT under the provisions of the Code and the corresponding provisions of state law. The Company expects to operate in a manner that will enable it to continue to be taxed as a REIT. A REIT is not subject to tax on its earnings to the extent that it distributes its REIT taxable income to its stockholders. As such, no provision for current or deferred income taxes has been made in the accompanying consolidated financial statements.

(l) Derivative Financial Instruments
Hedging Activity
As part of the Company’s interest rate risk management, it periodically hedges a portion of its interest rate risk using derivative financial instruments and does not enter into derivative transactions for speculative or trading purposes and, accordingly, accounts for its Swaps as cash flow hedges. The Company’s Swaps have the effect of modifying the interest rate repricing characteristics of the Company’s repurchase agreements and cash flows for such liabilities. No cost is incurred at the inception of a Swap, pursuant to which the Company agrees to pay a fixed rate of interest and receive a variable interest rate, generally based on one-month or three-month London Interbank Offered Rate (“LIBOR”), on the notional amount of the Swap. The Company documents its risk-management policies, including objectives and strategies, as they relate to its hedging activities and the relationship between the hedging instrument and the hedged liability. The Company assesses, both at inception of a hedge and on a quarterly basis thereafter, whether or not the hedge is “highly effective.”

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

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

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

Non-Hedging Activity/MBS Forwards
On January 1, 2009, the Company adopted new accounting guidance required for certain transfers of financial assets and repurchase financings. Given that this guidance was prospective, the initial adoption had no impact on the Company’s consolidated financial statements. Under the new accounting guidance, it is presumed that the initial transfer of a financial asset (i.e., the purchase of an MBS by the Company) and repurchase financing of this MBS with the same counterparty are considered part of the same arrangement, or a “linked transaction.” The two components of a linked transaction (MBS purchase and repurchase financing) are not reported separately but are netted together and reported as a derivative instrument, specifically as a net forward contract on the Company’s consolidated balance sheet. In addition, changes in the fair value of the net forward contract are reported as gains or losses on the Company’s consolidated statements of operation and are not included in other comprehensive income/(loss). (See Note 2(b)) However, if certain criteria are met, the initial transfer (i.e., purchase of a security by the Company) and repurchase financing will not be treated as a linked transaction and will be evaluated and reported separately, as an

MBS purchase and repurchase financing.

During the three months ended September 30, 2009, the Company entered into 14 transactions that were identified as linked transactions. As such, the Company accounted for these purchase contracts and related repurchase agreements on a net basis and recorded a derivative instrument, or forward contract on the Company's consolidated balance sheet. Changes in the fair value of these forward contracts (i.e., MBS Forwards) are reported as a net gain or loss on the Company's consolidated statements of operations. When or if a transaction is no longer considered to be linked, the MBS and repurchase financing will be reported on a gross basis. In this case, the fair value of the MBS at the time the transactions are no longer considered linked will become the cost basis of the MBS. (See Notes 4, 8, and 13)

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(m) Fair Value Measurements and the Fair Value Option for Financial Assets and Financial Liabilities
The Company's presentation of fair value for its financial assets and liabilities are determined within a framework that stipulates that the fair value of a financial asset or liability is an exchange price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability. The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. This definition of fair value is based on a consistent definition of fair value which focuses on exit price and prioritizes, the use of market-based inputs over entity-specific inputs when determining fair value. In addition, the framework for measuring fair value establishes a three-level hierarchy for fair value measurements based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. (See Notes 2(n) and 13)

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

(n) New Accounting Standards and Interpretations
Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities
On January 1, 2009, new accounting guidance became effective providing that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of basic earnings per share pursuant to the two-class method. The Company adopted this guidance on January 1, 2009 and retrospectively adjusted all previously reported EPS data, which did not have a material impact on its historical EPS amounts.

Other-than-temporary Impairments, Determining Fair Value and Interim Disclosures about Fair Value of Financial Instruments
In April 2009, new accounting guidance was issued with respect to determining fair value when the volume and level of activity for an asset or liability have significantly decreased, identifying transactions that are not orderly and interim disclosures about fair value of financial instruments. The Company adopted these new accounting rules as of April 1, 2009. The new guidance is summarized below.

In addition to existing guidance, an other-than-temporary impairment is deemed to exist if an entity does not expect to recover the entire amortized cost basis of a security. Among other things, the new accounting guidance addressed: (i) the determination as to when an investment is considered impaired; (ii) whether that impairment is other-than-temporary; (iii) the measurement of an impairment loss; (iv) accounting considerations subsequent to the recognition of an other-than-temporary impairment; and (v) certain required disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. Should an other-than-temporary impairment exist on a security that the Company expects to continue to hold, the security is written down, with the total other-than-temporary impairment bifurcated into (i) the amount related to expected credit losses, which are recognized through earnings, and (ii) the amount related to all other factors, which are recognized as a component of other comprehensive income. The disclosures required by this new accounting are included in Note 3 to the consolidated financial statements. The Company's adoption of this new accounting guidance required a reassessment of all securities which were other-than-temporarily impaired through March 31, 2009. This reassessment did not result in a cumulative effect adjustment to any component of stockholders' equity in connection with its adoption.

Additional guidance was provided for fair value measures in determining if the market for an asset or liability is inactive and, accordingly, if quoted market prices may not be indicative of fair value. The adoption of this guidance did not have a material impact on the Company's consolidated financial statements.

The existing disclosure requirements related to the fair value of financial instruments that were previously required in annual financial statements were extended to interim financial statements. This guidance provides for additional disclosures, such that its adoption did not have any impact on the Company's consolidated financial statements. The required disclosures are included in Note 13 to the consolidated financial statements.

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Accounting Standards Codification
See Note 2(a).

Accounting for Transfers of Financial Assets
On June 12, 2009, the FASB issued Statement No. 166, Accounting for Transfer of Financial Assets – an Amendment of FASB Statement No. 140 (“FAS 166”), which amends previous derecognition guidance. FAS 166, which remains authoritative until such time that it is integrated into the Codification, eliminates the concept of a qualified special purpose entity (“QSPE”) and eliminates the exception from applying FASB Interpretation 46(R), Consolidation of Variable Interest Entities to QSPEs. Additionally, FAS 166 clarifies that the objective of determining whether a transferor has surrendered control over transferred financial assets must consider the transferor’s continuing involvements in the transferred financial asset, including all arrangements or agreements made contemporaneously with, or in contemplation of, the transfer, even if they were not entered into at the time of the transfer. FAS 166 modifies the financial-components approach and limits the circumstances in which a financial asset, or portion of a financial asset, should be derecognized when the transferor has not transferred the entire original financial asset to an entity that is not consolidated with the transferor in the financial statements being presented and/or when the transferor has continuing involvement with the transferred financial asset. FAS 166 defines the term "participating interest" to establish specific conditions for reporting a transfer of a portion of a financial asset as a sale. Under FAS 166, when the transfer of financial assets are accounted for as a sale, the transferor must recognize and initially measure at fair value all assets obtained and liabilities incurred as a result of the transfer. This includes any retained beneficial interest. The implementation of FAS 166 materially affects the securitization process in general, as it eliminates off-balance sheet transactions when an entity retains any interest in or control over assets transferred in this process. The Company does not believe the implementation of FAS 166 will have a material impact on its consolidated financial statements, as it has no off-balance sheet transactions, no QSPEs, nor has it transferred assets through a securitization. FAS 166 becomes effective for the Company on January 1, 2010.

In conjunction with FAS 166, FASB issued Statement No. 167, Amendment to FASB Interpretation No 46(R) (“FAS 167”), which remains authoritative until such time that it is integrated into the Codification. FAS 166 requires an enterprise to perform an analysis to determine whether an enterprise's variable interest or interests give it a controlling financial interest in a variable interest entity (“VIE”). The analysis identifies the primary beneficiary of a VIE as the enterprise that has both the power to direct the activities that most significantly impact the entity's economic performance and the obligation to absorb losses of the entity or the right to receive benefits from the entity which could potentially be significant to the VIE. With the removal of the QSPE exemption, established QSPEs must be evaluated for consolidation under this statement. FAS 167 requires enhanced disclosures to provide users of financial statements with more transparent information about and an enterprise's involvement in a VIE. Further, FAS 166 also requires ongoing assessments of whether an enterprise is the primary beneficiary of a VIE. Currently, the Company is not the primary beneficiary of any VIEs. The effective date for FAS 167 is January 1, 2010. Upon implementation and, as required by the standard, on an ongoing basis, the Company will assess the applicability of this standard to its holdings and report accordingly.

(o) Reclassifications
Certain prior period amounts have been reclassified to conform to the current period presentation.

3. MBS

At September 30, 2009 and December 31, 2008, the Company’s MBS were primarily secured by hybrid mortgages that have a fixed interest rate for a specified period, typically three to ten years, and, thereafter, generally reset annually (“Hybrids”), and adjustable-rate mortgages (“ARMs”) (collectively, “ARM-MBS”). At September 30, 2009, 0.8% of the

Company's MBS portfolio were fixed-rate MBS secured by fixed rates mortgages, all of which were non-Agency MBS acquired during 2009.

The Company's MBS are primarily comprised of Agency MBS and, to a lesser extent, non-Agency MBS. The Company's MBS do not have a single maturity date and, further, the mortgage loans underlying ARM-MBS have interest rates that do not all reset at the same time. In addition, the Company may have investments in MBS, which may or may not be rated. The Company pledges a significant portion of its MBS as collateral against its repurchase agreements and Swaps. (See Note 8)

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

Non-Agency MBS: The Company’s non-Agency MBS, which are primarily comprised of the senior most tranches from the MBS structure (“Senior MBS”), are securities that are secured by pools of residential mortgages, and are not guaranteed by any U.S. government agency or any federally chartered corporation. The Company’s Senior MBS are rated by a nationally recognized rating agency, such as Moody’s Investors Services, Inc. (“Moody’s”), Standard & Poor’s Corporation (“S&P”) or Fitch, Inc. (collectively, “Rating Agencies”). At September 30, 2009, the Company’s non-Agency MBS were rated from AAA to C by one or more of the Rating Agencies or were unrated (i.e., not assigned a rating by any Rating Agency). The rating indicates the opinion of the Rating Agency as to the credit worthiness of the investment, indicating the obligor’s ability to meet its full financial commitment on the obligation.

The following table presents certain information about the Company's MBS at September 30, 2009 and December 31, 2008:

September 30, 2009 (In Thousands)	Principal/ Current Face	Purchase Premiums	Purchase Discounts	Credit Discounts (1)	Amortized Cost (2)	Carrying Value/ Fair Value	Gross Unrealized Gains	Gross Unrealized Losses
Agency MBS:								
Fannie Mae	$7,349,064	$97,977	$(615)	$-	$7,446,426	$7,747,168	$306,328	$(5,586)
Freddie Mac	584,745	8,912	-	-	608,674	628,345	19,843	(172)
Ginnie Mae	25,000	442	-	-	25,442	25,948	506	-
Total Agency MBS	7,958,809	107,331	(615)	-	8,080,542	8,401,461	326,677	(5,758)
Non-Agency MBS (3):								
Rated AAA	41,170	1,172	-	-	42,342	30,553	-	(11,789)
Rated AA	18,008	30	(5,378)	(2,298)	10,362	12,809	2,962	(515)
Rated A	33,637	55	(6,968)	(61)	26,662	25,821	2,174	(3,015)
Rated BBB	49,866	273	(2,178)	(5,133)	42,827	37,235	2,541	(8,133)
Rated BB	32,636	51	(4,121)	(10,458)	18,108	21,913	5,238	(1,433)
Rated B	73,010	-	(16,501)	(13,567)	42,942	51,711	8,769	-
Rated CCC	528,508	85	(54,186)	(189,824)	284,065	314,738	35,454	(4,781)
Rated CC	573,649	122	(41,611)	(154,015)	372,588	371,807	34,843	(35,624)
Rated C	126,854	30	(7,437)	(33,876)	83,670	79,319	6,875	(11,226)
Unrated and Other	7,940	-	(2,529)	(1,900)	1,698	1,685	3	(16)
Total Non-Agency MBS	1,485,278	1,818	(140,909)	(411,132)	925,264	947,591	98,859	(76,532)
Total MBS	$9,444,087	$109,149	$(141,524)	$(411,132)	$9,005,806	$9,349,052	$425,536	$(82,290)

Table continued

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Table continued

(In Thousands)	December 31, 2008 Principal/ Current Face	Purchase Premiums	Purchase Discounts	Credit Discounts(1)	Amortized Cost (2)	Carrying Value/ Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Net Unrealized Gain/(Loss)
Agency MBS:									
Fannie Mae	$8,986,206	$115,106	$(1,401)	$-	$9,099,911	$9,156,030	$78,148	$(22,029)	$56,119
Freddie Mac	714,110	10,753	-	-	732,248	732,719	3,462	(2,991)	471
Ginnie Mae	30,017	532	-	-	30,549	29,864	-	(685)	(685)
Total Agency MBS	9,730,333	126,391	(1,401)	-	9,862,708	9,918,613	81,610	(25,705)	55,905
Non-Agency MBS (3):									
Rated AAA	106,191	1,487	(4,705)	(2,585)	100,388	71,418	961	(29,931)	(28,970)
Rated AA	29,064	352	-	-	29,416	17,767	-	(11,649)	(11,649)
Rated A	115,213	-	(1,261)	(584)	113,368	67,346	269	(46,291)	