ANNALY CAPITAL MANAGEMENT INC
Form 10-Q
November 06, 2012

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, 2012

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: 1-13447

ANNALY CAPITAL MANAGEMENT, INC.
(Exact name of Registrant as specified in its Charter)

MARYLAND	22-3479661
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

1211 AVENUE OF THE AMERICAS, SUITE 2902
NEW YORK, NEW YORK
(Address of principal executive offices)

10036
(Zip Code)

(212) 696-0100
(Registrant's telephone number, including area code)

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

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act.

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the last practicable date:

Class	Outstanding at November 6, 2012
Common Stock, $.01 par value	974,964,290

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
(dollars in thousands, except share and per share amounts)

ASSETS		September 30, 2012 (Unaudited)		December 31, 2011(1)
Cash and cash equivalents	$	2,264,854	$	994,198
Reverse repurchase agreements		1,612,384		860,866
Investments, at fair value:				
U.S. Treasury Securities (including pledged assets of $2,242,039 and $352,820, respectively)		2,242,039		928,547
Securities borrowed		1,602,692		928,732
Agency mortgage-backed securities (including pledged assets of $105,841,340 and $90,406,535, respectively)		129,597,714		104,251,055
Agency debentures (including pledged assets of $774,437 and $567,383, respectively)		2,935,538		889,580
Investments in affiliates		224,899		211,970
Equity securities		-		3,891
Corporate debt, held for investment		64,928		52,073
Receivable for investments sold		470,266		-
Accrued interest and dividends receivable		434,026		409,023
Receivable from Prime Broker		3,272		3,272
Receivable for advisory and service fees (including from affiliates of $16,451 and $16,245, respectively)		20,271		19,550
Intangible for customer relationships (net of accumulated amortization of $7,177 and $5,432, respectively)		9,146		10,807
Goodwill		55,417		42,030
Other derivative contracts, at fair value		559		113
Other assets		38,595		24,295
Total assets	$	141,576,600	$	109,630,002
LIABILITIES AND STOCKHOLDERS' EQUITY				
Liabilities:				
U.S. Treasury Securities sold, not yet purchased, at fair value	$	1,418,750	$	826,912
Repurchase agreements		101,033,146		84,097,885
Securities loaned, at fair value		1,248,968		804,901
Payable for investments purchased		16,107,038		4,315,796
Convertible Senior Notes		999,749		539,913
Accrued interest payable		181,502		138,965
Dividends payable		487,237		552,806
Interest rate swaps, at fair value		2,926,461		2,552,687
Accounts payable and other liabilities		83,086		7,223
Total liabilities		124,485,937		93,837,088

6.00% Series B Cumulative Convertible Preferred Stock:

4,600,000 shares authorized, 0 and 1,331,849 shares issued and outstanding, respectively		-		32,272
Stockholders' Equity:				
7.875% Series A Cumulative Redeemable Preferred Stock: 7,412,500 authorized, issued and outstanding		177,088		177,088
7.625% Series C Cumulative Redeemable Preferred Stock: 12,650,000 and 0 authorized, respectively, 12,000,000 and 0 issued and outstanding, respectively		290,514		-
7.50% Series D Cumulative Redeemable Preferred Stock: 18,400,000 and 0 authorized, issued and outstanding, respectively		445,457		-
Common stock, par value $0.01 per share, 1,956,937,500 and 1,987,987,500 authorized, respectively, 974,799,779 and 970,161,647 issued and outstanding, respectively		9,748		9,702
Additional paid-in capital		15,144,200		15,068,870
Accumulated other comprehensive income (loss)		4,069,607		3,008,988
Accumulated deficit		(3,045,951)		(2,504,006)
Total stockholders' equity		17,090,663		15,760,642
Total liabilities, Series B Cumulative Convertible Preferred Stock and stockholders' equity	$	141,576,600	$	109,630,002

(1) Derived from the audited consolidated financial statements at December 31, 2011.

See notes to consolidated financial statements.

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ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(dollars in thousands, except share and per share amounts)
(Unaudited)

	For the Quarter Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Interest income:				
Investments	$754,096	$926,558	$2,481,284	$2,713,141
U.S. Treasury Securities	4,588	2,302	13,403	13,624
Securities loaned	2,581	1,942	7,797	5,153
Total interest income	761,265	930,802	2,502,484	2,731,918
Interest expense:				
Repurchase agreements	158,150	109,014	411,643	311,780
Convertible Senior Notes	18,026	8,798	51,718	22,465
U.S. Treasury Securities sold, not yet purchased	3,739	2,109	12,184	11,867
Securities borrowed	1,978	1,496	6,136	4,081
Total interest expense	181,893	121,417	481,681	350,193
Net interest income	579,372	809,385	2,020,803	2,381,725
Other income (loss):				
Investment advisory and other fee income	21,034	20,828	63,729	58,745
Net gains (losses) on disposition of investments	142,172	91,668	317,308	126,189
Net loss on extinguishment of Convertible Senior Notes	(87,328)	-	(87,328)	-
Dividend income from affiliates	7,097	8,706	21,239	23,233
Net gains (losses) on trading assets	1,368	1,942	7,729	15,042
Net unrealized gain (losses) on interest-only Agency mortgage-backed securities	(33,563)	(39,321)	(28,789)	(39,045)
Income from underwriting	-	2,772	-	5,599
Subtotal	50,780	86,595	293,888	189,763
Realized gains (losses) on interest rate swaps(1)	(224,272)	(231,849)	(665,614)	(654,757)
Realized gains (losses) on termination of interest rate swaps	-	-	(2,385)	-
Unrealized gains (losses) on interest rate swaps	(104,197)	(1,505,333)	(373,773)	(1,802,968)
Subtotal	(328,469)	(1,737,182)	(1,041,772)	(2,457,725)
Total other income (loss)	(277,689)	(1,650,587)	(747,884)	(2,267,962)
Expenses:				
Compensation expense	52,310	57,629	164,860	151,911
Other general and administrative expenses	10,694	7,565	30,615	22,339
Total expenses	63,004	65,194	195,475	174,250
Income (loss) before income taxes and income from equity method investment in affiliate	238,679	(906,396)	1,077,444	(60,487)

Income taxes	(13,921)	(15,417)	(42,039)	(41,754)
Income from equity method investment in affiliate	-	-	-	1,140
Net income (loss)	224,758	(921,813)	1,035,405	(101,101)
Dividends on preferred stock	9,367	4,172	19,813	12,706
Net income (loss) available (related) to common shareholders	$215,391	$(925,985)	$1,015,592	$(113,807)
Net income (loss) available (related) per share to common shareholders:				
Basic	$0.22	$(0.98)	$1.04	$(0.14)
Diluted	$0.22	$(0.98)	$1.00	$(0.14)
Weighted average number of common shares outstanding:				
Basic	974,729,078	948,545,975	973,674,586	841,912,810
Diluted	997,007,829	948,545,975	1,035,365,251	841,912,810

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Statement continued from previous page

Dividends Declared Per Share of Common Stock	$0.50	$0.60	$1.60	$1.87
Net income (loss)	$224,758	$(921,813)	$1,035,405	$(101,101)
Other comprehensive income (loss):				
Unrealized gains (losses) on available-for-sale securities	798,269	1,115,325	1,377,737	2,020,737
Unrealized losses on interest rate swaps	-	-	-	14,298
Reclassification adjustment for net (gains) losses included in net income (loss)	(141,982)	(91,668)	(317,118)	(126,189)
Other comprehensive income (loss)	656,287	1,023,657	1,060,619	1,908,846
Comprehensive income (loss)	$881,045	$101,844	$2,096,024	$1,807,745

(1) Interest expense related to the Company's interest rate swaps is recorded in Realized gains (losses) on interest rate swaps on the Consolidated Statements of Comprehensive Income.

See notes to consolidated financial statements.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(dollars in thousands, except per share data)
(Unaudited)

	7.875% Series A Cumulative Redeemable Preferred Stock	7.625% Series C Cumulative Redeemable Preferred Stock	7.50% Series D Cumulative Redeemable Preferred Stock	Common Stock Par Value	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Accumulated Deficit	Total
BALANCE, DECEMBER 31, 2010	$177,088	-	-	$6,316	$9,175,245	$1,164,642	$(658,391)	$9,864,900
Net income (loss)	-	-	-	-	-	-	(101,101)	(101,101)
Other comprehensive income (loss)	-	-	-	-	-	1,908,846	-	1,908,846
Exercise of stock options	-	-	-	6	7,858	-	-	7,864
Stock option expense and long-term compensation expense	-	-	-	4	3,858	-	-	3,862
Conversion of Series B cumulative preferred stock	-	-	-	7	6,361	-	-	6,368
Net proceeds from direct purchase and dividend reinvestment	-	-	-	261	455,445	-	-	455,706
Net proceeds from follow-on offering	-	-	-	3,105	5,348,741	-	-	5,351,846
Contingent beneficial conversion feature on Convertible Senior Notes	-	-	-	-	44,853	-	-	44,853
Preferred Series A dividends declared $1.477 per share	-	-	-	-	-	-	(10,945)	(10,945)
Preferred Series B dividends declared $1.125 per share	-	-	-	-	-	-	(1,761)	(1,761)

Common dividends declared, $1.87 per share	-	-	-	-	-	-	(1,620,416)	(1,620,416)
BALANCE, SEPTEMBER 30, 2011	$177,088	-	-	$9,699	$15,042,361	$3,073,488	$(2,392,614)	$15,910,022
BALANCE, DECEMBER 31, 2011	$177,088	-	-	$9,702	$15,068,870	$3,008,988	$(2,504,006)	$15,760,642
Net income (loss)	-	-	-	-	-	-	1,035,405	1,035,405
Other comprehensive income (loss)	-	-	-	-	-	1,060,619	-	1,060,619
Exercise of stock options	-	-	-	5	6,056	-	-	6,061
Stock option expense and long-term compensation expense	-	-	-	-	3,857	-	-	3,857
Conversion of Series B cumulative preferred stock	-	-	-	40	32,232	-	-	32,272
Net proceeds from direct purchase and dividend reinvestment	-	-	-	1	1,978	-	-	1,979
Contingent beneficial conversion feature on 4% Convertible Senior Notes	-	-	-	-	19,738	-	-	19,738
Equity component on 5% Convertible Senior Notes	-	-	-		11,717			11,717
Offering expenses	-	-	-	-	(248)	-	-	(248)
Net proceeds from 7.625% Series C Cumulative Redeemable Preferred Stock offering	-	290,514	-	-	-	-	-	290,514
Net proceeds from 7.50% Series D Cumulative	-	-	445,457	-	-	-	-	445,457

Redeemable Preferred Stock offering								
Extinguishment of convertible debt	-	-	-	-				
Preferred Series A dividends declared $1.477 per share	-	-	-	-	-	-	(10,945)	(10,945)
Preferred Series B dividends declared $0.375 per share	-	-	-	-	-	-	(289)	(289)
Preferred Series C dividends declared $0.715 per share	-	-	-	-	-	-	(8,579)	(8,579)
Common dividends declared, $1.60 per share	-	-	-	-	-	-	(1,557,537)	(1,557,537)
BALANCE, SEPTEMBER 30, 2012	$177,088	$290,514	$445,457	$9,748	$15,144,200	$4,069,607	$(3,045,951)	$17,090,663

See notes to consolidated financial statements.

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ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(dollars in thousands)
(Unaudited)

	For the Quarters Ended September 30, 2012	For the Quarters Ended September 30, 2011	For the Nine Months Ended September 30, 2012	For the Nine Months Ended September 30, 2011
Cash flows from operating activities:				
Net income (loss)	$224,758	$(921,813)	$1,035,405	$(101,101)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:				
Amortization of investment premiums and discounts, net	455,493	200,942	1,038,598	502,186
Amortization of intangibles	634	676	1,858	1,511
Amortization of deferred expenses	2,189	900	4,927	2,700
Amortization of contingent beneficial conversion feature and equity component on convertible senior notes	1,438	1,898	15,498	1,898
Net (gains) losses on disposal of investments	(142,172)	(91,668)	(317,308)	(126,189)
Net loss on extinguishment of 4% Convertible Senior Notes	87,328	-	87,328	-
Stock option and long-term compensation expense	997	1,403	3,857	3,862
Unrealized (gains) losses on interest rate swaps	104,197	1,505,333	373,773	1,802,968
Net unrealized (gains) losses on interest-only Agency mortgage-backed securities	33,563	39,321	28,789	39,045
Net (gains) losses on trading assets	(1,368)	(1,942)	(5,344)	(15,042)
Gain on investment in affiliate, equity method	-	-	-	(98)
Unrealized (gains) losses on equity securities	-	63	-	63
Proceeds from repurchase agreements from RCap	168,905,024	157,069,300	509,943,940	720,578,286
Payments on repurchase agreements from RCap	(166,150,546)	(156,683,356)	(502,959,819)	(719,466,382)
Proceeds from reverse repurchase agreements to RCap	113,457,928	27,610,583	299,139,881	132,302,897
Payments on reverse repurchase agreements to RCap	(113,053,067)	(27,359,741)	(299,884,954)	(131,634,729)
Proceeds from reverse repurchase agreements to Shannon	185,640	58,848	409,380	65,893
Payments on reverse repurchase agreements to Shannon	(177,414)	(76,140)	(415,825)	(88,213)
Proceeds from securities borrowed	26,397,098	12,445,883	45,821,749	14,898,651
Payments on securities borrowed	(26,534,463)	(12,978,764)	(46,495,709)	(15,734,785)
Proceeds from securities loaned	59,324,108	12,398,720	125,183,976	14,902,887
Payments on securities loaned	(59,188,247)	(11,938,989)	(124,739,909)	(14,213,667)
Proceeds from U.S. Treasury Securities	13,085,890	(5,303,369)	44,183,569	(18,193,311)
Payments on U.S. Treasury Securities	(13,407,718)	5,716,809	(45,248,472)	18,514,722
Net payments on derivatives	(648)	(1,771)	(18,108)	(4,545)
Net change in:				

Other assets	(3,226)	(4,795)	(1,072)	(4,110)
Accrued interest and dividend receivable	(4,812)	(22,148)	(16,942)	(62,792)
Advisory and service fees receivable	472	10	(721)	(3,484)
Accrued interest payable	6,683	5,618	42,537	12,605
Accounts payable and other liabilities	(11,767)	(4,058)	75,863	65,916
Net cash provided by (used in) operating activities	3,597,992	1,667,753	7,286,745	4,047,642
Cash flows from investing activities:				
Payments on purchases of Agency mortgage-backed securities and debentures	(21,398,098)	(17,054,754)	(59,518,222)	(49,344,466)
Proceeds from sales of Agency mortgage-backed securities and debentures	7,810,451	3,568,718	17,725,948	9,001,949
Principal payments on Agency mortgage-backed securities	9,943,910	5,074,528	25,197,941	14,429,098
Proceeds from Agency debentures called	327,385	288,925	1,177,548	906,523
Payments on purchase of corporate debt	(23,520)	-	(33,420)	(7,425)
Proceeds from corporate debt called	19,165	-	19,165	-
Principal payments on corporate debt	565	-	2,025	1,155
Net gains (losses) on other derivative securities	-	-	-	11,518
Earn out payment	-	-	(13,387)	-
Purchase of investment in affiliate	-	-	-	(57,500)
Purchase of customer relationships	-	-	-	(3,555)
Proceeds from sales of equity securities	-	(3,990)	4,048	(3,990)
Net cash provided by (used in) investing activities	(3,320,142)	(8,126,573)	(15,438,354)	(25,066,693)
Cash flows from financing activities:				
Proceeds from repurchase agreements	91,857,968	72,790,611	258,994,965	200,627,105
Principal payments on repurchase agreements	(90,340,097)	(65,127,815)	(249,043,825)	(180,776,641)
Proceeds from exercise of stock options	670	1,752	6,061	7,864
Net proceeds from Series C Preferred offering	-	-	290,514	-
Net proceeds from Series D Preferred offering	445,457	-	445,457	-
Net proceeds from issuance of 5% Convertible Senior Notes offering	-	-	727,500	-

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Net proceeds from direct purchases and dividend reinvestments	1,134	-	1,979	455,706
Net payment from extinguishment of 4% Convertible Senior Notes	(357,220)	-	(357,220)	-
Net (payment) proceeds from follow-on offerings	(17)	2,410,435	(248)	5,351,846
Dividends paid	(545,265)	(544,141)	(1,642,918)	(1,455,589)
Net cash provided by (used in) financing activities	1,062,630	9,530,842	9,422,265	24,210,291
Net (decrease) increase in cash and cash equivalents	1,340,480	3,072,022	1,270,656	3,191,240
Cash and cash equivalents, beginning of period	924,374	401,844	994,198	282,626
Cash and cash equivalents, end of period	$2,264,854	$3,473,866	$2,264,854	$3,473,866
Supplemental disclosure of cash flow information:				
Interest received	$1,203,598	$1,107,518	$3,514,893	$3,168,555
Dividends received	$6,621	$8,230	$22,425	$23,170
Fees received	$21,506	$20,838	$63,008	$55,261
Interest paid (excluding interest paid on interest rate swaps)	$173,889	$116,641	$423,752	$345,485
Net interest paid on interest rate swaps	$224,155	$229,109	$665,508	$644,962
Taxes paid	$17,374	$17,919	$46,541	$43,595
Noncash investing activities:				
Receivable for Investments sold	$470,266	$402,817	$470,266	$402,817
Payable for Investments purchased	$16,107,038	$5,852,986	$16,107,038	$5,852,986
Net change in unrealized loss on available-for-sale securities and interest rate swaps, net of reclassification adjustment	$656,287	$1,023,657	$1,060,619	$1,908,846
Noncash financing activities:				
Dividends declared, not yet paid	$487,237	$581,752	$487,237	$581,752
Conversion of Series B cumulative preferred stock	-	$6,295	$32,272	$6,368
Contingent beneficial conversion feature on 4% Convertible Senior Notes	$(26,603)	$44,853	$19,738	$44,853
Equity component of 5% Convertible Senior Notes	$11,717	-	$11,717	-

See notes to consolidated financial statements.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Annaly Capital Management, Inc. (“Annaly” or the “Company”) was incorporated in Maryland on November 25, 1996. The Company commenced its operations of purchasing and managing an investment portfolio of mortgage-backed securities on February 18, 1997, upon receipt of the net proceeds from the private placement of equity capital, and completed its initial public offering on October 14, 1997. The Company is a real estate investment trust (“REIT”) under the Internal Revenue Code of 1986, as amended. On June 4, 2004, the Company acquired Fixed Income Discount Advisory Company (“FIDAC”). FIDAC is a registered investment advisor and is a wholly owned taxable REIT subsidiary of the Company. On June 27, 2006, the Company made a majority equity investment in an affiliated investment fund (the “Fund”), which is now wholly owned by the Company. During the third quarter of 2008, the Company formed RCap Securities, Inc. (“RCap”). RCap was granted membership in the Financial Industry Regulatory Authority (“FINRA”) on January 26, 2009, and operates as a broker-dealer. RCap is a wholly owned taxable REIT subsidiary of the Company. On October 31, 2008, the Company acquired Merganser Capital Management, Inc. (“Merganser”). Merganser is a registered investment advisor and is a wholly owned taxable REIT subsidiary of the Company. In 2010, the Company established Shannon Funding LLC (“Shannon”), which provides warehouse financing to residential mortgage originators in the United States. In 2010, the Company also established Charlesfort Capital Management LLC (“Charlesfort”), which engages in corporate middle market lending transactions. In 2011, FIDAC established FIDAC Europe Limited (“FIDAC Europe”), which provides advice on commercial real estate transactions, including sale-leaseback and single tenant net leased properties across Europe. In 2011, the Company established FIDAC FSI LLC (“FIDAC FSI”), which invested in trading securities. FIDAC FSI was liquidated in August 2012.

A summary of the Company’s significant accounting policies follows:

Basis of Accounting

The accompanying consolidated financial statements and related notes of the Company have been prepared in accordance with accounting principles generally accepted in the United States ("U.S. GAAP"). In the opinion of management, all adjustments considered necessary for a fair presentation of the Company's consolidated financial position, results of operations and cash flows have been included and are of a normal and recurring nature.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company, FIDAC, FIDAC Europe, FIDAC FSI, Merganser, RCap, Shannon, Charlesfort and the Fund. All intercompany balances and transactions have been eliminated in consolidation.

Cash and Cash Equivalents - Cash and cash equivalents include cash on hand and cash held in money market funds on an overnight basis.

Reverse Repurchase Agreements – The Company through RCap enters into reverse repurchase agreements as part of the RCap’s matched book trading activity. Reverse repurchase agreements are recorded on trade date at the contract amount and are collateralized by mortgage-backed or other securities. Margin calls are made by RCap as necessary based on the daily valuation of the underlying collateral as compared to the contract price. The Company generates income from the spread between what is earned on the reverse repurchase agreements and what is paid on the matched repurchase agreements. The Company’s policy is to obtain possession of collateral with a market value in excess of the principal amount loaned under reverse repurchase agreements. To ensure that the market value of the underlying collateral remains sufficient, collateral is valued daily, and the Company will require counterparties to deposit additional collateral, when necessary. All reverse repurchase activities are transacted under master repurchase agreements that give the Company the right, in the event of default, to liquidate collateral held and to offset receivables and payables with the same counterparty.

Securities borrowed and loaned transactions – RCap records securities borrowed and loaned transactions at fair value. Securities borrowed transactions require RCap to provide the counterparty with collateral in the form of cash. RCap receives collateral in the form of cash for securities loaned transactions. For these transactions, the fees received or paid by RCap are recorded as interest income or expense, respectively. On a daily basis, market value changes of securities borrowed or loaned against the collateral value and RCap may require counterparties to deposit additional collateral or may require RCap to return collateral pledged, when appropriate.

U.S. Treasury Securities — RCap's trades in U.S. Treasury securities consist of long and short positions on U.S Treasury notes and bonds. U.S. Treasury securities are classified as trading investments and are recorded on the trade date at cost. Changes in fair value are reflected in the Company's Consolidated Statement of Comprehensive Income. Generally RCap does not hold the U.S. Treasury bills, notes and bonds to maturity and realizes gains and losses from trading those positions. Interest income or expense on U.S Treasury notes and bonds is accrued based on the outstanding principal amount of those investments and their stated terms.

Investment Securities –Agency mortgage-backed securities, Agency debentures, and corporate debt are referred to herein as "Investment Securities." Although the Company generally intends to hold most of its Investment Securities until maturity, it may, from time to time, sell any of its Investment Securities as part of its overall management of its portfolio. Investment Securities classified as available-for-sale are reported at fair values estimated by management that are compared to independent sources for reasonableness, with unrealized gains and losses reported as a component of stockholders' equity. Investment Securities transactions are recorded on the trade date. Realized gains and losses on sales of Investment Securities are determined using the average cost method.

On April 1, 2011, the Company elected the fair value option for Agency interest-only mortgage-backed securities acquired on or after such date. These Agency interest-only mortgage-backed securities represent the Company's right to receive a specified proportion of the contractual interest flows of specific Agency mortgage-backed securities. Agency interest-only mortgage-backed securities acquired on or after April 1, 2011 are measured at fair value through earnings in the Company's Consolidated Statements of Comprehensive Income. The interest-only securities are included in Agency mortgage-backed securities at fair value on the accompanying Consolidated Statements of Financial Condition.

Agency Mortgage-Backed Securities and Agency Debentures – The Company invests primarily in mortgage pass-through certificates, collateralized mortgage obligations and other mortgage-backed securities representing interests in or obligations backed by pools of mortgage loans, and certificates guaranteed by Ginnie Mae, Freddie Mac or Fannie Mae (collectively, "Agency mortgage-backed securities"). The Company also invests in Agency debentures issued by Federal Home Loan Bank ("FHLB"), Freddie Mac, and Fannie Mae.

Interest income from coupon payments is accrued based on the outstanding principal amount of the Investment Securities and their contractual terms. Premiums and discounts associated with the purchase of the Investment Securities are amortized into interest income over the projected lives of the securities using the interest method. The Company's policy for estimating prepayment speeds for calculating the effective yield is to evaluate historical performance, consensus prepayment speeds, and current market conditions. Adjustments are made for actual prepayment activity.

Equity Securities – The Company invests in equity securities that are classified as available-for-sale or trading. Equity securities classified as available-for-sale are reported at fair value, based on market quotes, with unrealized gains and losses reported as a component of stockholders' equity. Equity securities classified as trading are reported at fair value, based on market quotes, with unrealized gains and losses reported in the Consolidated Statement of Comprehensive Income. Dividends are recorded in earnings based on the declaration date.

Other-Than-Temporary Impairment – Management evaluates available-for-sale securities for other-than-temporary impairment at least quarterly, and more frequently when economic or market concerns warrant such evaluation. The Company determines if it (1) has the intent to sell the securities, (2) is more likely than not that it will be required to sell the securities before recovery, or (3) does not expect to recover the entire amortized cost basis of the securities. Further, the security is analyzed for credit loss (the difference between the present value of cash flows expected to be collected and the amortized cost basis). The credit loss, if any, will then be recognized in the Consolidated Statements of Comprehensive Income, while the balance of losses related to other factors will be recognized as a component of stockholders' equity. There was no other-than-temporary impairment for the quarters and nine months ended September 30, 2012 and 2011.

Derivative Instruments – The Company accounts for interest rate swaps at fair value as either assets or liabilities on the Consolidated Statements of Financial Condition. Changes in the fair value of interest rate swaps are recognized in earnings. The Company uses interest rate swaps to manage its exposure to changing interest rates on its repurchase agreements. Net payments on interest rate swaps are included in the Consolidated Statements of Cash Flows as a component of operating activities.

The Company elected to net, by counterparty, the fair value of interest rate swap contracts. These contracts contain legally enforceable provisions that allow for netting or setting off swap receivables and payables with each counterparty and, therefore, the fair value of those swap contracts are netted by counterparty. The credit support annex provisions of the Company's interest rate swap contracts allow the parties to mitigate their credit risk by requiring the party which is out of the money to post collateral. As the Company elected to net by counterparty the fair value of interest rate swap contracts, it also nets by counterparty any collateral exchanged as part of the interest rate swap contracts. Substantially all collateral is non-cash collateral under these contracts. In addition, the Company's agreements with certain of its counterparties with whom it has both interest rate swap contracts and master repurchase agreements contain legally enforceable provisions that allow for netting or setting off, on an aggregate basis, all receivables, payables and collateral postings required under both the interest rate swap contract and the master repurchase agreement with respect to each such counterparty.

RCap primarily enters into exchange traded U.S. interest rate, equity index, and FX futures and options contracts as well as German interest rate futures contracts for speculative or hedging purposes. RCap maintains a margin account which is settled daily with futures and options commission merchants. Changes in the unrealized gains or losses on the futures and options contracts are reflected in the Company's Consolidated Statements of Comprehensive Income. Unrealized gains (losses) are excluded from net income (loss) in arriving at cash flows from operating activities in the Consolidated Statements of Cash Flows.

Credit Risk – The Company has limited its exposure to credit losses on its portfolio of Agency mortgage-backed securities by only purchasing securities issued by Freddie Mac, Fannie Mae or Ginnie Mae and Agency debentures issued by the FHLB, Freddie Mac and Fannie Mae. The payment of principal and interest on the Freddie Mac and Fannie Mae Agency mortgage-backed securities are guaranteed by those respective agencies, and the payment of principal and interest on Ginnie Mae Agency mortgage-backed securities are backed by the full faith and credit of the U.S. government. Principal and interest on Agency debentures are guaranteed by the agency issuing the debenture. Substantially all of the Company's Investment Securities have an actual or implied "AAA" rating. The Company faces credit risk on the portions of its portfolio which are not Agency mortgage-backed securities and Agency debentures.

Market Risk - Weakness in the mortgage market may adversely affect the performance and market value of the Company's investments. This could negatively impact the Company's net book value. Furthermore, if many of the Company's lenders are unwilling or unable to provide additional financing, the Company could be forced to sell its Investment Securities at an inopportune time when prices are depressed. The Company does not anticipate having difficulty converting its assets to cash or extending financing terms due to the fact that its Agency mortgage-backed securities and Agency debentures have an actual or implied "AAA" rating and principal payment is guaranteed by Freddie Mac, Fannie Mae, or Ginnie Mae.

Repurchase Agreements - The Company finances the acquisition of a significant portion of its Agency mortgage-backed securities with repurchase agreements. None of the Company's repurchase agreements are accounted for as components of linked transactions. The Company examines each of the specified criteria in Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 860, Transfers and Servicing, at the inception of each transaction and has determined that each of the financings meet the specified criteria in this guidance. As a result, the Company separately accounts for the financial assets and related repurchase financings in the accompanying consolidated financial statements.

Reverse repurchase agreements and repurchase agreements with the same counterparty and the same maturity are presented net in the Consolidated Statements of Financial Condition when the terms of the agreements permit netting. The Company reports cash flows on repurchase agreements as financing activities in the Consolidated Statements of Cash Flows. The Company reports cash flows on repurchase agreements entered into by RCap and Shannon as operating activities in the Consolidated Statements of Cash Flows.

Convertible Senior Notes – The Company records the 4% Convertible Senior Notes and 5% Convertible Senior Notes (collectively, the “Convertible Senior Notes”) at their contractual amounts, adjusted by the effects of a beneficial conversion feature and a contingent beneficial conversion feature. This intrinsic value is included in “Additional paid-in capital” on the Company’s Consolidated Statements of Financial Condition and reduces the liability associated with the Convertible Senior Notes.

The Convertible Senior Notes have a conversion price adjustment feature that is evaluated at the time of the conversion price adjustment. A contingent beneficial conversion feature may be recognized as a result of adjustments to the conversion price for dividends declared. The Company determined the intrinsic value of a contingent beneficial conversion feature.

Cumulative Convertible Preferred Stock - The Series B Cumulative Convertible Preferred Stock (the “Series B Preferred Stock”) contains fundamental change provisions that allow the holder to redeem the Series B Preferred Stock for cash if certain events occur. As redemption under these provisions is not solely within the Company’s control, for the periods that the Company had Series B Preferred Stock issued and outstanding, the Company classified the Series B Preferred Stock as temporary equity in the accompanying Consolidated Statements of Financial Condition. As of September 30, 2012, there were no shares outstanding of Series B Preferred Stock.

Income Taxes - The Company has elected to be taxed as a REIT and intends to comply with the provisions of the Internal Revenue Code of 1986, as amended (the “Code”), with respect thereto. Accordingly, the Company will not be subjected to federal income tax to the extent of its distributions to shareholders and as long as certain asset, income and stock ownership tests are met. The Company and its direct and indirect subsidiaries, FIDAC, FIDAC Europe, Merganser and RCap, have made separate joint elections to treat these subsidiaries as taxable REIT subsidiaries. As such, each of the taxable REIT subsidiaries are taxable as a domestic C corporation and subject to federal, state, and local income taxes based upon their taxable income. FIDAC Europe is located in Europe and is not currently required to pay United States income taxes.

The provisions of ASC 740, Income Taxes, clarify the accounting for uncertainty in income taxes recognized in financial statements and prescribe a recognition threshold and measurement attribute for tax positions taken or expected to be taken on a tax return. ASC 740 also requires that interest and penalties related to unrecognized tax benefits be recognized in the financial statements. The Company does not have any unrecognized tax benefits that would affect its financial position. Thus, no accruals for penalties and interest were necessary as of September 30, 2012.

Goodwill and Intangible Assets - The Company’s acquisitions of FIDAC and Merganser and FIDAC Europe’s acquisition of certain assets were accounted for using the acquisition method. Under the acquisition method, net assets and results of operations of acquired companies are included in the consolidated financial statements from the date of acquisition. The costs of FIDAC and Merganser were allocated to the assets acquired, including identifiable intangible assets, and the liabilities assumed based on their estimated fair values at the date of acquisition. The excess of purchase price over the fair value of the net assets acquired was recognized as goodwill. In addition, FIDAC Europe acquired a customer relationship after its formation. Goodwill and intangible assets are periodically (but not less frequently than annually) reviewed for potential impairment. Intangible assets with an estimated useful life are amortized over the expected life. During the quarters and nine months ended September 30, 2012 and 2011, there were no impairment losses recognized related to goodwill and intangible assets.

Stock-Based Compensation - The Company is required to measure and recognize in the consolidated financial statements the compensation cost relating to share-based payment transactions. The Company recognizes compensation expense on a straight-line basis over the requisite service period for the entire award.

Use of Estimates - The preparation of the consolidated financial statements in conformity with U.S. 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. All assets classified as trading or available-for-sale and interest rate swaps are reported at their estimated fair value, based on market prices. The Company's policy is to obtain fair values from one or more independent sources to compare to internal prices for reasonableness. Actual results could differ from those estimates.

A Summary of Recent Accounting Pronouncements Follows:

Presentation

Balance Sheet (Topic 210)

On December 23, 2011, the FASB released Accounting Standards Update ("ASU") 2011-11, Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities. Under this update, the Company 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 transactions subject to an agreement similar to a master netting arrangement. The scope would include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements and securities borrowing and securities lending arrangements. This disclosure is intended to enable financial statement users to understand the effect of such arrangements on the Company's financial position. The objective of this update is to support further convergence between U.S. GAAP and International Financial Reporting Standards ("IFRS"). This update is effective for annual reporting periods beginning on or after January 1, 2013. This update is expected to result in additional disclosure.

Comprehensive Income (Topic 220)

In June 2011, the FASB released ASU 2011-05 Comprehensive Income: Presentation of Comprehensive Income, which attempts to improve the comparability, consistency, and transparency of financial reporting and increase the prominence of items reported in other comprehensive income ("OCI"). ASU 2011-05 requires that all non-owner changes in stockholders' equity be presented either in a single continuous statement of net income and comprehensive income or two separate consecutive statements. Either presentation requires the presentation on the face of the financial statements any reclassification adjustments for items that are reclassified from OCI to net income in the statements. There is no change in what must be reported in OCI or when an item of OCI must be reclassified to net income. This update is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. This update resulted in additional disclosure, but had no significant effect on the Company's consolidated financial statements.

On December 23, 2011, the FASB issued ASU 2011-12, Comprehensive Income: Deferral of Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income In ASU No. 2011-05, which defers those changes in ASU 2011-05 that relate to the presentation of reclassification adjustments out of accumulated OCI. This was done to allow the FASB time to re-deliberate the presentation on the face of the financial statements the effects of reclassifications out of accumulated OCI on the components of net income and OCI. No other requirements under ASU 2011-05 are affected by ASU 2011-12. FASB tentatively decided not to require presentation of reclassification adjustments out of accumulated other comprehensive income on the face of the financial statements and to propose new disclosures instead.

Assets

Intangibles – Goodwill and Other (Topic 350)

In September 2011, the FASB released ASU 2011-08, Intangibles-Goodwill and Other: Testing Goodwill for Impairment, which allows an entity to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. The objective of the update is to simplify how entities test goodwill for impairment. Under this update, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. This update is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after

December 15, 2011. This update had no significant impact on the Company's consolidated financial statements.

Broad Transactions

Fair Value Measurements and Disclosures (Topic 820)

In May 2011, the FASB released ASU 2011-04 Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS, further converging U.S. GAAP and IFRS by providing common fair value measurement and disclosure requirements. FASB made changes to the fair value measurement guidance, which include: 1) prohibiting the inclusion of block discounts in all fair value measurements, not just Level 1 measurements, 2) adding guidance on when to include other premiums and discounts in fair value measurements, 3) clarifying that the concepts of “highest and best use” and “valuation premise” apply only when measuring the fair value of non-financial assets and 4) adding an exception that allows the measurement of a group of financial assets and liabilities with offsetting risks (e.g., a portfolio of derivative contracts) at their net exposure to a particular risk if certain criteria are met. ASU 2011-04 also requires additional disclosure related to items categorized as Level 3 in the fair value hierarchy, including a description of the processes for valuing these assets, providing quantitative information about the significant unobservable inputs used to measure fair value, and in certain cases, explaining the sensitivity of the fair value measurements to changes in unobservable inputs. This guidance is effective for interim and annual reporting periods beginning after December 15, 2011. The Company does not hold any Level 3 assets and therefore, this update has no significant effect on the Company’s consolidated financial statements.

Transfers and Servicing (Topic 860)

In April 2011, the FASB issued ASU 2011-03, Transfers and Servicing: Reconsideration of Effective Control for Repurchase Agreements. In a typical repurchase agreement transaction, an entity transfers financial assets to the counterparty in exchange for cash with an agreement for the counterparty to return the same or equivalent financial assets for a fixed price in the future. Previous to this update, one of the factors in determining whether sale treatment could be used was whether the transferor maintained effective control of the transferred assets and in order to do so, the transferor must have the ability to repurchase such assets. In connection with the issuance of ASU 2011-03, the FASB concluded that the assessment of effective control should focus on a transferor’s contractual rights and obligations with respect to transferred financial assets, rather than whether the transferor has the practical ability to perform in accordance with those rights or obligations. ASU 2011-03 removes the transferor’s ability criterion from consideration of effective control. This update is effective for the first interim or annual period beginning on or after December 15, 2011. As the Company records repurchase agreements as secured borrowings and not sales, this update has no significant effect on the Company’s consolidated financial statements.

Financial Services – Investment Companies (Topic 946)

In October 2011, the FASB issued a proposed ASU 2011-20, Financial Services-Investment Companies: Amendments to the Scope, Measurement, and Disclosure Requirements, which would amend the criteria in Topic 946 for determining whether an entity qualifies as an investment company. As proposed, this ASU would affect the measurement, presentation and disclosure requirements for Investment Companies, as defined, amend the investment company definition in ASC 946, and remove the current exemption for Real Estate Investment Trusts from this topic. If promulgated in its current form, this proposal may result in a material modification to the presentation of the Company’s consolidated financial statements. The Company is monitoring developments related to this proposal and is evaluating the effects it would have on the Company’s consolidated financial statements.

2. AGENCY MORTGAGE-BACKED SECURITIES

The following tables present the Company’s available-for-sale Agency mortgage-backed securities portfolio as of September 30, 2012 and December 31, 2011 which were carried at their fair value:

September 30, 2012	Freddie Mac	Fannie Mae	Ginnie Mae	Total Mortgage-Backed Securities
	(dollars in thousands)			
Agency mortgage-backed securities, par value	$ 45,694,153	$ 74,191,691	$ 296,707	$ 120,182,551
Unamortized discount	(9,552)	(14,615)	(391)	(24,558)
Unamortized premium	2,009,836	3,443,390	24,344	5,477,570
Amortized cost	47,694,437	77,620,466	320,660	125,635,563
Gross unrealized gains	1,535,949	2,546,506	21,808	4,104,263
Gross unrealized losses	(17,193)	(124,164)	(755)	(142,112)
Estimated fair value	$ 49,213,193	$ 80,042,808	$ 341,713	$ 129,597,714

	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Estimated Fair Value
	(dollars in thousands)			
Adjustable rate	$ 6,671,582	$ 289,871	$ (4,450)	$ 6,957,003
Fixed rate	118,963,981	3,814,392	(137,662)	122,640,711
Total	$ 125,635,563	$ 4,104,263	$ (142,112)	$ 129,597,714

December 31, 2011	Freddie Mac	Fannie Mae	Ginnie Mae	Total Mortgage Backed Securities
	(dollars in thousands)			
Agency mortgage-backed securities, par value	$ 34,395,542	$ 63,066,372	$ 500,968	$ 97,962,882
Unamortized discount	(9,874)	(13,632)	(399)	(23,905)
Unamortized premium	1,139,881	2,205,138	15,949	3,360,968
Amortized cost	35,525,549	65,257,878	516,518	101,299,945
Gross unrealized gains	973,476	2,081,282	31,474	3,086,232
Gross unrealized losses	(15,243)	(118,871)	(1,008)	(135,122)
Estimated fair value	$ 36,483,782	$ 67,220,289	$ 546,984	$ 104,251,055

	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Estimated Fair Value

	(dollars in thousands)			
Adjustable rate	$ 8,698,746	$ 345,642	$ (3,188)	$ 9,041,200
Fixed rate	92,601,199	2,740,590	(131,934)	95,209,855
Total	$ 101,299,945	$ 3,086,232	$ (135,122)	$ 104,251,055

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Actual maturities of Agency mortgage-backed securities are generally shorter than stated contractual maturities because actual maturities of Agency mortgage-backed securities are affected by the contractual lives of the underlying mortgages, periodic payments and prepayments of principal. The following table summarizes the Company's Agency mortgage-backed securities as of September 30, 2012 and December 31, 2011, according to their estimated weighted-average life classifications:

	September 30, 2012		December 31, 2011	
Weighted-Average Life	Fair Value	Amortized Cost	Fair Value	Amortized Cost
	(dollars in thousands)			
Less than one year	$4,424,036	$4,379,206	$1,715,530	$1,697,101
Greater than one year through five years	124,868,825	120,967,061	97,344,791	94,534,782
Greater than five years through ten years	304,853	289,296	4,447,540	4,348,841
Greater than 10 years	-	-	743,194	719,221
Total	$129,597,714	$125,635,563	$104,251,055	$101,299,945

The weighted-average lives of the Agency mortgage-backed securities at September 30, 2012 and December 31, 2011 in the table above are based upon data provided through subscription-based financial information services, assuming constant principal prepayment rates to the reset date of each security. The prepayment model considers current yield, forward yield, steepness of the yield curve, current mortgage rates, mortgage rate of the outstanding loans, loan age, margin, volatility, and other factors. The actual weighted average lives of the Agency mortgage-backed securities could be longer or shorter than estimated.

The following table presents the gross unrealized losses and estimated fair value of the Company's Agency mortgage-backed securities by length of time that such securities have been in a continuous unrealized loss position at September 30, 2012 and December 31, 2011.

	Unrealized Loss Position For: (dollars in thousands)					
	Less than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
September 30, 2012	$1,302,641	$(31,172)	$360,621	$(110,940)	$1,663,262	$(142,112)
December 31, 2011	$1,087,552	$(118,593)	$883,143	$(16,529)	$1,970,695	$(135,122)

The decline in value of these securities is solely due to market conditions and not the quality of the assets. Substantially all of the Company's Investment Securities are Agency mortgage-backed securities that are "AAA" rated or carry an implied "AAA" rating. The investments are not considered to be other-than-temporarily impaired because the Company currently has the ability and intent to hold the investments to maturity or for a period of time sufficient for a forecasted market price recovery up to or beyond the cost of the investments, and it is not more likely than not that the Company will be required to sell the investments before recovery of the amortized cost bases, which may be maturity. Also, the Company is guaranteed payment of the principal amount of the securities by the respective issuing government agency.

During the quarter and nine months ended September 30, 2012, the Company sold $7.0 billion and $17.9 billion of Agency mortgage-backed securities, respectively, resulting in a net realized gain of $142.0 million and $317.1 million, respectively. During the quarter and nine months ended September 30, 2011, the Company sold $3.6 billion and $8.5 billion of Agency mortgage-backed securities, respectively, resulting in a realized gain of $91.7 million and

$118.5 million, respectively. Average cost is used for calculating gains or losses on securities sold.

Agency interest-only mortgage-backed securities represent the right to receive a specified portion of the contractual interest flows of the underlying unamortized principal balance of specific Agency mortgage-backed securities. As of September 30, 2012, Agency interest-only mortgage-backed securities had net unrealized losses of $129.9 million and an amortized cost of $604.5 million.

3. INVESTMENTS IN AFFILIATES, AVAILABLE FOR SALE EQUITY SECURITIES

Substantially all of the Company's available-for-sale equity securities are shares of Chimera Investment Corporation ("Chimera") and CreXus Investment Corp. ("CreXus") and are reported at fair value. The Company owned approximately 45.0 million shares of Chimera at September 30, 2012 and December 31, 2011 with a fair value of approximately $121.9 million and $112.9 million, respectively. At September 30, 2012 and December 31, 2011, the investment in Chimera had an unrealized loss of $16.9 million and $25.9 million, respectively. The Company owned approximately 9.5 million shares of CreXus at September 30, 2012 and December 31, 2011 with a fair value of approximately $103.0 million and $98.9 million, respectively. At September 30, 2012 and December 31, 2011, the investment in CreXus had an unrealized loss of $22.4 million and $26.5 million, respectively.

The Company has evaluated the near-term prospects of its investment in affiliates in relation to the severity and length of time of the impairment. Based on this evaluation, management has determined that its investment in affiliates is not considered to be other-than-temporarily impaired as of September 30, 2012 and December 31, 2011 as the Company has the intent and ability to retain its investments for a period of time sufficient to allow for any anticipated recovery in market value.

4. GOODWILL

Merganser's prior owners received an additional payment of $13.4 million during the first quarter of 2012 relating to earn-out provisions in the merger agreement. This amount was recorded as additional goodwill.

5. FAIR VALUE MEASUREMENTS

The Company follows fair value guidance in accordance with U.S. GAAP to account for its financial instruments. The Company categorizes its financial instruments, based on the priority of the inputs to the valuation technique, into a three-level fair value hierarchy. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). If the inputs used to measure the financial instruments fall within different levels of the hierarchy, the categorization is based on the lowest level input that is significant to the fair value measurement of the instrument. Financial assets and liabilities recorded at fair value on the consolidated statements of financial condition or disclosed in the related notes are categorized based on the inputs to the valuation techniques as follows:

Level 1– inputs to the valuation methodology are quoted prices (unadjusted) for identical assets and liabilities in active markets.

Level 2 – inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 – inputs to the valuation methodology are unobservable and significant to overall fair value.

Agency mortgage-backed securities, Agency debentures and interest rate swaps are valued using quoted prices, including dealer quotes, or internally estimated prices for similar assets. The Company incorporates common market pricing methods, including a spread measurement to the Treasury curve as well as underlying characteristics of the particular security including coupon, periodic and life caps, rate reset period and expected life of the security in its estimates of fair value. Management ensures that current market conditions are reflected in its estimates of fair value. Management compares internal prices to independent third party sources and dealer quotes for reasonableness.

The fair value of U.S. Treasury securities, securities borrowed and loaned, investments in affiliates and equity investments are based on quoted prices in active markets.

	Level 1	Level 2	Level 3
At September 30, 2012	(dollars in thousands)		
Assets:			
U.S. Treasury Securities	$2,242,039	$-	$-
Securities borrowed	-	1,602,692	-
Agency mortgage-backed securities	-	129,597,714	-
Agency debentures	-	2,935,538	-
Investment in affiliates	224,899	-	-
Other derivative contracts	559	-	-
Liabilities:			
U.S. Treasury securities sold, not yet purchased	1,418,750	-	-
Interest rate swaps	-	2,926,461	-
Securities loaned	-	1,248,968	-

	Level 1	Level 2	Level 3
At December 31, 2011	(dollars in thousands)		
Assets:			
U.S. Treasury securities	$928,547	$-	$-
Securities borrowed	-	928,732	-
Agency mortgage-backed securities	-	104,251,055	-
Agency debentures	-	889,580	-
Investments in affiliates	211,970	-	-
Equity securities	3,891	-	-
Other derivative contracts	113	-	-
Liabilities:			
U.S. Treasury securities sold, not yet purchased	826,912	-	-
Interest rate swaps	-	2,552,687	-
Securities loaned	-	804,901	-

The following table summarizes the estimated fair value for all financial assets and liabilities as of September 30, 2012 and December 31, 2011.

	September 30, 2012		December 31, 2011	
	Carrying Value	Fair Value	Carrying Value	Fair Value
	(dollars in thousands)			
Financial assets:				
Cash and cash equivalents(1)	$2,264,854	$2,264,854	$994,198	$994,198
Reverse repurchase agreements(1)	1,612,384	1,612,384	860,866	860,866
U.S. Treasury Securities(2)	2,242,039	2,242,039	928,547	928,547
Securities borrowed(2)	1,602,692	1,602,692	928,732	928,732
Agency mortgage-backed securities	129,597,714	129,597,714	104,251,055	104,251,055
Agency debentures	2,935,538	2,935,538	889,580	889,580
Investment in affiliates(2)	224,899	224,899	211,970	211,970
Receivable from Prime Broker	3,272	3,272	3,272	3,272
Equity securities(2)	-	-	3,891	3,891
Corporate debt(3)	64,928	66,195	52,073	52,628
Other derivatives(2)	559	559	113	113
Financial liabilities:				
U.S. Treasury Securities sold, not yet purchased(2)	$1,418,750	$1,418,750	$826,912	$826,912
Repurchase agreements(1)(4)	101,033,146	101,634,836	84,097,885	84,369,817
Securities loaned(2)	1,248,968	1,248,968	804,901	