Armour Residential REIT, Inc.
Form 10-Q
April 25, 2018

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 March 31, 2018
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

ARMOUR RESIDENTIAL REIT, INC.
(Exact name of registrant as specified in its charter)

Maryland	001-34766	26-1908763
(State or other jurisdiction of incorporation or organization)	(Commission File Number)	(I.R.S. Employer Identification No.)

3001 Ocean Drive, Suite 201, Vero Beach, FL 32963
(Address of principal executive offices)(zip code)

(772) 617-4340
(Registrant’s telephone number, including area code)

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

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

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

Large accelerated filer x Accelerated filer o Non-accelerated filer o (Do not check if a smaller reporting company)

Smaller reporting company o Emerging growth company o

If an emerging growth company, indicate by a check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act o

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

The number of outstanding shares of the Registrant's common stock as of April 24, 2018 was 41,902,723.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

ARMOUR Residential REIT, Inc.
CONSOLIDATED BALANCE SHEETS (UNAUDITED)
(in thousands, except per share)

	March 31, 2018	December 31, 2017
Assets		
Cash	$216,497	$265,232
Cash collateral posted to counterparties	13,150	17,162
Investments in securities, at fair value		
Agency Securities (including pledged securities of $5,725,997 at March 31, 2018 and $7,094,766 at December 31, 2017)	6,245,432	7,478,966
Credit Risk and Non-Agency Securities (including pledged securities of $884,531 at March 31, 2018 and $974,372 at December 31, 2017)	968,950	975,829
Interest-Only Securities	24,933	25,752
U.S. Treasury Securities - pledged securities	670,696	—
Receivable for unsettled sales (including pledged securities of $63,535 at March 31, 2018)	68,796	—
Derivatives, at fair value	135,703	37,211
Accrued interest receivable	20,492	22,165
Prepaid and other	1,608	1,600
Subordinated loans due from BUCKLER Securities LLC	105,000	105,000
Total Assets	$8,471,257	$8,928,917
Liabilities and Stockholders' Equity		
Liabilities:		
Repurchase agreements	$6,853,715	$7,555,917
Cash collateral posted by counterparties	127,721	29,593
Payable for unsettled purchases	227,409	—
Derivatives, at fair value	6,882	7,948
Accrued interest payable- repurchase agreements	5,274	6,452
Accounts payable and other accrued expenses	5,290	2,956
Total Liabilities	$7,226,291	$7,602,866
Commitments and contingencies (Note 11)		
Stockholders' Equity:		
Preferred stock, $0.001 par value, 50,000 shares authorized;		
8.250% Series A Cumulative Preferred Stock; 2,181 issued and outstanding ($54,514 aggregate liquidation preference)	2	2
7.875% Series B Cumulative Preferred Stock; 6,369 and 6,262 shares issued and outstanding at March 31, 2018 and December 31, 2017 ($159,232 and $156,560 aggregate liquidation preference, respectively)	6	6
Common stock, $0.001 par value, 125,000 shares authorized, 41,902 and 41,877 shares issued and outstanding at March 31, 2018 and December 31, 2017	42	42
Additional paid-in capital	2,712,611	2,709,335

Accumulated deficit	(1,346,867)	(1,363,223)
Accumulated other comprehensive loss	(120,828)	(20,111)
Total Stockholders' Equity	$1,244,966	$1,326,051
Total Liabilities and Stockholders' Equity	$8,471,257	$8,928,917

See financial statement notes (unaudited).

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ARMOUR Residential REIT, Inc.
CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(in thousands, except per share)

	For the Three Months Ended March 31,	
	2018	2017
Interest Income:		
Agency Securities, net of amortization of premium and fees	$52,253	$44,081
Credit Risk and Non-Agency Securities, including discount accretion	14,006	13,898
Interest-Only Securities	442	603
U.S. Treasury Securities	844	—
BUCKLER Subordinated loans	624	—
Total Interest Income	$68,169	$58,582
Interest expense- repurchase agreements	(32,018)	(18,064)
Net Interest Income	$36,151	$40,518
Other Income (Loss):		
Realized loss on sale of Agency Securities (reclassified from Other comprehensive income (loss))	(32,603)	(11,154)
Other than temporary impairment of Agency Securities (reclassified from Other comprehensive income)	(12,090)	—
Gain on Credit Risk and Non-Agency Securities	1,283	24,284
Gain (loss) on Interest-Only Securities	298	(3,743)
Gain on U.S. Treasury Securities	2,576	—
Subtotal	$(40,536)	$9,387
Realized loss on derivatives (1)	(38,604)	(12,249)
Unrealized gain on derivatives	97,201	23,768
Subtotal	$58,597	$11,519
Total Other Income	$18,061	$20,906
Expenses:		
Management fees	6,801	6,521
Professional fees	1,172	880
Insurance	165	277
Compensation	977	477
Other	350	551
Total Expenses	$9,465	$8,706
Net Income	$44,747	$52,718
Dividends on preferred stock	(4,253)	(3,905)
Net Income available to common stockholders	$40,494	$48,813
Net Income per share available to common stockholders (Note 14):		
Basic	$0.97	$1.33
Diluted	$0.96	$1.33
Dividends declared per common share	$0.57	$0.57
Weighted average common shares outstanding:		
Basic	41,887	36,724
Diluted	42,331	36,748

(1) Interest expense related to our interest rate swap contracts is recorded as realized loss on derivatives on the consolidated statements of operations. For additional information, see financial statement Note 10.

See financial statement notes (unaudited).

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ARMOUR Residential REIT, Inc.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (UNAUDITED)
(in thousands)

	For the Three Months Ended March 31,	
	2018	2017
Net Income	$44,747	$52,718
Other comprehensive income (loss):		
Reclassification adjustment for realized loss on sale of available for sale Agency Securities	32,603	11,154
Reclassification adjustment for other than temporary impairment of available for sale Agency Securities	12,090	—
Net unrealized gain (loss) on available for sale Agency Securities	(145,410)	6,114
Other comprehensive income (loss)	$(100,717)	$17,268
Comprehensive Income (Loss)	$(55,970)	$69,986

See financial statement notes (unaudited).

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ARMOUR Residential REIT, Inc.
CONSOLIDATED STATEMENT OF STOCKHOLDERS’ EQUITY (UNAUDITED)
(in thousands)

	Preferred Stock						Common Stock						
	8.250% Series A			7.875% Series B									
	Shares	Par Amount	Additional Paid-in Capital	Shares	Par Amount	Additional Paid-in Capital	Shares	Par Amount	Additional Paid-in Capital	Total Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total
Balance, January 1, 2017	2,181	$2	$53,172	6,262	$6	$151,515	41,877	$42	$2,504,648	$2,709,335	$(1,363,223)	$(20,111)	$1,3
Series A Preferred dividends	—	—	—	—	—	—	—	—	—	—	(1,124)	—	(1,12
Series B Preferred dividends	—	—	—	—	—	—	—	—	—	—	(3,129)	—	(3,12
Common stock dividends	—	—	—	—	—	—	—	—	—	—	(24,138)	—	(24,1
Issuance of Series B Preferred stock, net	—	—	—	107	—	2,632	—	—	—	2,632	—	—	2,63
Stock based compensation, net of withholding requirements	—	—	—	—	—	—	25	—	644	644	—	—	644
Net Income	—	—	—	—	—	—	—	—	—	—	44,747	—	44,7
Other comprehensive loss	—	—	—	—	—	—	—	—	—	—	—	(100,717)	(100
Balance, March 31, 2018	2,181	$2	$53,172	6,369	$6	$154,147	41,902	$42	$2,505,292	$2,712,611	$(1,346,867)	$(120,828)	$1,2

See financial statement notes (unaudited).

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ARMOUR Residential REIT, Inc.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(in thousands)

	For the Three Months Ended March 31,	
	2018	2017
Cash Flows From Operating Activities:		
Net Income	$44,747	$52,718
Adjustments to reconcile net income to net cash used in operating activities:		
Net amortization of premium on Agency Securities	9,794	12,633
Accretion of net discount on Credit Risk and Non-Agency Securities	(1,006)	(848)
Net amortization of Interest-Only Securities	1,117	1,311
Realized loss on sale of Agency Securities	32,603	11,154
Other than temporary impairment of Agency Securities	12,090	—
Gain on Credit Risk and Non-Agency Securities	(1,283)	(24,284)
(Gain) Loss on Interest-Only Securities	(298)	3,743
Gain on of U.S. Treasury Securities	(2,576)	—
Stock based compensation	644	200
Changes in operating assets and liabilities:		
(Increase) decrease in accrued interest receivable	1,971	(29)
(Increase) decrease in prepaid and other assets	56	(371)
Change in derivatives, at fair value	(99,558)	(57,159)
Decrease in accrued interest payable- repurchase agreements	(1,178)	(2,868)
Increase (decrease) in accounts payable and other accrued expenses	2,270	(1,239)
Net cash used in operating activities	$(607)	$(5,039)
Cash Flows From Investing Activities:		
Purchases of Agency Securities	—	(1,408,177)
Purchases of Credit Risk and Non-Agency Securities	—	(8,224)
Purchases of U.S. Treasury Securities	(668,120)	—
Principal repayments of Agency Securities	167,649	208,031
Principal repayments of Credit Risk and Non-Agency Securities	9,168	16,088
Proceeds from sales of Agency Securities	1,068,996	1,387,366
Increase in cash collateral	102,140	61,556
Net cash provided by investing activities	$679,833	$256,640
Cash Flows From Financing Activities:		
Issuance of Series B Preferred stock, net of expenses	2,632	—
Proceeds from repurchase agreements	35,593,550	35,245,549
Principal repayments on repurchase agreements	(36,295,752)	(35,549,608)
Series A Preferred stock dividends paid	(1,124)	(1,124)
Series B Preferred stock dividends paid	(3,129)	(2,781)
Common stock dividends paid	(24,138)	(20,951)
Net cash used in financing activities	$(727,961)	$(328,915)
Net decrease in cash	(48,735)	(77,314)
Cash - beginning of period	265,232	271,773
Cash - end of period	$216,497	$194,459
Supplemental Disclosure:		
Cash paid during the period for interest	$53,651	$36,117
Non-Cash Investing Activities:		

Receivable for unsettled sales	$68,796	$649,323
Payable for unsettled purchases	$227,409	$467,562
Net unrealized gain (loss) on available for sale Agency Securities	$(145,410)	$6,114

See financial statement notes (unaudited).

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ARMOUR Residential REIT, Inc.
FINANCIAL STATEMENT NOTES (UNAUDITED)
(in thousands, except per share)

Note 1 -Organization and Nature of Business Operations

References to “we,” “us,” “our,” or the “Company” are to ARMOUR Residential REIT, Inc. (“ARMOUR”) and its subsidiaries References to “ACM” are to ARMOUR Capital Management LP, a Delaware limited partnership.

ARMOUR is an externally managed Maryland corporation incorporated in 2008. The Company is managed by ACM, an investment advisor registered with the Securities and Exchange Commission (the “SEC”), (see Note 11 -Commitments and Contingencies and Note 16 -Related Party Transactions for additional discussion). We have elected to be taxed as a real estate investment trust (“REIT”) under the Internal Revenue Code, as amended (the "Code”). Our qualification as a REIT depends on our ability to meet, on a continuing basis, various complex requirements under the Code relating to, among other things, the sources of our gross income, the composition and values of our assets, our distribution levels and the concentration of ownership of our capital stock. We believe that we are organized in conformity with the requirements for qualification as a REIT under the Code and our manner of operations enables us to meet the requirements for taxation as a REIT for federal income tax purposes. As a REIT, we will generally not be subject to federal income tax on the REIT taxable income that we currently distribute to our stockholders. If we fail to qualify as a REIT in any taxable year and do not qualify for certain statutory relief provisions, we will be subject to federal income tax at regular corporate rates. Even if we qualify as a REIT for federal income tax purposes, we may still be subject to some federal, state and local taxes on our income.

We invest in residential mortgage backed securities issued or guaranteed by a United States (“U.S.”) Government-sponsored entity (“GSE”), such as the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), or a government agency such as Government National Mortgage Administration (Ginnie Mae) (collectively, “Agency Securities”). We also invest in Interest-Only Securities, which are the interest portion of Agency Securities, that is separated and sold individually from the principal portion of the same payment. Other securities backed by residential mortgages in which we invest, for which the payment of principal and interest is not guaranteed by a GSE or government agency (collectively, “Credit Risk and Non-Agency Securities” and together with Agency Securities and Interest-Only Securities, “MBS”), may benefit from credit enhancement derived from structural elements such as subordination, over collateralization or insurance.

Our securities portfolio consists primarily of Agency Securities backed by fixed rate home loans. From time to time, a portion of our assets may be invested in Agency Securities backed by hybrid adjustable rate and adjustable rate home loans as well as unsecured notes and bonds issued by GSEs, U.S. Treasury Securities and money market instruments, subject to certain income tests we must satisfy for our qualification as a REIT.

Note 2 -Basis of Presentation and Consolidation

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X promulgated by the SEC. Accordingly, the condensed financial statements do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2018 are not necessarily indicative of the results that may be expected for the calendar year ending December 31, 2018. These unaudited consolidated financial statements should be read in conjunction with the audited financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2017.

The unaudited consolidated financial statements include the accounts of ARMOUR Residential REIT, Inc. and its subsidiaries. All intercompany accounts and transactions have been eliminated. The preparation of the consolidated 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. Significant estimates affecting the accompanying condensed consolidated financial statements include the valuation of MBS

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ARMOUR Residential REIT, Inc.
FINANCIAL STATEMENT NOTES (UNAUDITED)
(in thousands, except per share)

(as defined below), including an assessment of whether other-than-temporary impairment (“OTTI”) exists, and derivative instruments.

Note 3 -Summary of Significant Accounting Policies

Cash

Cash includes cash on deposit with financial institutions. We may maintain deposits in federally insured financial institutions in excess of federally insured limits. However, management believes we are not exposed to significant credit risk due to the financial position and creditworthiness of the depository institutions in which those deposits are held.

Cash Collateral Posted To/By Counterparties

Cash collateral posted to/by counterparties represents cash posted by us to counterparties or posted by counterparties to us as collateral. Cash collateral posted to/by counterparties may include collateral for interest rate swap contracts (including swaptions and basis swap contracts), and repurchase agreements on our MBS and our Agency Securities purchased or sold on a to-be-announced basis (“TBA Agency Securities”).
Investments in Securities, at Fair Value

We generally intend to hold most of our securities for extended periods of time. We may, from time to time, sell any of our securities as part of the overall management of our securities portfolio. Management determines the appropriate classifications of the securities at the time they are acquired and evaluates the appropriateness of such classifications at each balance sheet date. Purchases and sales of our securities are recorded on the trade date.

Agency Securities - At March 31, 2018 and December 31, 2017, all of our Agency Securities were classified as available for sale securities. Agency Securities classified as available for sale are reported at their estimated fair values with unrealized gains and losses excluded from earnings and reported as part of the consolidated statements of comprehensive income (loss).

Credit Risk and Non-Agency Securities - At March 31, 2018 and December 31, 2017, all of our Credit Risk and Non-Agency Securities were classified as trading securities. Credit Risk and Non-Agency Securities classified as trading are reported at their estimated fair values with unrealized gains and losses included in Other Income (Loss) as a component of the consolidated statements of operations.

Interest-Only Securities - At March 31, 2018 and December 31, 2017, all of our Interest-Only Securities were classified as trading securities. Interest-Only Securities represent the right to receive a specified proportion of the contractual interest flows of specific Agency MBS. Interest-Only Securities classified as trading are reported at their estimated fair values with unrealized gains and losses included in Other Income (Loss) as a component of the consolidated statements of operations.

U.S. Treasury Securities - At March 31, 2018, all of our U.S. Treasury Securities were classified as trading securities. U.S. Treasury Securities classified as trading are reported at their estimated fair values with unrealized gains and losses included in Other Income (Loss) as a component of the consolidated statements of operations. We did not have any U.S. Treasury Securities at December 31, 2017.

Receivables and Payables for Unsettled Sales and Purchases

We account for purchases and sales of securities on the trade date, including purchases and sales for forward settlement. Receivables and payables for unsettled trades represent the agreed trade price multiplied by the outstanding balance of the securities at the balance sheet date.

Accrued Interest Receivable and Payable

Accrued interest receivable includes interest accrued between payment dates on securities. Accrued interest payable includes interest payable on our repurchase agreements and may, at certain times, contain interest payable on U.S. Treasury Securities sold short.

Repurchase Agreements

We finance the acquisition of our MBS through the use of repurchase agreements. Our repurchase agreements are secured by our MBS and bear interest rates that have historically moved in close relationship to the Federal Funds Rate and the London Interbank Offered Rate ("LIBOR"). Under these repurchase agreements, we sell MBS to a lender and agree to repurchase the same MBS in the future for a price that is higher than the original sales price. The difference between the sales price that we receive and the repurchase price that we pay represents interest paid to the lender. A repurchase agreement operates as a financing arrangement under which we pledge our MBS as collateral to secure a loan which is equal in value to a specified percentage of the estimated fair value of the pledged collateral. We retain beneficial ownership of the pledged collateral. At the maturity of a repurchase agreement, we are required to repay the loan and concurrently receive back our pledged collateral from the lender or, with the consent of the lender, we may renew such agreement at the then prevailing interest rate. The repurchase agreements may require us to pledge additional assets to the lender in the event the estimated fair value of the existing pledged collateral declines.

In addition to the repurchase agreement financing discussed above, at certain times we have entered into reverse repurchase agreements with certain of our repurchase agreement counterparties. Under a typical reverse repurchase agreement, we purchase U.S. Treasury Securities from a borrower in exchange for cash and agree to sell the same securities in the future in exchange for a price that is higher than the original purchase price. The difference between the purchase price originally paid and the sale price represents interest received from the borrower. Reverse repurchase agreement receivables and repurchase agreement liabilities are presented net when they meet certain criteria, including being with the same counterparty, being governed by the same master repurchase agreement ("MRA"), settlement through the same brokerage or clearing account and maturing on the same day. We did not have any reverse repurchase agreements outstanding at March 31, 2018 and December 31, 2017.

Derivatives, at Fair Value

We recognize all derivatives as either assets or liabilities at fair value on our consolidated balance sheets. All changes in the fair values of our derivatives are reflected in our consolidated statements of operations. We designate derivatives as hedges for tax purposes and any unrealized derivative gains or losses would not affect our distributable net taxable income. These transactions include interest rate swap contracts, interest rate swaptions and basis swap contracts. We also may utilize forward contracts for the purchase or sale of TBA Agency Securities. We account for TBA Agency Securities as derivative instruments if it is reasonably possible that we will not take or make physical delivery of the Agency Security upon settlement of the contract. We account for TBA dollar roll transactions as a series of derivative transactions.

We may also purchase and sell TBA Agency Securities as a means of investing in and financing Agency Securities (thereby increasing our "at risk" leverage) or as a means of disposing of or reducing our exposure to Agency Securities (thereby reducing our "at risk" leverage). Pursuant to TBA Agency Securities, we agree to purchase or sell, for future delivery, Agency Securities with certain principal and interest terms and certain types of collateral, but the particular Agency Securities to be delivered are not identified until shortly before the TBA settlement date. We may also choose, prior to settlement, to move the settlement of these securities out to a later date by entering into an offsetting short or long position (referred to as a “pair off”), net settling the paired off positions for cash, and simultaneously purchasing or selling a similar TBA Agency Security for a later settlement date. This transaction is commonly referred to as a “dollar roll.” When it is reasonably possible that we will pair off a TBA Agency Security, we account for that contract as a derivative.

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ARMOUR Residential REIT, Inc.
FINANCIAL STATEMENT NOTES (UNAUDITED)
(in thousands, except per share)

Revenue Recognition

Agency Securities - Interest income is earned and recognized on Agency Securities based on their unpaid principal amounts and their contractual terms. Recognition of interest income commences on the settlement date of the purchase transaction and continues through the settlement date of the sale transaction. Premiums and discounts associated with the purchase of Multi-Family MBS, which are generally not subject to prepayment, are amortized or accreted into interest income over the contractual lives of the securities using a level yield method. Premiums and discounts associated with the purchase of other Agency Securities are amortized or accreted into interest income over the actual lives of the securities, reflecting actual prepayments as they occur.

•Fair Value of Agency Securities: We invest in Agency Securities representing interests in or obligations backed by pools of fixed rate, hybrid adjustable rate and adjustable rate mortgage loans. GAAP requires us to classify our investments as either trading, available for sale or held to maturity securities. Management determines the appropriate classifications of the securities at the time they are acquired and evaluates the appropriateness of such classifications at each balance sheet date. We currently classify all of our Agency Securities as available for sale. Agency Securities classified as available for sale are reported at their estimated fair values with unrealized gains and losses excluded from earnings and reported as part of the statements of comprehensive income (loss).

•Agency Security purchase and sale transactions (including purchase of TBA Agency Securities): Purchases and Sales are recorded on the trade date to the extent it is probable that we will take or make timely physical delivery of the related securities. Gains or losses realized from the sale of securities are included in income and are determined using the specific identification method.

•Impairment of Assets: We evaluate Agency Securities for other than temporary impairment at least on a quarterly basis and more frequently when economic or market concerns warrant such evaluation. We consider an impairment to be other than temporary if we (1) have the intent to sell the Agency Securities, (2) believe it is more likely than not that we will be required to sell the securities before recovery (for example, because of liquidity requirements or contractual obligations) or (3) a credit loss exists. Impairment losses recognized establish a new cost basis for the related Agency Securities.

Credit Risk and Non-Agency Securities and Interest-Only Securities - Interest income on Credit Risk and Non-Agency Securities and Interest-Only Securities is recognized using the effective yield method over the life of the securities based on the future cash flows expected to be received. Future cash flow projections and related effective yields are determined for each security and updated quarterly. Other than temporary impairments, which establish a new cost basis in the security for purposes of calculating effective yields, are recognized when the fair value of a security is less than its cost basis and there has been an adverse change in the future cash flows expected to be received. Other changes in future cash flows expected to be received are recognized prospectively over the remaining life of the security.

U.S. Treasury Securities - Interest income on U.S. Treasury Securities is recognized based on their unpaid principal amounts and their contractual terms. Recognition of interest income commences on the settlement date of the purchase transaction and continues through the settlement date of the sale transaction.

Comprehensive Income (Loss)

Comprehensive income (loss) refers to changes in equity during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period, except those resulting from investments by owners and distributions to owners.

Note 4 -Recent Accounting Pronouncements

We consider the applicability and impact of all Accounting Standards Updates issued by the Financial Accounting Standards Board. Those not listed below were deemed to be either not applicable, are not expected to have a significant impact on our consolidated financial statements when adopted, or did not have a significant impact on our consolidated financial statements upon adoption.

In August 2017, the Financial Accounting Standards Board issued ASU 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities. The standard amends the hedge accounting recognition and presentation requirements in ASC 815. The standard is effective for fiscal years beginning after December 15, 2018 and interim periods therein, however, early adoption is permitted upon its issuance. The Company is currently assessing the impact of the standard and whether it may apply hedge accounting in the future.

In July 2016, the Financial Accounting Standards Board issued ASU 2016-13, Financial Instruments–Credit Losses (Topic 326). The standard introduces a new model for recognizing credit losses on financial instruments based on an estimate of current expected credit losses. The standard will apply to (1) loans, accounts receivable, trade receivables, and other financial assets measured at amortized cost, (2) loan commitments and certain other off–balance sheet credit exposures, (3) debt securities and other financial assets measured at fair value through other comprehensive income, and (4) beneficial interests in securitized financial assets. The standard is effective for fiscal years beginning after December 15, 2019. The Company is assessing the impact of this standard but does not expect it to have significant impact on the consolidated financial statements. However, the impact on the consolidated financial statements will depend on the debt securities held by the Company on the date of the adoption.

Note 5 -Fair Value of Financial Instruments

Our valuation techniques for financial instruments use observable and unobservable inputs. Observable inputs reflect readily obtainable data from third party sources, while unobservable inputs reflect management's market assumptions. The Accounting Standards Codification Topic No. 820, "Fair Value Measurement," classifies these inputs into the following hierarchy:

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

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

Level 3 Inputs - Prices determined using significant unobservable inputs. Unobservable inputs may be used in situations where quoted prices or observable inputs are unavailable (for example, when there is little or no market activity for an investment at the end of the period). Unobservable inputs reflect management's assumptions about the factors that market participants would use in pricing an asset or liability, and would be based on the best information available.

At the beginning of each quarter, we asses the assets and liabilities that are measured at fair value on a recurring basis to determine if any transfers between levels in the fair value hierarchy are needed.

The following describes the valuation methodologies used for our assets and liabilities measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy. Any transfers between levels are assumed to occur at the beginning of the reporting period.

Cash - Cash includes cash on deposit with financial institutions. The carrying amount of cash is deemed to be its fair value and is classified as Level 1. Cash balances posted by us to counterparties or posted by counterparties to us as collateral are classified as Level 2 because they are integrally related to the Company's repurchase financing and interest rate swap agreements, which are classified as Level 2.

Agency Securities - Fair value for the Agency Securities in our securities portfolio is based on obtaining a valuation for each Agency Security from third party pricing services and/or dealer quotes. The third party pricing services use common market pricing methods that may include pricing models that may incorporate such factors as coupons, prepayment speeds, spread to the Treasury curves and interest rate swap curves, duration, periodic and life caps and credit enhancement. If the fair value of an Agency Security is not available from the third party pricing services or such data appears unreliable, we obtain pricing indications from up to three dealers who make markets in similar Agency Securities. Management reviews pricing used to ensure that current market conditions are properly reflected. This review includes, but is not limited to, comparisons of similar market transactions or alternative third party pricing services, dealer pricing indications and comparisons to a third party pricing model. Fair values obtained from the third party pricing services for similar instruments are classified as Level 2 securities if the inputs to the pricing models used are consistent with the Level 2 definition. If quoted prices for a security are not reasonably available from the third party pricing service, but dealer pricing indications are, the security will be classified as a Level 2 security. If neither is available, management will determine the fair value based on characteristics of the security that we receive from the issuer and based on available market information and classify it as a Level 3 security. At March 31, 2018 and December 31, 2017, all of our Agency Security fair values are classified as Level 2 based on the inputs used by our third party pricing services and dealer quotes.

Credit Risk and Non-Agency Securities - The fair value for the Credit Risk and Non-Agency Securities in our securities portfolio is based on obtaining a valuation for each Credit Risk and Non-Agency Security from third party pricing services and/or dealer quotes. The third party pricing services incorporate such factors as collateral type, bond structure and priority of payments, coupons, prepayment speeds, defaults, delinquencies and severities. If the fair value of a Credit Risk and Non-Agency Security is not available from the third party pricing services or such data appears unreliable, we obtain pricing indications from up to three dealers who make markets in similar Credit Risk and Non-Agency Securities. Management reviews pricing used to ensure that current market conditions are properly reflected. This review includes, but is not limited to, comparisons of similar market transactions or alternative third party pricing services, dealer pricing indications and comparisons to fair value determined using a third party pricing model. Fair values obtained from the third party pricing services for similar instruments are classified as Level 2 securities if the inputs to the pricing models used are consistent with the Level 2 definition. If quoted prices for a security are not reasonably available from the third party pricing service, but dealer pricing indications are, the security will be classified as a Level 2 security. If neither is available, management will determine the fair value based on characteristics of the security that we receive from the issuer and based on available market information and classify it as a Level 3 security. At March 31, 2018 and December 31, 2017, all of our Credit Risk and Non-Agency Securities are classified as Level 2 based on the inputs used by our third party pricing services and dealer quotes.

Interest-Only Securities - The fair value for the Interest-Only Securities in our securities portfolio is based on obtaining a valuation for each Interest-Only Security from third party pricing services and/or dealer quotes. The third party pricing services use common market pricing methods that may include pricing models consistent with those models used to price Agency Securities underlying the Interest-Only Securities that may incorporate such factors as coupons, prepayment speeds, spread to the Treasury curves and interest rate swap curves, duration, periodic and life caps and credit enhancement. If the fair value of an Interest-Only Security is not available from the third party pricing services or such data appears unreliable, we obtain pricing indications from up to three dealers who make markets in similar Interest-Only Securities. Management reviews pricing used to ensure that current market conditions are properly reflected. This review includes, but is not limited to, comparisons of similar market transactions or alternative third party pricing services, dealer pricing indications and comparisons to a third party pricing model. Fair values obtained from the third party pricing services for similar instruments are classified as Level 2 securities if the inputs to the pricing models used are consistent with the Level 2 definition. If quoted prices for a security are not reasonably available from the third party pricing service, but dealer pricing indications are, the security will be classified as a Level 2 security. If neither is available, management will determine the fair value based on characteristics of the security that we receive from the issuer and based on available market information and classify it as a Level 3 security. At March 31, 2018 and December 31, 2017, all of our Interest-Only Security fair values are classified as Level 2 based on the inputs used by our third party pricing services and dealer quotes.

U.S. Treasury Securities- Fair value for the U.S. Treasury Securities in our securities portfolio is based on obtaining a valuation for each U.S. Treasury Securities from third party pricing services and/or dealer quotes. At March 31, 2018, all of our U.S. Treasury Securities fair values are classified as Level 1, as quoted unadjusted prices are available in active markets for identical assets.

Receivables and Payables for Unsettled Sales and Purchases - The carrying amount is generally deemed to be fair value because of the relatively short time to settlement. Such receivables and payables are classified as Level 2 because they are effectively secured by the related securities and could potentially be subject to counterparty credit considerations.

(in thousands, except per share)

Repurchase Agreements - The fair value of repurchase agreements reflects the present value of the contractual cash flows discounted at the estimated LIBOR based market interest rates at the valuation date for repurchase agreements with a term equivalent to the remaining term to interest rate repricing, which may be at maturity, of our repurchase agreements. The fair value of the repurchase agreements approximates their carrying amount due to the short-term nature of these financial instruments. Our repurchase agreements are classified as Level 2.

Derivative Transactions - The fair values of our interest rate swap contracts, interest rate swaptions and basis swaps are valued using information provided by third party pricing services that incorporate common market pricing methods that may include current interest rate curves, forward interest rate curves and market spreads to interest rate curves. We estimate the fair value of TBA Agency Securities based on similar methods used to value our Agency Securities. Management compares the pricing information received to dealer quotes to ensure that the current market conditions are properly reflected. The fair values of our interest rate swap contracts, interest rate swaptions, basis swap contracts and TBA Agency Securities are classified as Level 2.

The following tables provide a summary of our assets and liabilities that are measured at fair value on a recurring basis at March 31, 2018 and December 31, 2017.

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at March 31, 2018
Assets at Fair Value:				
Agency Securities	$—	$6,245,432	$ —	$6,245,432
Credit Risk and Non-Agency Securities	$—	$968,950	$ —	$968,950
Interest-Only Securities	$—	$24,933	$ —	$24,933
U.S. Treasury Securities	$670,696	$—	$ —	$670,696
Derivatives	$—	$135,703	$ —	$135,703
Liabilities at Fair Value:				
Derivatives	$—	$6,882	$ —	$6,882

There were no transfers of assets or liabilities between the levels of the fair value hierarchy during the three months ending March 31, 2018.

	Quoted Prices in Active Markets for Identical Assets	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at December 31, 2017

	(Level 1)			
Assets at Fair Value:				
Agency Securities	$ —	$7,478,966	$ —	$7,478,966
Credit Risk and Non-Agency Securities	$ —	$975,829	$ —	$975,829
Interest-Only Securities	$ —	$25,752	$ —	$25,752
Derivatives	$ —	$37,211	$ —	$37,211
Liabilities at Fair Value:				
Derivatives	$ —	$7,948	$ —	$7,948

(in thousands, except per share)

The following tables provide a summary of the carrying values and fair values of our financial assets and liabilities not carried at fair value but for which fair value is required to be disclosed at March 31, 2018 and December 31, 2017.

March 31, 2018			Fair Value Measurements using:		
	Carrying Value	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial Assets:					
Cash	$216,497	$216,497	$216,497	$—	$ —
Cash collateral posted to counterparties	$13,150	$13,150	$—	$13,150	$ —
Receivable for unsettled sales	$68,796	$68,796	$—	$68,796	$ —
Accrued interest receivable	$20,492	$20,492	$—	$20,492	$ —
Subordinated loans due from BUCKLER Securities LLC	$105,000	$105,000	$—	$105,000	$ —
Financial Liabilities:					
Repurchase agreements	$6,853,715	$6,853,715	$—	$6,853,715	$ —
Cash collateral posted by counterparties	$127,721	$127,721	$—	$127,721	$ —
Payable for unsettled purchases	$227,409	$227,409	$—	$227,409	$ —
Accrued interest payable- repurchase agreements	$5,274	$5,274	$—	$5,274	$ —

December 31, 2017			Fair Value Measurements using:		
	Carrying Value	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial Assets:					
Cash	$265,232	$265,232	$265,232	$—	$ —
Cash collateral posted to counterparties	$17,162	$17,162	$—	$17,162	$ —
Accrued interest receivable	$22,165	$22,165	$—	$22,165	$ —
Subordinated loans due from BUCKLER Securities LLC	$105,000	105,000	$—	$105,000	$ —
Financial Liabilities:					
Repurchase agreements	$7,555,917	$7,555,917	$—	$7,555,917	$ —
Cash collateral posted by counterparties	$29,593	$29,593	$—	$29,593	$ —

Accrued interest payable- repurchase agreements	$6,452	$6,452	$—	$6,452	$	—

(in thousands, except per share)

The following table provides a summary of the changes in Level 3 assets measured at fair value on a recurring basis at March 31, 2018 and March 31, 2017.

	For the Three Months Ended March 31,	
Credit Risk and Non-Agency Securities	2018	2017
Balance, beginning of period	$—	$1,052,170
Purchases of Credit Risk and Non-Agency Securities, at cost	—	8,224
Principal repayments of Credit Risk and Non-Agency Securities	—	(16,088)
Gain on Credit Risk and Non-Agency Securities	—	24,284
Accretion of net discount on Credit Risk and Non-Agency Securities	—	848
Balance, end of period	$—	$1,069,438
Gain on Credit Risk and Non-Agency Securities	$—	$24,284

The significant unobservable inputs used in the fair value measurement of our Level 3 Credit Risk and Non-Agency Securities at March 31, 2017, included assumptions for underlying loan collateral, cumulative default rates and loss severities in the event of default, as well as discount rates. At the beginning of the third quarter 2017, we determined that third party pricing services and or/dealer quotes available for Credit Risk and Non-Agency Securities meet the criteria for Level 2 classification. Fair values obtained from third party pricing services for similar instruments are classified as Level 2 securities, if the inputs to the pricing model used is consistent with the Level 2 definition. We transferred the securities to Level 2 from Level 3 at the commencement of the third quarter in 2017.

Note 6 -Agency Securities

At March 31, 2018 and December 31, 2017, investments in Agency Securities accounted for 79.0% and 88.2% of our securities portfolio.

We evaluated our Agency Securities with unrealized losses at March 31, 2018, March 31, 2017 and December 31, 2017, to determine whether there was an other than temporary impairment. All of our Agency Securities are issued and guaranteed by GSEs or Ginnie Mae. The GSEs have a long term credit rating of AA+. At those dates, we also considered whether we intended to sell Agency Securities and whether it was more likely than not that we could meet our liquidity requirements and contractual obligations without selling Agency Securities.

Results of this evaluation for the three months ending March 31, 2018 - At March 31, 2018, we recognized additional losses on Agency Securities, previously identified during 2017, totaling $12,090 for the three months ended March 31, 2018 in our consolidated financial statements of operations. The aggregate fair value of the remaining identified low yielding Agency Securities is $681,827 at March 31, 2018. We determined that there was no other than temporary impairment of our remaining Agency Securities as of March 31, 2018.

Results of this evaluation for the period ending March 31, 2017 - No other than temporary impairment was recognized for the three months ended March 31, 2017 because we determined that we 1) did not have the intent to sell the Agency Securities in an unrealized loss position, 2) did not believe it more likely than not that we were required to sell the securities before recovery (for example, because of liquidity requirements or contractual obligations), and/or 3) determined that a credit loss did not exist.

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ARMOUR Residential REIT, Inc.
FINANCIAL STATEMENT NOTES (UNAUDITED)
(in thousands, except per share)

Results of this evaluation for the year ended December 31, 2017 - During the second quarter of 2017, we identified certain low yielding Agency Securities that we replaced with securities having more attractive returns as market conditions permit. Accordingly, we recognized losses totaling $13,707 in our consolidated statements of operations for the year ended December 31, 2017, thereby establishing a new cost basis for those Agency Securities with an aggregate fair value of $795,724 as of December 31, 2017. We determined that there was no other than temporary impairment of our remaining Agency Securities as of December 31, 2017.

At March 31, 2018, we had the following Agency Securities in an unrealized gain or loss position as presented below. The components of the carrying value of our Agency Securities at March 31, 2018 are also presented below. Our Agency Securities had a weighted average coupon of 3.71% at March 31, 2018.

March 31, 2018	Amortized Cost	Gross Unrealized Loss	Gross Unrealized Gain	Fair Value	Percent of Total
Fannie Mae					
ARMs & Hybrids	$26,277	$(304)	$ 74	$26,047	0.42 %
Multi-Family MBS	1,482,115	(19,283)	1,235	1,464,067	23.44
10 Year Fixed	28,927	(403)	90	28,614	0.46
15 Year Fixed	939,147	(11,784)	—	927,363	14.85
20 Year Fixed	28,155	(1,016)	—	27,139	0.43
25 Year Fixed	25,185	(669)	—	24,516	0.39
30 Year Fixed	2,429,537	(59,659)	281	2,370,159	37.95
Total Fannie Mae	$4,959,343	$(93,118			