MFA FINANCIAL, INC.
Form 10-Q
April 29, 2010
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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, 2010

OR

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

For the transition period from to

Commission File Number: 1-13991

MFA FINANCIAL, INC.

(Exact name of registrant as specified in its charter)

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

(212) 207-6400

(Registrant s telephone number, including area code)

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

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 x	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 o No x

280,162,633 shares of the registrant s common stock, $0.01 par value, were outstanding as of April 27, 2010.

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CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Per Share Amounts)		**March 31, 2010 (Unaudited)**		**December 31, 2009**
Assets:				
Agency mortgage-backed securities (MBS), at fair value ($5,819,179 and $7,597,136 pledged as collateral, respectively)	$	6,156,682	$	7,664,851
Non-Agency MBS, at fair value ($1,028,445 and $240,694 pledged as collateral, respectively)		1,312,030		1,093,103
Cash and cash equivalents		768,656		653,460
Restricted cash		39,387		67,504
Forward contracts to repurchase MBS (MBS Forwards), at fair value		101,659		86,014
Interest receivable		35,099		41,775
Real estate, net		10,954		10,998
Goodwill		7,189		7,189
Prepaid and other assets		3,057		2,315
Total Assets	$	8,434,713	$	9,627,209
Liabilities:				
Repurchase agreements	$	6,013,875	$	7,195,827
Accrued interest payable		8,263		13,274
Mortgage payable on real estate		9,101		9,143
Interest rate swap agreements (Swaps), at fair value		153,750		152,463
Dividends and dividend equivalents rights (DERs) payable		387		76,286
Accrued expenses and other liabilities		4,278		11,954
Total Liabilities	$	6,189,654	$	7,458,947
Commitments and contingencies (Note 9)				
Stockholders Equity:				
Preferred stock, $.01 par value; series A 8.50% cumulative redeemable; 5,000 shares authorized; 3,840 shares issued and outstanding ($96,000 aggregate liquidation preference)	$	38	$	38
Common stock, $.01 par value; 370,000 shares authorized; 280,163 and 280,078 issued and outstanding, respectively		2,802		2,801
Additional paid-in capital, in excess of par		2,181,451		2,180,605
Accumulated deficit		(121,552)		(202,189)
Accumulated other comprehensive income		182,320		187,007
Total Stockholders Equity	$	2,245,059	$	2,168,262
Total Liabilities and Stockholders Equity	$	8,434,713	$	9,627,209

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

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MFA FINANCIAL, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In Thousands, Except Per Share Amounts)	Three Months Ended March 31, 2010 (Unaudited)	2009
Interest Income:		
MBS	$ 107,644	$ 132,153
Cash and cash equivalent investments	53	611
Interest Income	107,697	132,764
Interest Expense	38,451	72,137
Net Interest Income	69,246	60,627
Other-Than-Temporary Impairments:		
Total other-than-temporary impairment losses		(1,549)
Portion of loss recognized in other comprehensive income		
Net Impairment Losses Recognized in Earnings		(1,549)
Other Income/(Loss):		
Gain on MBS Forwards, net	12,800	
Gains on sales of MBS	33,739	
Revenue from operations of real estate	374	383
Losses on termination of repurchase agreements	(26,815)	
Miscellaneous other income, net		44
Other Income, net	20,098	427
Operating and Other Expense:		
Compensation and benefits	4,368	3,502
Other general and administrative expense	1,853	1,868
Real estate operating expense and mortgage interest	446	462
Operating and Other Expense	6,667	5,832
Net Income Before Preferred Stock Dividends	82,677	53,673
Less: Preferred Stock Dividends	2,040	2,040
Net Income to Common Stockholders	$ 80,637	$ 51,633
Income Per Share of Common Stock:		
Basic and Diluted	$ 0.29	$ 0.23

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

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CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Three Months Ended March 31,	
	2010	**2009**
(In Thousands)	**(Unaudited)**	
Net income before preferred stock dividends	$ 82,677	$ 53,673
Other Comprehensive Income:		
Unrealized gain on MBS arising during the period, net	38,059	121,786
Reclassification adjustment for MBS sales	(41,459)	
Reclassification adjustment for net losses included in net income for other-than-temporary impairments		1,405
Unrealized (loss)/gain on Swaps arising during the period, net	(1,287)	10,821
Comprehensive income before preferred stock dividends	$ 77,990	$ 187,685
Dividends declared on preferred stock	(2,040)	(2,040)
Comprehensive Income to Common Stockholders	$ 75,950	$ 185,645

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

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CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

(In Thousands, Except Per Share Amounts)		**Three Months Ended March 31, 2010 (Unaudited)**
Preferred Stock, Series A 8.50% Cumulative Redeemable Liquidation Preference $25.00 per Share:		
Balance at December 31, 2009 and March 31, 2010 (3,840 shares)	$	38
Common Stock, Par Value $0.01:		
Balance at December 31, 2009 (280,078 shares)		2,801
Issuance of common stock (85 shares)		1
Balance at March 31, 2010 (280,163 shares)		2,802
Additional Paid-in Capital, in excess of Par:		
Balance at December 31, 2009		2,180,605
Issuance of common stock, net of expenses		124
Equity-based compensation expense		722
Balance at March 31, 2010		2,181,451
Accumulated Deficit:		
Balance at December 31, 2009		(202,189)
Net income		82,677
Dividends declared on preferred stock		(2,040)
Balance at March 31, 2010		(121,552)
Accumulated Other Comprehensive Income:		
Balance at December 31, 2009		187,007
Change in unrealized gains on MBS, net		(3,400)
Unrealized losses on Swaps		(1,287)
Balance at March 31, 2010		182,320
Total Stockholders Equity at March 31, 2010	$	2,245,059

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

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MFA FINANCIAL, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three Months Ended March 31,			
		2010		2009
(In Thousands)	(Unaudited)			
Cash Flows From Operating Activities:				
Net income	$	82,677	$	53,673
Adjustments to reconcile net income to net cash provided by operating activities:				
Gains on sale of MBS		(33,739)		
Losses on termination of repurchase agreements		26,815		
Other-than-temporary impairment charges				1,549
Net (accretion)/amortization of purchase (discount) and premium on MBS		(485)		4,228
Decrease in interest receivable		6,676		1,585
Depreciation and amortization on real estate		163		94
Unrealized gain and other on MBS Forwards		(8,927)		
Increase in prepaid and other assets and other		(664)		(746)
Decrease in accrued expenses and other liabilities		(7,676)		(2,181)
Decrease in accrued interest payable		(5,011)		(7,745)
Equity-based compensation expense		722		474
Negative amortization and principal accretion on MBS				(12)
Net cash provided by operating activities	$	60,551	$	50,919
Cash Flows From Investing Activities:				
Principal payments on MBS	$	574,798	$	357,525
Proceeds from sale of MBS		939,119		
Purchases of MBS		(193,851)		(62,034)
Net additions to leasehold improvements, furniture, fixtures and real estate investment		(210)		(218)
Net cash provided by investing activities	$	1,319,856	$	295,273
Cash Flows From Financing Activities:				
Principal payments on repurchase agreements	$	(13,998,897)	$	(16,630,370)
Proceeds from borrowings under repurchase agreements		12,816,945		16,364,175
Payments to terminate repurchase agreements		(26,815)		
Principal payments on MBS Forwards		(346,435)		
Proceeds from MBS Forwards		339,717		
Payments made for margin calls on repurchase agreements and Swaps		(259,286)		(74,360)
Proceeds received for reverse margin calls on repurchase agreements and Swaps		287,416		70,820
Proceeds from issuances of common stock		125		16,373
Dividends paid on preferred stock		(2,040)		(2,040)
Dividends paid on common stock and DERs		(75,899)		(46,351)
Principal payments on mortgage loan		(42)		(39)
Net cash used by financing activities	$	(1,265,211)	$	(301,792)
Net increase in cash and cash equivalents	$	115,196	$	44,400
Cash and cash equivalents at beginning of period	$	653,460	$	361,167
Cash and cash equivalents at end of period	$	768,656	$	405,567

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

1. Organization

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

2. Summary of Significant Accounting Policies

(a) Basis of Presentation and Consolidation

The interim unaudited financial statements of the Company have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and note disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) have been condensed or omitted according to such SEC rules and regulations. Management believes, however, that the disclosures included in these interim financial statements are adequate to make the information presented not misleading. The accompanying financial statements should be read in conjunction with the financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2009. In the opinion of management, all normal and recurring adjustments necessary to present fairly the financial condition of the Company at March 31, 2010 and results of operations for all periods presented have been made. The results of operations for the three months ended March 31, 2010 should not be construed as indicative of the results to be expected for the full year.

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

Effective July 1, 2009, the Company adopted the provisions of the Financial Accounting Standards Board (FASB), Accounting Standards Codification, (the Codification), which is now the source of authoritative GAAP. While the Codification did not change GAAP, all existing authoritative accounting literature, with certain exceptions, was superseded and incorporated into the Codification. As a result, pre-Codification references to GAAP have been eliminated.

(b) Agency and Non-Agency MBS

The Company has investments in residential MBS that are issued or guaranteed as to principal and/or interest by a federally chartered corporation, such as Fannie Mae or Freddie Mac, or any agency of the U.S. Government, such as Ginnie Mae (collectively, Agency MBS), and MBS not guaranteed by any U.S. Government agency or any federally chartered corporation (Non-Agency MBS), as described in Note 3.

Designation

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

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

Revenue Recognition, Premium Amortization and Discount Accretion

Interest income on securities is accrued based on the outstanding principal balance and their contractual terms. Premiums and discounts associated with Agency MBS and Non-Agency MBS rated AA and higher at the time of purchase, are amortized into interest income over the life of such securities using the effective yield method. Adjustments to premium amortization are made for actual prepayment activity.

Interest income on the Non-Agency MBS that were purchased at a discount to par value and/or were rated below AA at the time of purchase is recognized based on the security s effective interest rate. The effective interest

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rate on these securities is based on the projected cash flows from each security, which are estimated based on the Company s observation of current information and events and include assumptions related to interest rates, prepayment speeds and the timing and amount of credit losses. On at least a quarterly basis, the Company reviews and, if appropriate, makes adjustments to its cash flow projections based on input and analysis received from external sources, internal models, and its judgment about prepayment rates, the timing and amount of credit losses, and other factors. Changes in cash flows from those originally projected, or from those estimated at the last evaluation, may result in a prospective change in the yield/interest income recognized on such securities. (See Note 3)

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

Determination of MBS Fair Value

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

Impairments

When the fair value of an investment security is less than its amortized cost at the balance sheet date, the security is considered impaired. The Company assesses its impaired securities on at least a quarterly basis, and designates such impairments as either temporary or other-than-temporary. If the Company intends to sell an impaired security, or it is more likely than not that it will be required to sell the impaired security before its anticipated recovery, then it must recognize an other-than-temporary impairment through charges to earnings equal to the entire difference between the investment s amortized cost and its fair value at the balance sheet date. If the Company does not expect to sell an other-than-temporarily impaired security, only the portion of the other-than-temporary impairment related to credit losses is recognized through charges to earnings with the remainder recognized as a component of other accumulated comprehensive income on the consolidated balance sheet. Impairments recognized through other comprehensive income do not impact earnings. Following the recognition of an other-than-temporary impairment through earnings, a new cost basis is established for the security and may not be adjusted for subsequent recoveries in fair value through earnings. However, other-than-temporary impairments recognized through charges to earnings may be accreted back to the amortized cost basis of the security on a prospective basis through interest income. The determination as to whether an other-than-temporary impairment exists and, if so, the amount considered other-than-temporarily impaired is subjective, as such determinations are based on both factual and subjective information available at the time of assessment. As a result, the timing and amount of other-than-temporary impairments constitute material estimates that are susceptible to significant change. (See Note 3)

Non-Agency MBS on which impairments are recognized have experienced, or are expected to experience, adverse cash flow changes. The Company s estimation of cash flows expected for its Non-Agency MBS is based on its review of the underlying mortgage loans securing the MBS. The Company considers information available about the performance of underlying mortgage loans, including credit enhancement, default rates, loss severities, delinquency rates, percentage of non-performing, Fair Isaac Corporation (FICO) scores at loan origination, year of origination, loan-to-value ratios, geographic concentrations, as well as reports by nationally recognized statistical rating organization, such as Moody s Investors Services, Inc. (Moody s), Standard & Poor s Corporation (S&P), or Fitch, Inc. (collectively, Rating Agencies), general mark assessments, and dialogue with market participants. As a result, significant judgment is used in the Company s analysis to determine the expected cash flows for its MBS. In determining the component of the gross other-than-temporary impairment related to credit losses, the Company compares the amortized cost basis of each other-than-temporarily impaired security to the expected principal recovery on the impaired MBS.

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Balance Sheet Presentation

The Company s MBS pledged as collateral against repurchase agreements and Swaps are included in MBS on the consolidated balance sheets with the fair value of the MBS pledged disclosed parenthetically. Purchases and sales of securities are recorded on the trade date or when all significant uncertainties regarding the securities are removed. However, if a repurchase agreement is determined to be linked to the purchase of an MBS, then the MBS and linked repurchase borrowing will be reported net, as an MBS Forward. (See Notes 2(l) and 4)

(c) Cash and Cash Equivalents

Cash and cash equivalents include cash on deposit with financial institutions and investments in high quality money market funds, all of which have original maturities of three months or less. Cash and cash equivalents may also include cash pledged as collateral to the Company by its repurchase agreement and/or Swap counterparties as a result of reverse margin calls (i.e., margin calls made by the Company). The Company did not hold any cash pledged by its counterparties at March 31, 2010 or December 31, 2009. At March 31, 2010, all of the Company s cash investments were in high quality overnight money market funds. (See Notes 8 and 13)

(d) Restricted Cash

Restricted cash represents the Company s cash held by its counterparties as collateral against the Company s Swaps and/or repurchase agreements. Restricted cash, which earns interest, is not available to the Company for general corporate purposes, but may be applied against amounts due to counterparties to the Company s repurchase agreements and/or Swaps, or returned to the Company when the collateral requirements are exceeded or at the maturity of the Swap or repurchase agreement. The Company had aggregate restricted cash held as collateral against its Swaps of $39.4 million at March 31, 2010 and $67.5 million held as collateral against its repurchase agreements and Swaps at December 31, 2009. (See Notes 4, 7, 8 and 13)

(e) Goodwill

At March 31, 2010 and December 31, 2009, the Company had goodwill of $7.2 million, which represents the unamortized portion of the excess of the fair value of its common stock issued over the fair value of net assets acquired in connection with its formation in 1998. Goodwill is tested for impairment at least annually, or more frequently under certain circumstances, at the entity level. Through March 31, 2010, the Company had not recognized any impairment against its goodwill.

(f) Real Estate

The Company has 100% of the ownership interest in Lealand Place, a 191-unit apartment property located in Lawrenceville, Georgia, through Lealand Place, LLC (Lealand), an indirect, wholly-owned subsidiary. This property was acquired through a tax-deferred exchange under Section 1031 of the Internal Revenue Code of 1986, as amended (the Code). (See Note 6)

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

(g) Repurchase Agreements

The Company finances the acquisition of a significant portion of its MBS with repurchase agreements. Under repurchase agreements, the Company sells securities to a lender and agrees to repurchase the same securities in the future for a price that is higher than the original sale price. The difference between the sale price that the Company receives and the repurchase price that the Company pays represents interest paid to the lender. Although structured as a sale and repurchase, under its repurchase agreements, the Company pledges its securities as collateral to secure the borrowing, which is equal in value to a specified percentage of the fair value of the pledged collateral, while the Company retains beneficial ownership of the pledged collateral. At the maturity of a repurchase agreement, the Company is required to repay the loan and concurrently receives back its pledged collateral from the lender. With the consent of the lender, the Company may renew a repurchase agreement at the then prevailing financing terms. Margin calls, whereby a lender requires that the Company pledge additional securities or cash as collateral to secure borrowings under its repurchase agreements with such lender, are routinely experienced by the Company when the value of the MBS pledged as collateral declines as a result of principal amortization or due to changes in market interest rates, spreads or other market conditions. To date, the Company had satisfied all of its margin calls and has never sold assets in response to a margin call.

The Company s repurchase agreements typically have terms ranging from one month to six months at inception, with some having longer terms. Should a counterparty decide not to renew a repurchase agreement at maturity, the Company must either refinance elsewhere or be in a position to satisfy the obligation. If, during the

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term of a repurchase agreement, a lender should file for bankruptcy, the Company might experience difficulty recovering its pledged assets which could result in an unsecured claim against the lender for the difference between the amount loaned to the Company plus interest due to the counterparty and the fair value of the collateral pledged to such lender. The Company enters into repurchase agreements with multiple counterparties with a maximum loan from any lender of no more than three times the Company s stockholders equity. (See Notes 2(l), 4, 7 and 8)

(h) Equity Based Compensation

Compensation expense for equity based awards is recognized over the vesting period of such awards, based upon the fair value of such awards at the grant date. Payments pursuant to DERs, which are attached to certain equity based awards, are charged to stockholders equity when declared. The Company has applied a zero forfeiture rate for its equity based awards, as such awards have been granted to a limited number of employees and historical forfeitures have been minimal. Forfeitures, or an indication that forfeitures may occur, would result in a revised forfeiture rate and are accounted for prospectively as a change in estimate.

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

(i) Earnings per Common Share (EPS)

Basic EPS is computed by dividing net income to common stockholders by the weighted average number of shares of common stock outstanding during the period, which also includes participating securities representing unvested share-based payment awards that contain nonforfeitable rights to dividends or DERs. Diluted EPS is computed by dividing net income available to holders of common stock by the weighted average shares of common stock and common equivalent shares outstanding during the period. For the diluted EPS calculation, common equivalent shares outstanding includes the weighted average number of shares of common stock outstanding adjusted for the effect of dilutive unexercised stock options and restricted stock units (RSUs) outstanding using the treasury stock method. Under the treasury stock method, common equivalent shares are calculated assuming that all dilutive common stock equivalents are exercised and the proceeds, along with future compensation expenses for unvested stock options and RSUs, are used to repurchase shares of the Company s outstanding common stock at the average market price during the reported period. No common share equivalents are included in the computation of any diluted per share amount for a period in which a net operating loss is reported. (See Note 11)

(j) Comprehensive Income

The Company s comprehensive income includes net income, the change in net unrealized gains/(losses) on its MBS and hedging instruments, adjusted by realized net gains/(losses) reclassified out of accumulated other comprehensive income for MBS and is reduced by dividends declared on the Company s preferred stock.

(k) U.S. Federal Income Taxes

The Company has elected to be taxed as a REIT under the provisions of the Code and the corresponding provisions of state law. The Company expects to operate in a manner that will enable it to continue to be taxed as a REIT. A REIT is not subject to tax on its earnings to the extent that it distributes at least 90% of its annual REIT taxable income to its stockholders. As such, no provision for current or deferred income taxes has been made in the accompanying consolidated financial statements.

(l) Derivative Financial Instruments

Hedging Activity

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

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(UNAUDITED)

basis thereafter, whether or not the hedge is highly effective.

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

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

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

Non-Hedging Activity/MBS Forwards

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

During the three months ended March 31, 2010, the Company entered into 10 transactions that were identified as linked transactions. As such, the Company accounted for these purchase contracts and related repurchase agreements on a net basis and recorded a derivative instrument, or forward contract on the Company s consolidated balance sheet. Changes in the fair value of these forward contracts (i.e., MBS Forwards) are reported as a net gain or loss on the Company s consolidated statements of operations. When or if a transaction is no longer considered to be linked, the MBS and repurchase financing will be reported on a gross basis. In this case, the fair value of the MBS at the time the transactions are no longer considered linked will become the cost basis of the MBS. (See Notes 4, 8 and 13)

(m) Fair Value Measurements and the Fair Value Option for Financial Assets and Financial Liabilities

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

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

(n) New Accounting Standards and Interpretations

Accounting Standards Codification

See Note 2(a).

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Accounting for Transfers of Financial Assets

On June 12, 2009, the FASB issued new accounting for transfers of financial assets which: (i) eliminates the concept of a qualified special purpose entity (QSPE) and eliminates its exemption as a variable interest entity; (ii) clarifies that the objective of determining whether a transferor has surrendered control over transferred financial assets must consider the transferor s continuing involvements in the transferred financial asset, including all arrangements or agreements made contemporaneously with, or in contemplation of, the transfer, even if they were not entered into at the time of the transfer; (iii) modifies the financial-components approach and limits the circumstances in which a financial asset, or portion of a financial asset, should be derecognized when the transferor has not transferred the entire original financial asset to an entity that is not consolidated with the transferor in the financial statements being presented and/or when the transferor has continuing involvement with the transferred financial asset; and (iv) defines the term participating interest to establish specific conditions for reporting a transfer of a portion of a financial asset as a sale. Under this new accounting, when the transfer of financial assets are accounted for as a sale, the transferor must recognize and initially measure at fair value all assets obtained and liabilities incurred as a result of the transfer, including any retained beneficial interest. This new accounting eliminated off-balance sheet transactions when an entity retains any interest in or control over assets transferred in this process. The implementation of the new accounting for transfers of financial assets on January 1, 2010 did not have any impact on the Company s consolidated financial statements, as it has no off-balance sheet transactions, no QSPEs, nor has it transferred assets through a securitization.

In conjunction with new accounting for transfers of financial assets, the FASB issued new guidance that requires an enterprise to perform an analysis to determine whether an enterprise s variable interest or interests give it a controlling financial interest in a variable interest entity (VIE). The analysis identifies the primary beneficiary of a VIE as the enterprise that has both the power to direct the activities that most significantly impact the entity s economic performance and the obligation to absorb losses of the entity or the right to receive benefits from the entity which could potentially be significant to the VIE. With the removal of the QSPE exemption, established QSPEs must be evaluated for consolidation under this statement. In addition, enhanced disclosures are required to provide users of financial statements with more transparent information about and an enterprise s involvement in a VIE and also requires ongoing assessments of whether an enterprise is the primary beneficiary of a VIE. The Company does not have any interests in a VIE. The Company s adoption of this new accounting on January 1, 2010 did not have any impact on the Company, as it is not the primary beneficiary of any VIE.

(o) Reclassifications

Certain prior period amounts have been reclassified to conform to the current period presentation.

3. MBS

The Company s MBS are primarily comprised of Agency MBS and, to a lesser extent, Non-Agency MBS, as described below. MBS do not have a single maturity date and, further, the mortgage loans underlying ARM-MBS have interest rates that do not all reset at the same time. At March 31, 2010 and December 31, 2009, the Company s MBS were primarily secured by hybrid mortgages that have a fixed interest rate for a specified period, typically three to ten years, and, thereafter, generally reset annually (Hybrids), and adjustable-rate mortgages (ARMs)

(collectively, ARM-MBS). At March 31, 2010, 0.2% of the Company s MBS portfolio was comprised of MBS secured by fixed rates mortgages.

The Company pledges a significant portion of its MBS as collateral against its borrowings under repurchase agreements and Swaps. The Company has Non-Agency MBS that are accounted for as components of MBS Forwards and, accordingly, are not reflected in the tables set forth in this note. (See Notes 4 and 8)

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

Non-Agency MBS: The Company s Non-Agency MBS are secured by pools of residential mortgages, and are not guaranteed by an agency of U.S. Government or any federally chartered corporation. Non-Agency MBS may be rated by one or more Rating Agencies or may be unrated (i.e., not assigned a rating by any Rating Agency). The rating indicates the opinion of the Rating Agency as to the credit worthiness of the investment, indicating the obligor s ability to meet its full financial commitment on the obligation. A rating of D is assigned when a security has defaulted on any of its contractual terms. The Company s Non-Agency MBS are primarily comprised of the

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senior most tranches from the MBS structure. The Company s Non-Agency MBS categories include MFR MBS , which were purchased beginning in late 2008 at discounts to par value through its wholly-owned subsidiary MFResidential Assets I, LLC (MFR) and MBS purchased by the Company prior to July 2007 (Legacy MBS).

The following tables present certain information about the Company s MBS at March 31, 2010 and December 31, 2009:

March 31, 2010

(In Thousands)	Principal/ Current Face	Purchase Premiums	Purchase Discounts	Credit Discounts *(1)*	Amortized Cost *(2)*	Carrying Value/ Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Net Unrealized Gain/(Loss)
Agency MBS:									
Fannie Mae	$ 5,335,797	$ 70,122	$ (325)	$	$ 5,405,594	$ 5,600,003	$ 200,385	$ (5,976)	$ 194,409
Freddie Mac	445,841	6,767			521,604	535,859	14,419	(164)	14,255
Ginnie Mae	20,090	353			20,443	20,820	377		377
Total Agency MBS	5,801,728	77,242	(325)		5,947,641	6,156,682	215,181	(6,140)	209,041
Non-Agency MBS *(3)*									
Rated AAA	37,346	1,062			38,408	30,437		(7,971)	(7,971)
Rated AA	2,987	29	(524)	(17)	2,474	2,536	375	(313)	62
Rated A	37,172	53	(5,913)	(2,646)	28,666	31,322	4,518	(1,862)	2,656
Rated BBB	96,300	22	(8,556)	(4,408)	83,358	83,966	3,247	(2,639)	608
Rated BB	40,506		(731)	(4,652)	34,442	33,175	1,534	(2,801)	(1,267)
Rated B	61,336		(15,653)	(11,114)	34,568	48,641	14,073		14,073
Rated CCC	569,158		(44,046)	(186,101)	337,441	394,482	60,222	(3,181)	57,041
Rated CC	836,809		(55,813)	(265,534)	505,296	559,169	79,386	(25,513)	53,873
Rated C	155,718		(10,557)	(57,878)	87,283	99,724	12,441		12,441
Unrated and D-rated *(4)*	46,886		(3,827)	(5,409)	33,065	28,578	2,002	(6,489)	(4,487)
Total Non-Agency MBS	1,884,218	1,166	(145,620)	(537,759)	1,185,001	1,312,030	177,798	(50,769)	127,029
Total MBS	$ 7,685,946	$ 78,408	$ (145,945)	$ (537,759)	$ 7,132,642	$ 7,468,712	$ 392,979	$ (56,909)	$ 336,070

December 31, 2009

(In Thousands)	Principal/ Current Face	Purchase Premiums	Purchase Discounts	Credit Discounts *(1)*	Amortized Cost *(2)*	Carrying Value/ Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Net Unrealized Gain/(Loss)
Agency MBS:									
Fannie Mae	$ 6,723,557	$ 88,712	$ (544)	$	$ 6,811,725	$ 7,056,211	$ 247,964	$ (3,478)	$ 244,486
Freddie Mac	545,787	8,327			567,049	585,462	18,589	(176)	18,413
Ginnie Mae	22,353	397			22,750	23,178	428		428
Total Agency MBS	7,291,697	97,436	(544)		7,401,524	7,664,851	266,981	(3,654)	263,327
Non-Agency MBS *(3)*									
Rated AAA	38,125	1,084			39,209	29,971		(9,238)	(9,238)

Rated AA	23,594	29	(5,797)	(2,640)	15,186	18,300	3,477	(363)	3,114
Rated A	32,849	54	(6,873)	(61)	25,969	26,416	2,613	(2,166)	447
Rated BBB	97,412	23	(6,239)	(8,074)	82,441	80,556	3,755	(5,640)	(1,885)
Rated BB	53,184		(7,401)	(12,026)	33,533	38,676	6,228	(1,085)	5,143
Rated B	73,343		(15,574)	(15,537)	42,232	53,853	11,621		11,621
Rated CCC	575,112	53	(47,178)	(216,391)	310,249	350,495	49,024	(8,778)	40,246
Rated CC	601,050		(48,057)	(159,680)	383,146	406,709	48,908	(25,345)	23,563
Rated C	101,820		(9,667)	(38,695)	53,458	63,560	10,149	(47)	10,102
Unrated and D-rated *(4)*	41,257		(2,533)	(1,900)	31,537	24,567	78	(7,048)	(6,970)
Total Non-Agency MBS	1,637,746	1,243	(149,319)	(455,004)	1,016,960	1,093,103	135,853	(59,710)	76,143
Total MBS	$ 8,929,443	$ 98,679	$ (149,863)	$ (455,004)	$ 8,418,484	$ 8,757,954	$ 402,834	$ (63,364)	$ 339,470

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(1) Purchase discounts designated as credit discounts are not expected to be accreted into interest income.

(2) Includes principal payments receivable, which are not included in the Principal/Current Face. Amortized cost is reduced by other-than-temporary impairments recognized through earnings.

(3) Non-Agency MBS are reported based on the lowest rating issued by a Rating Agency, if more than one rating is issued on the security, at the date presented.

(4) Includes two MBS, which were D-rated and had an aggregate amortized cost and fair value of $29.3 million and $22.8 million, respectively, at March 31, 2010 and had an aggregate amortized cost and fair value of $29.9 million and $22.8 million, respectively, at December 31, 2009. The Company recognized other-than-temporary impairments on these MBS during 2009.

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The table below presents the Company s unrealized gain/loss position by MBS category at March 31, 2010 and December 31, 2009:

	March 31, 2010		December 31, 2009	
(Dollars in Thousands)	Unrealized Gains	Unrealized Losses	Unrealized Gains	Unrealized Losses
Agency MBS	$ 215,181	$ 6,140	$ 266,981	$ 3,654
MFR MBS	177,798	5,709	135,819	6,577
Legacy Non-Agency MBS		45,060	34	53,133
Total	$ 392,979	$ 56,909	$ 402,834	$ 63,364

Unrealized Losses on MBS and Impairments

The following table presents information about the Company s MBS that were in an unrealized loss position at March 31, 2010:

	Unrealized Loss Position For:							
	Less than 12 Months			12 Months or more			Total	
(In Thousands)	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses
Agency MBS:								
Fannie Mae	$ 293,563	$ 2,893	17	$ 65,780	$ 3,083	16	$ 359,343	$ 5,976
Freddie Mac				7,221	164	2	7,221	164
Total Agency MBS	293,563	2,893	17	73,001	3,247	18	366,564	6,140
Non-Agency MBS:								
Rated AAA				30,437	7,971	3	30,437	7,971
Rated AA				1,184	313	2	1,184	313
Rated A				13,235	1,862	3	13,235	1,862
Rated BBB				10,465	2,639	1	10,465	2,639
Rated BB				15,366	2,801	1	15,366	2,801
Rated CCC	15,840	69	1	10,748	3,112	3	26,588	3,181
Rated CC	6,000	5,640	1	100,783	19,873	2		