DYNEX CAPITAL INC
Form 10-Q
November 09, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
FORM 10-Q

R Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended September 30, 2011
or
£ Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
Commission File Number: 1-9819

DYNEX CAPITAL, INC.
(Exact name of registrant as specified in its charter)

Virginia	52-1549373
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
4991 Lake Brook Drive, Suite 100, Glen Allen, Virginia	23060-9245
(Address of principal executive offices)	(Zip Code)

(804) 217-5800
(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 R 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 R No £

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

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

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

On November 3, 2011, the registrant had 40,380,797 shares outstanding of common stock, $0.01 par value, which is the registrant's only class of common stock.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

DYNEX CAPITAL, INC.
CONSOLIDATED BALANCE SHEETS
(amounts in thousands except share data)

	September 30, 2011 (unaudited)	December 31, 2010
ASSETS		
Agency MBS (including pledged of $1,893,209 and $1,090,174, respectively)	$2,072,110	$1,192,579
Non-Agency MBS (including pledged of $367,642 and $259,350, respectively)	403,705	267,356
Securitized mortgage loans, net	118,700	152,962
Other investments, net	1,059	1,229
	2,595,574	1,614,126
Cash and cash equivalents	10,156	18,836
Derivative assets	—	692
Principal receivable on investments	10,305	3,739
Accrued interest receivable	12,353	6,105
Other assets, net	5,298	6,086
Total assets	$2,633,686	$1,649,584
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Repurchase agreements	$2,053,686	$1,234,183
Payable for securities pending settlement	74,098	—
Non-recourse collateralized financing	84,013	107,105
Derivative liabilities	28,838	3,532
Accrued interest payable	1,240	1,079
Accrued dividends payable	10,903	8,192
Other liabilities	11,374	3,136
Total liabilities	2,264,152	1,357,227
Commitments and Contingencies (Note 12)		
Shareholders' equity:		
Common stock, par value $.01 per share, 100,000,000 shares authorized; 40,380,276 and 30,342,897 shares issued and outstanding, respectively	404	303
Additional paid-in capital	634,317	538,304
Accumulated other comprehensive (loss) income	(1,605)	10,057
Accumulated deficit	(263,582)	(256,307)
Total shareholders' equity	369,534	292,357
Total liabilities and shareholders' equity	$2,633,686	$1,649,584

See notes to unaudited consolidated financial statements.

DYNEX CAPITAL, INC.
CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)
(amounts in thousands except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Interest income:				
Agency MBS	$14,898	$5,607	$41,660	$15,085
Non-Agency MBS	4,442	3,345	11,963	9,586
Securitized mortgage loans	1,773	2,748	5,953	9,726
Other investments	29	30	91	94
Cash and cash equivalents	1	4	6	9
	21,143	11,734	59,673	34,500
Interest expense:				
Repurchase agreements	5,305	1,672	13,493	4,297
Non-recourse collateralized financing	1,278	1,661	3,856	6,674
	6,583	3,333	17,349	10,971
Net interest income	14,560	8,401	42,324	23,529
Provision for loan losses	(300)	(211)	(750)	(770)
Net interest income after provision for loan losses	14,260	8,190	41,574	22,759
Litigation settlement and related costs	(8,240)	—	(8,240)	—
(Loss) gain on non-recourse collateralized financing	(1,970)	561	(1,970)	561
Gain on sale of investments, net	581	—	1,323	794
Fair value adjustments, net	(662)	77	(657)	230
Other (loss) income, net	(102)	165	84	1,389
General and administrative expenses:				
Compensation and benefits	(1,106)	(1,191)	(3,447)	(3,033)
Other general and administrative	(1,229)	(780)	(3,261)	(2,874)
Net income	1,532	7,022	25,406	19,826
Preferred stock dividends	—	(1,056)	—	(3,061)
Net income to common shareholders	$1,532	$5,966	$25,406	$16,765
Weighted average common shares:				
Basic	40,353	17,230	37,973	15,532
Diluted	40,353	21,457	37,974	19,757
Net income per common share:				
Basic	$0.04	$0.35	$0.67	$1.08
Diluted	$0.04	$0.33	$0.67	$1.00
Dividends declared per common share	$0.27	$0.25	$0.81	$0.94

See notes to unaudited consolidated financial statements.

DYNEX CAPITAL, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(UNAUDITED)
(amounts in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Net income	$1,532	$7,022	$25,406	$19,826
Other comprehensive income:				
Change in market value of available-for-sale securities	7,145	2,212	13,310	14,199
Reclassification adjustment for net gain on sale of investments, net	(581)	—	(1,323)	(779)
Net unrealized loss on cash flow hedging instruments	(14,868)	(2,048)	(23,649)	(5,881)
Other comprehensive (loss) income	(8,304)	164	(11,662)	7,539
Comprehensive (loss) income	(6,772)	7,186	13,744	27,365
Dividends declared on preferred stock	—	(1,056)	—	(3,061)
Comprehensive (loss) income to common shareholders	$(6,772)	$6,130	$13,744	$24,304

See notes to unaudited consolidated financial statements.

DYNEX CAPITAL, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)
(amounts in thousands)

	Nine Months Ended September 30, 2011	2010
Operating activities:		
Net income	$25,406	$19,826
Adjustments to reconcile net income to cash provided by operating activities:		
(Increase) decrease in accrued interest receivable	(6,248)	451
Increase (decrease) in accrued interest payable	161	(418)
Provision for loan losses	750	770
Gain on sale of investments, net	(1,323)	(794)
Loss (gain) on non-recourse collateralized financing	1,970	(561)
Fair value adjustments, net	657	(230)
Increase in litigation settlement and related costs reserve	7,861	—
Amortization and depreciation	22,312	4,266
Stock-based compensation expense	492	558
Net change in other assets and other liabilities	1,564	(3,302)
Net cash and cash equivalents provided by operating activities	53,602	20,566
Investing activities:		
Purchase of investments	(1,440,594)	(432,182)
Principal payments received on investments	344,649	207,485
(Increase) decrease in principal receivable on investments	(6,566)	168
Proceeds from sales of investments	124,797	50,882
Principal payments received on securitized mortgage loans	32,655	51,109
Other investing activities	77	(295)
Net cash and cash equivalents used in investing activities	(944,982)	(122,833)
Financing activities:		
Borrowings under repurchase agreements, net	819,503	106,818
Borrowings under non-recourse collateralized financing	—	50,678
Principal payments on non-recourse collateralized financing	(2,094)	(42,652)
Cash paid to redeem non-recourse collateralized financing	—	(56,406)
Proceeds from issuance of common stock	95,261	44,010
Dividends paid	(29,970)	(13,160)
Net cash and cash equivalents provided by financing activities	882,700	89,288
Net decrease in cash and cash equivalents	(8,680)	(12,979)
Cash and cash equivalents at beginning of period	18,836	30,173
Cash and cash equivalents at end of period	$10,156	$17,194
Supplemental Disclosure of Cash Activity:		
Cash paid for interest	$16,411	$11,751

See notes to unaudited consolidated financial statements.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
DYNEX CAPITAL, INC.
(amounts in thousands except share and per share data)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying consolidated financial statements of Dynex Capital, Inc. and its qualified real estate investment trust (“REIT”) subsidiaries and its taxable REIT subsidiary (together, “Dynex” or the “Company”) have been prepared in accordance with the instructions to the Quarterly Report on Form 10-Q and Article 10, Rule 10-01 of Regulation S-X promulgated by the Securities and Exchange Commission (the “SEC”). Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America (“GAAP”) for complete financial statements. In the opinion of management, all significant adjustments, consisting of normal recurring accruals considered necessary for a fair presentation of the consolidated financial statements, have been included. Operating results for the three and nine months ended September 30, 2011 are not necessarily indicative of the results that may be expected for any other interim periods or for the entire year ending December 31, 2011. The unaudited consolidated financial statements included herein should be read in conjunction with the audited financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2010, filed with the SEC.

Certain items in the prior year’s consolidated financial statements have been reclassified to conform to the current year’s presentation. The Company’s consolidated balance sheet for December 31, 2010 now presents separately its "principal receivable on investments", which was previously included within the fair value amounts shown for Agency and non-Agency mortgage-backed securities ("MBS"). The Company's consolidated statement of income for the three and nine months ended September 30, 2010 now present separately "(loss) gain on non-recourse collateralized financing", which was previously included within "other (loss) income, net" for those periods. The Company’s consolidated statement of cash flows for the nine months ended September 30, 2010 now presents separately “(increase) decrease in principal receivable on investments”, which was previously included within “other investing activities” for that period. In addition, the line item "gain on redemption of securitization financing bonds" on the statement of cash flows for the nine months ended September 30, 2010 has been renamed "(loss) gain on non-recourse collateralized financing". These presentation changes have no effect on reported total assets, total liabilities, results of operations, or cash flow activities.

Consolidation of Subsidiaries

The consolidated financial statements include the accounts of the Company, its qualified REIT subsidiaries and its taxable REIT subsidiary. The consolidated financial statements represent the Company’s accounts after the elimination of intercompany balances and transactions. The Company consolidates entities in which it owns more than 50% of the voting equity and control does not rest with others and variable interest entities in which it is determined to be the primary beneficiary in accordance with Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 810. The Company follows the equity method of accounting for investments with greater than a 20% and less than 50% interest in partnerships and corporate joint ventures or when it is able to influence the financial and operating policies of the investee but owns less than 50% of the voting equity.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements as well as the reported amounts of revenue and expenses during the reported period. Actual results could differ from those estimates. The most significant estimates used by management include but are not limited to fair value measurements of its investments, allowance for loan losses, other-than-temporary impairments, commitments and contingencies, and amortization of premiums and discounts. These items are discussed further below within this note to the consolidated financial statements.

Federal Income Taxes

The Company believes it has complied with the requirements for qualification as a REIT under the Internal Revenue Code of 1986, as amended (the “Code”). As such, the Company believes that it qualifies as a REIT for federal income tax purposes, and it generally will not be subject to federal income tax on the amount of its income or gain that is distributed as dividends to shareholders. The Company uses the calendar year for both tax and financial reporting purposes. There may be differences between taxable income and income computed in accordance with GAAP.

Investments

The Company’s investments include Agency MBS, non-Agency MBS, securitized mortgage loans, and other investments.

Agency MBS. Agency MBS are comprised of residential mortgage-backed securities (“RMBS”) and commercial mortgage-backed securities (“CMBS”) issued or guaranteed by a federally chartered corporation, such as Federal National Mortgage Corporation, or Fannie Mae, or Federal Home Loan Mortgage Corporation, or Freddie Mac, or an agency of the U.S. government, such as Government National Mortgage Association, or Ginnie Mae. The Company’s Agency RMBS are comprised primarily of hybrid Agency adjustable-rate mortgage loans ("ARMs") and Agency ARMs. Hybrid Agency ARMs are MBS collateralized by hybrid adjustable-rate mortgage loans which are loans that have a fixed rate of interest for a specified period (typically three to ten years) and which then adjust their interest rate at least annually to an increment over a specified interest rate index as further discussed below. Agency ARMs are MBS collateralized by adjustable-rate mortgage loans which have interest rates that generally will adjust at least annually to an increment over a specified interest rate index. Agency ARMs also include hybrid Agency ARMs that are past their fixed-rate periods or within twelve months of their initial reset period.

Interest rates on the adjustable-rate mortgage loans collateralizing hybrid Agency ARMs or Agency ARMs are based on specific index rates, such as the one-year constant maturity treasury rate, or CMT, the London Interbank Offered Rate, or LIBOR, the Federal Reserve U.S. 12-month cumulative average one-year CMT, or MTA, or the 11th District Cost of Funds Index, or COFI. These loans will typically have interim and lifetime caps on interest rate adjustments, or interest rate caps, limiting the amount that the rates on these loans may reset in any given period.

The Company’s Agency CMBS are typically comprised of fixed-rate securities issued by Fannie Mae or Freddie Mac. Securities of both of these issuers are collateralized by first mortgage loans on multifamily properties that are usually either locked out of prepayment options or have yield maintenance provisions which provide the Company protection against prepayment of the investment.

A portion of the Company's Agency CMBS also include interest only securities ("IOs") which represent the right to receive contractual interest flows (but not principal cash flows) from the underlying unamortized principal balance of specific Agency CMBS.

The Company accounts for its Agency MBS in accordance with ASC Topic 320, which requires that investments in debt and equity securities be designated as either “held-to-maturity,” “available-for-sale” or “trading” at the time of acquisition. As of September 30, 2011, the Company has Agency MBS that are designated as either available-for-sale or trading. Although the Company generally intends to hold its available-for-sale securities until maturity, it may, from time to time, sell any of these securities as part of the overall management of its business. The available-for-sale designation provides the Company with this flexibility.

All of the Company’s Agency MBS are recorded at their fair value on the consolidated balance sheet. The Company determines the fair value of its Agency MBS based upon prices obtained from a third-party pricing service and broker quotes. Changes in the fair value of Agency MBS designated as trading are recognized in net income within “fair value adjustments, net”. Gains (losses) realized upon the sale, impairment, or other disposal of a trading security are also recognized within “fair value adjustments, net”. Alternatively, changes in the fair value of Agency MBS designated as available-for-sale are reported in other comprehensive income as unrealized gains (losses) until the security is collected, disposed of, or determined to be other than temporarily impaired. Upon the sale of an available-for-sale security, any unrealized gain or loss is reclassified out of accumulated other comprehensive income (“AOCI”) into net income as a realized “gain (loss) on sale of investments, net” using the specific identification method.

Non-Agency MBS. The Company’s non-Agency MBS are comprised of RMBS and CMBS, the majority of which are rated as investment grade. Interest rates for non-Agency MBS collateralized with ARMs are based on indices similar to those of Agency MBS. A portion of the Company's non-Agency CMBS also includes non-Agency interest-only securities (IOs) that, as with Agency IOs, represent the right to receive contractual interest flows (but not principal cash flows) from the underlying unamortized principal balance of specific non-Agency CMBS.

Like Agency MBS, the Company accounts for its non-Agency MBS in accordance with ASC Topic 320. As of September 30, 2011, all of the Company’s non-Agency MBS are designated as available-for-sale and are recorded at their fair value on the consolidated balance sheet. Changes in fair value are reported in other comprehensive income until the security is collected, disposed of, or determined to be other than temporarily impaired. Upon the sale of an available-for-sale security, any unrealized gain or loss is reclassified out of AOCI into net income as a realized "gain (loss) on sale of investments, net" using the specific identification method.

The Company determines the fair value for certain of its non-Agency MBS based upon prices obtained from a third-party pricing service and broker quotes. The remainder of the non-Agency MBS are valued by discounting the estimated future cash flows derived from pricing models that utilize information such as the security's coupon rate, estimated prepayment speeds, expected weighted average life, collateral composition, estimated future interest rates, expected losses, credit enhancement, as well as certain other relevant information.

Securitized Mortgage Loans. Securitized mortgage loans consist of loans pledged to support the repayment of securitization financing bonds issued by the Company. Securitized mortgage loans are reported at amortized cost. An allowance has been established for currently existing estimated losses on such loans. Securitized mortgage loans can only be sold subject to the lien of the respective securitization financing indenture.

Other Investments. Other investments include unsecuritized single-family and commercial mortgage loans which are carried at amortized cost.

Allowance for Loan Losses

An allowance for loan losses has been estimated and established for currently existing and probable losses for mortgage loans that are considered impaired. Provisions made to increase the allowance are charged as a current period expense. Commercial mortgage loans are secured by income-producing real estate and are evaluated individually for impairment when the debt service coverage ratio on the mortgage loan is less than 1:1 or when the mortgage loan is delinquent. An allowance may be established for a particular impaired commercial mortgage loan. Commercial mortgage loans not evaluated for individual impairment are evaluated for a general allowance. Certain of the commercial mortgage loans are covered by mortgage loan guarantees that limit the Company's exposure on these mortgage loans. Single-family mortgage loans are considered homogeneous and are evaluated on a pool basis for a general allowance.

The Company considers various factors in determining its specific and general allowance requirements, including whether a loan is delinquent, the Company's historical experience with similar types of loans, historical cure rates of delinquent loans, and historical and anticipated loss severity of the mortgage loans as they are liquidated. The factors may differ by mortgage loan type (e.g., single-family versus commercial) and collateral type (e.g., multifamily versus office property). The allowance for loan losses is evaluated and adjusted periodically by management based on the actual and estimated timing and amount of probable credit losses, using the above factors, as well as industry loss experience.

Repurchase Agreements

Repurchase agreements are treated as financings in accordance with the provision of ASC Topic 860 under which the Company pledges its securities as collateral to secure a loan, which is equal in value to a specified percentage of the estimated fair value of the pledged collateral. The Company retains beneficial ownership of the pledged collateral. At the maturity of a repurchase agreement, the Company is required to repay the loan and concurrently receives back its pledged collateral from the lender or, with the consent of the lender, the Company may renew the agreement at the then prevailing financing rate. A repurchase agreement lender may require the Company to pledge additional collateral in the event of a decline in the fair value of the collateral pledged. Repurchase agreement financing is recourse to the Company and the assets pledged. The Company's repurchase agreements are based on the September 1996 version of the Bond Market Association Master Repurchase Agreement, which generally provides that the lender, as buyer, is responsible for obtaining collateral valuations from a generally recognized source agreed to by both the Company and the lender, or, in an instance when such source is not available, the value determination is made by the lender.

Securitization Transactions

The Company has securitized mortgage loans and non-Agency CMBS through securitization transactions by transferring financial assets to a wholly owned trust, where the trust issues non-recourse securitization financing bonds pursuant to an indenture. The Company retains some form of control over the transferred assets, and therefore the trust is included in the consolidated financial statements of the Company. For accounting and tax purposes, the loans and securities financed through the issuance of bonds in a securitization financing transaction are treated as assets of the Company (presented as securitized mortgage loans on the consolidated balance sheet), and the associated bonds issued are treated as debt of the Company (presented as a portion of non-recourse collateralized financing on the consolidated balance sheet). The Company has retained certain of the bonds issued by the trust and has transferred collateral in excess of the bonds issued. This excess is typically referred to as overcollateralization. Each securitization trust generally provides the Company the right to redeem, at its option, the remaining outstanding bonds prior to their maturity date.

Derivative Instruments

The Company may enter into interest rate swap agreements, interest rate cap agreements, interest rate floor agreements, financial forwards, financial futures and options on financial futures ("interest rate agreements") to manage its sensitivity to changes in interest rates. The Company accounts for its interest rate agreements under ASC Topic 815, designating each as either a cash flow hedging position or a trading position using criteria established therein. In order to qualify as a cash flow hedge, ASC Topic 815 requires formal documentation to be prepared at the inception of the interest rate agreement that meets certain conditions. If these conditions are not met, an interest rate agreement will be classified as a trading position.

For interest rate agreements designated as trading positions, the Company records these instruments at fair value on the Company's balance sheet in accordance with ASC Topic 815. Changes in their market value are measured at each reporting date and recognized in the current period's statement of income.

For interest rate agreements designated as cash flow hedges, the Company evaluates the effectiveness of these hedges against the financial instrument being hedged. The effective portion of the hedge relationship on an interest rate agreement designated as a cash flow hedge is reported in AOCI and is later reclassified into the consolidated statement of income in the same period during which the hedged transaction affects earnings. The ineffective portion of such hedge is immediately reported in the current period's consolidated statement of income. These derivative instruments are carried at fair value on the Company's consolidated balance sheets in accordance with ASC Topic 815. Cash posted to meet margin calls, if any, is included on the consolidated balance sheets in other assets.

The Company may be required periodically to terminate hedging instruments. Any basis adjustments or changes in the fair value of hedges recorded in AOCI are recognized into income or expense in conjunction with the original hedge or hedged exposure.

If the underlying asset, liability or commitment is sold or matures, the hedge is deemed partially or wholly ineffective, or if the criterion that was established at the time the hedging instrument was entered into no longer exists, the interest rate agreement no longer qualifies as a designated hedge. Under these circumstances, such changes in the market value of the interest rate agreement are recognized in the current period's statement of income.

Interest Income

Interest income on Agency and non-Agency MBS that are rated "AAA" and loans is recognized over the expected life of the investment using the effective interest method. Interest income on non-Agency MBS that are rated "AA" or lower is recognized over the expected life as adjusted for estimated prepayments and credit losses of the securities in accordance with ASC Topic 325. For loans, the accrual of interest is discontinued when, in the opinion of management, the interest is not collectible in the normal course of business, when the loan is significantly past due or when the primary servicer of the loan fails to advance the interest and/or principal due on the loan. Loans are considered past due when the borrower fails to make a timely payment in accordance with the underlying loan agreement. For securities and other investments, the accrual of interest is discontinued when, in the opinion of management, it is probable that all amounts contractually due will not be collected. All interest accrued but not collected for investments that are placed on a non-accrual status or are charged-off is reversed against interest income. Interest on these investments is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual status. Investments are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Amortization of Premiums, Discounts, and Deferred Issuance Costs

Premiums and discounts on investments and obligations, as well as debt issuance costs and hedging basis adjustments, are amortized into interest income or expense, respectively, over the contractual life of the related investment or obligation using the effective interest method in accordance with ASC Topic 310 and ASC Topic 470. For securities representing beneficial interests in securitizations that are not highly rated, unamortized premiums and discounts are recognized over the expected life, as adjusted for estimated prepayments and credit losses of the securities, in accordance with ASC Topic 325. Actual prepayment and credit loss experience are reviewed, and effective yields are recalculated, when originally anticipated prepayments and credit losses differ from amounts actually received plus anticipated future prepayments.

Other-than-Temporary Impairments

The Company evaluates all debt securities in its investment portfolio for other-than-temporary impairments by applying the guidance prescribed in ASC Topic 320, which states that a debt security is considered to be other-than-temporarily impaired if the present value of cash flows expected to be collected is less than the security's amortized cost basis (the difference being defined as the credit loss) or if the fair value of the security is less than the security's amortized cost basis and the Company intends, or is required, to sell the security before recovery of the security's amortized cost basis. Although the principal and interest related to Agency MBS are guaranteed by the issuers, who have the implicit guarantee of the U.S. government, the Company assesses its ability to hold an Agency MBS with an unrealized loss until the recovery in its value.

Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other-than-temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. Any remaining difference between fair value and amortized cost is recognized in other comprehensive income.

In certain instances, as a result of the other-than-temporary impairment analysis, the recognition or accrual of interest will be discontinued and the security will be placed on non-accrual status. Securities normally are not placed on non-accrual status if the servicer continues to advance on the delinquent mortgage loans in the security.

Contingencies

In the normal course of business, there are various lawsuits, claims, and other contingencies pending against the Company. In accordance with ASC Topic 450, we evaluate whether to establish provisions for estimated losses from those matters. Although the ultimate outcome of the various matters cannot be ascertained at this point, it is the opinion of management, after consultation with counsel, that the resolution of the foregoing matters will not have a material adverse effect on the Company's consolidated financial condition or liquidity. The resolution of any such matters could, however, have a material effect on the consolidated results of operations or cash flows in a given future reporting period. Please refer to Note 12 for details on the most significant matters currently pending.

Recent Accounting Pronouncements

In April 2011, FASB issued Accounting Standards Update ("ASU" or "Update") No. 2011-02, which amends ASC Topic 310 to clarify the guidance on evaluating whether a restructuring constitutes a troubled debt restructuring. Specifically, a creditor must separately conclude that the restructuring constitutes a concession and that the debtor is experiencing financial difficulties. If a debtor does not otherwise have access to funds at a market rate for debt with similar risk characteristics as the restructured debt, the restructuring would be considered to be at a below-market rate, which may indicate that the creditor has granted a concession. A temporary or permanent increase in the contractual interest rate does not preclude the restructuring from being considered a concession because the contractual interest rate on the restructured debt may still be below the market interest rate for new debt with similar characteristics. If the creditor determines that it has granted a concession to the debtor, it must then evaluate whether a debtor is experiencing financial difficulties. The amendments clarify that a debtor does not have to be currently in payment default in order to be considered as experiencing financial difficulties. Additionally, a creditor should evaluate whether it is probable that the debtor will be in payment default on any of its debt in the foreseeable future without the modification. The amendments in this Update became effective for the first interim or annual reporting period beginning on or after June 15, 2011 and should be applied retrospectively to the beginning of the annual period of adoption.As a result of its retrospective application, an entity may identify receivables that are newly considered impaired. For purposes of measuring impairment of those receivables, an entity should apply the amendments prospectively for the first interim or annual period beginning on or after June 15, 2011. An entity should disclose the total amount of receivables and the allowance for credit losses as of the end of the period of adoption related to those receivables that are newly considered impaired under ASC Topic 310 for which impairment was previously measured under ASC Topic 450. In addition, ASU No. 2011-02 requires an entity to disclose the information required by ASU No. 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses, which was subsequently deferred temporarily by ASU No. 2011-01. Management has evaluated these amendments and does not believe that they have had a material impact on the Company's financial condition or results of operations.

In April 2011, FASB issued ASU No. 2011-03 to improve the accounting for repurchase agreements and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. ASC Topic 860 prescribes when an entity may or may not recognize a sale upon transfer of financial assets subject to repurchase agreements. That determination is based, in part, on whether the entity has maintained effective control over the transferred financial assets. Previously, under ASC Topic 860, the transferor was required to have the ability to repurchase the same or substantially the same assets in order to assert that it has maintained effective control over the transferred assets. ASU No. 2011-03 removes the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, and also removes the collateral maintenance implementation guidance related to that criterion. 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, not on whether the transferor has the practical ability to perform in accordance with those rights or obligations. These amendments are effective for the first interim or annual reporting period beginning on or after December 15, 2011 and are to be applied prospectively. Management has evaluated these amendments and does not believe that they will have a material impact on the Company's financial condition or results of operations.

In May 2011, FASB issued ASU No. 2011-04 to amend ASC Topic 820 to clarify the FASB's intent about the application of existing fair value measurement and disclosure requirements as well as to change certain principles or requirements for measuring fair value or disclosing information about fair value measurements. One of its amendments which will apply to the Company is the disclosure of quantitative information about the unobservable inputs used in a fair value measurement that is categorized within Level 3 of the fair value hierarchy. In addition, the amendments will require more information from the Company about the valuation processes used by the reporting entity for fair value measurements categorized within Level 3 and the sensitivity of those measurements to changes in unobservable inputs. These amendments (and others included in the Update which are not discussed here as they are not applicable to the Company) are effective during interim and annual reporting periods beginning after December 15, 2011 and are to be applied prospectively. Early application by public entities is not permitted. Management has evaluated these amendments and does not believe that they will have a material impact on the Company's financial condition or results of operations.

NOTE 2 – NET INCOME PER COMMON SHARE

Net income per common share is presented on both a basic and diluted basis. Diluted net income per common share assumes the exercise of stock options using the treasury stock method, and for the three and nine months ended September 30, 2010 the conversion of the Company's formerly outstanding convertible preferred stock into common stock using the two-class method, but only if these items are dilutive. Each share of Series D preferred stock was convertible into one share of common stock. The following tables reconcile the numerator and denominator for both basic and diluted net income per common share:

	Three Months Ended September 30,			
	2011		2010	
	Income	Weighted-Average Common Shares (1)	Income	Weighted-Average Common Shares (1)
Net income	$1,532		$7,022	
Preferred stock dividends	—		(1,056)	
Net income to common shareholders	$1,532	40,353,219	$5,966	17,230,410
Effect of dilutive items	—	82	1,056	4,226,862
Diluted	$1,532	40,353,301	$7,022	21,457,272
Net income per common share:				
Basic		$ 0.04		$0.35
Diluted (1)		$ 0.04		$0.33
Components of dilutive items:				
Convertible preferred stock	$—	—	$1,056	4,221,387
Stock options	—	82	—	5,475
	$—	82	$1,056	4,226,862

(1)

For the three months ended September 30, 2011, the calculation of diluted net income per common share excludes the effect of 15,000 unexercised stock option awards because their inclusion would have been anti-dilutive.

	Nine Months Ended September 30, 2011		2010	
	Income	Weighted-Average Common Shares (1)	Income	Weighted-Average Common Shares (1)
Net income	$25,406		$19,826	
Preferred stock dividends	—		(3,061)	
Net income to common shareholders	25,406	37,972,766	16,765	15,531,847
Effect of dilutive items	—	1,183	3,061	4,225,145
Diluted	$25,406	$ 37,973,949	$19,826	19,756,992
Net income per common share:				
Basic		$ 0.67		$ 1.08
Diluted (1)		$ 0.67		$ 1.00
Components of dilutive items:				
Convertible preferred stock	$—	—	$3,061	4,221,387
Stock options	—	1,183	—	3,758
	$—	1,183	$3,061	4,225,145

(1) For the nine months ended September 30, 2011 and September 30, 2010, the calculation of diluted net income per common share excludes the effects of 15,000 unexercised stock option awards because their inclusion would have been anti-dilutive.

NOTE 3 – AGENCY MBS

The following table presents the components of the Company's investment in Agency MBS as of September 30, 2011 and December 31, 2010:

	September 30, 2011			December 31, 2010		
	RMBS	CMBS	Total	RMBS	CMBS	Total
Principal/par value	$1,619,518	$270,760	$1,890,278	$937,376	$190,511	$1,127,887
Unamortized premium	92,188	73,318	165,506	43,776	18,757	62,533
Unamortized discount	(1)	—	(1)	(36)	—	(36)
Amortized cost	1,711,705	344,078	2,055,783	981,116	209,268	1,190,384
Unrealized gains:						
Available for sale	11,607	10,946	22,553	8,266	567	8,833
Trading	—	1,819	1,819	—	—	—
Unrealized losses:						
Available for sale	(7,091)	(954)	(8,045)	(3,371)	(3,267)	(6,638)
Trading	—	—	—	—	—	—
Fair value	$1,716,221	$355,889	$2,072,110	$986,011	$206,568	$1,192,579
Weighted average coupon based on par value	4.55%	5.14%	5.12%	4.46%	5.41%	4.62%

The Company has purchased $1,189,862 of Agency RMBS and $143,747 of Agency CMBS since December 31, 2010. Included in the table above are Agency CMBS with a par value of $24,776 that were pending settlement as of September 30, 2011.

As of September 30, 2011, the amortized cost and fair value of Agency CMBS designated as trading securities was $27,276 and $29,095, respectively, with the remainder of the Company's Agency CMBS and Agency RMBS designated as available-for-sale. The Company did not hold any Agency CMBS or RMBS designated as trading securities as of December 31, 2010. The Company has not sold any of its trading securities purchased during the nine months ended September 30, 2011, and has recognized a net unrealized gain for the three and nine months ended September 30, 2011 of $744 and $1,819, respectively, related to their changes in fair value, which is included within “fair value adjustments, net” in its consolidated statements of income. The Company also has derivatives designated as trading instruments, and the changes in their fair value are also included within "fair value adjustments, net". For the three and nine months ended September 30, 2011, the Company recognized a net unrealized loss of $(1,446) and $(2,649), respectively, related to these derivatives. Please refer to Note 7 for additional information on these derivatives designated as trading instruments.

A portion of the Company's Agency CMBS as reported in the table above as of September 30, 2011 are interest-only securities. The Company did not hold any Agency interest-only securities as of December 31, 2010. The table below presents the Company's Agency CMBS by security type as of September 30, 2011.

	September 30, 2011			
	Principal	Premium	Unrealized Gain (Loss)	Total
Principal and interest securities	$270,760	$21,646	$12,750	$305,156
Interest only securities [1]	—	51,672	(939)	50,733
Fair value of Agency CMBS	$270,760	$73,318	$11,811	$355,889

(1) The combined notional balance for the Agency interest-only securities is $1,498,210 as of September 30, 2011.

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NOTE 4 – NON-AGENCY MBS

The following table presents the components of the Company's non-Agency MBS as of September 30, 2011 and December 31, 2010:

	September 30, 2011			December 31, 2010		
	RMBS	CMBS	Total	RMBS	CMBS	Total
Principal/par value	$14,271	$357,644	$371,915	$16,101	$247,494	$263,595
Unamortized premium	—	39,006	39,006	138	5,352	5,490
Unamortized discount	(1,044)	(16,528)	(17,572)	(1,115)	(11,296)	(12,411)
Amortized cost	13,227	380,122	393,349	15,124	241,550	256,674
Unrealized gains	520	12,875	13,395	632	10,978	