

ANNALY CAPITAL MANAGEMENT INC  
Form 10-Q  
August 04, 2016  
UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

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FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED: JUNE 30, 2016

OR

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

FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_

COMMISSION FILE NUMBER: 1-13447

ANNALY CAPITAL MANAGEMENT, INC.  
(Exact Name of Registrant as Specified in its Charter)

MARYLAND  
(State or other jurisdiction of  
incorporation or organization)

22-3479661  
(IRS Employer Identification No.)

1211 AVENUE OF THE AMERICAS  
NEW YORK, NY 10036  
(Address of principal executive offices)

10036  
(Zip Code)

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

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

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

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

Class	Outstanding at July 31, 2016
Common Stock, \$.01 par value	995,532,782 (an additional 23,280,779 shares remain to be issued in connection with the previously announced acquisition of Hatteras Financial Corp.)

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ANNALY CAPITAL MANAGEMENT, INC.  
FORM 10-Q  
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## PART I – FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

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

	June 30, 2016 (Unaudited)	December 31, 2015 <sup>(1)</sup>
<b>ASSETS</b>		
Cash and cash equivalents (including cash pledged as collateral of \$2,578,551 and \$1,584,686, respectively) <sup>(2)</sup>	\$2,735,250	\$1,769,258
Investments, at fair value:		
Agency mortgage-backed securities (including pledged assets of \$59,749,105 and \$60,678,548, respectively)	64,862,992	65,718,224
Agency debentures (including pledged assets of \$0 and \$0, respectively)	-	152,038
Credit risk transfer securities (including pledged assets of \$167,549 and \$184,160, respectively)	520,321	456,510
Non-Agency mortgage-backed securities (including pledged assets of \$1,057,899 and \$744,783, respectively)	1,197,549	906,722
Commercial real estate debt investments (including pledged assets of \$4,361,972 and \$2,911,828, respectively) <sup>(3)</sup>	4,361,972	2,911,828
Commercial real estate debt and preferred equity, held for investment (including pledged assets of \$654,111 and \$578,820, respectively) <sup>(4)</sup>	1,137,971	1,348,817
Loans held for sale, net	164,175	278,600
Investments in commercial real estate	504,605	535,946
Corporate debt	669,612	488,508
Interest rate swaps, at fair value	146,285	19,642
Other derivatives, at fair value	137,490	22,066
Receivable for investments sold	697,943	121,625
Accrued interest and dividends receivable	227,225	231,336
Other assets	237,959	119,422
Goodwill	71,815	71,815
Intangible assets, net	43,306	38,536
<b>Total assets</b>	<b>\$77,716,470</b>	<b>\$75,190,893</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Liabilities:</b>		
Repurchase agreements	\$53,868,385	\$56,230,860
Other secured financing	3,588,326	1,845,048
Securitized debt of consolidated VIEs <sup>(5)</sup>	3,748,289	2,540,711
Participation sold	13,079	13,286
Mortgages payable	327,643	334,707
Interest rate swaps, at fair value	3,208,986	1,677,571

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Other derivatives, at fair value	154,017	49,963
Dividends payable	277,479	280,779
Payable for investments purchased	746,090	107,115
Accrued interest payable	159,435	151,843
Accounts payable and other liabilities	62,868	53,088
<b>Total liabilities</b>	<b>66,154,597</b>	<b>63,284,971</b>
<b>Stockholders' Equity:</b>		
7.875% Series A Cumulative Redeemable Preferred Stock:		
7,412,500 authorized, issued and outstanding	177,088	177,088
7.625% Series C Cumulative Redeemable Preferred Stock:		
12,650,000 authorized, 12,000,000 issued and outstanding	290,514	290,514
7.50% Series D Cumulative Redeemable Preferred Stock:		
18,400,000 authorized, issued and outstanding	445,457	445,457
Common stock, par value \$0.01 per share, 1,956,937,500 authorized, 924,929,607 and 935,929,561 issued and outstanding, respectively	9,249	9,359
Additional paid-in capital	14,575,426	14,675,768
Accumulated other comprehensive income (loss)	1,117,046	(377,596 )
Accumulated deficit	(5,061,565 )	(3,324,616 )
<b>Total stockholders' equity</b>	<b>11,553,215</b>	<b>11,895,974</b>
Noncontrolling interest	8,658	9,948
<b>Total equity</b>	<b>11,561,873</b>	<b>11,905,922</b>
<b>Total liabilities and equity</b>	<b>\$77,716,470</b>	<b>\$75,190,893</b>

(1) Derived from the audited consolidated financial statements at December 31, 2015.

(2) Includes cash of consolidated VIEs of \$9.7 million and \$48.5 million at June 30, 2016 and December 31, 2015, respectively.

(3) Includes senior securitized commercial mortgage loans of consolidated VIEs carried at fair value of \$4.0 billion and \$2.6 billion at June 30, 2016 and December 31, 2015, respectively.

(4) Includes senior securitized commercial mortgage loans of a consolidated VIE with a carrying value of \$187.2 million and \$262.7 million carried at amortized cost, net of an allowance for losses of \$0, at June 30, 2016 and December 31, 2015, respectively.

(5) Includes securitized debt of consolidated VIEs carried at fair value of \$3.7 billion and \$2.4 billion at June 30, 2016 and December 31, 2015, respectively.

See notes to consolidated financial statements.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(dollars in thousands, except per share data)

(Unaudited)

	Quarter Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Net interest income:				
Interest income	\$457,118	\$624,277	\$845,261	\$1,143,391
Interest expense	152,755	113,072	300,202	242,492
Net interest income	304,363	511,205	545,059	900,899
Realized and unrealized gains (losses):				
Realized gains (losses) on interest rate swaps <sup>(1)</sup>	(130,762 )	(144,465 )	(278,237 )	(302,704 )
Realized gains (losses) on termination of interest rate swaps	(60,064 )	-	(60,064 )	(226,462 )
Unrealized gains (losses) on interest rate swaps	(373,220 )	700,792	(1,404,940 )	234,590
Subtotal	(564,046 )	556,327	(1,743,241 )	(294,576 )
Net gains (losses) on disposal of investments	12,535	3,833	10,860	66,189
Net gains (losses) on trading assets	81,880	(114,230 )	207,069	(121,136 )
Net unrealized gains (losses) on financial instruments measured at fair value through earnings	(54,154 )	17,581	(54,026 )	(15,965 )
Impairment of goodwill	-	(22,966 )	-	(22,966 )
Subtotal	40,261	(115,782 )	163,903	(93,878 )
Total realized and unrealized gains (losses)	(523,785 )	440,545	(1,579,338 )	(388,454 )
Other income (loss):				
Investment advisory income	-	10,604	-	21,068
Dividend income from affiliate	-	4,318	-	8,636
Other income (loss)	(9,930 )	(22,275 )	(16,045 )	(23,299 )
Total other income (loss)	(9,930 )	(7,353 )	(16,045 )	6,405
General and administrative expenses:				
Compensation and management fee	36,048	37,014	73,045	75,643
Other general and administrative expenses	13,173	14,995	24,121	27,304
Total general and administrative expenses	49,221	52,009	97,166	102,947
Income (loss) before income taxes	(278,573 )	892,388	(1,147,490 )	415,903
Income taxes	(76 )	(7,683 )	(913 )	(7,669 )
Net income (loss)	(278,497 )	900,071	(1,146,577 )	423,572
Net income (loss) attributable to noncontrolling interest	(385 )	(149 )	(547 )	(239 )
Net income (loss) attributable to Annaly	(278,112 )	900,220	(1,146,030 )	423,811
Dividends on preferred stock	17,992	17,992	35,984	35,984



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Net income (loss) available (related) to common stockholders	\$ (296,104 )	\$ 882,228	\$ (1,182,014 )	\$ 387,827
Net income (loss) per share available (related) to common stockholders:				
Basic	\$ (0.32 )	\$ 0.93	\$ (1.28 )	\$ 0.41
Diluted	\$ (0.32 )	\$ 0.93	\$ (1.28 )	\$ 0.41
Weighted average number of common shares outstanding:				
Basic	924,887,316	947,731,493	925,850,452	947,700,832
Diluted	924,887,316	947,929,762	925,850,452	947,878,958
Dividends declared per share of common stock	\$ 0.30	\$ 0.30	\$ 0.60	\$ 0.60
Net income (loss)	\$ (278,497 )	\$ 900,071	\$ (1,146,577 )	\$ 423,572
Other comprehensive income (loss):				
Unrealized gains (losses) on available-for-sale securities	483,930	(1,125,043 )	1,501,637	(493,571 )
Reclassification adjustment for net (gains) losses included in net income (loss)	(7,250 )	(3,921 )	(6,995 )	(66,277 )
Other comprehensive income (loss)	476,680	(1,128,964 )	1,494,642	(559,848 )
Comprehensive income (loss)	\$ 198,183	\$ (228,893 )	\$ 348,065	\$ (136,276 )
Comprehensive income (loss) attributable to noncontrolling interest	(385 )	(149 )	(547 )	(239 )
Comprehensive income (loss) attributable to Annaly	198,568	(228,744 )	348,612	(136,037 )
Dividends on preferred stock	17,992	17,992	35,984	35,984
Comprehensive income (loss) attributable to common stockholders	\$ 180,576	\$ (246,736 )	\$ 312,628	\$ (172,021 )

(1) Consists of interest expense on interest rate swaps.

See notes to consolidated financial statements.

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ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(dollars in thousands, except per share data)

(Unaudited)

	7.875% Series A Cumulative Redeemable Preferred Stock	7.625% Series C Cumulative Redeemable Preferred Stock	7.50% Series D Cumulative Redeemable Preferred Stock	Common stock par value	Additional paid-in capital	Accumulated other comprehensive income (loss)	Accumulated deficit	Total stockholders' equity	Noncon- trolling inter- est
BALANCE, December 31, 2014	\$177,088	\$290,514	\$445,457	\$9,476	\$14,786,509	\$204,883	\$(2,585,436)	\$13,328,491	\$5,290,000
Net income (loss) attributable to Annaly	-	-	-	-	-	-	423,811	423,811	-
Net income (loss) attributable to noncontrolling interest	-	-	-	-	-	-	-	-	(239,000)
Unrealized gains (losses) on available-for-sale securities	-	-	-	-	-	(493,571 )	-	(493,571 )	-
Reclassification adjustment for net (gains) losses included in net income (loss)	-	-	-	-	-	(66,277 )	-	(66,277 )	-
Stock compensation expense	-	-	-	-	1,024	-	-	1,024	-
Net proceeds from direct purchase and dividend reinvestment	-	-	-	2	1,144	-	-	1,146	-
Equity contributions from (distributions to) noncontrolling interest	-	-	-	-	-	-	-	-	(245,000)
Preferred Series A dividends, declared \$0.984 per share	-	-	-	-	-	-	(7,296 )	(7,296 )	-
Preferred Series C dividends,	-	-	-	-	-	-	(11,438 )	(11,438 )	-

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declared \$0.953 per share Preferred Series D dividends, declared \$0.938 per share	-	-	-	-	-	-	(17,250 )	(17,250 )	-
Common dividends declared, \$0.60 per share	-	-	-	-	-	-	(568,641 )	(568,641 )	-
BALANCE, June 30, 2015	\$177,088	\$290,514	\$445,457	\$9,478	\$14,788,677	\$(354,965 )	\$(2,766,250)	\$12,589,999	\$4,800,000
BALANCE, December 31, 2015	\$177,088	\$290,514	\$445,457	\$9,359	\$14,675,768	\$(377,596 )	\$(3,324,616)	\$11,895,974	\$9,940,000
Net income (loss) attributable to Annaly	-	-	-	-	-	-	(1,146,030)	(1,146,030)	-
Net income (loss) attributable to noncontrolling interest	-	-	-	-	-	-	-	-	(547)
Unrealized gains (losses) on available-for-sale securities	-	-	-	-	-	1,501,637	-	1,501,637	-
Reclassification adjustment for net (gains) losses included in net income (loss)	-	-	-	-	-	(6,995 )	-	(6,995 )	-
Stock compensation expense	-	-	-	-	1,084	-	-	1,084	-
Net proceeds from direct purchase and dividend reinvestment	-	-	-	1	1,175	-	-	1,176	-
Buyback of common stock	-	-	-	(111 )	(102,601 )	-	-	(102,712 )	-
Equity contributions from (distributions to) noncontrolling interest	-	-	-	-	-	-	-	-	(743)
Preferred Series A dividends, declared \$0.984 per share	-	-	-	-	-	-	(7,296 )	(7,296 )	-

Preferred Series C dividends, declared \$0.953 per share	-	-	-	-	-	-	(11,438 )	(11,438 )	-
Preferred Series D dividends, declared \$0.938 per share	-	-	-	-	-	-	(17,250 )	(17,250 )	-
Common dividends declared, \$0.60 per share	-	-	-	-	-	-	(554,935 )	(554,935 )	-
BALANCE, June 30, 2016	\$177,088	\$290,514	\$445,457	\$9,249	\$14,575,426	\$1,117,046	\$(5,061,565)	\$11,553,215	\$8,650,000

See notes to consolidated financial statements

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ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in thousands)

(Unaudited)

	Six Months Ended June 30,	
	2016	2015
Cash flows from operating activities:		
Net income (loss)	\$(1,146,577	) \$423,572
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Amortization of Residential Investment Securities premiums and discounts, net	621,146	378,814
Amortization of commercial real estate investment premiums and discounts, net	(1,552	) (581 )
Amortization of intangibles	7,621	3,586
Amortization of deferred financing costs	1,019	4,561
Amortization of net origination fees and costs, net	(2,868	) (2,350 )
Amortization of contingent beneficial conversion feature and equity component of Convertible Senior Notes	-	12,246
Depreciation expense	10,684	5,687
Net gain on sale of commercial real estate	(821	) -
Net gain on sale of commercial loans held for sale	67	100
Net loss on sale of commercial real estate debt investments	165	-
Net (gains) losses on sales of Residential Investment Securities	(10,271	) (66,289 )
Stock compensation expense	1,084	1,024
Impairment of goodwill	-	22,966
Unrealized (gains) losses on interest rate swaps	1,404,940	(234,590 )
Net unrealized (gains) losses on financial instruments measured at fair value through earnings	54,026	15,965
Equity in net income from unconsolidated joint ventures	4,417	-
Net (gains) losses on trading assets	(207,069	) 121,136
Proceeds from sale of loans held for sale	114,358	-
Proceeds from repurchase agreements of RCap	1,076,600,000	895,400,000
Payments on repurchase agreements of RCap	(1,075,750,000)	(900,650,000)
Proceeds from reverse repurchase agreements	29,700,000	26,925,000
Payments on reverse repurchase agreements	(29,700,000	) (26,825,000 )
Net payments on derivatives	196,016	(116,122 )
Net change in:		
Due to / from brokers	(5	) -
Other assets	(65,653	) (15,686 )
Accrued interest and dividends receivable	3,202	45,897
Receivable for investment advisory income	-	(187 )
Accrued interest payable	7,592	(48,857 )
Accounts payable and other liabilities	24,331	13,952
Net cash provided by (used in) operating activities	1,865,852	(4,585,156 )
Cash flows from investing activities:		
Payments on purchases of Residential Investment Securities	(7,088,346	) (8,638,138 )
Proceeds from sales of Residential Investment Securities	4,008,291	18,278,224
Principal payments on Agency mortgage-backed securities	4,615,505	5,342,053
Payments on purchases of corporate debt	(245,447	) (187,035 )
Principal payments on corporate debt	65,804	42,352

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Purchases of commercial real estate debt investments	(76,862	) (276,918	)
Sales of commercial real estate debt investments	-	41,016	
Purchase of securitized loans at fair value	(1,489,268	) (2,574,353	)
Origination of commercial real estate investments, net	(189,020	) (180,531	)
Proceeds from sale of commercial real estate investments	12,750	46,806	
Principal payments on commercial real estate debt investments	61,601	1,616	
Principal payments on securitized loans at fair value	52,407	-	
Principal payments on commercial real estate investments	402,459	321,050	
Purchase of investments in real estate	(1,187	) (121	)
Investment in unconsolidated joint venture	(559	) (12,410	)
Distributions in excess of cumulative earnings from unconsolidated joint ventures	2,117	-	
Purchase of equity securities	(88,062	) (8,130	)
Proceeds from sales of equity securities	16,112	-	
Net cash provided by (used in) investing activities	58,295	12,195,481	
Cash flows from financing activities:			
Proceeds from repurchase agreements	85,723,588	105,819,378	
Principal payments on repurchase agreements	(88,936,063	) (114,471,752)	)
Payments on maturity of convertible senior notes	-	(857,541	)
Proceeds from other secured financing	2,146,084	203,200	
Payments on other secured financing	(402,806	) -	
Proceeds from issuance of securitized debt	1,381,640	2,382,810	
Principal repayments on securitized debt	(163,472	) (37,915	)
Principal repayments on securitized loans	-	50	
Payment of deferred financing cost	(3,076	) (641	)
Net proceeds from direct purchases and dividend reinvestments	1,176	1,144	
Principal payments on participation sold	(153	) (147	)
Principal payments on mortgages payable	(7,399	) (165	)
Distributions to noncontrolling interests	(743	) (245	)
Net payment on share repurchase	(102,712	) -	
Dividends paid	(594,219	) (604,587	)
Net cash provided by (used in) financing activities	(958,155	) (7,566,411	)
Net (decrease) increase in cash and cash equivalents	965,992	43,914	
Cash and cash equivalents, beginning of period	1,769,258	1,741,244	
Cash and cash equivalents, end of period	\$2,735,250	\$1,785,158	
	-	-	
Supplemental disclosure of cash flow information:			
Interest received	\$1,456,076	\$1,541,718	
Dividends received	\$-	\$8,366	
Investment advisory income received	\$-	\$20,881	
Interest paid (excluding interest paid on interest rate swaps)	\$282,146	\$218,272	
Net interest paid on interest rate swaps	\$281,120	\$305,327	
Taxes paid	\$591	\$1,901	
Noncash investing activities:			
Receivable for investments sold	\$697,943	\$247,361	
Payable for investments purchased	\$746,090	\$673,933	
	\$1,494,642	\$(559,848	)



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

1. DESCRIPTION OF BUSINESS

Annaly Capital Management, Inc. (the “Company” or “Annaly”) is a Maryland corporation that commenced operations on February 18, 1997. The Company owns a portfolio of real estate related investments, including mortgage pass-through certificates, collateralized mortgage obligations, Agency debentures, credit risk transfer (“CRT”) securities, other securities representing interests in or obligations backed by pools of mortgage loans, commercial real estate assets and corporate debt. The Company’s principal business objectives are to generate net income for distribution to its stockholders from its investments and capital preservation. The Company is externally managed by Annaly Management Company LLC (the “Manager”).

The Company’s business operations are primarily comprised of the following:

Annaly, the parent company, which invests primarily in Agency mortgage-backed securities and related derivatives to hedge these investments. Its portfolio also includes residential credit investments such as CRT and non-Agency mortgage-backed securities.

Annaly Commercial Real Estate Group, Inc. (“ACREG,” formerly known as CreXus Investment Corp.), a wholly-owned subsidiary that was acquired during the second quarter of 2013 which specializes in acquiring, financing and managing commercial real estate loans and other commercial real estate debt, commercial mortgage-backed securities and other commercial real estate-related assets.

Annaly Middle Market Lending LLC (“MML,” formerly known as Charlesfort Capital Management LLC), a wholly-owned subsidiary which engages in corporate middle market lending transactions.

RCap Securities, Inc. (“RCap”), a wholly-owned subsidiary, which operates as a broker-dealer and is a member of the Financial Industry Regulatory Authority (“FINRA”).

The Company has elected to be taxed as a Real Estate Investment Trust (“REIT”) as defined under the Internal Revenue Code of 1986, as amended, and regulations promulgated thereunder (the “Code”).

2. BASIS OF PRESENTATION

The accompanying consolidated financial statements and related notes of the Company have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”).

The accompanying consolidated financial statements and related notes are unaudited and should be read in conjunction with the audited consolidated financial statements included in the Company’s most recent annual report on Form 10-K. The consolidated financial information as of December 31, 2015 has been derived from audited consolidated financial statements not included herein.

In the opinion of management, all normal, recurring adjustments have been included for a fair presentation of this interim financial information. Interim period operating results may not be indicative of the operating results for a full year.

3. SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation – The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries and consolidated variable interest entities. All intercompany balances and transactions have been eliminated in consolidation. The Company reclassified previously presented financial information so that amounts previously presented conform to the current period presentation.

The Company has evaluated all of its investments in legal entities in order to determine if they are variable interests in Variable Interest Entities (“VIEs”). A VIE is defined as an entity in which equity investors (i) do not have the characteristics of a controlling financial interest, and/or (ii) do not have sufficient equity at risk for the entity to



finance its activities without additional subordinated financial support from other parties. A variable interest is an investment or other interest that will absorb portions of a VIE's expected losses or receive portions of the entity's expected residual returns. A VIE is required to be consolidated by its primary beneficiary, which is defined as the party that (i) has the power to direct the activities that most significantly impact the VIE's economic performance and (ii) has the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

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To assess whether the Company has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, the Company considers all facts and circumstances, including the Company's role in establishing the VIE and the Company's ongoing rights and responsibilities. This assessment includes first, identifying the activities that most significantly impact the VIE's economic performance; and second, identifying which party, if any, has power over those activities. In general, the parties that make the most significant decisions affecting the VIE or have the right to unilaterally remove those decision makers are deemed to have the power to direct the activities of a VIE.

To assess whether the Company has the obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE, the Company applies significant judgment and considers all of its economic interests, including debt and equity investments and other arrangements deemed to be variable interests, both explicit and implicit, in the VIE. This assessment requires that the Company applies judgment in determining whether these interests, in the aggregate, are considered potentially significant to the VIE. Factors considered in assessing significance include: the design of the VIE, including its capitalization structure; subordination of interests; payment priority; relative share of interests held across various classes within the VIE's capital structure; and the reasons why the interests are held by the Company.

The Company performs ongoing reassessments of whether changes in the facts and circumstances regarding the Company's involvement with a VIE causes the Company's consolidation conclusion regarding the VIE to change.

Cash and Cash Equivalents – Cash and cash equivalents include cash on hand, cash held in money market funds on an overnight basis and cash pledged as collateral with counterparties. Cash deposited with clearing organizations is carried at cost, which approximates fair value. The Company also maintains collateral in the form of cash on margin with counterparties to its interest rate swaps and other derivatives. RCap is a member of various clearing organizations with which it maintains cash required to conduct its day-to-day clearance activities. Cash and securities deposited with clearing organizations and collateral held in the form of cash on margin with counterparties to the Company's interest rate swaps and other derivatives totaled approximately \$2.6 billion and \$1.6 billion at June 30, 2016 and December 31, 2015, respectively.

Fair Value Measurements – The Company reports various financial instruments at fair value. A complete discussion of the methodology utilized by the Company to estimate the fair value of certain financial instruments is included in these Notes to Consolidated Financial Statements.

Revenue Recognition – The revenue recognition policy by asset class is discussed below.

Agency Mortgage-Backed Securities, Agency Debentures, Non-Agency Mortgage-Backed Securities and CRT Securities – The Company invests in mortgage pass-through certificates, collateralized mortgage obligations and other mortgage-backed securities representing interests in or obligations backed by pools of mortgage loans and certificates guaranteed by the Government National Mortgage Association (“Ginnie Mae”), the Federal Home Loan Mortgage Corporation (“Freddie Mac”) or the Federal National Mortgage Association (“Fannie Mae”) (collectively, “Agency mortgage-backed securities”). These Agency mortgage-backed securities may include forward contracts for Agency mortgage-backed securities purchases or sales of a generic pool, on a to-be-announced basis (“TBA securities”). The Company also invests in Agency debentures issued by the Federal Home Loan Banks, Freddie Mac and Fannie Mae, as well as CRT securities. CRT securities are risk sharing instruments issued by Fannie Mae and Freddie Mac, and similarly structured transactions arranged by third party market participants. CRT securities are designed to synthetically transfer mortgage credit risk from Fannie Mae, Freddie Mac and/or third parties to private investors. The Company also invests in non-Agency mortgage-backed securities, such as those issued in non-performing loan (“NPL”) and re-performing loan (“RPL”) securitizations.

Agency mortgage-backed securities, Agency debentures, non-Agency mortgage-backed securities and CRT securities are referred to herein as “Residential Investment Securities.” Although the Company generally intends to hold most of

its Residential Investment Securities until maturity, it may, from time to time, sell any of its Residential Investment Securities as part of the overall management of its portfolio. Residential Investment Securities classified as available-for-sale are reported at fair value with unrealized gains and losses reported as a component of other comprehensive income (loss) unless the Company has elected the fair value option, where the unrealized gains and losses on these financial instruments are recorded through earnings (e.g., interest-only securities). The fair value of Residential Investment Securities classified as available-for-sale is estimated by management and is compared to independent sources for reasonableness. Residential Investment Securities transactions are recorded on trade date, including TBA

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## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

## Item 1. Financial Statements

securities that meet the regular-way securities scope exception from derivative accounting. Gains and losses on sales of Residential Investment Securities are recorded on trade date based on the specific identification method.

The Company elected the fair value option for interest-only mortgage-backed securities, non-Agency mortgage-backed securities and certain CRT securities. Interest-only securities and inverse interest-only securities are collectively referred to as “interest-only securities.” These interest-only mortgage-backed securities represent the Company’s right to receive a specified proportion of the contractual interest flows of specific mortgage-backed securities. Interest-only mortgage-backed securities, non-Agency mortgage-backed securities and certain CRT securities are measured at fair value with changes in fair value recorded as Net unrealized gains (losses) on financial instruments measured at fair value through earnings in the Company’s Consolidated Statements of Comprehensive Income (Loss). The interest-only securities are included in Agency mortgage-backed securities at fair value on the accompanying Consolidated Statements of Financial Condition.

The Company recognizes coupon income, which is a component of interest income, based upon the outstanding principal amounts of the Residential Investment Securities and their contractual terms. In addition, the Company amortizes or accretes premiums or discounts into interest income for its Agency mortgage-backed securities, excluding interest-only securities, considering estimates of future principal prepayment in the calculation of the effective yield because they are probable and the timing and amount of prepayments can be reasonably estimated. The Company recalculates the effective yield as differences between anticipated and actual prepayments occur. Using third-party model and market information to project future cash flows and expected remaining lives of securities, the effective interest rate determined for each security is applied as if it had been in place from the date of the security’s acquisition. The amortized cost of the investment is then adjusted to the amount that would have existed had the new effective yield been applied since the acquisition date. The adjustment to amortized cost is offset with a charge or credit to interest income. Changes in interest rates and other market factors will impact prepayment speed projections and the amount of premium amortization recognized in any given period.

Premiums or discounts associated with the purchase of Agency interest-only securities and residential credit securities are amortized or accreted into interest income based upon current expected future cash flows with any adjustment to yield made on a prospective basis.

Interest income for Agency debentures is recognized by applying the interest method using contractual cash flows without estimating prepayments.

The table below summarizes the interest income recognition methodology for Residential Investment Securities:

	Interest Income Methodology
Agency	
Fixed-rate pass-through <sup>(1)</sup>	Effective yield <sup>(3)</sup>
Adjustable-rate pass-through <sup>(1)</sup>	Effective yield <sup>(3)</sup>
CMO <sup>(1)</sup>	Effective yield <sup>(3)</sup>
	Contractual Cash
Debentures <sup>(1)</sup>	Flows
Interest-only <sup>(2)</sup>	Prospective
Residential Credit	
CRT <sup>(2)</sup>	Prospective
Legacy <sup>(2)</sup>	Prospective
NPL/RPL <sup>(2)</sup>	Prospective
New issue <sup>(2)</sup>	Prospective
New issue interest-only <sup>(2)</sup>	Prospective

(1) Changes in fair value are recognized in Other comprehensive income (loss) on the accompanying Consolidated Statements of Comprehensive Income (Loss).

(2) Changes in fair value are recognized in Net unrealized gains (losses) on financial instruments measured at fair value through earnings on the accompanying Consolidated Statements of Comprehensive Income (Loss).

(3) Effective yield is recalculated for differences between estimated and actual prepayments and the amortized cost is adjusted as if the new effective yield had been applied since inception.

Equity Securities – The Company may invest in equity securities that are classified as available-for-sale or trading. Equity securities classified as available-for-sale are reported at fair value, based on market quotes, with unrealized gains and losses reported as a component of other comprehensive income (loss). Equity securities classified as trading are reported at fair value, based on market quotes, with unrealized gains and losses reported in the Consolidated Statements of Comprehensive Income (Loss) as Net gains (losses) on trading assets. Dividends are recorded in earnings based on the declaration date.

Derivative Instruments – The Company may use a variety of derivative instruments to economically hedge some of its exposure to market risks, including interest rate and prepayment risk. These instruments include, but are not limited to, interest rate swaps, options to enter into interest rate swaps (“swaptions”), TBA contracts without intent to

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accept delivery (“TBA derivatives”), options on TBA contracts (“MBS options”) and U.S. Treasury and Eurodollar futures contracts. The Company may also invest in other types of mortgage derivatives such as interest-only securities and synthetic total return swaps, such as the Markit IOS Synthetic Total Return Swap Index. Derivatives are accounted for in accordance with the Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 815, Derivatives and Hedging, which requires recognition of all derivatives as either assets or liabilities at fair value in the Consolidated Statements of Financial Condition with changes in fair value recognized in the Consolidated Statements of Comprehensive Income (Loss). None of the Company’s derivative transactions have been designated as hedging instruments for accounting purposes.

Some derivative agreements contain provisions that allow for netting or setting off by counterparty; however, the Company elected to present related assets and liabilities on a gross basis in the Consolidated Statements of Financial Condition.

Interest rate swap agreements - Interest rate swaps are the primary instrument used to mitigate interest rate risk. In particular, the Company uses interest rate swaps to manage its exposure to changing interest rates on its repurchase agreements by economically hedging cash flows associated with these borrowings. Swap agreements may or may not be cleared through a derivatives clearing organization (“DCO”). Uncleared swaps are fair valued using internal pricing models and compared to the counterparty market values. Centrally cleared swaps are fair valued using the DCO’s market values.

Interest rate swaptions - Interest rate swaptions are purchased/sold to mitigate the potential impact of increases or decreases in interest rates. Interest rate swaptions provide the option to enter into an interest rate swap agreement for a predetermined notional amount, stated term and pay and receive interest rates in the future. They are not centrally cleared. The premium paid/received for interest rate swaptions is reported as an asset/liability in the Consolidated Statements of Financial Condition. The difference between the premium and the fair value of the swaption is reported in Net gains (losses) on trading assets in the Consolidated Statements of Comprehensive Income (Loss). If a swaption expires unexercised, the realized gain (loss) on the swaption would be equal to the premium received/paid. If the Company sells or exercises a swaption, the realized gain or loss on the swaption would be equal to the difference between the cash received or the fair value of the underlying interest rate swap received and the premium paid. The fair value of interest rate swaptions is estimated using internal pricing models and compared to the counterparty market value.

TBA Dollar Rolls - TBA dollar roll transactions are accounted for as a series of derivative transactions. The fair value of TBA derivatives is based on similar methods used to value Agency mortgage-backed securities with gains and losses recorded in Net gains (losses) on trading assets in the Consolidated Statements of Comprehensive Income (Loss).

MBS Options – MBS options are generally options on TBA contracts, which help manage mortgage market risks and volatility while providing the potential to enhance returns. MBS options are over-the-counter traded instruments and those written on current-coupon mortgage-backed securities are typically the most liquid. MBS options are measured at fair value using internal pricing models and compared to the counterparty market value at the valuation date with gains and losses recorded in Net gains (losses) on trading assets in the Consolidated Statements of Comprehensive Income (Loss).

Futures Contracts - Futures contracts are derivatives that track the prices of specific assets. Short sales of futures contracts help mitigate the potential impact of changes in interest rates on the portfolio performance. The Company maintains margin accounts that are settled daily with Futures Commission Merchants (“FCMs”). The margin requirement varies based on the market value of the open positions and the equity retained in the account. Futures

contracts are fair valued based on exchange pricing with gains and losses recorded in Net gains (losses) on trading assets in the Consolidated Statements of Comprehensive Income (Loss).

Repurchase Agreements – The Company finances the acquisition of a significant portion of its Agency mortgage-backed securities with repurchase agreements. The Company examines each of the specified criteria in ASC 860, Transfers and Servicing, at the inception of each transaction and has determined that each of the financings meet the specified criteria in this guidance.

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

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Goodwill and Intangible Assets – The Company’s acquisitions are accounted for using the acquisition method. Under the acquisition method, net assets and results of operations of acquired companies are included in the consolidated financial statements from the date of acquisition. The purchase prices are allocated to the assets acquired, including identifiable intangible assets, and the liabilities assumed based on their estimated fair values at the date of acquisition. The excess of purchase price over the fair value of the net assets acquired is recognized as goodwill. Conversely, any excess of the fair value of the net assets acquired over the purchase price is recognized as a bargain purchase gain. The Company tests goodwill for impairment on an annual basis and at interim periods when events or circumstances may make it more likely than not that an impairment has occurred. If a qualitative analysis indicates that there may be an impairment, a quantitative analysis is performed. The quantitative impairment test for goodwill utilizes a two-step approach, whereby the Company compares the carrying value of each identified reporting unit to its fair value. If the carrying value of the reporting unit is greater than its fair value, the second step is performed, where the implied fair value of goodwill is compared to its carrying value. The Company recognizes an impairment charge for the amount by which the carrying amount of goodwill exceeds its fair value. An impairment of the goodwill associated with the Company’s acquisition of Fixed Income Discount Advisory Company (“FIDAC”) was recorded during the year ended December 31, 2015.

Intangible assets with an estimated useful life are amortized over their expected useful lives.

Convertible Senior Notes – The Company recorded the 4% Convertible Senior Notes and 5% Convertible Senior Notes (collectively, the “Convertible Senior Notes”) at their contractual amounts, adjusted by the effects of a beneficial conversion feature and a contingent beneficial conversion feature (collectively, the “Conversion Features”). The Conversion Features’ intrinsic value is included in “Additional paid-in capital” on the Company’s Consolidated Statements of Financial Condition and reduces the recorded liability amount associated with the Convertible Senior Notes. A Conversion Feature may be recognized as a result of adjustments to the conversion price for dividends declared to common stockholders. The 4% and 5% Convertible Senior Notes matured in February 2015 and May 2015, respectively.

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

Income Taxes – The Company has elected to be taxed as a REIT and intends to comply with the provisions of the Code, with respect thereto. Accordingly, the Company will not be subject to federal income tax to the extent of its distributions to stockholders and as long as certain asset, income and stock ownership tests are met. The Company and certain of its direct and indirect subsidiaries, including FIDAC, RCap and certain subsidiaries of ACREG, have made separate joint elections to treat these subsidiaries as taxable REIT subsidiaries (“TRSs”). As such, each of these TRSs is taxable as a domestic C corporation and subject to federal, state and local income taxes based upon their taxable income.

The provisions of ASC 740, Income Taxes, (“ASC 740”) clarify the accounting for uncertainty in income taxes recognized in financial statements and prescribe a recognition threshold and measurement attribute for uncertain tax positions taken or expected to be taken on a tax return. ASC 740 also requires that interest and penalties related to unrecognized tax benefits be recognized in the financial statements. The Company does not have any unrecognized tax benefits that would affect its financial position. Thus, no accruals for penalties and interest were necessary as of June 30, 2016 and December 31, 2015.

Use of Estimates – 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.



## Commercial Real Estate Investments

Commercial Real Estate Debt Investments - The Company's commercial real estate debt investments are comprised of commercial mortgage-backed securities and loans held by consolidated collateralized financing entities. Commercial mortgage-backed securities are classified as available-for-sale and reported at fair value with unrealized gains and losses reported as a component of other comprehensive income (loss). Management evaluates commercial mortgage-backed securities for other-than-temporary impairment at least quarterly. See the "Commercial Real Estate Investments" Note for additional information regarding the consolidated collateralized financing entities.

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Commercial Real Estate Loans – The Company's commercial real estate loans are comprised of fixed-rate and adjustable-rate loans. The Company designates loans as held for investment if it has the intent and ability to hold the loans until maturity or payoff. The difference between the principal amount of a loan and proceeds at acquisition is recorded as either a discount or premium. Commercial real estate loans that are designated as held for investment and are originated or purchased by the Company are carried at their outstanding principal balance, net of unamortized origination fees and costs, premiums or discounts, less a reserve for estimated losses if necessary.

If the Company intends to sell or securitize the loans and the financing vehicle is not expected to be consolidated, they are classified as held for sale. Commercial real estate loans that are designated as held for sale are carried at the lower of amortized cost or fair value and recorded as Loans held for sale in the accompanying Consolidated Statements of Financial Condition. Any origination fees and costs or purchase premiums or discounts are deferred and recognized upon sale. The Company determines the fair value of commercial real estate loans held for sale on an individual loan basis. The Company has elected the fair value option for multi-family mortgage loans held in securitization trusts that it was required to consolidate. Preferred equity interests are designated as held for investment and are carried at their outstanding principal balance, net of unamortized origination fees and costs, premiums or discounts, less a reserve for estimated losses if necessary. See “Commercial Real Estate Investments” Note for additional information.

Investments in Commercial Real Estate – Investments in commercial real estate are carried at historical cost less accumulated depreciation. Historical cost includes all costs necessary to bring the asset to the condition and location necessary for its intended use, including financing during the construction period. Costs directly related to acquisitions deemed to be business combinations are expensed. Ordinary repairs and maintenance which are not reimbursed by tenants are expensed as incurred. Major replacements and improvements that extend the useful life of the asset are capitalized and depreciated over their useful life.

Investments in commercial real estate are depreciated using the straight-line method over the estimated useful lives of the assets, summarized as follows:

<u>Category</u>	<u>Term</u>
Building	30 - 40 years
Site improvements	1 - 28 years

The Company follows the acquisition method of accounting for acquisitions of operating real estate held for investment, where the purchase price of operating real estate is allocated to tangible assets such as land, building, site improvements and other identified intangibles such as above/below market and in-place leases.

The Company applies the equity method of accounting for its investments in joint ventures where it is not considered to have a controlling financial interest. Under the equity method of accounting, the Company will recognize its share of earnings or losses of the investee in the period in which they are reported by the investee. The Company also considers whether there are any indicators of other-than-temporary impairment of joint ventures accounted for under the equity method.

The Company evaluates whether real estate acquired in connection with a foreclosure (“REO”) or UCC/deed in lieu of foreclosure (herein collectively referred to as a foreclosure) constitutes a business and whether business combination accounting is applicable. Upon foreclosure of a property, the excess of the carrying value of a loan, if any, over the estimated fair value of the property, less estimated costs to sell, is charged to provision for loan losses.

Investments in commercial real estate, including REO, that do not meet the criteria to be classified as held for sale are separately presented in the Consolidated Statements of Financial Condition as held for investment. Real estate held for sale is reported at the lower of its carrying value or its estimated fair value less estimated costs to sell. Once a property is determined to be held for sale, depreciation is no longer recorded.

The Company's real estate portfolio (REO and real estate held for investment) is reviewed on a quarterly basis, or more frequently as necessary, to assess whether there are any indicators that the value of its operating real estate may be impaired or that its carrying value may not be recoverable. A property's value is considered impaired if the Company's estimate of the aggregate future undiscounted cash flows to be generated by the property is less than the carrying value of the property. In conducting this review, the Company considers U.S. macroeconomic factors, including real estate sector conditions, together with asset specific and other factors. To the extent impairment has occurred and is considered to be other than temporary, the loss will be measured as the excess of the carrying amount of the property over the calculated fair value of the property.

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Revenue Recognition – Commercial Real Estate Investments - Interest income is accrued based on the outstanding principal amount of the commercial real estate loans and preferred equity interests held for investment (collectively referred to as “CRE Debt and Preferred Equity Investments”) and their contractual terms. Premiums and discounts associated with the purchase of CRE Debt and Preferred Equity Investments are amortized or accreted into interest income over the projected lives of the CRE Debt and Preferred Equity Investments using the interest method.

Corporate Debt

Corporate Loans – The Company’s investments in corporate debt that are loans are designated as held for investment when the Company has the intent and ability to hold the investment until maturity or payoff. These investments are carried at their principal balance outstanding plus any premiums or discounts less allowances for loan losses. Interest income from coupon payments is accrued based upon the outstanding principal amounts of the debt and its contractual terms. Premiums and discounts are amortized or accreted into interest income using the interest method. These investments typically take the form of senior secured loans primarily in first lien and second lien loans. The Company’s senior secured loans generally have stated maturities of three to eight years. In connection with these senior secured loans the Company receives a security interest in certain of the assets of the borrower and such assets support repayment of such loans. Senior secured loans are generally exposed to the least amount of credit risk given their seniority to scheduled principal and interest and priority of security in the assets of the borrower. To date, the majority of the Company’s investments have been funded term loans versus debt securities.

Corporate Debt Securities – The Company’s investments in corporate debt securities are designated as held-to-maturity when the Company has the intent and ability to hold the investments until maturity. These investments are carried at their principal balance outstanding plus any premiums or discounts less other-than-temporary impairment. Interest income from coupon payments is accrued based upon the outstanding principal amounts of the debt and its contractual terms. Premiums and discounts are amortized or accreted into interest income using the interest method.

Other-Than-Temporary Impairment – Management evaluates available-for-sale securities and held-to-maturity debt securities for other-than-temporary impairment at least quarterly, and more frequently when economic or market conditions warrant such evaluation. When the fair value of an available-for-sale security is less than its amortized cost, the security is considered impaired. For available-for-sale securities that are impaired, the Company determines if it (1) has the intent to sell the security, (2) is more likely than not that it will be required to sell the security before recovery of its amortized cost basis, or (3) does not expect to recover the entire amortized cost basis of the security. Further, the security is analyzed for credit loss (the difference between the present value of cash flows expected to be collected and the amortized cost basis). The credit loss, if any, will then be recognized in the Consolidated Statements of Comprehensive Income (Loss), while the balance of losses related to other factors will be recognized as a component of other comprehensive income (loss). If the fair value is less than the cost of a held-to-maturity security, the Company performs an analysis to determine whether it expects to recover the entire cost basis of the security. There was no other-than-temporary impairment recognized for the quarters ended June 30, 2016 and 2015.

Allowance for Losses – The Company evaluates the need for a loss reserve on its CRE Debt and Preferred Equity Investments and its corporate loans. A provision for losses related to CRE Debt and Preferred Equity Investments and corporate loans, including those accounted for under ASC 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality, may be established when it is probable the Company will not collect amounts contractually due or all amounts previously estimated to be collectable. Management assesses the credit quality of the portfolio and adequacy of loan loss reserves on a quarterly basis, or more frequently as necessary. Significant judgment is required in this analysis. Depending on the expected recovery of its investment, the Company considers the estimated net recoverable value of the CRE Debt and Preferred Equity Investments as well as other factors, including but not limited to the fair value of any collateral, the amount and the status of any senior debt, the prospects for the borrower and the competitive landscape where the borrower conducts business. To determine if loan loss allowances are required on investments in corporate debt, the Company reviews the monthly and/or quarterly financial

statements of the borrowers, verifies loan compliance packages if applicable and analyzes current results relative to budgets and sensitivities performed at inception of the investment. Because these determinations are based upon projections of future economic events, which are inherently subjective, the amounts ultimately realized may differ materially from the carrying value as of the reporting date.

The Company may be exposed to various levels of credit risk depending on the nature of its investments and credit enhancements, if any, supporting its assets. The Company's core investment process includes procedures related to the initial approval and periodic monitoring of credit risk and other risks associated with each investment.

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The Company's investment underwriting procedures include evaluation of the underlying borrowers' ability to manage and operate their respective properties or companies. Management reviews loan-to-value metrics upon either the origination or the acquisition of a new investment but generally does not update the loan-to-value metrics in the course of quarterly surveillance. Management generally reviews the most recent financial information produced by the borrower, which may include, but is not limited to, net operating income ("NOI"), debt service coverage ratios, property debt yields (net cash flow or NOI divided by the amount of outstanding indebtedness), loan per unit and rent rolls relating to each of the Company's CRE Debt and Preferred Equity Investments, and may consider other factors management deems important. Management also reviews market pricing to determine each borrower's ability to refinance their respective assets at the maturity of each loan. Management also reviews economic trends, both macro and those affecting the property specifically, and the supply and demand of competing projects in the sub-market in which each subject property is located. Management monitors the financial condition and operating results of its corporate borrowers and continually assesses the future outlook of the borrower's financial performance in light of industry developments, management changes and company-specific considerations.

In connection with the quarterly surveillance review process, CRE Debt and Preferred Equity Investments are assigned an internal risk rating. Effective December 31, 2015, the loan risk ratings were enhanced and considered guidance provided by the Office of the Comptroller of the Currency for commercial real estate lending. The initial internal risk ratings ("Initial Ratings") are based on loan-to-values and the NOI debt yields of the underlying collateral of the Company's CRE Debt and Preferred Equity Investments and based upon leverage and cash flow coverages of the borrowers' debt and operating obligations. The final internal risk ratings are influenced by other quantitative and qualitative factors that can result in an adjustment to the Initial Ratings, subject to review and approval by the respective committee. The internal risk rating categories include "Performing", "Performing - Closely Monitored", "Performing - Special Mention", "Substandard", "Doubtful" or "Loss". Performing loans meet all present contractual obligations. Performing - Closely Monitored loans meet all present contractual obligations, are transitional or could be exhibiting some weakness in both leverage and liquidity. Performing - Special Mention loans meet all present contractual obligations, but exhibit potential weakness that deserves management's close attention and if uncorrected, may result in deterioration of repayment prospects. Substandard loans are inadequately protected by sound worth and paying capacity of the obligor or of the collateral pledged with a distinct possibility that loss will be sustained if some of the deficiencies are not corrected. Doubtful loans are Substandard loans whereby collection of all contractual principal and interest is highly questionable or improbable. Loss loans are considered uncollectible. The presentation of prior period internal risk ratings have been revised to conform to the current period presentation.

The Company did not have any impaired loans, nonaccrual loans, or loans in default as all of the loans were performing as of June 30, 2016 and December 31, 2015. Accordingly, no allowance for loan losses was deemed necessary as of June 30, 2016 and December 31, 2015.

Broker Dealer Activities

In January 2014, RCap ceased its trading activity in U.S. Treasury securities, derivatives and securities borrowed and loaned transactions.

Reverse Repurchase Agreements – RCap enters into reverse repurchase agreements and repurchase agreements as part of its matched book trading activity. Reverse repurchase agreements are recorded on settlement date at the contract amount and are collateralized by mortgage-backed or other securities. Margin calls are made by RCap as necessary based on the daily valuation of the underlying collateral as compared to the contract price. RCap generates income from the spread between what is earned on the reverse repurchase agreements and what is paid on the matched repurchase agreements. RCap's policy is to obtain possession of collateral with a market value in excess of the principal amount loaned under reverse repurchase agreements. To ensure that the market value of the underlying collateral remains sufficient, collateral is valued daily, and RCap requires counterparties to deposit additional collateral, when necessary. All reverse repurchase activities are transacted under master repurchase agreements that

give RCap the right, in the event of default, to liquidate collateral held and in some instances, to offset receivables and payables with the same counterparty. Substantially all of RCap's reverse repurchase activity is with affiliated entities.

#### Recent Accounting Pronouncements

The following table provides a brief description of recent accounting pronouncements that could potentially impact the Company's consolidated financial statements:

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## Item 1. Financial Statements

Standard	Description	Date of Adoption	Effect on the financial statements or other significant matters
Standards that are not yet adopted			
ASU 2016-13 Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments	This ASU updates the existing incurred loss model to a current expected credit loss model for financial assets and net investments in leases that are not accounted for at fair value through earnings. The amendments affect loans, debt securities, trade receivables, net investments in leases, off balance sheet credit exposures and any other financial assets not excluded from the scope. There are also changes to the accounting for available for sale debt securities.	January 1, 2020 (early adoption permitted)	The Company is assessing the impact to the consolidated financial statements.
ASU 2016-02 Leases (Topic 842)	The amendments require lessees to recognize a right-of-use asset and a liability to make lease payments in the statement of financial position for most leases. The accounting for lessors is largely unchanged.	January 1, 2019 (early adoption permitted)	Not expected to have a significant impact to the consolidated financial statements.
ASU 2016-01 Financial Instruments - Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities	The amendments address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments.	January 1, 2018 (early adoption permitted for a provision related presentation of instrument-specific credit risk of liabilities accounted for under the fair value option)	Expected to impact disclosures only and not have a significant impact to the consolidated financial statements.
ASU 2014-15, Presentation of Financial Statements – Going Concern (Subtopic 205-04) Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern	This ASU requires management to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the Company’s ability to continue as a going concern within one year after the date the financial statements are issued.	January 1, 2017 (early adoption permitted)	Not expected to have an impact to the consolidated financial statements.
ASU 2014-09, Revenue from Contracts with Customers	This guidance applies to contracts with customers to transfer goods or services and contracts to transfer nonfinancial assets unless those	January 1, 2018	Not expected to have a significant impact to the consolidated



Standard	Description	Date of Adoption	financial statements or other significant matters
	contracts are within the scope of other standards (for example, lease transactions).		financial statements.
Standards that were adopted			Effect on the financial statements or other significant matters
ASU 2015-16 Business Combinations (Topic 805) Simplifying the Accounting Measurement-Period Adjustments	This amendment removes the requirement to present adjustments to provisional amounts retrospectively. The update requires that an acquirer record, in the same period's financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to provisional amounts.	January 1, 2016 (early adoption permitted)	Did not have a significant impact to the consolidated financial statements.
ASU 2015-15, Interest - Imputation of Interest (Subtopic 835-30) Simplifying the Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements - Amendments to SEC Paragraphs Pursuant to Staff Announcement at June 18, 2015 EITF Meeting (SEC Update)	This amendment provides SEC guidance that it would not object to filers presenting debt issue costs related to line-of-credit arrangements as an asset and ratably amortizing the costs over the term of the arrangement.	June 18, 2015 (early adoption permitted)	Did not have an impact to the consolidated financial statements.
ASU 2015-10, Technical Corrections and Improvements	This perpetual project updates the Codification for technical corrections and improvements.	January 1, 2016 (early adoption permitted), for amendments subject to transition guidance	Did not have a significant impact to the consolidated financial statements.
ASU 2015-08, Business Combinations Topic 805 Pushdown Accounting Amendments to SEC Paragraphs Pursuant to Staff Accounting Bulletin No. 115	This update amends the codification for SEC Staff Bulletin No. 115	November 18, 2014	Did not have a significant impact to the consolidated financial statements.
ASU 2015-07, Fair Value Measurement (Topic 820): Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)	This update removes the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient and also removes certain disclosure requirements for these investments.	January 1, 2016 (early adoption permitted)	Did not have an impact to the consolidated financial statements.



## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

## Item 1. Financial Statements

Standard	Description	Date of Adoption	Effect on the financial statements or other significant matters
ASU 2015-05, Customer's Accounting for Fees Paid in a Cloud Computing Arrangement	This update clarifies that customers should determine whether a cloud computing arrangement includes the license of software by applying the same guidance cloud service providers use. The guidance also eliminates the current requirement that customers analogize to the leasing standard when determining the asset acquired in a software licensing arrangement.	January 1, 2016 (early adoption permitted)	Did not have a significant impact to the consolidated financial statements.
ASU 2015-03, Interest - Imputation of Interest (Subtopic 835-30) Simplifying the Presentation of Debt Issuance Costs	This ASU requires that debt issue costs are presented in the balance sheet as a direct deduction from the carrying amount of that debt liability. The recognition and measurement of debt issue costs are not affected.	January 1, 2016 (early adoption permitted)	Impacted presentation only and did not have a significant impact to the consolidated financial statements.
ASU 2015-02, Consolidation (Topic 810) Amendments to the Consolidation Analysis	This update affects the following areas of the consolidation analysis: limited partnerships and similar entities, evaluation of fees paid to a decision maker or service provider as a variable interest and in determination of the primary beneficiary, effect of related parties on the primary beneficiary determination and for certain investment funds.	January 1, 2016 (early adoption permitted)	Did not have a significant impact to the consolidated financial statements.
ASU 2015-01, Income Statement - Extraordinary and Unusual Items (Subtopic 225-20)	This update eliminates from GAAP the concept of extraordinary items.	January 1, 2016 (early adoption permitted)	Did not have an impact to the consolidated financial statements.
ASU 2014-16, Derivatives and Hedging (Topic 815) Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share is More Akin to Debt or Equity	This ASU provides additional guidance for evaluating whether conversion rights, redemption rights, voting rights, liquidation rights and dividend payment preferences and other features embedded in a share, including preferred stock, contain embedded derivatives requiring bifurcation. The update requires that an entity determine the nature of the host contract by considering all stated and implied terms and features in a hybrid instrument.	January 1, 2016 (early adoption permitted)	Did not have a significant impact to the consolidated financial statements.
ASU 2014-13, Consolidation (Topic 810) Measuring the Financial Assets and the Financial	This update provides a practical expedient to measure the fair value of the financial assets and financial liabilities of	January 1, 2015 (early adoption)	The Company early adopted this ASU and applied the guidance to

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Liabilities of a Consolidated Collateralized Financing Entity	a consolidated collateralized financing entity, which the reporting entity has elected to or is required to measure on a fair value basis.	permitted)	commercial mortgage backed securitization transactions. See "Commercial Real Estate Investments" footnote for further disclosure.
ASU 2014-11, Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosure	This update makes limited amendments to the guidance in ASC 860 on accounting for certain repurchase agreements.	January 1, 2015	Impacted disclosures only and did not have a significant impact to the consolidated financial statements.
ASU 2014-08, Presentation of Financial Statements (Topic 205) and Property, Plant and Equipment (Topic 360) Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity	This ASU raises the threshold for a disposal to be treated as discontinued operations.	April 1, 2015	Did not have a significant impact to the consolidated financial statements.
ASU 2014-04 Receivables–Troubled Debt Restructurings by Creditors, Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure	This update clarifies that an in substance repossession or foreclosure has occurred, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, when the creditor obtains legal title to the property upon completion of a foreclosure or the borrower conveys all interest in the property to the creditor through a deed in lieu of foreclosure or similar arrangement.	January 1, 2015	Did not have a significant impact to the consolidated financial statements.

## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

## Item 1. Financial Statements

## 4. RESIDENTIAL INVESTMENT SECURITIES

The following tables present the Company's Residential Investment Securities portfolio carried at fair value as of June 30, 2016 and December 31, 2015:

Agency	June 30, 2016						
	Principal / Notional (dollars in thousands)	Remaining Premium	Remaining Discount	Amortized Cost	Unrealized Gains <sup>(1)</sup>	Unrealized Losses <sup>(1)</sup>	Estimated Fair Value
Fixed-rate pass-through	\$55,843,681	\$3,073,647	\$(2,017 )	\$58,915,311	\$1,080,129	\$(55,271 )	\$59,940,169
Adjustable-rate pass-through	2,906,239	62,572	(5,173 )	2,963,638	77,317	-	3,040,955
CMO	473,489	9,860	(430 )	482,919	15,080	(252 )	497,747
Debentures	-	-	-	-	-	-	-
Interest-only	9,061,768	1,572,531	-	1,572,531	18,835	(207,245)	1,384,121
Total Agency investments	\$68,285,177	\$4,718,610	\$(7,620 )	\$63,934,399	\$1,191,361	\$(262,768)	\$64,862,992
Residential Credit CRT	\$519,387	\$1,878	\$(12,415 )	\$508,850	\$12,476	\$(1,005 )	\$520,321
Legacy <sup>(2)</sup>	690,679	815	(91,368 )	600,126	12,553	(924 )	611,755
NPL/RPL	374,096	65	(1,240 )	372,921	1,785	(82 )	374,624
New issue	194,334	973	(373 )	194,934	4,444	-	199,378
New issue interest-only	1,020,183	17,223	-	17,223	-	(5,431 )	11,792
Total residential credit investments	\$2,798,679	\$20,954	\$(105,396)	\$1,694,054	\$31,258	\$(7,442 )	\$1,717,870
Total Residential Investment Securities	\$71,083,856	\$4,739,564	\$(113,016)	\$65,628,453	\$1,222,619	\$(270,210)	\$66,580,862

Agency	December 31, 2015						
	Principal / Notional (dollars in thousands)	Remaining Premium	Remaining Discount	Amortized Cost	Unrealized Gains <sup>(1)</sup>	Unrealized Losses <sup>(1)</sup>	Estimated Fair Value
Fixed-rate pass-through	\$57,339,705	\$3,270,521	\$(2,832 )	\$60,607,394	\$400,350	\$(824,862)	\$60,182,882
Adjustable-rate pass-through	2,894,192	61,781	(6,427 )	2,949,546	70,849	(10,317 )	3,010,078
CMO	964,095	27,269	(477 )	990,887	9,137	(12,945 )	987,079
Debentures	158,802	-	(648 )	158,154	-	(6,116 )	152,038
Interest-only	9,499,332	1,634,312	-	1,634,312	18,699	(114,826)	1,538,185
Total Agency investments	\$70,856,126	\$4,993,883	\$(10,384 )	\$66,340,293	\$499,035	\$(969,066)	\$65,870,262
Residential Credit CRT	\$476,084	\$2,225	\$(12,840 )	\$465,469	\$250	\$(9,209 )	\$456,510

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Legacy <sup>(2)</sup>	378,527	773	(37,150 )	342,150	698	(1,140 )	341,708
NPL/RPL	354,945	19	(1,270 )	353,694	19	(1,172 )	352,541
New issue	197,695	566	-	198,261	-	(1,060 )	197,201
New issue interest-only	811,245	15,430	-	15,430	-	(158 )	15,272
Total residential credit securities	\$2,218,496	\$19,013	\$(51,260 )	\$1,375,004	\$967	\$(12,739 )	\$1,363,232

Total Residential

Investment Securities	\$73,074,622	\$5,012,896	\$(61,644 )	\$67,715,297	\$500,002	\$(981,805)	\$67,233,494
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(1) Unrealized gains and losses on Agency investments, excluding interest-only investments, are reported as a component of other comprehensive income (loss). Unrealized gains and losses on residential credit investments and Agency interest-only investments are generally reported in Net unrealized gains (losses) on financial instruments measured at fair value through earnings in the Consolidated Statements of Comprehensive Income (Loss).

(2) Legacy residential credit refers to securities whose underlying collateral was securitized prior to 2009.

The following tables present the Company's Agency mortgage-backed securities portfolio by issuing Agency concentration as of June 30, 2016 and December 31, 2015:

Investment Type	June 30,	December
	2016	31, 2015
	(dollars in thousands)	
Fannie Mae	\$42,009,658	\$42,647,075
Freddie Mac	22,769,693	22,960,595
Ginnie Mae	83,641	110,554
Total	\$64,862,992	\$65,718,224

Actual maturities of the Company's Residential Investment Securities portfolio are generally shorter than stated contractual maturities because actual maturities of the portfolio are affected by periodic payments and prepayments of principal on underlying mortgages. The

following table summarizes the Company's available-for-sale Residential Investment Securities as of June 30, 2016 and December 31, 2015, according to their estimated weighted average life classifications:

## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

## Item 1. Financial Statements

Weighted Average Life	June 30, 2016		December 31, 2015	
	Estimated Fair Value	Amortized Cost	Estimated Fair Value	Amortized Cost
	(dollars in thousands)			
Less than one year	\$83,514	\$84,500	\$37,862	\$37,850
Greater than one year through five years	53,216,416	52,372,346	20,278,111	20,066,435
Greater than five years through ten years	13,272,846	13,163,536	46,473,701	47,174,319
Greater than ten years	8,086	8,071	443,820	436,693
Total	\$66,580,862	\$65,628,453	\$67,233,494	\$67,715,297

The weighted average lives of the Agency mortgage-backed securities at June 30, 2016 and December 31, 2015 in the table above are based upon projected principal prepayment rates. The actual weighted average lives of the Agency mortgage-backed securities could be materially longer or shorter than projected.

The following table presents the gross unrealized losses and estimated fair value of the Company's Agency mortgage-backed securities by length of time that such securities have been in a continuous unrealized loss position at June 30, 2016 and December 31, 2015.

	June 30, 2016			December 31, 2015		
	Estimated Fair Value <sup>(1)</sup>	Gross Unrealized Losses <sup>(1)</sup>	Number of Securities <sup>(1)</sup>	Estimated Fair Value <sup>(1)</sup>	Gross Unrealized Losses <sup>(1)</sup>	Number of Securities <sup>(1)</sup>
	(dollars in thousands)					
Less than 12 Months	\$467	\$ (3 )	1	\$20,072,072	\$ (164,259 )	463
12 Months or More	9,608,938	(55,520 )	81	21,705,764	(689,981 )	189
Total	\$9,609,405	\$ (55,523 )	82	\$41,777,836	\$ (854,240 )	652

(1) Excludes interest-only mortgage-backed securities.

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

During the quarter and six months ended June 30, 2016, the Company disposed of \$1.8 billion and \$5.2 billion of Residential Investment Securities, respectively, resulting in a net realized gain of \$11.9 million and \$10.3 million, respectively.

During the quarter and six months ended June 30, 2015, the Company disposed of \$2.5 billion and \$17.4 billion of Residential Investment Securities, respectively, resulting in a net realized gain of \$3.9 million and \$66.3, respectively.

## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

## Item 1. Financial Statements

## 5. COMMERCIAL REAL ESTATE INVESTMENTS

On December 11, 2015, the Company originated a \$335.0 million recapitalization financing with respect to eight class A/B office properties in Orange County, California.

As of December 31, 2015, such financing is comprised of a \$280.0 million senior mortgage loan (\$278.6 million, net of origination fees), and mezzanine debt with an initial principal balance of \$55.0 million (\$52.7 million, net of origination fees) and a future funding component of \$30.0 million. The senior loan was held for sale as of December 31, 2015. In April 2016, the Company sold \$115.0 million (\$114.3 million, net of origination fees) of the senior loan to an unrelated third party at carrying value, accordingly, no gain or loss was recorded in connection with the sale. The balance of the senior loan of \$165.0 million (\$164.2 million, net of origination fees) remains held for sale as of June 30, 2016.

The following tables present commercial real estate investments held for investment at June 30, 2016 and December 31, 2015.

## CRE Debt and Preferred Equity Investments

	June 30, 2016		Percentage of Loan Portfolio <sup>(2)</sup>	December 31, 2015		Percentage of Loan Portfolio <sup>(2)</sup>	
	Outstanding Principal	Carrying Value <sup>(1)</sup>		Outstanding Principal	Carrying Value <sup>(1)</sup>		
	(dollars in thousands)						
Senior mortgages	\$480,665	\$478,260	42.0	% \$387,314	\$385,838	28.6	%
Senior securitized mortgages <sup>(3)</sup>	187,322	187,246	16.4	% 263,072	262,703	19.4	%
Mezzanine loans	466,844	463,507	40.8	% 582,592	578,503	43.0	%
Preferred equity	9,000	8,958	0.8	% 122,444	121,773	9.0	%
Total (4)	\$1,143,831	\$1,137,971	100.0	% \$1,355,422	\$1,348,817	100.0	%

(1) Carrying value includes unamortized origination fees of \$5.9 million and \$6.9 million as of June 30, 2016 and December 31, 2015, respectively.

(2) Based on outstanding principal.

(3) Assets of consolidated VIEs.

(4) Excludes Loans held for sale, net.

	June 30, 2016				
	Senior Mortgages	Senior Securitized Mortgages <sup>(1)</sup>	Mezzanine Loans	Preferred Equity	Total
	(dollars in thousands)				
Beginning balance	\$385,838	\$262,703	\$578,503	\$121,773	\$1,348,817
Originations & advances (principal)	158,502	-	32,363	-	190,865
Principal payments	(65,153)	(75,750)	(148,111)	(113,444)	(402,458)
Sales (principal)	-	-	-	-	-
Amortization & accretion of (premium) discounts	(66)	-	(205)	-	(271)
Net (increase) decrease in origination fees	(1,566)	-	(282)	-	(1,848)
Amortization of net origination fees	705	293	1,239	629	2,866



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Transfers	-	-	-	-	-
Allowance for loan losses	-	-	-	-	-
Net carrying value <sup>(2)</sup>	\$478,260	\$ 187,246	\$463,507	\$8,958	\$1,137,971

(1) Assets of consolidated VIE.

(2) Excludes Loans held for sale, net.

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ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

Item 1. Financial Statements

	December 31, 2015				Total
	Senior Mortgages	Senior Securitized Mortgages <sup>(1)</sup>	Mezzanine Loans	Preferred Equity	
	(dollars in thousands)				
Beginning balance	\$383,895	\$ 398,634	\$522,731	\$212,905	\$1,518,165
Originations & advances (principal)	293,925	-	195,312	-	489,237
Principal payments	(243,270)	(136,469 )	(153,693 )	(92,210 )	(625,642 )
Sales (principal)	(46,945 )	-	-	-	(46,945 )
Amortization & accretion of (premium) discounts	(142 )	-	(232 )	517	143
Net (increase) decrease in origination fees	(3,702 )	(279 )	(4,806 )	-	(8,787 )
Amortization of net origination fees	2,077	817	691	561	4,146
Transfers	-	-	18,500	-	18,500
Allowance for loan losses	-	-	-	-	-
Net carrying value <sup>(2)</sup>	\$385,838	\$ 262,703	\$578,503	\$121,773	\$1,348,817

(1) Assets of consolidated VIE.

(2) Excludes Loans held for sale, net.

Internal CRE Debt and Preferred Equity Investment Ratings

The Company's internal loan risk ratings are based on the guidance provided by the Office of the Comptroller of the Currency for commercial real estate lending. The Company's internal risk rating categories include "Performing", "Performing - Closely Monitored", "Performing - Special Mention", "Substandard", "Doubtful" or "Loss". Performing loans meet all present contractual obligations. Performing - Closely Monitored loans meet all present contractual obligations, are transitional or could be exhibiting some weakness in both leverage and liquidity. Performing - Special Mention loans meet all present contractual obligations, but exhibit potential weakness that deserves management's close attention and if uncorrected, may result in deterioration of repayment prospects. Substandard loans are inadequately protected by sound worth and paying capacity of the obligor or of the collateral pledged with a distinct possibility that loss will be sustained if some of the deficiencies are not corrected. Doubtful loans are Substandard loans whereby collection of all contractual principal and interest is highly questionable or improbable. Loss loans are considered uncollectible. The presentation of prior period internal risk ratings have been revised to conform to the current period presentation. The Company did not have any impaired loans, nonaccrual loans, or loans in default as all of the loans were performing as of June 30, 2016 and December 31, 2015. Accordingly, no allowance for loan losses was deemed necessary as of June 30, 2016 and December 31, 2015.

Investment Type	June 30, 2016									
	Outstanding Principal <sup>(1)</sup>	Preferred Equity Portfolio	Percentage of CRE Debt	Internal Rating	Performing - Closely Monitored	Performing - Special Mention	Substandard	Doubtful	Loss	Total
Senior mortgages	\$480,665	42.0 %	\$91,620	Performing	\$243,605	\$145,440	\$ -	\$ -	\$ -	\$480,665
	187,322	16.4 %	58,426	Performing	17,500	111,396	-	-	-	187,322

Senior securitized mortgages <sup>(2)</sup>										
Mezzanine loans	466,844	40.8	%	276,658	153,869	36,317	-	-	-	466,844
Preferred equity	9,000	0.8	%	-	-	9,000	-	-	-	9,000
	\$1,143,831	100.0	%	\$426,704	\$414,974	\$302,153	\$-	\$-	\$-	\$1,143,831

(1) Excludes Loans held for sale, net.

(2) Assets of consolidated VIE.

	December 31, 2015									
	Percentage Internal Ratings of CRE Debt and									
	Outstanding	Preferred		Performing	Performing					
Investment Type	Principal	Equity		- Closely	- Special		Substand	Doubtful	Loss	Total
	(1)	Portfolio	Performing	Monitored	Mention					
	(dollars in thousands)									
Senior mortgages	\$387,314	28.6	%	\$71,000	\$283,148	\$33,166	\$-	\$-	\$-	\$387,314
Senior securitized mortgages <sup>(2)</sup>	263,072	19.4	%	106,770	15,500	140,802	-	-	-	263,072
Mezzanine loans	582,592	43.0	%	342,493	219,969	20,130	-	-	-	582,592
Preferred equity	122,444	9.0	%	-	81,944	40,500	-	-	-	122,444
	\$1,355,422	100.0	%	\$520,263	\$600,561	\$234,598	\$-	\$-	\$-	\$1,355,422

(1) Excludes Loans held for sale, net.

(2) Assets of consolidated VIE.

## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

## Item 1. Financial Statements

## Investments in Commercial Real Estate

There were no acquisitions of new real estate holdings during the quarter and six months ended June 30, 2016. The following table summarizes real estate held for investment acquired in 2015:

Date of Acquisition	Type	Location	Original Purchase Price	Remaining Lease Term (Years) <sup>(1)</sup>
July 2015	Single Tenant Retail	Ohio	\$ 11,000	4.4
August 2015	Multi Tenant Retail	Florida	\$ 18,900	4.9
October 2015	Multifamily Property	Washington, DC	\$ 75,000	0.1
October 2015	Multi Tenant Retail	California	\$ 37,750	2.8
November 2015	Multi Tenant Retail	Texas	\$ 131,950	4.6

(1) Does not include extension options.

In the second quarter of 2016, the Company finalized the purchase price allocation of the eleven multi-tenant retail properties portfolio ("Texas Portfolio") acquired in November 2015 for a total purchase price of \$132.0 million and recognized \$4.2 million of additional depreciation and amortization as a result. The following presents the aggregate final purchase price allocation of the Texas Portfolio:

	Texas (dollars in thousands)
Purchase Price Allocation:	
Land	\$ 32,452
Buildings	82,552
Site improvements	5,446
Tenant Improvements	6,835
Real estate held for investment	127,285
Intangible assets (liabilities):	
Leasehold intangible assets	14,598
Above market lease	274
Below market lease	(10,207 )
Total purchase price	\$ 131,950

The Company sold three non-core properties of the Texas Portfolio in June 2016 for \$12.8 million and recognized a gain on sale of \$0.8 million.

The weighted average amortization period for intangible assets and liabilities as of June 30, 2016 is 4.6 years. Above market leases and leasehold intangible assets are included in Intangible assets, net and below market leases are included in Accounts payable and other liabilities in the Consolidated Statements of Financial Condition.

## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

## Item 1. Financial Statements

	June 30, 2016	December 31, 2015
	(dollars in thousands)	
Real estate held for investment, at amortized cost		
Land	\$117,023	\$113,494
Buildings and improvements	355,082	373,603
Subtotal	472,105	487,097
Less: accumulated depreciation	(27,260)	(16,886)
Total real estate held for investment, at amortized cost, net	444,845	470,211
Equity in unconsolidated joint ventures	59,760	65,735
Investments in commercial real estate, net	\$504,605	\$535,946

Depreciation expense was \$6.1 million and \$10.7 million for the quarter and six months ended June 30, 2016, respectively. Depreciation expense was \$2.9 million and \$5.7 million for the quarter and six months ended June 30, 2015, respectively. Depreciation expense is included in Other income (loss) in the Consolidated Statements of Comprehensive Income (Loss).

**Rental Income**

The minimum rental amounts due under leases are generally either subject to scheduled fixed increases or adjustments. The leases generally also require that the tenants reimburse us for certain operating costs. Approximate future minimum rents payments under non-cancelable operating leases in effect at June 30, 2016 for consolidated investments in real estate are as follows:

	June 30, 2016 (dollars in thousands)
2016 (remaining)	\$ 17,762
2017	35,242
2018	31,518
2019	27,614
2020	23,401
Later years	58,656
	\$ 194,193

Mortgage loans payable as of June 30, 2016 and December 31, 2015, were as follows:

June 30, 2016

Property	Mortgage Carrying Value	Mortgage Principal	Interest Rate	Fixed/Floating Rate	Maturity Date	Priority
			2.30%			
			to			
Joint Ventures	\$285,804	\$289,125	4.61%	Fixed	2016, 2024 and 2025	First liens
Tennessee	12,244	12,350	4.01%	Fixed	9/6/2019	First liens
Virginia	11,013	11,025	3.58%	Fixed	6/6/2019	First liens
Arizona	16,176	16,145	3.50%	Fixed	1/1/2017	First liens

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Nevada	2,406	2,401	3.45% Floating <sup>(1)</sup>	3/29/2017	First liens
	\$327,643	\$331,046			

(1) Includes a mortgage with a fixed rate via an interest rate swap (pay fixed 3.45%, receive floating rate of L+200).

December 31, 2015

Property	Mortgage Carrying Value	Mortgage Principal	Interest Rate	Fixed/Floating Rate	Maturity Date	Priority
			2.30%			
			to			
Joint Ventures	\$292,658	\$296,325	4.61%	Fixed	2016, 2024 and 2025	First liens
Tennessee	12,228	12,350	4.01%	Fixed	9/6/2019	First liens
Virginia	11,012	11,025	3.58%	Fixed	6/6/2019	First liens
Arizona	16,365	16,308	3.50%	Fixed	1/1/2017	First liens
Nevada	2,444	2,436	3.45%	Floating <sup>(1)</sup>	3/29/2017	First liens
	\$334,707	\$338,444				

(1) Includes a mortgage with a fixed rate via an interest rate swap (pay fixed 3.45%, receive floating rate of L+200).

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The following table details future mortgage loan principal payments as of June 30, 2016:

	Mortgage Loan Principal Payments (dollars in thousands)
2016 (remaining)	\$ 202
2017	18,344
2018	-
2019	23,375
2020	-
Later years	289,125
	\$ 331,046

## VIEs

## Securitization

In January 2014, the Company closed NLY Commercial Mortgage Trust 2014-FL1 (the "Trust"), a \$399.5 million securitization financing transaction which provides permanent, non-recourse financing collateralized by floating-rate first mortgage debt investments originated or co-originated by the Company and is not subject to margin calls. A total of \$260.7 million of investment grade bonds were issued by the Trust, representing an advance rate of 65.3% at a weighted average coupon of LIBOR plus 1.74% at closing. The Company used the proceeds to originate commercial real estate investments. The Company retained bonds rated below investment grade and the interest-only bond issued by the Trust, which are referred to as the subordinate bonds.

The Company incurred approximately \$4.3 million of costs in connection with the securitization that have been capitalized and are being amortized to interest expense. Deferred financing costs are included in Securitized debt of consolidated VIEs in the accompanying Consolidated Statements of Financial Condition.

As of June 30, 2016 the carrying value of the Trust's assets was \$187.2 million, net of \$0.1 million of unamortized origination fees, which are included in Commercial real estate debt and preferred equity in the accompanying Consolidated Statements of Financial Condition. As of June 30, 2016, the carrying value of the Trust's liabilities was \$59.3 million, net of \$0.1 million of deferred financing costs, classified as Securitized debt of consolidated VIEs in the accompanying Consolidated Statements of Financial Condition.

In February 2015, the Company purchased the junior-most tranche, Class C Certificate of the Freddie Mac securitization, FREMF Mortgage Trust 2015-KLSF ("FREMF 2015-KLSF") for \$102.1 million. The underlying portfolio is a pool of 11 floating rate multifamily mortgage loans with a cut-off principal balance of \$1.4 billion. The Company was required to consolidate the FREMF 2015-KLSF Trust's assets and liabilities of \$1.3 billion and \$1.2 billion, respectively, at June 30, 2016.

In April 2015, the Company purchased the junior-most tranche, Class C Certificate of the Freddie Mac securitization, FREMF Mortgage Trust 2015-KF07 ("FREMF 2015-KF07") for \$89.4 million. The underlying portfolio is a pool of 40 floating rate multifamily mortgage loans with a cut-off principal balance of \$1.2 billion. The Company was required

to consolidate the FREMF 2015-KF07 Trust's assets and liabilities of \$1.1 billion and \$1.0 billion, respectively, at June 30, 2016.

In February 2016, the Company purchased the junior-most tranche, Class C Certificate of the Freddie Mac securitization, FREM Mortgage Trust 2016-KLH1 ("FREM 2016-KLH1") for \$107.6 million, net of a \$4.4 million discount to face value of \$112.0 million. The underlying portfolio is a pool of 28 floating rate multifamily mortgage loans with a cut-off principal balance of \$1.5 billion. The Company was required to consolidate the FREM 2016-KLH1 Trust's assets and liabilities of \$1.5 billion and \$1.4 billion, respectively, at June 30, 2016. FREMF 2015-KLSF, FREMF 2015-KF07 and FREM 2016-KLH1 are collectively referred to herein as the FREMF Trusts.

The FREMF Trusts are structured as pass-through entities that receive principal and interest on the underlying collateral and distribute those payments to the certificate holders. The FREMF Trusts are VIEs and the Company is considered to be the primary beneficiary as a result of its ability to replace the special servicer without cause through its ownership of the Class C



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Certificates and its current designation as the directing certificate holder. The Company's exposure to the obligations of the VIEs is generally limited to the Company's investment in the FREMF Trusts of \$298.2 million at June 30, 2016. Assets of the FREMF Trusts may only be used to settle obligations of the FREMF Trusts. Creditors of the FREMF Trusts have no recourse to the general credit of the Company. The Company is not contractually required to provide and has not provided any form of financial support to the FREMF Trusts. No gain or loss was recognized upon initial consolidation of the FREMF Trusts, but \$0.2 million and \$0.8 million of related costs were expensed during the six months ended June 30, 2016 and the year ended December 31, 2015, respectively. The FREMF Trusts' assets are included in Commercial real estate debt investments and the FREMF Trusts' liabilities are included in Securitized debt of consolidated VIEs in the accompanying Consolidated Statements of Financial Condition.

Upon consolidation, the Company elected the fair value option for the financial assets and liabilities of the FREMF Trusts in order to avoid an accounting mismatch, and to more accurately represent the economics of its interest in the entities. The fair value option requires that changes in fair value be reflected in the Company's Consolidated Statements of Comprehensive Income (Loss). The Company has adopted ASU 2014-13 and applied the practical expedient fair value measurement whereby the Company determines whether the fair value of the financial assets or financial liabilities is more observable as a basis for measuring the less observable financial instruments. The Company has determined that the fair value of the financial liabilities of the FREMF Trusts is more observable, since the prices for these liabilities are primarily available from third-party pricing services utilized for multifamily mortgage-backed securities, while the fair value of the individual assets of the trusts are inherently less capable of precise measurement given their illiquid nature and the limitations on available information related to these assets. Given that the Company's methodology for valuing the financial assets of the FREMF Trusts is an aggregate fair value derived from the fair value of the financial liabilities, the Company has determined that the fair value of each of the financial assets in their entirety should be classified in Level 2 of the fair value measurement hierarchy.

The statement of financial condition of the FREMF Trusts that is reflected in the Company's Consolidated Statements of Financial Condition at June 30, 2016 and December 31, 2015 are as follows:

	June 30, 2016	December 31, 2015
	(dollars in thousands)	
<b>Assets</b>		
Senior securitized commercial mortgages carried at fair value	\$3,987,191	\$2,554,023
Accrued interest receivable	8,166	4,994
<b>Total assets</b>	<b>\$3,995,357</b>	<b>\$2,559,017</b>
<b>Liabilities</b>		
Securitized debt (non-recourse) at fair value	\$3,688,977	\$2,366,878
Accrued interest payable	4,214	4,183
<b>Total liabilities</b>	<b>\$3,693,191</b>	<b>\$2,371,061</b>

The FREMF Trusts mortgage loans had an unpaid principal balance of \$4.0 billion at June 30, 2016. As of June 30, 2016 there are no loans 90 days or more past due or on nonaccrual status. There is no gain or loss attributable to instrument-specific credit risk of the underlying loans or securitized debt securities as of June 30, 2016 based upon the Company's process of monitoring events of default on the underlying mortgage loans. Interest income and expense is recognized using the effective interest method.

The statement of comprehensive income (loss) of the FREMF Trusts that is reflected in the Company's Consolidated Statements of Comprehensive Income (Loss) for the quarter and six months ended June 30, 2016 are as follows:



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	For the Quarter Ended June 30, 2016	For the Six Months Ended June 30, 2016
	(dollars in thousands)	
Net interest income:		
Interest income	\$23,794	\$44,824
Interest expense	10,347	18,223
Net interest income	13,447	26,601
Other income (loss):		
Unrealized gain (loss) on financial instruments at fair value <sup>(1)</sup>	6,838	6,985
Guarantee fees and servicing costs	(6,791)	(12,088)
Other income (loss)	47	(5,103)
General and administration expenses	-	2
Net income	\$13,494	\$21,496

(1) Included in Net unrealized gains (losses) on financial instruments measured at fair value through earnings.

The geographic concentrations of credit risk exceeding 5% of the total loan unpaid principal balances related to the FREMF Trusts as of June 30, 2016 are as follows:

Securitized Loans at Fair Value			
Geographic Concentration of Credit Risk			
Property Location	Principal Balance	% of Balance	
(dollars in thousands)			
Texas	\$749,569	18.8	%
North Carolina	537,375	13.5	%
Maryland	499,495	12.5	%
Florida	456,589	11.4	%
Other	1,751,918	43.8	%
Total	\$3,994,946	100.0	%

## 6. CORPORATE DEBT

The Company invests in corporate loans and corporate debt securities through the MML subsidiary. The industry and interest rate characteristics of the portfolio as of June 30, 2016 are as follows:

Industry Dispersion		
Fixed Rate	Floating Rate	Total
(dollars in thousands)		

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Business Services	\$-	\$41,311	\$41,311
Commercial Fishing	-	41,196	41,196
Cybersecurity	-	93,517	93,517
Drugs	-	34,452	34,452
Home Health Care Services	-	39,455	39,455
Insurance Agents, Brokers & Services	4,369	44,446	48,815
Miscellaneous Business Services	-	19,612	19,612
Miscellaneous Food Preparations	-	27,221	27,221
Miscellaneous Health & Allied Services	-	39,031	39,031
Miscellaneous Nonmetallic Minerals	-	24,676	24,676
Miscellaneous Plastic Products	-	27,114	27,114
Motor Vehicles, Parts & Supplies	-	12,375	12,375
Offices & Clinics of Doctors of Medicine	-	83,919	83,919
Research, Development & Testing Services	-	17,740	17,740
Schools & Educational Services	-	21,105	21,105
Security	84,410	-	84,410
Surgical, Medical & Dental Instruments	-	13,663	13,663
Total	\$88,779	\$580,833	\$669,612

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The table below reflects the Company's aggregate positions by their respective place in the capital structure of the borrowers as of June 30, 2016.

	June 30, 2016 (dollars in thousands)
First lien loans	\$ 418,972
Second lien loans	161,862
Second lien notes	84,409
Subordinated notes	4,369
Total	\$ 669,612

In June 2016, a consolidated subsidiary of the Company (the "Borrower") entered into a \$300.0 million credit facility with a third party financial institution. As of June 30, 2016, the Borrower had not drawn on the credit facility.

## 7. FAIR VALUE MEASUREMENTS

The Company follows fair value guidance in accordance with GAAP to account for its financial instruments. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

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

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

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

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

The Company designates its financial instruments as trading, available for sale or held to maturity depending upon the type of instrument and the Company's intent and ability to hold such instrument to maturity. Instruments classified as available for sale and trading are reported at fair value on a recurring basis.

The following is a description of the valuation methodologies used for instruments carried at fair value. These methodologies are applied to assets and liabilities across the three-level fair value hierarchy, with the observability of inputs determining the appropriate level.

Futures contracts are valued using quoted prices for identical instruments in active markets. Residential Investment Securities, interest rate swaps, swaptions and other derivatives are valued using quoted prices or internally estimated prices for similar assets using internal models. The Company incorporates common market pricing methods, including a spread measurement to the Treasury curve as well as underlying characteristics of the particular security including coupon, prepayment speeds, periodic and life caps, rate reset period and expected life of the security in its estimates of fair value. Management reviews and

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indirectly corroborates its estimates of the fair value derived using internal models by comparing its results to independent prices provided by dealers in the securities and/or third party pricing services. Certain liquid asset classes, such as Agency fixed-rate pass-throughs, may be priced using independent sources such as quoted prices for TBA securities.

The Residential Investment Securities, interest rate swap and swaption markets are considered to be active markets such that participants transact with sufficient frequency and volume to provide transparent pricing information on an ongoing basis. The liquidity of the Residential Investment Securities, interest rate swaps, swaptions, TBA derivatives and MBS options markets and the similarity of the Company's securities to those actively traded enable the Company to observe quoted prices in the market and utilize those prices as a basis for formulating fair value measurements. Consequently, the Company has classified Residential Investment Securities, interest rate swaps, swaptions, TBA derivatives and MBS options as Level 2 inputs in the fair value hierarchy. Additionally, as discussed in the "Commercial Real Estate Investments" Note, Commercial real estate debt investments carried at fair value are classified as Level 2.

The following table presents the estimated fair values of financial instruments measured at fair value on a recurring basis.

	Level 1	Level 2	Level 3	Total
June 30, 2016	(dollars in thousands)			
Assets:				
Agency mortgage-backed securities	\$-	64,862,992	\$ -	\$64,862,992
Credit risk transfer securities	-	520,321	-	520,321
Non-Agency mortgage-backed securities	-	1,197,549	-	1,197,549
Commercial real estate debt investments	-	4,361,972	-	4,361,972
Interest rate swaps	-	146,285	-	146,285
Other derivatives	-	137,490	-	137,490
Total assets	\$-	\$71,226,609	\$ -	\$71,226,609
Liabilities:				
Securitized debt of consolidated VIEs	\$-	3,688,977	\$ -	\$3,688,977
Interest rate swaps	-	3,208,986	-	3,208,986
Other derivatives	154,017	-	-	154,017
Total liabilities	\$154,017	\$6,897,963	\$ -	\$7,051,980

	Level 1	Level 2	Level 3	Total
December 31, 2015	(dollars in thousands)			
Assets:				
Agency mortgage-backed securities	\$-	\$65,718,224	\$ -	\$65,718,224
Agency debentures	-	152,038	-	152,038
Credit risk transfer securities	-	456,510	-	456,510
Non-Agency mortgage-backed securities	-	906,722	-	906,722
Commercial real estate debt investments	-	2,911,828	-	2,911,828
Interest rate swaps	-	19,642	-	19,642
Other derivatives	12,443	9,623	-	22,066
Total assets	\$12,443	\$70,174,587	\$ -	\$70,187,030
Liabilities:				

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Securitized debt of consolidated VIEs	\$-	\$2,366,878	\$ -	\$2,366,878
Interest rate swaps	-	1,677,571	-	1,677,571
Other derivatives	32,778	17,185	-	49,963
Total liabilities	\$32,778	\$4,061,634	\$ -	\$4,094,412

GAAP requires disclosure of fair value information about financial instruments, whether or not recognized in the financial statements, for which it is practical to estimate the value. In cases where quoted market prices are not available, fair values are based upon discounted cash flows using market yields, methodologies that incorporate market-based transactions or other valuation methodologies. Considerable judgment is necessary to interpret market data and develop estimated fair values. Accordingly, fair values are not necessarily indicative of the amount the Company would realize on disposition of the financial instruments. The use of different market assumptions or estimation methodologies could have a material effect on the estimated fair value amounts.

The carrying value of short-term instruments, including cash and cash equivalents, reverse repurchase agreements, repurchase agreements and other secured financing whose term is less than twelve months, generally approximates fair value due to the short-term nature of the instruments.



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The estimated fair value of commercial real estate debt and preferred equity investments takes into consideration changes in credit spreads and interest rates from the date of origination or purchase to the reporting date. The fair value also reflects consideration of asset-specific maturity dates and other items that could have an impact on the fair value as of the reporting date.

Estimates of fair value of corporate debt require the use of judgments and inputs including, but not limited to, the enterprise value of the borrower (i.e., an estimate of the total fair value of the borrower's debt and equity), the nature and realizable value of any collateral, the borrower's ability to make payments when due and its earnings history. Management also considers factors that affect the macro and local economic markets in which the borrower operates.

The fair value of repurchase agreements with remaining maturities greater than one year or with embedded optionality are valued as structured notes, with term to maturity, LIBOR rates and the Treasury curve being primary determinants of estimated fair value.

The fair value of mortgages payable is calculated using the estimated yield of a new par loan to value the remaining terms in place. A par loan is created using the identical terms of the existing loan; however, the coupon is derived by using the original spread against the interpolated Treasury. The fair value of mortgages payable also reflects consideration of the value of the underlying collateral and changes in credit risk from the time the debt was originated.

The carrying value of participation sold is based on the loan's amortized cost. The fair value of participation sold is based on the fair value of the underlying related commercial loan.

The fair value of securitized debt of consolidated VIEs is determined using the average of external vendor pricing services.

The following table summarizes the estimated fair value for financial assets and liabilities as of June 30, 2016 and December 31, 2015.

	Level in Fair Value Hierarchy	June 30, 2016		December 31, 2015	
		Carrying Value	Fair Value	Carrying Value	Fair Value
<b><u>Financial assets:</u></b>					
Cash and cash equivalents	1	\$2,735,250	\$2,735,250	\$1,769,258	\$1,769,258
Agency mortgage-backed securities	2	64,862,992	64,862,992	65,718,224	65,718,224
Agency debentures	2	-	-	152,038	152,038
Credit risk transfer securities	2	520,321	520,321	456,510	456,510
Non-Agency mortgage-backed securities	2	1,197,549	1,197,549	906,722	906,722
Commercial real estate debt investments	2	4,361,972	4,361,972	2,911,828	2,911,828
Commercial real estate debt and preferred equity, held for investment	3	1,137,971	1,137,130	1,348,817	1,350,968
Loans held for sale, net	3	164,175	165,000	278,600	278,600
Corporate debt <sup>(1)</sup>	2	669,612	661,169	488,508	470,894
Interest rate swaps	2	146,285	146,285	19,642	19,642
Other derivatives	1,2	137,490	137,490	22,066	22,066
<b><u>Financial liabilities:</u></b>					
Repurchase agreements	1,2	\$53,868,385	\$53,976,010	\$56,230,860	\$56,361,623

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Other secured financing	1,2	3,588,326	3,590,510	1,845,048	1,846,095
Securitized debt of consolidated VIEs	2	3,748,289	3,748,366	2,540,711	2,541,193
Participation sold	2	13,079	12,985	13,286	13,138
Mortgage payable	3	327,643	350,065	334,707	339,849
Interest rate swaps	2	3,208,986	3,208,986	1,677,571	1,677,571
Other derivatives	1,2	154,017	154,017	49,963	49,963

Includes a held-to-maturity debt security carried at amortized cost of \$84.4 million and \$74.7 million as of June 30, (1)2016 and December 31, 2015, respectively. The held-to-maturity debt security had a fair value of \$80.8 million and \$61.3 million as of June 30, 2016 and December 31, 2015, respectively.

**8. SECURED FINANCING**

The Company had outstanding \$53.9 billion and \$56.2 billion of repurchase agreements with weighted average

## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

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borrowing rates of 1.81% and 1.83%, after giving effect to the Company's interest rate swaps used to hedge cost of funds, and weighted average remaining maturities of 129 days and 151 days as of June 30, 2016 and December 31, 2015, respectively.

At June 30, 2016 and December 31, 2015, the repurchase agreements had the following remaining maturities, collateral types and weighted average rates:

June 30, 2016									
Repurchase Agreements by Collateral Type									
	Agency			Non-Agency			Total	Weighted	
	Mortgage-backed			Mortgage-backed			Commercial	Repurchase	Average
	Securities	Debentures	CRTs	Securities		Loans	Agreements	Rate	
(dollars in thousands)									
1 day	\$7,506,405	\$ -	\$-	\$ -		\$ -	\$7,506,405	0.91	%
2 to 29 days	12,431,760	-	53,590	221,210		-	12,706,560	0.81	%
30 to 59 days	6,747,130	-	70,170	197,005		-	7,014,305	0.95	%
60 to 89 days	5,746,813	-	-	223,289		-	5,970,102	0.86	%
90 to 119 days	6,159,644	-	-	19,411		-	6,179,055	0.82	%
Over 120 days <sup>(1)</sup>	14,187,091	-	-	-		304,867	14,491,958	1.44	%
Total	\$52,778,843	\$ -	\$123,760	\$ 660,915		\$ 304,867	\$53,868,385	1.02	%

## December 31, 2015

December 31, 2015									
Repurchase Agreements by Collateral Type									
	Agency			Non-Agency			Total	Weighted	
	Mortgage-backed			Mortgage-backed			Commercial	Repurchase	Average
	Securities	Debentures	CRTs	Securities		Loans	Agreements	Rate	
(dollars in thousands)									
1 day	\$-	\$ -	\$-	\$ -		\$ -	\$-	0.00	%
2 to 29 days	20,123,464	-	83,664	260,359		-	20,467,487	0.69	%
30 to 59 days	7,898,646	-	59,189	65,374		-	8,023,209	0.74	%
60 to 89 days	4,046,593	-	-	78,833		-	4,125,426	0.74	%
90 to 119 days	4,846,580	-	-	-		-	4,846,580	0.60	%
Over 120 days <sup>(1)</sup>	18,557,715	-	-	31,015		179,428	18,768,158	1.33	%
Total	\$55,472,998	\$ -	\$142,853	\$ 435,581		\$ 179,428	\$56,230,860	0.90	%

(1) Approximately 9% and 14% of the total repurchase agreements had a remaining maturity over 1 year as of June 30, 2016 and December 31, 2015, respectively.

Repurchase agreements and reverse repurchase agreements with the same counterparty and the same maturity are presented net in the Consolidated Statements of Financial Condition when the terms of the agreements permit netting. The following table summarizes the gross amounts of reverse repurchase agreements and repurchase agreements, amounts offset in accordance with netting arrangements and net amounts of repurchase agreements and reverse repurchase agreements as presented in the Consolidated Statements of Financial Condition as of June 30, 2016 and December 31, 2015. Refer to "Derivative Instruments" Note for information related to the effect of netting arrangements on the Company's derivative instruments.

	December 31,
June 30, 2016	2015



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Financial instruments pledged as collateral under secured financing arrangements and interest rate swaps had an estimated fair value and accrued interest of \$61.8 billion and \$187.0 million, respectively, at June 30, 2016 and \$62.3 billion and \$171.7 million, respectively, at December 31, 2015.

## 9. DERIVATIVE INSTRUMENTS

In connection with the Company's investment/market rate risk management strategy, the Company economically hedges a portion of its interest rate risk by entering into derivative financial instrument contracts, which include interest rate swaps, swaptions and futures contracts. The Company may also enter into TBA derivatives, MBS options and U.S. Treasury or Eurodollar futures contracts to economically hedge its exposure to market risks. The purpose of using

derivatives is to manage overall portfolio risk with the potential to generate additional income for distribution to stockholders. These derivatives are subject to changes in market values resulting from changes in interest rates, volatility, Agency mortgage-backed security spreads to U.S. Treasuries and market liquidity. The use of derivatives also creates exposure to credit risk relating to potential losses that could be recognized if the counterparties to these instruments fail to perform their obligations under the stated contract. Additionally, the Company may have to pledge cash or assets as collateral for the derivative transactions, the amount of which may vary based on the market value, notional amount and remaining term of the derivative contract. In the event of a default by the counterparty, the Company could have difficulty obtaining its Residential Investment Securities pledged as collateral as well as receiving payments in accordance with the terms of the derivative contracts.

The table below summarizes fair value information about our derivative assets and liabilities as of June 30, 2016 and December 31, 2015:

Derivatives Instruments Balance Sheet Location		June 30, 2016	December 31, 2015
Assets:		(dollars in thousands)	
Interest rate swaps	Interest rate swaps, at fair value	\$146,285	\$19,642
TBA derivatives	Other derivatives, at fair value	137,490	9,622
Futures contracts	Other derivatives, at fair value	-	12,444
		\$283,775	\$41,708
Liabilities:			
Interest rate swaps	Interest rate swaps, at fair value	\$3,208,986	\$1,677,571
TBA derivatives	Other derivatives, at fair value	-	17,185
Futures contracts	Other derivatives, at fair value	154,017	32,778
		\$3,363,003	\$1,727,534

The following table summarizes certain characteristics of the Company's interest rate swaps at June 30, 2016 and December 31, 2015:

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June 30, 2016

Maturity (dollars in thousands)	Current Notional <sup>(1)</sup>	Weighted Average Pay Rate <sup>(2)</sup> <sup>(3)</sup>	Weighted Average Receive Rate <sup>(2)</sup>	Weighted Average Years to Maturity <sup>(2)</sup>
0 - 3 years	\$1,152,401	1.63 %	0.53 %	2.61
3 - 6 years	12,025,000	1.88 %	0.74 %	4.00
6 - 10 years	9,570,550	2.43 %	0.81 %	7.73
Greater than 10 years	3,434,400	3.70 %	0.55 %	18.87
Total / Weighted Average	\$26,182,351	2.28 %	0.74 %	7.04

December 31, 2015

Maturity (dollars in thousands)	Current Notional <sup>(1)</sup>	Weighted Average Pay Rate <sup>(2)</sup> <sup>(3)</sup>	Weighted Average Receive Rate <sup>(2)</sup>	Weighted Average Years to Maturity <sup>(2)</sup>
0 - 3 years	\$3,240,436	1.85 %	0.36 %	1.80
3 - 6 years	11,675,000	1.82 %	0.55 %	4.25
6 - 10 years	11,635,250	2.44 %	0.57 %	7.92
Greater than 10 years	3,634,400	3.70 %	0.43 %	19.37
Total / Weighted Average	\$30,185,086	2.26 %	0.53 %	7.02

(1) Notional amount includes \$200.0 million in forward starting receive fixed swaps and \$500.0 million in forward starting pay fixed swaps as of June 30, 2016 and December 31, 2015, respectively.

(2) Excludes forward starting swaps.

(3) Weighted average fixed rate on forward starting receive fixed swaps was 1.38% as of June 30, 2016. Weighted average fixed rate on forward starting pay fixed swaps was 1.44% as of December 31, 2015.

There were no swaptions outstanding as of June 30, 2016 and December 31, 2015, respectively.

The following table summarizes certain characteristics of the Company's TBA derivatives as of June 30, 2016 and December 31, 2015:

June 30, 2016

Purchase and sale contracts for derivative TBAs (dollars in thousands)	Notional	Implied Cost Basis	Implied Market Value	Net Carrying Value
Purchase contracts	\$12,739,000	\$13,246,011	\$13,383,501	\$137,490

December 31, 2015

Purchase and sale contracts for derivative TBAs Notional

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	Implied Cost Basis	Implied Market Value	Net Carrying Value
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(dollars in thousands)

Purchase contracts	\$13,761,000	\$14,177,338	\$14,169,775	\$(7,563 )
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The following table summarizes certain characteristics of the Company's futures derivatives as of June 30, 2016 and December 31, 2015:

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## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

## Item 1. Financial Statements

	June 30, 2016	
	Notional	Weighted
	- Notional -	Average
	Long	Short
	Positions	Positions
	Maturity	
	(dollars in thousands)	
2-year swap equivalent Eurodollar contracts	\$- \$(6,200,000)	2.00
U.S. Treasury futures - 5 year	- (1,447,200)	4.42
U.S. Treasury futures - 10 year and greater	- (655,600 )	6.88
Total	\$- \$(8,302,800)	2.81

	December 31, 2015	
	Notional	Weighted
	- Notional -	Average
	Long	Short
	Positions	Positions
	Maturity	
	(dollars in thousands)	
2-year swap equivalent Eurodollar contracts	\$- \$(7,000,000)	2.00
U.S. Treasury futures - 5 year	- (1,847,200)	4.42
U.S. Treasury futures - 10 year and greater	- (655,600 )	6.92
Total	\$- \$(9,502,800)	2.81

The Company presents derivative contracts on a gross basis on the Consolidated Statements of Financial Condition. Derivative contracts may contain legally enforceable provisions that allow for netting or setting off receivables and payables with each counterparty.

The following tables present information about derivative assets and liabilities that are subject to such provisions and can potentially be offset on our Consolidated Statements of Financial Condition as of June 30, 2016 and December 31, 2015, respectively.

June 30, 2016	Amounts Eligible for			
	Gross	Financial	Cash	Net
	Amounts	Instruments	Collateral	Amounts
	(dollars in thousands)			
<b>Assets:</b>				
Interest rate swaps, at fair value	\$146,285	\$(146,285)	\$-	\$-
TBA derivatives, at fair value	137,490	-	-	137,490
Futures contracts, at fair value	-	-	-	-
<b>Liabilities:</b>				
Interest rate swaps, at fair value	\$3,208,986	\$(146,285)	\$(1,878,983)	\$1,183,718
TBA derivatives, at fair value	-	-	-	-
Futures contracts, at fair value	154,017	-	(154,017 )	-



December 31, 2015	Gross Amounts (dollars in thousands)	Amounts Eligible for Offset		Net Amounts
		Financial Instruments	Cash Collateral	
<b>Assets:</b>				
Interest rate swaps, at fair value	\$19,642	\$(18,040 )	\$-	\$1,602
TBA derivatives, at fair value	9,622	(7,367 )	-	2,255
Futures contracts, at fair value	12,443	(10,868 )	-	1,575
<b>Liabilities:</b>				
Interest rate swaps, at fair value	\$1,677,571	\$(18,040 )	\$(913,576 )	\$745,955
TBA derivatives, at fair value	17,185	(7,367 )	-	9,818
Futures contracts, at fair value	32,778	(10,868 )	(21,910 )	-

The effect of interest rate swaps on the Consolidated Statements of Comprehensive Income (Loss) is as follows:

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## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

## Item 1. Financial Statements

	Location on Consolidated Statements of Comprehensive Income (Loss)		
	Realized		
	Gains	Realized	Unrealized
	(Losses)	Gains	Gains
	on	(Losses) on	(Losses) on
	Interest	Termination	Interest
	Rate	of Interest	Rate
	Swaps <sup>(1)</sup>	Rate Swaps	Swaps
	(dollars in thousands)		
Quarters Ended:			
June 30, 2016	\$(130,762)	\$(60,064 )	\$(373,220 )
June 30, 2015	\$(144,465)	\$-	\$700,792
Six Months Ended:			
June 30, 2016	\$(278,237)	\$(60,064 )	\$(1,404,940)
June 30, 2015	\$(302,704)	\$(226,462 )	\$234,590

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

The effect of other derivative contracts on the Company's Consolidated Statements of Comprehensive Income (Loss) is as follows:

## Quarter Ended June 30, 2016

	Realized	Unrealized	Amount of
	Gain	Gain	Gain/(Loss)
	(Loss)	(Loss)	Recognized
			in
			Net Gains
			(Losses) on
			Trading
			Assets
Derivative Instruments (dollars in thousands)			
Net TBA derivatives <sup>(1)</sup>	\$98,371	\$60,758	\$ 159,129
Net interest rate swaptions	-	-	-
Futures	8,314	(85,563 )	(77,249 )
			\$ 81,880

## Quarter Ended June 30, 2015

	Realized	Unrealized	Amount of
	Gain	Gain	Gain/(Loss)
	(Loss)	(Loss)	Recognized
			in
			Net Gains
			(Losses) on
			Trading
			Assets
Derivative Instruments			

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(dollars in thousands)

Quarter Ended June 30, 2015

Net TBA derivatives <sup>(1)</sup>	\$ (50,801)	\$ (106,974)	\$ (157,775 )
Net interest rate swaptions	(7,600 )	7,033	(567 )
Futures	(9,230 )	53,351	44,121
			\$ (114,221 )

Six Months Ended June 30, 2016

	Realized Gain (Loss)	Unrealized Gain (Loss)	Amount of Gain/(Loss) Recognized in Net Gains (Losses) on Trading Assets
Derivative Instruments (dollars in thousands)			
Net TBA derivatives <sup>(1)</sup>	\$ 318,363	\$ 145,052	\$ 463,415
Net interest rate swaptions	-	-	-
Futures	(122,680)	(133,683)	(256,363 )
			\$ 207,052

Six Months Ended June 30, 2015

	Realized Gain (Loss)	Unrealized Gain (Loss)	Amount of Gain/(Loss) Recognized in Net Gains (Losses) on Trading Assets
Derivative Instruments (dollars in thousands)			
Net TBA derivatives <sup>(1)</sup>	\$ (106,445)	\$ 10,213	\$ (96,232 )
Net interest rate swaptions	(29,491 )	24,116	(5,375 )
Futures	(14,737 )	(4,775 )	(19,512 )
			\$ (121,119 )

(1) Includes options on TBA contracts

Certain of the Company's derivative contracts are subject to International Swaps and Derivatives Association Master Agreements or other similar agreements which may contain provisions that grant counterparties certain rights with respect to the applicable agreement upon the occurrence of certain events such as (i) a decline in stockholders' equity in excess of specified thresholds or dollar amounts over set periods of time, (ii) the Company's failure to maintain its REIT status, (iii) the Company's failure to comply with limits on the amount of leverage, and (iv) the Company's stock being delisted from the New York Stock Exchange (NYSE). Upon the occurrence of any one of items (i) through (iv), or another default under the agreement, the counterparty to the applicable agreement has a right to terminate the agreement in accordance

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

Item 1. Financial Statements

with its provisions. The aggregate fair value of all derivative instruments with the aforementioned features that are in a net liability position at June 30, 2016 was approximately \$3.0 billion, which represents the maximum amount the Company would be required to pay upon termination. This amount is fully collateralized.

10. CONVERTIBLE SENIOR NOTES

In 2010, the Company issued \$600.0 million in aggregate principal amount of its 4% Convertible Senior Notes for net proceeds of approximately \$582.0 million. In 2012, the Company repurchased \$492.5 million in aggregate principal amount of its 4% Convertible Senior Notes. In February 2015, the 4% Convertible Senior Notes matured and the Company repaid the remaining 4% Convertible Senior Notes for the face amount of \$107.5 million.

In May 2012, the Company issued \$750.0 million in aggregate principal amount of its 5% Convertible Senior Notes due 2015 for net proceeds of approximately \$727.5 million. In May 2015, the 5% Convertible Senior Notes matured and the Company repaid the 5% Convertible Senior Notes for the face amount of \$750.0 million.

11. COMMON STOCK AND PREFERRED STOCK

The Company's authorized shares of capital stock, par value of \$0.01 per share, consists of 1,956,937,500 shares classified as common stock, 7,412,500 shares classified as 7.875% Series A Cumulative Redeemable Preferred Stock, 4,600,000 shares classified as 6.00% Series B Cumulative Convertible Preferred Stock, 12,650,000 shares classified as 7.625% Series C Cumulative Redeemable Preferred Stock and 18,400,000 shares classified as 7.50% Series D Cumulative Redeemable Preferred Stock.

(A) Common Stock

At June 30, 2016 and December 31, 2015, the Company had issued and outstanding 924,929,607 and 935,929,561 shares of common stock, respectively, with a par value of \$0.01 per share.

No options were exercised during the six months ended June 30, 2016 and 2015.

During the six months ended June 30, 2016, the Company raised \$1.2 million, by issuing 116,000 shares, through the Direct Purchase and Dividend Reinvestment Program. During the six months ended June 30, 2015, the Company raised \$1.1 million, by issuing 111,000 shares, through the Direct Purchase and Dividend Reinvestment Program.

In August 2015, the Company announced that its board of directors ("Board") had authorized the repurchase of up to \$1.0 billion of its outstanding common shares through December 31, 2016 ("Repurchase Program"). During the six months ended June 30, 2016, the Company repurchased 11,132,226 shares of its common stock under the Repurchase Program for an aggregate amount of \$102.7 million. All common shares purchased were part of a publicly announced plan in open-market transactions.

In March 2012, the Company entered into six separate Distribution Agency Agreements ("Distribution Agency Agreements") with each of Merrill Lynch; Pierce, Fenner & Smith Incorporated; Credit Suisse Securities (USA) LLC; Goldman, Sachs & Co.; J.P. Morgan Securities LLC; Morgan Stanley & Co. LLC; and RCap Securities, Inc. (together, the Agents). Pursuant to the terms of the Distribution Agency Agreements, the Company may sell from time to time through the Agents, as its sales agents, up to 125,000,000 shares of the Company's common stock. The Company did not make any sales under the Distribution Agency Agreements during the six months ended June 30, 2016 and 2015.

(B) Preferred Stock

At June 30, 2016 and December 31, 2015, the Company had issued and outstanding 7,412,500 shares of Series A Cumulative Redeemable Preferred Stock ("Series A Preferred Stock"), with a par value of \$0.01 per share and a liquidation preference of \$25.00 per share plus accrued and unpaid dividends (whether or not declared). The Series A Preferred Stock is entitled to a dividend at a rate of 7.875% per year based on the \$25.00 liquidation preference before the common stock is entitled to receive any dividends. The Series A Preferred Stock is redeemable at \$25.00 per share plus accrued and unpaid dividends (whether or not declared) exclusively at the Company's option commencing on April 5, 2009 (subject to the Company's right under limited circumstances to redeem the Series A Preferred Stock earlier in order to preserve its qualification as a REIT). Through June 30, 2016, the Company had declared and paid all required quarterly dividends on the Series A Preferred Stock.

At June 30, 2016 and December 31, 2015, the Company had issued and outstanding 12,000,000 shares of Series C Preferred Stock, with a par value of \$0.01 per share and a liquidation preference of \$25.00 per share plus

## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

## Item 1. Financial Statements

accrued and unpaid dividends (whether or not declared). The Series C Preferred Stock is entitled to a dividend at a rate of 7.625% per year based on the \$25.00 liquidation preference before the common stock is entitled to receive any dividends. The Series C Preferred Stock is redeemable at \$25.00 per share plus accrued and unpaid dividends (whether or not declared) exclusively at the Company's option commencing on May 16, 2017 (subject to the Company's right under limited circumstances to redeem the Series C Preferred Stock earlier in order to preserve its qualification as a REIT or under limited circumstances related to a change of control of the Company). Through June 30, 2016, the Company had declared and paid all required quarterly dividends on the Series C Preferred Stock.

At June 30, 2016 and December 31, 2015, the Company had issued and outstanding 18,400,000 shares of Series D Preferred Stock, with a par value of \$0.01 per share and a liquidation preference of \$25.00 per share plus accrued and unpaid dividends (whether or not declared). The Series D Preferred Stock is entitled to a dividend at a rate of 7.50% per year based on the \$25.00 liquidation preference before the common stock is entitled to receive any dividends. The Series D Preferred Stock is redeemable at \$25.00 per share plus accrued and unpaid dividends (whether or not declared) exclusively at the Company's option commencing on September 13, 2017 (subject to the Company's right under limited circumstances to redeem the Series D Preferred Stock earlier in order to preserve its qualification as a REIT or under limited circumstances related to a change of control of the Company). Through June 30, 2016, the Company had declared and paid all required quarterly dividends on the Series D Preferred Stock.

The 7.875% Series A Cumulative Redeemable Preferred Stock, 7.625% Series C Cumulative Redeemable Preferred Stock and 7.50% Series D Cumulative Redeemable Preferred Stock rank senior to the common stock of the Company.

## (C) Distributions to Stockholders

The following table provides a summary of the Company's dividend distribution activity for the periods presented:

	For the Six Months Ended:	
	June 30, 2016	June 30, 2015
	(dollars in thousands, except per share data)	
Distributions declared to common stockholders	\$554,935	\$568,640
Distributions declared per common share	\$0.60	\$0.60
Distributions paid to common stockholders after period end	\$277,479	\$284,331
Distributions paid per common share after period end	\$0.30	\$0.30
	July 29, 2016	July 30, 2015
Date of distributions paid to common stockholders after period end		
Dividends declared to Series A Preferred stockholders	\$7,296	\$7,296
Dividends declared per Series A Preferred share	\$0.984	\$0.984
Dividends declared to Series C Preferred stockholders	\$11,438	\$11,438
Dividends declared per Series C Preferred share	\$0.953	\$0.953
Dividends declared to Series D Preferred stockholders	\$17,250	\$17,250
Dividends declared per Series D Preferred share	\$0.938	\$0.938

## 12. INTEREST INCOME AND INTEREST EXPENSE

The table below presents the components of the Company's interest income and interest expense for the quarters and six months ended June 30, 2016 and 2015.

	For the Quarters		For the Six Months	
	Ended June 30,		Ended June 30,	
	2016	2015	2016	2015
Interest income:	(dollars in thousands)			
Residential Investment Securities	\$394,850	\$570,493	\$710,567	\$1,048,732
Commercial investment portfolio <sup>(1)</sup>	59,578	52,429	129,765	92,765
Reverse repurchase agreements	2,690	1,355	4,929	1,894
Total interest income	457,118	624,277	845,261	1,143,391
Interest expense:				
Repurchase agreements	136,176	101,225	269,067	203,973
Convertible Senior Notes	-	6,113	-	29,740
Securitized debt of consolidated VIEs	11,226	5,475	20,259	8,357
Participation sold	157	159	315	318
Other	5,196	100	10,561	104
Total interest expense	152,755	113,072	300,202	242,492
Net interest income	\$304,363	\$511,205	\$545,059	\$900,899

<sup>(1)</sup> Includes commercial real estate debt, preferred equity and corporate debt.

## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

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## 13. GOODWILL

At June 30, 2016 and December 31, 2015, goodwill totaled \$71.8 million.

## 14. NET INCOME (LOSS) PER COMMON SHARE

The following table presents a reconciliation of net income (loss) and shares used in calculating basic and diluted net income (loss) per share for the quarters and six months ended June 30, 2016 and 2015.

	For the Quarters Ended		For the Six Months Ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
	(dollars in thousands, except per share data)			
Net income (loss)	\$(278,497 )	\$900,071	\$(1,146,577 )	\$423,572
Less: Net income (loss) attributable to noncontrolling interest	(385 )	(149 )	(547 )	(239 )
Net income (loss) attributable to Annaly	(278,112 )	900,220	(1,146,030 )	423,811
Less: Preferred stock dividends	17,992	17,992	35,984	35,984
Net income (loss) available (related) to common stockholders, prior to adjustment for dilutive potential common shares, if necessary	(296,104 )	882,228	(1,182,014 )	387,827
Add: Interest on Convertible Senior Notes, if dilutive	-	-	-	-
Net income (loss) available to common stockholders, as adjusted	\$(296,104 )	\$882,228	\$(1,182,014 )	\$387,827
Weighted average shares of common stock outstanding-basic	924,887,316	947,731,493	925,850,452	947,700,832
Add: Effect of stock awards and Convertible Senior Notes, if dilutive	-	198,269	-	178,126
Weighted average shares of common stock outstanding-diluted	924,887,316	947,929,762	925,850,452	947,878,958
Net income (loss) per share available (related) to common share:				
Basic	\$(0.32 )	\$0.93	\$(1.28 )	\$0.41
Diluted	\$(0.32 )	\$0.93	\$(1.28 )	\$0.41

Options to purchase 1.1 million shares of common stock were outstanding and considered anti-dilutive as their exercise price and option expense exceeded the average stock price for the quarter and six months ended June 30, 2016, respectively.

Options to purchase 2.0 million shares of common stock were outstanding and considered anti-dilutive as their exercise price and option expense exceeded the average stock price for the quarter and six months ended June 30, 2015, respectively.

## 15. LONG-TERM STOCK INCENTIVE PLAN

The Company adopted the 2010 Equity Incentive Plan (the "Plan"), which authorizes the Compensation Committee of the Board of Directors to grant options, stock appreciation rights, dividend equivalent rights, or other share-based awards, including restricted shares up to an aggregate of 25,000,000 shares, subject to adjustments as provided in the 2010 Equity Incentive

Plan. The Company had previously adopted a long term stock incentive plan for executive officers, key employees and non-employee directors (the "Prior Plan"). The Prior Plan authorized the Compensation Committee of the Board of Directors to grant awards, including non-qualified options as well as incentive stock options as defined under Section 422 of the Code. The Prior Plan authorized the granting of options or other awards for an aggregate of the greater of 500,000 shares or 9.5% of the diluted outstanding shares of the Company's common stock, up to a ceiling of 8,932,921



shares. No further awards will be made under the Prior Plan, although existing awards remain effective.

Stock options were issued at the market price on the date of grant, subject to an immediate or four year vesting in four equal installments with a contractual term of 5 or 10 years.

The following table sets forth activity related to the Company's stock options awarded under the Plan:

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## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

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	For the Six Months Ended			
	June 30, 2016		June 30, 2015	
	Number of	Weighted	Number of	Weighted
	Shares	Average	Shares	Average
		Exercise		Exercise
		Price		Price
Options outstanding at the beginning of period	1,168,775	\$ 15.34	2,259,335	\$ 15.35
Granted	-	-	-	-
Exercised	-	-	-	-
Forfeited	(6,400 )	14.69	(259,799 )	15.26
Expired	(36,750 )	12.90	(6,250 )	17.24
Options outstanding at the end of period	1,125,625	\$ 15.43	1,993,286	\$ 15.36
Options exercisable at the end of period	1,125,625	\$ 15.43	1,993,286	\$ 15.36

The weighted average remaining contractual term was approximately 2.0 years and 2.6 years for stock options outstanding and exercisable as of June 30, 2016 and 2015, respectively.

As of June 30, 2016 and 2015, there was no unrecognized compensation cost related to nonvested share-based compensation awards.

## 16. INCOME TAXES

For the quarter ended June 30, 2016 the Company was qualified to be taxed as a REIT under Code Sections 856 through 860. As a REIT, the Company is not subject to federal income tax to the extent that it distributes its taxable income to its stockholders. To maintain qualification as a REIT, the Company must distribute at least 90% of its annual REIT taxable income to its stockholders and meet certain other requirements such as assets it may hold, income it may generate and its stockholder composition. It is generally the Company's policy to distribute 100% of its REIT taxable income. To the extent there is any undistributed REIT taxable income at the end of a year, the Company distributes such shortfall within the next year as permitted by the Code. For years prior to 2013, the Company retained the amount of taxable income attributable to certain employee remuneration deductions disallowed for tax purposes pursuant to Section 162(m) of the Code ("Section 162(m)"). As a result of the externalization of management effective as of July 1, 2013, the Company was not subject to the Section 162(m) disallowance for the 2013 tax year.

The state and local tax jurisdictions for which the Company is subject to tax-filing obligations recognize the Company's status as a REIT, and therefore, the Company generally does not pay income tax in such jurisdictions. The Company may, however, be subject to certain minimum state and local tax filing fees as well as certain excise, franchise or business taxes. The Company's TRSs are subject to federal, state and local taxes.

During the quarter and six months ended June 30, 2016, the Company recorded \$0.1 million and \$0.9 million, respectively, of income tax benefit for losses attributable to its TRSs. During both the quarter and six months ended June 30, 2015, the Company recorded a net income tax benefit of \$7.7 million for losses attributable to its TRSs.

The Company's federal, state and local tax returns from 2012 and forward remain open for examination.

## 17. LEASE COMMITMENTS AND CONTINGENCIES

## Commitments

The Company had a non-cancelable lease for office space which commenced in May 2002 and expired in December 2014. In September 2014, the Company entered into a non-cancelable lease for office space which commenced in July 2014 and expires in September 2025. FIDAC has a lease for office space which commenced in October 2010 and expired in February 2016. The lease expense for each of the quarters ended June 30, 2016 and 2015 was \$0.8 million. The Company's aggregate future minimum lease payments totaled \$34.5 million. The following table details the future lease payments.

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## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

## Item 1. Financial Statements

Years Ending December 31,	Lease Commitments (dollars in thousands)
2016 (remaining)	\$ 1,782
2017	3,565
2018	3,565
2019	3,565
2020	3,652
Later years	18,343
	\$ 34,472

The Company had no material unfunded loan commitments as of June 30, 2016 and December 31, 2015.

## Contingencies

From time to time, the Company is involved in various claims and legal actions arising in the ordinary course of business. There were no material contingencies as of June 30, 2016 and December 31, 2015.

## 18. RISK MANAGEMENT

The primary risks to the Company are liquidity, investment/market risk and credit risk. Interest rates are highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond the Company's control. Changes in the general level of interest rates can affect net interest income, which is the difference between the interest income earned on Interest Earning Assets and the interest expense incurred in connection with the Interest Bearing Liabilities and hedges, by affecting the spread between the Interest Earning Assets and Interest Bearing Liabilities. Changes in the level of interest rates can also affect the value of the Interest Earning Assets and the Company's ability to realize gains from the sale of these assets. A decline in the value of the Interest Earning Assets pledged as collateral for borrowings under repurchase agreements and derivative contracts could result in the counterparties demanding additional collateral pledges or liquidation of some of the existing collateral to reduce borrowing levels.

The Company may seek to mitigate the potential financial impact by entering into interest rate agreements such as interest rate swaps, interest rate swaptions and other hedges.

Weakness in the mortgage market, the shape of the yield curve and changes in the expectations for the path and volatility of future interest rates may adversely affect the performance and market value of the Company's investments. This could negatively impact the Company's book value. Furthermore, if the Company's lenders are unwilling or unable to provide additional financing, the Company could be forced to sell its Residential Investment Securities and commercial real estate investments at an inopportune time when prices are depressed. The Company has established policies and procedures for mitigating risks, including conducting scenario analyses and utilizing a range of hedging strategies.

The payment of principal and interest on the Freddie Mac and Fannie Mae Agency mortgage-backed securities, excluding CRT securities issued by Freddie Mac and Fannie Mae, are guaranteed by those respective agencies and the payment of principal and interest on Ginnie Mae Agency mortgage-backed securities are backed by the full faith and credit of the U.S. government. Principal and interest on Agency debentures are guaranteed by the Agency issuing the debenture. The majority of the Company's Residential Investment Securities have an actual or implied "AAA" rating.

The Company faces credit risk on the portions of its portfolio which are not guaranteed by the respective Agency or by the full faith and credit of the U.S. government. The Company is exposed to credit risk on CRE Debt and Preferred Equity Investments, investments in commercial real estate, commercial mortgage-backed securities, CRT securities, other non-Agency mortgage-backed securities and corporate debt. The Company is exposed to risk of loss if an issuer, borrower, tenant or counterparty fails to perform its obligations under contractual terms. The Company has established policies and procedures for mitigating credit risk, including reviewing and establishing limits for credit exposure, limiting transactions with specific counterparties, maintaining qualifying collateral and periodically assessing the creditworthiness of issuers, borrowers, tenants and counterparties.

#### 19. RCAP REGULATORY REQUIREMENTS

RCap is subject to regulations of the securities business that include but are not limited to trade practices, use and safekeeping of funds and securities, capital structure, recordkeeping and conduct of directors, officers and employees.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

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As a self-clearing, registered broker dealer, RCap is required to maintain minimum net capital by FINRA. As of June 30, 2016 RCap had a minimum net capital requirement of \$0.3 million. RCap consistently operates with capital in excess of its regulatory capital requirements. RCap's regulatory net capital as defined by SEC Rule 15c3-1, as of June 30, 2016 was \$391.9 million with excess net capital of \$391.6 million.

20. RELATED PARTY TRANSACTIONS

Investment in Affiliate and Advisory Fees

In August 2015, FIDAC entered into an agreement with Chimera Investment Corporation ("Chimera") to internalize the management of Chimera. As part of the agreement, the companies agreed to terminate the management agreement between FIDAC and Chimera effective August 5, 2015.

In connection with the transaction, Annaly and Chimera entered into a share repurchase agreement pursuant to which Chimera purchased the Company's approximately 9.0 million shares of Chimera at an aggregate price of \$126.4 million. The share repurchase agreement closed in August 2015.

For the quarter and six months ended June 30, 2016, the Company did not record any advisory fees. For the quarter and six months ended June 30, 2015, the Company recorded advisory fees from Chimera totaling \$10.6 million and \$21.1 million, respectively. In August 2014, the management agreement between FIDAC and Chimera was amended and restated to amend certain of the terms and conditions of the prior agreement. Among other amendments to the terms of the prior agreement, effective August 8, 2014, the management fee was increased from 0.75% to 1.20% of Chimera's gross stockholders' equity (as defined in the amended and restated management agreement).

Management Agreement

The Company and the Manager have entered into a management agreement pursuant to which the Company's management is conducted by the Manager through the authority delegated to it in the Management Agreement and pursuant to the policies established by the Board (the "Externalization"). The management agreement was effective as of July 1, 2013 and applicable for the entire 2013 calendar year and was subsequently amended on November 5, 2014 and April

11, 2016 (the management agreement, as amended, is referred to as "Management Agreement").

Pursuant to the terms of the Management Agreement, the Company pays the Manager a monthly management fee in an amount equal to 1/12th of 1.05% of stockholders' equity, as defined in the Management Agreement, for its management services. For the quarters ended June 30, 2016 and 2015, the compensation and management fee was \$36.0 million and \$37.0 million, respectively. For the six months ended June 30, 2016 and 2015, the compensation and management fee was \$73.0 million and \$75.6 million, respectively. At June 30, 2016 and December 31, 2015, the Company had amounts payable to the Manager of \$11.9 million and \$12.1 million, respectively.

The Management Agreement provides for a two year term ending December 31, 2016 with automatic two-year renewals unless at least two-thirds of the Company's independent directors or the holders of a majority of the Company's outstanding shares of common stock elect to terminate the agreement in their sole discretion for any or no reason. At any time during the term or any renewal term the Company may deliver to the Manager written notice of the Company's intention to terminate the Management Agreement. The Company must designate a date not less than one year from the date of the notice on which the Management Agreement will terminate. The Management Agreement also provides that the Manager may terminate the Management Agreement by providing to the Company prior written notice of its intention to terminate the Management Agreement no less than one year prior to the date designated by the Manager on which the Manager would cease to provide services or such earlier date as determined

by the Company in its sole discretion.

The Company has a limited number of employees following the Externalization, all of whom are employees of the Company's subsidiaries for regulatory or corporate efficiency reasons. All compensation expenses associated with such retained employees reduce the amount paid to the Manager.

The Management Agreement may be amended or modified by agreement between the Company and the Manager. There is no termination fee for a termination of the Management Agreement by either the Company or the Manager.

#### 21. SUBSEQUENT EVENTS

Acquisition of Hatteras Financial Corp.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

Item 1. Financial Statements

As previously disclosed in the Company's filings with the SEC, on July 12, 2016 the Company completed its acquisition of Hatteras Financial Corp. ("Hatteras" and such acquisition, the "Hatteras Acquisition"), an externally managed mortgage REIT that invests primarily in single-family residential mortgage real estate assets, for aggregate consideration to Hatteras common shareholders of approximately \$1.5 billion. The Company issued 93.9 million shares of common shares as part of the consideration for the Hatteras Acquisition.

On July 11, 2016 the Company obtained a controlling financial interest in Hatteras as 74.12% of Hatteras' outstanding shares were validly tendered and not validly withdrawn from the Offer. In accordance with Maryland law, the Merger was consummated on July 12, 2016 and Hatteras became a wholly owned subsidiary of the Company. In addition, as part of the Hatteras Acquisition, each share of Hatteras 7.625% Series A Cumulative Redeemable Preferred Stock, par value \$0.001 per share ("Hatteras Preferred Share"), that was outstanding as of immediately prior to the completion of the Hatteras Acquisition was converted into one share of a newly-designated series of the Company's preferred stock, par value \$0.01 per share, which the Company classified and designated as 7.625% Series E Cumulative Redeemable Preferred Stock, and which has rights, preferences, privileges and voting powers substantially the same as a Hatteras Preferred Share.

Prior to closing the Hatteras Acquisition, each of Hatteras and the Company declared a prorated dividend to their respective shareholders with a record date of July 11, 2016. Each of the dividends was prorated based on the number of days that elapsed since the record date for the most recent quarterly dividend paid to Hatteras and the Company's shareholders, respectively, and the amount of such prior quarterly dividend, as applicable.

In addition, in connection with the closing of the Hatteras Acquisition, the management agreement between Hatteras and its external manager, Atlantic Capital Advisors LLC ("ACA") terminated, and as a result of such termination, Hatteras paid ACA a termination fee of \$45.4 million.

Hatteras' portfolio of adjustable rate mortgage-backed securities is expected to be complementary to the Company's existing portfolio which is comprised primarily of fixed rate-mortgage-backed securities, the combined capital base is expected to support continued growth of the Company's businesses and the acquisition is expected to create efficiency and growth opportunities.

Under the acquisition method of accounting, merger-related transaction costs (such as advisory, legal, valuation and other professional fees) are not included as components of consideration transferred but are expensed in the periods in which the costs are incurred. Transaction costs of \$2.2 million were incurred during the six months ended June 30, 2016 and were included in other general and administrative expenses in the Consolidated Statements of Comprehensive Income (Loss). Also, in connection with the Hatteras Acquisition, the Company entered into consulting agreements with certain former employees of Hatteras. The consulting agreements provide for monthly consulting fees totaling \$0.7 million during a consulting period ending on the 30-month anniversary of the Hatteras Acquisition closing date. Considering the proximity of the closing of the Hatteras Acquisition, additional disclosures required under ASC 805, Business Combinations, will be provided in the Company's next quarterly filing.

For additional details regarding the terms and conditions of the Hatteras Acquisition and related matters, please refer to the Company's other filings with the SEC that were made in connection with the Hatteras Acquisition, including the Prospectus/Offer to Exchange filed with the SEC pursuant to Rule 424(b)(3) on July 8, 2016 and the Current Report on Form 8-K filed with the SEC on July 12, 2016.



ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

Item 2. Management's Discussion and Analysis

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Special Note Regarding Forward-Looking Statements

Certain statements contained in this quarterly report, and certain statements contained in our future filings with the Securities and Exchange Commission (the SEC or the Commission), in our press releases or in our other public or stockholder communications contain or incorporate by reference certain forward-looking statements which are based on various assumptions (some of which are beyond our control) and may be identified by reference to a future period or periods or by the use of forward-looking terminology, such as "may," "will," "believe," "expect," "anticipate," "continue," or similar terms or variations on those terms or the negative of those terms. Actual results could differ materially from those set forth in forward-looking statements due to a variety of factors, including, but not limited to, changes in interest rates; changes in the yield curve; changes in prepayment rates; the availability of mortgage-backed securities and other securities for purchase; the availability of financing and, if available, the terms of any financings; changes in the market value of our assets; changes in business conditions and the general economy; our ability to grow our commercial business; our ability to grow our residential mortgage credit business; credit risks related to our investments in credit risk transfer securities, residential mortgage-backed securities and related residential mortgage credit assets, commercial real estate assets and corporate debt; risks related to investments in mortgage servicing rights

and ownership of a servicer; any potential business disruption following the acquisition of Hatteras Financial Corp.; our ability to consummate any contemplated investment opportunities; changes in government regulations affecting our business; our ability to maintain our qualification as a REIT; and our ability to maintain our exemption from registration under the Investment Company Act of 1940, as amended. For a discussion of the risks and uncertainties which could cause actual results to differ from those contained in the forward-looking statements, see "Risk Factors" in our most recent Annual Report on Form 10-K and Item 1A "Risk Factors" in this quarterly report on Form 10-Q. We do not undertake, and specifically disclaim any obligation, to publicly release the result of any revisions which may be made to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements, except as required by law.

This Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our most recent annual report on Form 10-K. All references to "Annaly," "we," "us" or "our" mean Annaly Capital Management, Inc. and all entities owned by us, except where it is made clear that the term means only the parent company. Refer to the section titled "Glossary of Terms" located at the end of this Item 2 for definitions of commonly used terms in this quarterly report on Form 10-Q.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

Item 2. Management's Discussion and Analysis

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ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

Item 2. Management’s Discussion and Analysis

Overview

Annaly is a leading real estate finance company whose principal business objectives are to generate net income for distribution to its shareholders from its investments and capital preservation. Annaly is a Maryland corporation that has elected to be taxed as a real estate investment trust (“REIT”). Annaly is externally managed by Annaly Management Company LLC (or Manager). Our common stock is listed on the New York Stock Exchange under the symbol “NLY.” Since our founding in 1997, we have strived to generate net income for distribution to our stockholders through the prudent selection and management of our investments. We own a portfolio of real estate related investments. We use our capital coupled with borrowed funds to invest in real estate related investments, earning the spread between the yield on our assets and the cost of our borrowings and hedging activities.

We are primarily organized around the following operations:

Annaly, the parent company	Invests primarily in various types of Agency mortgage-backed securities and related derivatives to hedge these investments. Its portfolio also includes residential credit investments such as CRTs and non-Agency mortgage-backed securities.
Annaly Commercial Real Estate Group, Inc. (or ACREG)	Wholly-owned subsidiary that specializes in originating or acquiring, financing and managing commercial loans and other commercial real estate debt, commercial mortgage-backed securities and other commercial real estate-related assets.
Annaly Middle Market Lending LLC (or MML)	Wholly-owned subsidiary that engages in corporate middle market lending transactions.
RCap Securities, Inc. (or RCap)	Wholly-owned subsidiary that operates as a broker-dealer, and is a member of the Financial Industry Regulatory Authority (or FINRA)

For a full discussion of our business, refer to the section titled “Business Overview” in our most recent Annual Report on Form 10-K.

Acquisition of Hatteras

As previously disclosed in our filings with the SEC, the acquisition of Hatteras Financial Corp. (or Hatteras and such acquisition, the Hatteras Acquisition), an externally managed mortgage REIT that invests primarily in single-family residential mortgage real estate assets, closed on July 12, 2016 for an aggregate consideration to Hatteras common shareholders of approximately \$1.5 billion. Annaly issued 93.9 million shares of common shares as part of the consideration for the Hatteras Acquisition.

In addition, as part of the Hatteras Acquisition, each share of Hatteras 7.625% Series A Cumulative Redeemable Preferred Stock, par value \$0.001 per share (or Hatteras Preferred Share), that was outstanding as of immediately prior to the completion of the Hatteras Acquisition was converted into one share of a newly-designated series of Annaly’s preferred stock, par value \$0.01 per share, which we classified and designated as 7.625% Series E Cumulative Redeemable Preferred Stock, and which has rights, preferences, privileges and voting powers substantially the same as a Hatteras Preferred Share.

Prior to closing the Hatteras Acquisition, each of Hatteras and Annaly declared a prorated dividend to their respective shareholders with a record date of July 11, 2016. Each of the dividends was prorated based on the number of days that elapsed since the record date for the most recent quarterly dividend paid to Hatteras and Annaly’s shareholders, respectively, and the amount of such prior quarterly dividend, as applicable.

In addition, in connection with the closing of the Hatteras Acquisition, the management agreement between Hatteras and its external manager, Atlantic Capital Advisors LLC (or ACA) terminated, and as a result of such termination,

Hatteras paid ACA a termination fee of \$45.4 million.

Hatteras' portfolio of adjustable rate mortgage-backed securities is expected to be complementary to our existing portfolio which is comprised primarily of fixed rate-mortgage-backed securities, the combined capital base is expected to support continued growth of our businesses and the acquisition is expected to create efficiency and growth opportunities.

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ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

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For additional details regarding the terms and conditions of the Hatteras Acquisition and related matters, please refer to our other filings with the SEC that were made in connection with the Hatteras Acquisition, including the Prospectus/Offer to Exchange filed with the SEC pursuant to Rule 424(b)(3) on July 8, 2016 and the Current Report on Form 8-K filed with the SEC on July 12, 2016.

Business Environment

Similar to the first quarter of 2016, the aggregate size of our residential investment securities portfolio and commercial real estate investments remained roughly unchanged in the second quarter of 2016 ahead of finalizing the acquisition of the Hatteras portfolio. The second quarter of 2016 witnessed the unexpected United Kingdom (or UK) referendum result as a tremendous inflection point across financial markets, resulting in the decline of 10-year Treasury yields below 1.5%. In light of this environment of increased uncertainty, we continue to improve the quality of collateral held in the portfolio to counteract increased prepayment concerns at such low rate levels. In addition, we remain cautious with regard to portfolio positioning and leverage.

Economic Environment

Through the second quarter of 2016, investors continued to face a low growth, low inflation environment in which asset prices were supported by unprecedented central bank accommodation. Within this fragile global growth environment, financial markets remained vulnerable to shocks, highlighted by geopolitical risks domestically and abroad. Early readings of second quarter 2016 economic growth, as measured by real gross domestic product (or GDP) according to the Bureau of Economic Analysis, suggest that the U.S. economy expanded at a weak seasonally-adjusted annualized rate of 1.2%, compared to 0.8% in the first quarter of 2016. This slight bounce back in economic activity was on the back of a return of consumer spending to the recent trend, driven by continued job and wage growth. The report was weak throughout all other sectors, with business and residential investment, government spending and inventories detracting, and net trade a modest positive. However, the drawdown of inventories subtracted an abnormally large (1.2%) off of the second quarter of 2016 GDP after a (0.4%) impact in first quarter of 2016, which is likely to be reversed as a boost to second half growth.

Amidst the modest increase in growth pace, unemployment fell slightly during the second quarter of 2016. The pace of hiring slowed, as the economy added 147,000 jobs per month during the second quarter of 2016 according to the Bureau of Labor Statistics, below the monthly average of 196,000 in the first quarter of 2016. Meanwhile, the unemployment rate dropped to 4.9% from 5.0%, largely due to people dropping out of the labor force. Wage growth, meanwhile, showed more progress, as the median wage increased 3.6% year-over-year in June 2016, according to the Atlanta Fed, up from 3.2% in March 2016.

Realized inflation remained below the Fed's 2% target as measured by their official target, the headline Personal Consumer Expenditure Chain Price Index (or PCE), which rose 0.9% year-over-year in May 2016 compared to 0.8% in March 2016. The more stable core PCE measure, which excludes food and energy prices, rose 1.6% year-over-year, also roughly even to the rise in March 2016. Despite a modest upward trend in realized inflation in recent months, both market- and survey-based measures of inflation expectations fell during the quarter, providing the Fed with more time in its rate hike cycle than what would be anticipated by the realized inflation figures alone.

During the second quarter of 2016, the Federal Open Market Committee (or FOMC) maintained the federal funds rate target at a range of ¼ to ½ percent, while simultaneously reinvesting the runoff of its portfolio of U.S. Treasury and agency mortgage-backed securities. At their meeting on April 27, 2016, the Fed held steady while releasing a measured statement, noting labor market progress and a slowing in growth. However, the Minutes for the meeting, released on May 18, 2016 were surprisingly hawkish, saying "most participants" believed a June hike would be appropriate "if incoming data were consistent with economic growth picking up in the second quarter." The Fed entered

their June 2016 meeting with two items on mind: the most recent jobs report showed only 38,000 jobs were created in May 2016, and the UK vote to possibly leave the European Union would occur in the succeeding week. In consideration of the risks posed by potentially slowing job growth or a further slowing of growth abroad, the Fed reacted with a very dovish tone in June 2016, with six members only expecting one hike in 2016 compared to one member in March 2016, and the median Fed funds rate expectation dropping to 1.9% from 2.4% for year-end 2017 and 3.0% from 3.3% for year-end 2018. As Yellen noted in a June 2016 speech that “a UK vote to exit the European Union could have significant



## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

## Item 2. Management's Discussion and Analysis

economic repercussions,” the market expectation is for a continued cautious Fed in the third quarter of 2016. The July 27, 2016 meeting was uneventful, as the statement noted an improvement in the labor market and that “near-term risks to the economic outlook have diminished,” both likely a reference to the strong June 2016 employment report after a weak reading in May 2016.

Interest rates declined approximately 15-35 basis points across the yield curve over the course of the second quarter of 2016, with long-term Treasury yields reaching their lowest level on record. The decline in interest rates was driven by the market moves following the UK's vote to exit the European Union on June 23, 2016 which led to a broad-based repricing of global short-term rate expectations related to increased central bank accommodation amid the economic impact of the vote outcome. In addition, the increased global central bank accommodation – with the European Central Bank increasing its quantitative easing program by extending to corporate bonds and expectations of further action from the Bank of England and Bank of Japan – has left the United States with a large share of positive yielding developed market government debt, in turn increasing relative attractiveness of U.S. yields, despite their historically low levels. The mortgage basis, or the spread between the 30-year Agency mortgage-backed security coupon and 10-year U.S. Treasury, narrowed early in the second quarter of 2016 before widening modestly in June 2016.

The following table below presents interest rates at each date presented:

	June 30, 2016	December 31, 2015	June 30, 2015
30-Year mortgage current coupon	2.31%	3.00%	3.10%
Mortgage basis	84 bps	73 bps	75 bps
10-Year U.S. Treasury rate	1.47%	2.27%	2.35%
<b>LIBOR:</b>			
1-Month	0.47%	0.43%	0.19%
6-Month	0.92%	0.84%	0.44%

## Financial Regulatory Reform

Uncertainty remains surrounding financial regulatory reform and its impact on the markets and the broader economy. In particular, the U.S. government is attempting to change its involvement through the Agencies in the mortgage market. There have been numerous legislative initiatives introduced regarding the Agencies, and it is unclear which approach, if any, may become law. In addition, regulators remain focused on the wholesale funding markets, bank capital levels and shadow banking. It is difficult to predict the ultimate legislative and other regulatory outcomes of these efforts. We continue to monitor these legislative and regulatory developments to evaluate their potential impact on our business.

On January 12, 2016, the Federal Housing Finance Administration (or FHFA) issued final rules relating to captive insurance company membership in the Federal Home Loan Bank (or FHLB) System, which provide that these entities will no longer be eligible for membership in the FHLB System. As part of their membership in the FHLB System, captive insurance companies typically pledge assets as collateral for advances by the FHLB. The rules provide for extensions of the advances outstanding prior to February 19, 2016 until their scheduled maturity for existing members as well as continued membership in the FHLB System for either one or five years depending on when an existing member was admitted as a member of the FHLB System. Our captive insurance subsidiary Truman Insurance Company LLC (or Truman) was admitted as a member of the FHLB System prior to September 2014 and, therefore, is eligible under the rules to remain as a member of the FHLB of Des Moines (or FHLB Des Moines) through February 2021.

### Results of Operations

The results of our operations are affected by various factors, many of which are beyond our control. Some of these risks and uncertainties are described herein (see “Special Note Regarding Forward-Looking Statements”) and in Part I, Item 1A. “Risk factors” of our most recent annual report on Form 10-K.

### Net Income (Loss) Summary

The following table presents summarized financial information related to our results of operations as of and for the quarters and six months ended June 30, 2016 and 2015.

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ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

Item 2. Management's Discussion and Analysis

	For the Quarter Ended June 30,		For the Six Months Ended June 30,	
	2016	2015	2016	2015
	(dollars in thousands, except per share data)			
Interest income	\$457,118	\$624,277	\$845,261	\$1,143,391
Interest expense	152,755	113,072	300,202	242,492
Net interest income	304,363	511,205	545,059	900,899
Realized and unrealized gains (losses)	(523,785 )	440,545	(1,579,338 )	(388,454 )
Other income (loss)	(9,930 )	(7,353 )	(16,045 )	6,405
General and administrative expenses	49,221	52,009	97,166	102,947
Income (loss) before income taxes	(278,573 )	892,388	(1,147,490 )	415,903
Income taxes	(76 )	(7,683 )	(913 )	(7,669 )
Net income (loss)	(278,497 )	900,071	(1,146,577 )	423,572
Net income (loss) attributable to noncontrolling interest	(385 )	(149 )	(547 )	(239 )
Net income (loss) attributable to Annaly	(278,112 )	900,220	(1,146,030 )	423,811
Dividends on preferred stock	17,992	17,992	35,984	35,984
Net income (loss) available (related) to common stockholders	\$(296,104 )	\$882,228	\$(1,182,014 )	\$387,827
Net income (loss) per share available (related) to common stockholders:				
Basic	\$(0.32 )	\$0.93	\$(1.28 )	\$0.41
Diluted	\$(0.32 )	\$0.93	\$(1.28 )	\$0.41
Weighted average number of common shares outstanding:				
Basic	924,887,316	947,731,493	925,850,452	947,700,832
Diluted	924,887,316	947,929,762	925,850,452	947,878,958
Other information:				
Asset portfolio at period-end	\$73,419,197	\$72,923,481	\$73,419,197	\$72,923,481
Average total assets	\$77,580,218	\$77,110,679	\$76,783,776	\$80,858,908
Average equity	\$11,609,940	\$12,859,698	\$11,708,601	\$13,017,725
Leverage at period-end <sup>(1)</sup>	5.3:1	4.8:1	5.3:1	4.8:1
Economic leverage at period-end <sup>(2)</sup>	6.1:1	5.6:1	6.1:1	5.6:1
Capital ratio <sup>(3)</sup>	13.2	% 14.6	% 13.2	% 14.6
Annualized return on average total assets	(1.44	%) 4.67	% (2.99	%) 1.05
Annualized return (loss) on average equity	(9.60	%) 28.00	% (19.59	%) 6.51
Annualized core return on average equity <sup>(4)(5)</sup>	9.73	% 10.31	% 9.81	% 10.35
Net interest margin <sup>(6)</sup>	1.15	% 2.06	% 0.97	% 1.67
Core net interest margin <sup>(4)(5)</sup>	1.54	% 1.70	% 1.54	% 1.69
Average yield on interest earning assets	2.48	% 3.32	% 2.29	% 2.91
Core average yield on interest earning assets <sup>(4)(5)</sup>	2.95	% 2.90	% 2.98	% 2.93
Average cost of interest bearing liabilities	1.68	% 1.59	% 1.71	% 1.62
Net interest spread	0.80	% 1.73	% 0.58	% 1.29
Core net interest spread <sup>(4)(5)</sup>	1.27	% 1.31	% 1.27	% 1.31
Constant prepayment rate	12.7	% 12.1	% 10.8	% 10.5
Long-term constant prepayment rate	13.0	% 7.7	% 13.0	% 7.7

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Common stock book value per share	\$11.50	\$12.32	\$11.50	\$12.32
Core interest income <sup>(4)(5)</sup>	\$542,701	\$544,695	\$1,099,252	\$1,151,692
Economic interest expense <sup>(4)</sup>	\$261,056	\$252,845	\$531,627	\$539,597
Economic core net interest income <sup>(4)(5)</sup>	\$281,645	\$291,850	\$567,625	\$612,095
Core earnings <sup>(4)(5)</sup>	\$282,176	\$331,473	\$573,933	\$673,438
Core earnings per common share <sup>(4)(5)</sup>	\$0.29	\$0.33	\$0.58	\$0.67

- (1) Includes repurchase agreements, other secured financing, Convertible Senior Notes and non-recourse securitized debt, loan participation and mortgages payable.
- (2) Computed as the sum of recourse debt, TBA derivative notional outstanding and net forward purchases of investments divided by total equity.
- (3) Represents the ratio of stockholders' equity to total assets (inclusive of total market value of TBA derivatives and exclusive of consolidated VIEs associated with B-Piece commercial mortgage-backed securities).
- (4) See "Non-GAAP Financial Measures" for a reconciliation of our non-GAAP measures to their corresponding GAAP amounts.
- (5) Excludes the premium amortization adjustment due to quarter-over-quarter changes in long-term CPR estimates. Represents the sum of annualized economic core net interest income, inclusive of interest expense on interest rate swaps used to hedge costs of funds, plus TBA dollar roll income less interest expense on interest rate swaps used to hedge dollar roll transactions divided by the sum of average Interest Earning Assets plus average outstanding TBA contract balances.

This Management Discussion and Analysis section contains analysis and discussion of non-GAAP measurements. See "Non-GAAP Financial Measures" for further information.

GAAP

Net income (loss) was (\$278.5) million, which includes (\$0.4) million attributable to a noncontrolling interest, or (\$0.32) per average basic common share, for the quarter ended June 30, 2016 compared to \$900.1 million, which includes (\$0.1) million attributable to a noncontrolling interest, or \$0.93 per average basic common share, for the same period in 2015. We attribute the majority of the change in net income (loss) to the change in unrealized gains (losses) on interest rate swaps and lower interest income. Unrealized gains (losses) on interest rate swaps were (\$373.2) million for the quarter ended June 30, 2016 compared to \$700.8 million for the same period in 2015, reflecting an unfavorable change in the fair value of interest rate swaps due to lower forward interest rates for the quarter ended June 30, 2016 compared to the same period in 2015. Interest income decreased \$167.2 million to \$457.1 million for the quarter ended June 30, 2016 compared to the same period in

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

Item 2. Management's Discussion and Analysis

2015, primarily due to lower coupon income resulting from lower average Interest Earning Assets and higher amortization expense reflecting higher projected long-term CPR on Residential Investment Securities, partially offset by higher interest income from the commercial investment portfolio.

Net income (loss) was (\$1.1) billion, which includes (\$0.5) million attributable to a noncontrolling interest, or (\$1.28) per average basic common share, for the six months ended June 30, 2016 compared to \$423.6 million, which includes (\$0.2) million attributable to a noncontrolling interest, or \$0.41 per average basic common share, for the same period in 2015. We attribute the majority of the change in net income (loss) to the change in unrealized gains (losses) on interest rate swaps and lower interest income. Unrealized gains (losses) on interest rate swaps were (\$1.4) billion for the six months ended June 30, 2016 compared to \$234.6 million for the same period in 2015, reflecting an unfavorable change in the fair value of interest rate swaps due to lower forward interest rates for the six months ended June 30, 2016 compared to the same period in 2015. Interest income decreased \$298.1 million to \$845.3 million for the six months ended June 30, 2016 compared to the same period in 2015, primarily due to lower coupon income resulting from a lower average yield on Interest Earning Assets, lower average Interest Earning Assets and higher amortization expense reflecting higher projected long-term CPR on Residential Investment Securities, partially offset by higher interest income from the commercial investment portfolio.

Non-GAAP

Core earnings were \$282.2 million, or \$0.29 per average common share, for the quarter ended June 30, 2016 compared to \$331.5 million, or \$0.33 per average common share, for the same period in 2015. Core earnings decreased during the quarter ended June 30, 2016 compared to the same period in 2015 primarily due to a reduction in core interest income earned on lower Residential Investment Securities balances, partially offset by increased interest income on a larger commercial investment portfolio.

Core earnings were \$573.9 million, or \$0.58 per average common share, for the six months ended June 30, 2016 compared to \$673.4 million, or \$0.67 per average common share, for the same period in 2015. Core earnings declined during the six months ended June 30, 2016 compared to the same period in 2015 primarily due to a reduction in core interest income earned on lower Residential Investment Securities balances, partially offset by increased interest income on a larger commercial investment portfolio.

Non-GAAP Financial Measures

This Management Discussion and Analysis section contains analysis and discussion of non-GAAP financial measures. The Company's presentation of non-GAAP financial measures has important limitations. Other market participants may calculate non-GAAP financial measures differently than the Company calculates them, making comparative analysis difficult.

Although the Company believes its presentation of non-GAAP financial measures provides insight into the Company's financial position and performance excluding the effects of certain transactions, non-GAAP financial measures may have limited usefulness as an analytical tool. Therefore, the non-GAAP financial measures should not be viewed in isolation and are not a substitute for financial measures computed in accordance with GAAP.

- core earnings;
- core earnings per common share;
- annualized core return on average equity;
- core interest income;
- economic interest expense;

- economic core net interest income;
- core average yield on interest earning assets;
- core net interest margin; and
- core net interest spread

The Company's management relies on non-GAAP financial measures to evaluate the performance of the business. Further, the Company's management relies on these performance metrics, which exclude the effect of the PAA, in its consideration of dividend payments to shareholders. Given the quarter-over-quarter volatility of premium amortization cost (benefit), the Company believes that quantifying the component of premium amortization expense associated with the change in estimated long-term prepayment speeds provides investors with better visibility into the underlying performance of the business. Quantifying this component and disclosing the long-term CPR for investors on a quarterly basis eliminates the need for extrapolation and guesswork. These metrics are also useful in comparing performance versus industry peers as similar financial measures are disclosed by certain peers, and are frequently relied upon by analysts, investors and other interested parties to evaluate companies in our industry.

## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

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Economic interest expense is comprised of interest expense, as computed in accordance with GAAP, plus interest expense on interest rate swaps used to hedge cost of funds, a component of Realized gains (losses) on interest rate swaps in the Company's Consolidated Statements of Comprehensive Income (Loss). The Company uses interest rate swaps to manage its exposure to changing interest rates on its repurchase agreements by economically hedging cash flows associated with these borrowings. Presenting the contractual interest payments in interest rate swaps with the interest paid on interest-bearing liabilities reflects total contractual interest payments. This presentation depicts the economic cost of our financing strategy.

TBA dollar roll income, a component of Net gains (losses) on trading assets in the Company's Consolidated Statements of Comprehensive Income (Loss), is defined as the difference in price between two TBA contracts with the same terms but different settlement dates. Dollar roll income represents the equivalent of interest income on the underlying security less an implied cost of financing and is included in the Company's determination of core earnings.

## Core Earnings

The following table provides GAAP measures of net income (loss) and net income (loss) per basic share available to common stockholders for the quarters and six months ended June 30, 2016 and 2015 and details with respect to reconciling the aforementioned line items on a non-GAAP basis:

	For the Quarters Ended June 30,		For the Six Months Ended June 30,	
	2016	2015	2016	2015
	(dollars in thousands, except per share data)			
GAAP net income (loss)	\$(278,497)	\$900,071	\$(1,146,577)	\$423,572
Less:				
Realized (gains) losses on termination of interest rate swaps	60,064	-	60,064	226,462
Unrealized (gains) losses on interest rate swaps	373,220	(700,792)	1,404,940	(234,590)
Net (gains) losses on disposal of investments	(12,535 )	(3,833 )	(10,860 )	(66,189 )
Net (gains) losses on trading assets	(81,880 )	114,230	(207,069 )	121,136
Net unrealized (gains) losses on financial instruments measured at fair value through earnings	54,154	(17,581 )	54,026	15,965
Impairment of goodwill	-	22,966	-	22,966
Corporate acquisition related expenses <sup>(1)</sup>	2,163	-	2,163	-
Net (income) loss attributable to noncontrolling interest	385	149	547	239
Premium amortization adjustment cost (benefit)	85,583	(79,582 )	253,991	8,301

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Plus:				
TBA dollar roll income (loss) <sup>(2)</sup>	79,519	95,845	162,708	155,576
Core earnings	\$282,176	\$331,473	\$573,933	\$673,438
GAAP net income (loss) per average common share	\$(0.32	) \$0.93	\$(1.28	) \$0.41
Core earnings per common share	\$0.29	\$0.33	\$0.58	\$0.67

(1) Represents transaction costs incurred in connection with the Hatteras Acquisition.

(2) This amount is included as a component of Net gains (losses) on trading assets in the Consolidated Statements of Comprehensive Income (Loss).

Core Interest Income, Economic Interest Expense and Economic Core Net Interest Income

We believe the economic value of our investment strategy is depicted by the economic core net interest income we earn. We calculate core interest income by determining our GAAP interest income and adjusting it by the PAA. Our economic interest expense, which is composed of interest expense on our Interest Bearing Liabilities plus interest expense on interest rate swaps used to hedge cost of funds, reflects total contractual interest payments. We calculate economic core net interest income by determining our GAAP net interest income and adjusting it by the PAA and reducing it by realized losses on interest rate swaps used to hedge cost of funds, which represents interest expense on interest rate swaps.



## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

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The following table illustrates the impact of the PAA on premium amortization expense for the periods presented:

	For the Quarters Ended		For the Six Months Ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
	(dollars in thousands)			
Premium amortization expense	265,475	94,037	621,146	378,814
Less: PAA Cost (Benefit)	85,583	(79,582 )	253,991	8,301
Premium amortization expense exclusive of PAA	179,892	173,619	367,155	370,513

	For the Quarters Ended		For the Six Months Ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
	(per common share)			
Premium amortization expense	0.29	0.10	0.67	0.40
Less: PAA Cost (Benefit)	0.10	(0.08 )	0.27	0.01
Premium amortization expense exclusive of PAA	0.19	0.18	0.40	0.39

The following tables provide GAAP measures of interest income, interest expense and net interest income and details with respect to reconciling the aforementioned line items on a non-GAAP basis for each respective period:

Core Interest Income

	Total Interest Income	PAA Cost (Benefit)	Core Interest Income
	(dollars in thousands)		
Quarters Ended:			
June 30, 2016	\$457,118	\$85,583	\$542,701
June 30, 2015	\$624,277	\$(79,582 )	\$544,695
Six Months Ended:			
June 30, 2016	\$845,261	\$253,991	\$1,099,252
June 30, 2015	\$1,143,391	\$8,301	\$1,151,692

Economic Interest Expense and Economic Core Net Interest Income

GAAP Interest Expense	Add: Interest Expense on Interest Rate Swaps	Economic Interest Expense	GAAP Net Interest Income	Less: Interest Expense on Interest Rate Swaps	Economic Net Interest Income	Add: PAA Cost (Benefit)	Economic Core Net Interest Income
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	Used to Hedge Cost of Funds <sup>(1)</sup>				Used to Hedge Cost of Funds <sup>(1)</sup>			
For the Quarters Ended:	(dollars in thousands)				(dollars in thousands)			
June 30, 2016	\$ 152,755	\$ 108,301	\$ 261,056	\$ 304,363	\$ 108,301	\$ 196,062	\$ 85,583	\$ 281,645
June 30, 2015	\$ 113,072	\$ 139,773	\$ 252,845	\$ 511,205	\$ 139,773	\$ 371,432	\$ (79,582 )	\$ 291,850
Six Months Ended:								
June 30, 2016	\$ 300,202	\$ 231,425	\$ 531,627	\$ 545,059	\$ 231,425	\$ 313,634	\$ 253,991	\$ 567,625
June 30, 2015	\$ 242,492	\$ 297,105	\$ 539,597	\$ 900,899	\$ 297,105	\$ 603,794	\$ 8,301	\$ 612,095

(1) A component of realized gains (losses) on interest rate swaps on the Consolidated Statements of Comprehensive Income (Loss).

#### Experienced and Projected Long-term CPR

Prepayment speeds, as reflected by the Constant Prepayment Rate, or CPR, and interest rates vary according to the type of investment, conditions in financial markets, competition and other factors, none of which can be predicted with any certainty. In general, as prepayment speeds and expectations of prepayment speeds on our Agency mortgage-backed securities portfolio increase, related premium amortization increases, thereby reducing the yield on such assets. The following table presents the weighted average experienced CPR and weighted average projected long-term CPR on our Agency mortgage-backed securities portfolio as of or for the periods presented.

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Quarters Ended	Experienced CPR <sup>(1)</sup>	Projected Long-term CPR <sup>(2)</sup>
June 30, 2016	12.7%	13.0%
June 30, 2015	12.1%	7.7%

Six Months Ended	Experienced CPR <sup>(1)</sup>	Projected Long-term CPR <sup>(2)</sup>
June 30, 2016	10.8%	13.0%
June 30, 2015	10.5%	7.7%

<sup>(1)</sup> For the quarters and six months ended June 30, 2016 and 2015, respectively.

<sup>(2)</sup> As of June 30, 2016 and 2015, respectively.

## Core Interest Income and Core Average Yield on Interest Earning Assets

We had average Interest Earning Assets of \$73.6 billion and \$75.3 billion, and the core average yield on Interest Earning Assets was 2.95% and 2.90% for the quarters ended June 30, 2016 and 2015, respectively.

We had average Interest Earning Assets of \$73.9 billion and \$78.6 billion, and the core average yield on Interest Earning Assets was 2.98% and 2.93% for the six months ended June 30, 2016 and 2015, respectively.

Core interest income was \$542.7 million for the quarter ended June 30, 2016, a decrease of \$2.0 million compared to \$544.7 million for the same period in 2015. Core interest income was \$1.1 billion for the six months ended June 30, 2016, a decrease of \$52.4 million compared to \$1.2 billion for the same period in 2015. The change in each period was primarily due to a reduction in core interest income earned on lower Residential Investment Securities balances, partially offset by increased interest income on a larger commercial investment portfolio.

## Economic Interest Expense and the Average Cost of Interest Bearing Liabilities

Typically, our largest expense is the cost of Interest Bearing Liabilities and interest expense on interest rate swaps, which is recorded in realized gains (losses) on interest rate swaps on the Consolidated Statements of Comprehensive Income (Loss). The table below shows our average Interest Bearing Liabilities and average cost of Interest Bearing Liabilities as compared to average one-month and average six-month LIBOR for the periods presented.

Cost of Funds on Average Interest Bearing Liabilities

							Average Cost of Interest Bearing Liabilities	Average Cost of Interest Bearing Liabilities
			Average Cost of Interest Bearing Liabilities	Average One-Month LIBOR	Average Six-Month LIBOR	Average Six-Month LIBOR	Relative to Average One-Month LIBOR	Relative to Average Six-Month LIBOR
Average Interest Bearing Liabilities	Interest Bearing Liabilities at Period End	Economic Interest Expense <sup>(1)</sup>	Interest Bearing Liabilities	One-Month LIBOR	Six-Month LIBOR	Six-Month LIBOR	Relative to Average One-Month LIBOR	Relative to Average Six-Month LIBOR

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For the Quarters Ended:	(dollars in thousands)										
June 30, 2016	\$62,049,474	\$61,218,079	\$261,056	1.68 %	0.44 %	0.92 %	(0.48 %)	1.24 %	0.76 %		
June 30, 2015	\$63,504,983	\$60,287,216	\$252,845	1.59 %	0.18 %	0.42 %	(0.24 %)	1.41 %	1.17 %		
For the Six Months Ended:											
June 30, 2016	\$62,214,585	\$61,218,079	\$531,627	1.71 %	0.44 %	0.90 %	(0.46 %)	1.27 %	0.81 %		
June 30, 2015	\$66,821,183	\$60,287,216	\$539,597	1.62 %	0.18 %	0.40 %	(0.22 %)	1.44 %	1.22 %		

(1) Economic interest expense includes interest expense on interest rate swaps used to hedge cost of funds.

Economic interest expense for the quarter ended June 30, 2016 increased by \$8.2 million compared to the same period in 2015, primarily due to higher funding costs on Interest Bearing Liabilities partially offset by lower interest expense on interest rate swaps used to hedge cost of funds.

Economic interest expense for the six months ended June 30, 2016 decreased by \$8.0 million compared to the same period in 2015, primarily due to lower interest expense on interest rate swaps used to hedge cost of funds partially offset by higher funding costs on Interest Bearing Liabilities.

We do not manage our portfolio to have a pre-designated amount of borrowings at quarter or year end. Our borrowings at period end are a snapshot of our borrowings as of a date, and this number should be expected to differ from average borrowings over the period for a number of reasons. The mortgage-backed securities we own pay principal and interest towards the end of each month and the mortgage-backed securities

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we purchase are typically settled during the beginning of the month. As a result, depending on the amount of mortgage-backed securities we have committed to purchase, we may retain the principal and interest we receive in the prior month, or we may use it to pay down our borrowings. Moreover, we generally use interest rate swaps, swaptions and other derivative instruments to hedge our portfolio, and as we pledge or receive collateral under these agreements, our borrowings on any given day may be increased or decreased. Our average borrowings during a quarter will differ from period end borrowings as we implement our portfolio management strategies and risk management strategies over changing market conditions by increasing or decreasing leverage. Additionally, these numbers will differ during periods when we conduct capital raises, as in certain instances we may purchase additional assets and increase leverage with the expectation of a successful capital raise. Since our average borrowings and period end borrowings can be expected to differ, we believe our average borrowings during a period provide a more accurate representation of our exposure to the risks associated with leverage.

As of June 30, 2016 and December 31, 2015, 93% and 95%, respectively, of our debt represents repurchase agreements and other secured financing arrangements collateralized by a pledge of our Residential Investment Securities and commercial real estate debt investments. All of our Residential Investment Securities are currently accepted as collateral for these borrowings. However, we limit our borrowings, and thus our potential asset growth, in order to maintain unused borrowing capacity and thus increase the liquidity and strength of our balance sheet. As of June 30, 2016, the term to maturity of some of our repurchase agreements extends beyond two years, reflecting our laddered approach.

## Economic Core Net Interest Income

The table below shows our average Interest Earning Assets, core interest income, core average yield on Interest Earning Assets, average Interest Bearing Liabilities, economic interest expense, average cost of Interest Bearing Liabilities, economic core net interest income, core net interest spread and core net interest margin for the periods presented.

Economic Core Net Interest Income

	Average Interest Earning Assets <sup>(1)</sup>	Core Interest Income <sup>(2)</sup>	Core Average Yield on Interest Earning Assets <sup>(2)</sup>	Average Interest Bearing Liabilities	Economic Interest Expense <sup>(3)</sup>	Average Cost of Interest Bearing Liabilities	Economic Core Net Interest Income <sup>(2)</sup> <sup>(3)</sup>	Core Net Interest Spread <sup>(2)</sup>	Core Net Interest Margin <sup>(4)</sup>
For the Quarters Ended:	(dollars in thousands)								
June 30, 2016	\$73,587,753	\$542,701	2.95 %	\$62,049,474	\$261,056	1.68 %	\$281,645	1.27 %	1.54 %
June 30, 2015	\$75,257,299	\$544,695	2.90 %	\$63,504,983	\$252,845	1.59 %	\$291,850	1.31 %	1.70 %
For the Six Months									

Ended:

June 30, 2016	\$73,879,848	\$1,099,252	2.98 %	\$62,214,585	\$531,627	1.71 %	\$567,625	1.27 %	1.54 %
June 30, 2015	\$78,576,777	\$1,151,692	2.93 %	\$66,821,183	\$539,597	1.62 %	\$612,095	1.31 %	1.69 %

(1) Does not reflect unrealized gains/(losses).

(2) Adjusted by the PAA.

(3) Economic interest expense and economic core net interest income is net of interest expense on interest rate swaps used to hedge cost of funds.

(4) Represents the sum of annualized economic core net interest income, inclusive of interest expense on interest rate swaps used to hedge costs of funds, plus TBA dollar roll income less interest expense on interest rate swaps used to hedge dollar roll transactions divided by the sum of average Interest Earning Assets plus average outstanding TBA contract balances.

#### Realized and Unrealized Gains (Losses)

Realized and unrealized gains (losses) is comprised of net gains (losses) on interest rate swaps, net gains (losses) on disposal of investments, net gains (losses) on

trading assets and net unrealized gains (losses) on financial instruments measured at fair value through earnings.

These components of realized and unrealized gains (losses) for the quarters and six months ended June 30, 2016 and 2015 were as follows:

## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

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	For the Quarters		For the Six Months	
	Ended,		Ended,	
	June 30,	June 30,	June 30,	June 30,
	2016	2015	2016	2015
	(dollars in thousands)			
Net gains (losses) on interest rate swaps <sup>(1)</sup>	\$ (564,046)	\$ 556,327	\$ (1,743,241)	\$ (294,576)
Net gains (losses) on disposal of investments	12,535	3,833	10,860	66,189
Net gains (losses) on trading assets	81,880	(114,230)	207,069	(121,136)
Net unrealized gains (losses) on financial instruments measured at fair value through earnings	(54,154 )	17,581	(54,026 )	(15,965 )
Impairment of goodwill	-	(22,966 )	-	(22,966 )
Total	\$ (523,785)	\$ 440,545	\$ (1,579,338)	\$ (388,454)

(1) Includes realized gains (losses) on interest rate swaps, realized gains (losses) on termination of interest rate swaps and unrealized gains (losses) on interest rate swaps.

For the Quarters End June 30, 2016 and 2015

Net gains (losses) on interest rate swaps for the quarter ended June 30, 2016 was (\$564.0) million compared to \$556.3 million for the same period in 2015. Unrealized gains (losses) on interest rate swaps for the quarter ended June 30, 2016 was (\$373.2) million compared to \$700.8 million for the same period in 2015, reflecting an unfavorable change in the fair value of interest rate swaps due to lower forward interest rates for the quarter ended June 30, 2016 compared to the same period in 2015.

During the quarter ended June 30, 2016, we disposed of Residential Investment Securities with a carrying value of \$1.8 billion for an aggregate net gain of \$11.9 million. For the same period in 2015, we disposed of Residential Investment Securities with a carrying value of \$2.5 billion for an aggregate net gain of \$3.9 million.

Net gains (losses) on trading assets were \$81.9 million for the quarter ended June 30, 2016 compared to (\$114.2) million for the same period in 2015. Net gains (losses) on TBA derivatives was \$159.1 million for the quarter ended June 30, 2016 compared with (\$157.8) million for the same period in 2015. Net gains (losses) on futures contracts was (\$77.3) million for the quarter ended June 30, 2016 compared with \$44.1 million for the same period in 2015.

Net unrealized gains (losses) on financial instruments measured at fair value through earnings was (\$54.2) million for the quarter ended June 30, 2016 compared to \$17.6 million for the same period in 2015. The change was primarily attributable to unfavorable valuations on interest-only mortgage-backed securities and certain commercial mortgage-backed securities for the quarter ended June 30, 2016 compared to the same period in 2015.

For the Six Months End June 30, 2016 and 2015

Net losses on interest rate swaps increased by \$1.4 billion for the six months ended June 30, 2016 compared to the same period in 2015, primarily attributable to the change in unrealized gains (losses) on interest rate swaps which was (\$1.4) billion for the six months ended June 30, 2016 compared to \$234.6 million for the same period in 2015, partially offset by a \$166.4 million decrease in realized losses on termination of interest swaps for the six months ended June 30, 2016 compared to the same period in 2015.

During the six months ended June 30, 2016, we disposed of Residential Investment Securities with a carrying value of \$5.2 billion for an aggregate net gain of \$10.3 million. For the same period in 2015, we disposed of Investment Securities with a carrying value of \$17.4 billion for an aggregate net gain of \$66.3 million.

Net gains (losses) on trading assets were \$207.1 million for the six months ended June 30, 2016 compared to (\$121.1) million for the same period in 2015. Net gains (losses) on TBA derivatives was \$463.4 million for the six months

ended June 30, 2016 compared with (\$96.2) million for the same period in 2015. In addition, net losses on futures contracts increased \$236.9 million to (\$256.4) million for the six months ended June 30, 2016 compared with the same period in 2015.

Net unrealized gains (losses) on financial instruments measured at fair value through earnings was (\$54.0) million for the six months ended June 30, 2016 compared to (\$16.0) million for the same period in 2015. The change was primarily attributable to higher losses on interest-only mortgage-backed securities.

#### Other Income (Loss)

We report in “Other income (loss)” items that are non-recurring in nature or whose amounts, either individually or in the aggregate, would not, in the opinion of management, be meaningful to readers of the financial statements. The composition of this line item consists of non-recurring revenues and expenses and certain revenues and costs associated with our investments in commercial real estate, including rental income and recoveries, operating and transaction costs as well as depreciation and amortization expense. Given the non-routine nature of certain components of this line item, balances may fluctuate from period to period.



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## General and Administrative Expenses

General and administrative (or G&A) expenses consists of compensation expense, the management fee and other expenses.

The table below shows our total G&A expenses as compared to average total assets and average equity for the periods presented.

G&A Expenses and Operating Expense Ratios

	Total G&A Expenses (1)	Total G&A Expenses/Average Assets (1)		Total G&A Expenses/Average Equity (1)	
For the Quarters Ended:	(dollars in thousands)				
June 30, 2016	\$49,221	0.25	%	1.70	%
June 30, 2015	\$52,009	0.27	%	1.62	%
For the Six Months Ended:					
June 30, 2016	\$97,166	0.25	%	1.66	%
June 30, 2015	\$102,947	0.25	%	1.58	%

(1) Includes \$2.2 million in Hatteras Acquisition related expenses.

G&A expenses decreased \$2.8 million to \$49.2 million for the quarter ended June 30, 2016 compared to the same period in 2015. G&A expenses decreased \$5.8 million to \$97.2 million for the six months ended June 30, 2016 compared to the same period in 2015. The change in each period was due to lower compensation and management fee, reflecting a decline in adjusted stockholders' equity, and lower other general and administrative expenses, primarily attributable to decreases in professional fees partially offset by higher technology related expenses.

## Unrealized Gains and Losses

With our available-for-sale accounting treatment on our Agency mortgage-backed securities, which represent the largest portion of assets on our balance sheet, unrealized fluctuations in market values of assets do not impact our GAAP or taxable income but rather are reflected on our balance sheet by changing the carrying value of the asset and stockholders' equity under Accumulated Other Comprehensive Income (Loss). As a result of this fair value accounting treatment, our book value and book value per share are likely to fluctuate far more than if we used amortized cost accounting. As a result, comparisons with companies that use amortized cost accounting for some or all of their balance sheet may not be meaningful.

The table below shows cumulative unrealized gains and losses on our available-for-sale investments reflected in the Consolidated Statements of Financial Condition.

	June 30, 2016	December 31, 2015
	(dollars in thousands)	
Unrealized gain	\$1,172,589	\$480,336
Unrealized loss	(55,543)	(857,932)
Net unrealized gain (loss)	\$1,117,046	\$(377,596)

Unrealized changes in the estimated fair value of available-for-sale investments may have a direct effect on our potential earnings and dividends: positive changes will increase our equity base and allow us to increase our borrowing capacity while negative changes tend to reduce borrowing capacity under our investment policy. A very large negative change in the net fair value of our available-for-sale residential investment securities might impair our liquidity position, requiring us to sell assets with the likely result of realized losses upon sale.

The fair value of these securities being less than amortized cost as of June 30, 2016 is solely due to market conditions and not the quality of the assets. Substantially all of the Agency mortgage-backed securities and debentures are “AAA” rated or carry an implied “AAA” rating. The investments are not considered to be other-than-temporarily impaired because we currently have the ability and intent to hold the investments to maturity or for a period of time sufficient for a forecasted market price recovery up to or

## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

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beyond the cost of the investments, and it is not more likely than not that we will be required to sell the investments before recovery of the amortized cost bases, which may be maturity. Also, we are guaranteed payment of the principal amount of the securities by the respective issuing Agency.

## Return on Average Equity

Our return (loss) on average equity was (9.60%) and 28.00% for the quarters ended June 30, 2016 and 2015, respectively. Our return (loss) on average equity was (19.59%) and 6.51% for the six months ended June 30, 2016 and 2015, respectively.

The table below shows the components of our return on average equity for the periods presented.

Components of Return on Average Equity

	Economic Net Interest Income/ Average Equity <sup>(1)</sup>		Realized and Unrealized Gains and Losses/Average Equity <sup>(2)</sup>		Other Income (Loss)/Average Equity <sup>(3)</sup>		G&A Expenses/ Average Equity		Income Taxes/ Average Equity		Return on Average Equity
For the Quarters Ended:											
June 30, 2016	6.75	%	(14.31	%)	(0.34	%)	(1.70	%)	0.00	%	(9.60 %)
June 30, 2015	11.56	%	18.20	%	(0.38	%)	(1.62	%)	0.24	%	28.00 %
For the Six Months Ended:											
June 30, 2016	5.36	%	(23.04	%)	(0.27	%)	(1.66	%)	0.02	%	(19.59 %)
June 30, 2015	9.26	%	(1.31	%)	0.02	%	(1.58	%)	0.12	%	6.51 %

(1) Economic net interest income includes interest expense on interest rate swaps used to hedge cost of funds.

(2) Realized and unrealized gains and losses excludes interest expense on interest rate swaps used to hedge cost of funds.

(3) Other income (loss) includes investment advisory income, dividend income from affiliate, and other income (loss).

## Financial Condition

Total assets were \$77.7 billion and \$75.2 billion as of June 30, 2016 and December 31, 2015, respectively. The change was primarily due to a \$1.5 billion increase in commercial real estate debt investments, which includes assets held in consolidated VIEs, a \$966.0 million increase in cash and cash equivalents and a \$290.8 million increase in non-Agency mortgage-backed securities, partially offset by an \$855.2 million decrease in Agency mortgage-backed securities and \$152.0 million decrease in Agency debentures.

Our portfolio composition, net equity allocation and debt-to-net equity ratio by asset class was as follows as of June 30, 2016:

Residential

Commercial

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	Agency MBS	TBAs	CRTs	Non-Agency MBS	CRE Debt & Preferred Equity Investments	Loans Held for Sale	Investments in CRE	Corporat Debt
(dollars in thousands)								
Assets:								
Fair Value/Carrying Value	\$64,862,992	\$13,383,501	\$520,321	\$1,197,549	\$5,499,943	\$164,175	\$504,605	\$669,612
Debt:								
Repurchase agreements	52,778,843	12,739,000	123,760	660,915	304,867	-	-	-
Other secured financing	3,023,733	-	-	188,164	376,429	-	-	-
Securitized debt	-	-	-	-	3,748,289	-	-	-
Participation sold	-	-	-	-	13,079	-	-	-
Mortgages payable	-	-	-	-	-	-	327,643	-
Net Equity Allocated	\$9,060,416	\$644,501	\$396,561	\$348,470	\$1,057,279	\$164,175	\$176,962	\$669,612
Net Equity Allocated (%)	76	% 5	% 3	% 3	% 10	% 1	% 1	% 6
Debt/Net Equity Ratio	6.2:1	19.8:1	0.3:1	2.4:1	4.2:1	0.0:1	1.9:1	0.0:1

(1) Excludes the TBA asset and debt balances.

(2) Net Equity Allocated, as disclosed in the above table, excludes non-portfolio related activity and may differ from stockholders' equity per the Consolidated Statements of Financial Condition.

(3) Represents the debt/net equity ratio as determined using amounts on the Consolidated Statements of Financial Condition.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

Item 2. Management's Discussion and Analysis

Residential Investment Securities

Substantially all of our Agency mortgage-backed securities at June 30, 2016 and December 31, 2015 were backed by single-family mortgage loans. Substantially all of the mortgage assets underlying these mortgage-backed securities were secured with a first lien position on the underlying single-family properties. Our mortgage-backed securities were largely Freddie Mac, Fannie Mae or Ginnie Mae pass-through certificates or CMOs, which carry an actual or implied "AAA" rating. We carry all of our Agency mortgage-backed securities at fair value on the Consolidated Statements of Financial Condition.

We accrete discount balances as an increase to interest income over the expected life of the related Interest Earning Assets and we amortize premium balances as a decrease to interest income over the expected life of the related Interest Earning Assets. At June 30, 2016 and December 31, 2015 we had on our Consolidated Statements of Financial Condition a total of \$113.0 million and \$61.6 million, respectively, of unamortized discount (which is the difference between the remaining principal value and current amortized cost of our Residential Investment Securities acquired at a price below principal value) and a total of \$4.7 billion and \$5.0 billion, respectively, of unamortized premium (which is the difference between the remaining principal value and the current amortized cost of our Residential Investment Securities acquired at a price above principal value).

We received mortgage principal repayments from Residential Investment Securities of \$2.7 billion for each of the quarters ended June 30, 2016 and 2015. The weighted average experienced prepayment speed for the quarters ended June 30, 2016 and 2015 was 12.7% and 12.1%, respectively. The weighted average projected long-term prepayment speed on our Agency mortgage-backed securities portfolio for the quarters ended June 30, 2016 and 2015 was 13.0% and 7.7%, respectively. Given our current portfolio composition, if mortgage principal prepayment rates were to increase over the life of our mortgage-backed securities, all other factors being equal, our net interest income would decrease during the life of these mortgage-backed securities as we would be required to amortize our net premium balance into income over a shorter time period. Similarly, if mortgage principal prepayment rates were to decrease over the life of our mortgage-backed securities, all other factors being equal, our net interest income would increase during the life of these mortgage-backed securities as we would amortize our net premium balance over a longer time period.

The table below summarizes certain characteristics of our Residential Investment Securities (excluding interest-only mortgage-backed securities) and interest-only mortgage-backed securities as of the dates presented.

## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

## Item 2. Management's Discussion and Analysis

	June 30, 2016		December 31, 2015	
	(dollars in thousands)			
Residential Investment Securities: <sup>(1)</sup>				
Principal Amount	\$61,001,905		\$62,764,045	
Net Premium	3,036,794		3,301,510	
Amortized Cost	64,038,699		66,065,555	
Amortized Cost/Principal Amount	104.98	%	105.26	%
Carrying Value	65,184,949		65,680,037	
Carrying Value / Principal Amount	106.86	%	104.65	%
Weighted Average Coupon Rate	3.70	%	3.68	%
Weighted Average Yield	2.70	%	2.82	%
Adjustable-Rate Residential Investment Securities: <sup>(1)</sup>				
Principal Amount	\$4,592,639		\$3,623,673	
Weighted Average Coupon Rate	3.26	%	3.06	%
Weighted Average Yield	3.24	%	2.90	%
Weighted Average Term to Next Adjustment	57 Months		57 Months	
Weighted Average Lifetime Cap <sup>(2)</sup>	8.97	%	9.15	%
Principal Amount at Period End as % of Total Residential Investment Securities	7.53	%	5.77	%
Fixed-Rate Residential Investment Securities: <sup>(1)</sup>				
Principal Amount	\$56,409,266		\$59,140,372	
Weighted Average Coupon Rate	3.73	%	3.72	%
Weighted Average Yield	2.66	%	2.82	%
Principal Amount at Period End as % of Total Residential Investment Securities	92.47	%	94.23	%
Interest-Only Residential Investment Securities:				
Notional Amount	\$10,081,951		\$10,310,577	
Net Premium	1,589,754		1,649,742	
Amortized Cost	1,589,754		1,649,742	
Amortized Cost/Notional Amount	15.77	%	16.00	%
Carrying Value	1,395,913		1,553,457	
Carrying Value/Notional Amount	13.85	%	15.07	%
Weighted Average Coupon Rate	3.89	%	3.97	%
Weighted Average Yield	5.13	%	8.89	%

(1) Excludes interest-only mortgage-backed securities.

(2) Excludes non-Agency mortgage-backed securities and CRT securities as this attribute is not applicable to these asset classes.

The tables below summarize certain characteristics of our residential credit portfolio as of June 30, 2016.

## By Sector Product

Product	Market Value	Coupon	Credit Enhancement	60+ Delinquencies	3M VPR <sup>(1)</sup>
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(dollars in thousands)

Alt-A	\$167,918	4.25	%	6.80	%	9.45	%	6.89	%
Prime	213,906	4.43	%	1.22	%	1.80	%	1.97	%
Subprime	229,931	1.95	%	20.40	%	17.36	%	3.17	%
Prime Jumbo (>=2010 Vintage)	199,378	3.49	%	15.37	%	-		22.10	%
Prime Jumbo (>=2010 Vintage) Interest Only	11,792	0.39	%	-		-		19.33	%
Re-Performing Loan Securitizations	66,024	3.82	%	46.62	%	9.82	%	2.95	%
Agency Credit Risk Transfer	468,721	4.39	%	1.25	%	0.11	%	15.68	%
Private Label Credit Risk Transfer	51,600	5.98	%	7.11	%	0.02	%	3.46	%
Non-Performing Loan Securitizations	308,600	4.08	%	51.14	%	63.38	%	0.89	%
Total/Weighted Average	\$1,717,870	2.62	%	10.59	%	9.62	%	12.36	%

(1) Represents the 3 month voluntary prepayment rate (or VPR).

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## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

## Item 2. Management's Discussion and Analysis

## Market Value By Sector and Payment Structure

Product (dollars in thousands)	Senior	Subordinate	Total
Alt-A	\$83,890	\$ 84,028	\$167,918
Prime	37,156	176,750	213,906
Subprime	132,374	97,557	229,931
Prime Jumbo (>=2010 Vintage)	194,751	4,627	199,378
Prime Jumbo (>=2010 Vintage) Interest Only	11,792	-	11,792
Re-Performing Loan Securitizations	66,024	-	66,024
Agency Credit Risk Transfer	-	468,721	468,721
Private Label Credit Risk Transfer	-	51,600	51,600
Non-Performing Loan Securitizations	305,115	3,485	308,600
Total/Weighted Average	\$831,102	\$ 886,768	\$1,717,870

## Market Value By Sector and Bond Coupon

Product (dollars in thousands)	ARM	Fixed	Floater	Interest Only	Total
Alt-A	\$19,367	\$ 94,453	\$54,098	\$-	\$167,918
Prime	106,629	107,277	-	-	213,906
Subprime	-	45,332	184,599	-	229,931
Prime Jumbo (>=2010 Vintage)	-	199,378	-	-	199,378
Prime Jumbo (>=2010 Vintage) Interest Only	-	-	-	11,792	11,792
Re-Performing Loan Securitizations	-	66,024	-	-	66,024
Agency Credit Risk Transfer	-	-	468,721	-	468,721
Private Label Credit Risk Transfer	-	-	51,600	-	51,600
Non-Performing Loan Securitizations	-	308,600	-	-	308,600
Total	\$125,996	\$ 821,064	\$759,018	\$11,792	\$1,717,870

## Contractual Obligations

The following table summarizes the effect on our liquidity and cash flows from contractual obligations as of June 30, 2016. The table does not include the effect

of net interest rate payments on our interest rate swap agreements. The net swap payments will fluctuate based on monthly changes in the receive rate. As of June 30, 2016, the interest rate swaps had a net fair value of (\$3.1) billion.

	Within One Year	One to Three Years	Three to Five Years	More than Five Years	Total
	(dollars in thousands)				
Repurchase agreements	\$48,768,518	\$5,099,867	\$-	\$-	\$53,868,385
Interest expense on repurchase agreements <sup>(1)</sup>	211,088	49,002	-	-	260,090
Other secured financing	-	-	3,588,326	-	3,588,326
Interest expense on other secured financing <sup>(1)</sup>	21,922	43,843	32,893	-	98,658
Securitized debt of consolidated VIEs (principal)	59,319	-	-	3,695,323	3,754,642



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Mortgages payable (principal)	18,546	12,350	-	300,150	331,046
Participation sold (principal)	12,985	-	-	-	12,985
Long-term operating lease obligations	3,267	7,129	7,340	16,736	34,472
Total	\$49,095,645	\$5,212,191	\$3,628,559	\$4,012,209	\$61,948,604

(1) Interest expense on repurchase agreements and other secured financing calculated based on rates at June 30, 2016.

In the coming periods, we expect to continue to finance our Residential Investment Securities in a manner that is largely consistent with our current operations. We may use FHLB Des Moines advances, securitization structures, mortgages payable or other term financing structures to finance certain of our assets. During the six months ended June 30, 2016, we received \$4.6 billion from principal repayments and \$4.0 billion in cash from disposal of Residential Investment Securities, respectively. During the six months ended June 30, 2015, we received \$5.3 billion from principal repayments and \$18.3 billion in cash from disposal of Residential Investment Securities.

#### Off-Balance Sheet Arrangements

We do not have any relationships with unconsolidated entities or financial partnerships which would have been established for the sole purpose of facilitating off-balance sheet arrangements, or other contractually narrow or limited purposes.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

Item 2. Management's Discussion and Analysis

The Company has limited future funding commitments related to certain of its unconsolidated joint ventures. In addition, the Company has provided customary non-recourse carve-out and environmental guarantees (or underlying indemnities with respect thereto) with respect to mortgage loans held by subsidiaries of these unconsolidated joint ventures. The Company believes that the likelihood of making any payments under these guarantees is remote, and has not accrued a related liability as of June 30, 2016.

Capital Management

Maintaining a strong balance sheet that can support the business even in times of economic stress and market volatility is of critical importance to our business strategy. A strong and robust capital position is essential to executing our investment strategy. Our capital strategy is predicated on a strong capital position, which enables us to execute our investment strategy regardless of the market environment.

Our Internal Capital Adequacy Assessment Program (or ICAAP) supports capital and business performance measurement, and is integrated within the overall risk governance framework. The ICAAP framework is designed to align capital measurement with our risk appetite.

Our objective is to maintain an active ICAAP that reflects sound governance, requires active assessment and reporting of internal capital adequacy, incorporates stress testing based on internal and external factors and identifies potential capital actions to ensure our capital and available financial resources remain in excess of internal capital requirements.

The capital policy defines the parameters and principles supporting a comprehensive capital management practice, including processes that effectively identify, measure and monitor risks impacting capital adequacy. The capital assessment process considers the precision in risk measures as well as the volatility of exposures and the relative activities producing risk. Parameters used in modeling economic capital must align with our risk appetite. Economic capital is our internal quantification of the risks inherent in our business and considers the amount of capital we need as a buffer to protect against risks. It is considered the capital needed to remain solvent over a one-year period under extreme scenarios.

The major risks impacting capital applicable to us are liquidity, investment/market, credit, counterparty, operational. For further discussion of the risks we are subject to, please see Part I, Item 1A. "Risk Factors" in our most recent Annual Report on Form 10-K and Item 1A. "Risk Factors" in this quarterly report on Form 10-Q.

Capital requirements are based on maintaining levels above approved limits, ensuring the quality of our capital appropriately reflects our asset mix, market and funding structure. As such we use a complement of capital metrics and related threshold levels to measure and analyze our capital from a magnitude and composition perspective. Our policy is to maintain an appropriate amount of available financial resources over the aggregate economic capital requirements.

Available Financial Resources (or AFR) is the actual capital held to protect against the unexpected losses measured in our capital management process and may include:

- § Common and preferred equity
- § Other forms of equity-like capital
- § Surplus credit reserves over expected losses
- § Other loss absorption instruments

In the event we fall short of our internal limits, we will consider appropriate actions which may include asset sales, changes in asset mix, reductions in asset purchases or originations, issuance of capital or other capital enhancing or risk reduction strategies.

Stockholders' Equity

The following table provides a summary of total stockholders' equity as of June 30, 2016 and December 31, 2015:

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## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

## Item 2. Management's Discussion and Analysis

	June 30, 2016	December 31, 2015
Stockholders' Equity:	(dollars in thousands)	
7.875% Series A Cumulative Redeemable Preferred Stock	\$177,088	\$177,088
7.625% Series C Cumulative Redeemable Preferred Stock	290,514	290,514
7.50% Series D Cumulative Redeemable Preferred Stock	445,457	445,457
Common stock	9,249	9,359
Additional paid-in capital	14,575,426	14,675,768
Accumulated other comprehensive income (loss)	1,117,046	(377,596 )
Accumulated deficit	(5,061,565 )	(3,324,616 )
Total stockholders' equity	\$11,553,215	\$11,895,974

## Common and Preferred Stock

The following table provides a summary of option and direct purchase activity for the periods presented:

	Options Exercised Price	Aggregate Exercise Price	Shares Issued Through Direct Purchase	Amount Raised from Direct Purchase and Dividend Reinvestment Program
For the Six Months Ended:	(dollars in thousands)			
June 30, 2016	-	\$ -	116,000	\$ 1,176
June 30, 2015	-	\$ -	111,000	\$ 1,146

In August 2015, our Board authorized the repurchase of up to \$1.0 billion of our outstanding common shares through December 31, 2016. During the six months ended June 30, 2016, we repurchased 11,132,226 shares of our common stock under this repurchase program for an aggregate amount of \$102.7 million.

In March 2012, we entered into six separate Distribution Agency Agreements (or Distribution Agency Agreements) with each of Merrill Lynch; Pierce, Fenner & Smith Incorporated; Credit Suisse Securities (USA) LLC; Goldman, Sachs & Co.; J.P. Morgan Securities LLC; Morgan Stanley & Co. LLC; and RCap (together, the Agents). Pursuant to the terms of the Distribution Agency Agreements, we may sell from time to time through the Agents, as our sales agents, up to 125,000,000 shares of our common stock. We did not make any sales under the Distribution Agency Agreements during the six months ended June 30, 2016 or 2015.

## Leverage and Capital

We believe that it is prudent to maintain conservative debt-to-equity and economic leverage ratios as there continues to be volatility in the mortgage and credit markets. Our capital policy governs our capital and leverage position including setting limits. Based on the guidelines, we will maintain an economic leverage ratio of less than 10:1. Our actual economic leverage ratio varies from time to time based upon various factors, including our management's opinion of the level of risk of our assets and liabilities, our liquidity position, our level of unused borrowing capacity, the availability of credit, over-collateralization levels required by lenders when we pledge assets to secure borrowings

and our assessment of domestic and international market conditions.

Our debt-to-equity ratio at June 30, 2016 and December 31, 2015 was 5.3:1 and 5.1:1, respectively. Our economic leverage ratio, which is computed as the sum of recourse debt, TBA derivative notional outstanding and net forward purchases of investments divided by total equity, at June 30, 2016 and December 31, 2015 was 6.1:1 and 6.0:1, respectively. Our capital ratio, which represents our ratio of stockholders' equity to total assets (inclusive of total market value of TBA derivatives and exclusive of consolidated VIEs associated with B-Piece commercial mortgage-backed securities), was 13.2% and 13.7% at June 30, 2016 and December 31, 2015, respectively.

#### Risk Management

We are subject to a variety of risks in the ordinary conduct of our business. The effective management of these risks is of critical importance to the overall success of Annaly. The objective of our risk management framework is to measure, monitor and manage these risks. Our risk management framework is intended to facilitate a holistic, enterprise wide view of risk. We have built a strong and collaborative risk culture throughout Annaly focused on awareness which ensures the key risks are understood and managed appropriately. Each employee of our Manager is accountable for monitoring and managing risk within their area of responsibility.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

Item 2. Management’s Discussion and Analysis

Risk Appetite

We maintain a firm-wide risk appetite statement which defines the types and levels of risk we are willing to take in order to achieve our business objectives, and reflects our risk management philosophy. Fundamentally, we will only engage in risk activities based on our core expertise that enhance value for our stockholders. Our activities focus on capital preservation and income generation through proactive portfolio management, supported by a conservative liquidity and leverage posture.

The risk appetite statement includes the following key parameters to guide our risk management activities:

Portfolio Composition	We will maintain a portfolio comprised of target assets approved by our Board and in accordance with our capital allocation policy.
Leverage	We will operate at an economic leverage ratio no greater than 10:1.
Liquidity Risk	We will seek to maintain an unencumbered asset portfolio sufficient to meet our liquidity needs under adverse market conditions.
Interest Rate Risk	We will seek to manage interest rate risk to protect the portfolio from adverse rate movements utilizing derivative instruments targeting both income and capital preservation.
Credit Risk	We will seek to manage credit risk by making investments which conform within our specific investment policy parameters and optimize risk-adjusted returns.
Capital Preservation	We will seek to protect our capital base through disciplined risk management practices.
Compliance	We will comply with regulatory requirements needed to maintain our REIT status and our exemption from registration under the Investment Company Act.

Governance

Risk management begins with our board of directors, through the review and oversight of the risk management framework, and executive management, through the ongoing formulation of risk management practices and related execution in managing risk. The board of directors exercises its oversight of risk management primarily through the Board Risk Committee (or BRC) and Board Audit Committee (or BAC). The BRC is responsible for oversight of our risk governance structure, risk management and risk assessment guidelines and policies, our risk appetite and our capital, liquidity and funding practices. The BAC is responsible for oversight of the quality and integrity of our accounting, internal controls and financial reporting practices, including independent auditor selection, evaluation and review, and oversight of the internal audit function.

Risk assessment and risk management are the responsibility of our management. A series of management committees have oversight or decision-making responsibilities for risk management activities. Membership of these committees is reviewed regularly to ensure the appropriate personnel are engaged in the risk management process. Four primary management committees have been established to provide a comprehensive framework for risk management. The management committees responsible for our risk management include the Enterprise Risk Committee, Asset and Liability Committee, Investment Committee and the Financial Reporting and Disclosure Committee. Each of these committees reports to our management Operating Committee which is responsible for oversight and management of our operations including oversight and approval authority over all aspects of our enterprise risk management.

Audit Services is an independent function with reporting lines to the BAC. Audit Services is responsible for performing our internal audit activities, which includes independently assessing and validating key controls within the risk management framework.

#### Description of Risks

We are subject to a variety of risks due to the business we operate. Risk categories are an important component of a robust enterprise wide risk management framework. We have identified the following primary categories that we utilize to identify, assess, measure and monitor risk.

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## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

## Item 2. Management's Discussion and Analysis

Risk	Description
Liquidity Risk	Risk to earnings, capital or business arising from our inability to meet our obligations when they come due without incurring unacceptable losses because of inability to liquidate assets or obtain adequate funding.
Investment/Market Risk	Risk to earnings, capital or business resulting in the decline in value of our assets or an increase in the costs of financing caused by changes in market variables, such as interest rates, which affect the values of investment securities and other investment instruments.
Counterparty Risk	Risk to earnings, capital or business, resulting from counterparty's failure to meet the terms of any contract or otherwise failure to perform as agreed. This risk is present in funding and hedging activities.
Credit Risk	Risk to earnings, capital or business resulting from an obligor's failure to meet the terms of any contract or otherwise failure to perform as agreed. This risk is present in lending, and investing activities.
Operational Risk	Risk to earnings, capital, reputation or business arising from inadequate or failed internal processes or systems, human factors or external events. Model risk is included in operational risk.
Compliance, Regulatory and Legal Risk	Risk to earnings, capital, reputation or conduct of business arising from violations of, or nonconformance with internal and external applicable rules and regulations, losses resulting from lawsuits or adverse judgments, or from changes in the regulatory environment that may impact our business model.

## Liquidity Risk Management

Our liquidity risk management strategy is designed to ensure the availability of sufficient resources to support our business and meet our financial obligations under both normal and adverse market and business environments. Our liquidity risk management practices consist of the following primary elements:

Funding	Availability of diverse and stable sources of funds.
Excess Liquidity	Excess liquidity primarily in the form of unencumbered assets.
Maturity Profile	Diversity and tenor of liabilities and modest use of leverage.
Stress Testing	Scenario modeling to measure the resiliency of our liquidity position.
Liquidity Management Policies	Comprehensive policies including monitoring, risk limits and an escalation protocol.

## Funding

Our primary financing sources are repurchase agreements provided through counterparty arrangements and directly through RCap, other secured financing including FHLB funding, securitized debt, mortgages, credit facilities, note sales and various forms of equity. We maintain excess liquidity through high quality assets.

We conservatively manage our repurchase agreement funding position through a variety of methods including diversity, breadth and depth of counterparties and maintaining a staggered and longer-term maturity profile. Additionally, our wholly owned subsidiary, RCap, provides direct access to third party funding as a FINRA member broker-dealer. RCap raises funds through the General Collateral Finance Repo service offered by the Fixed Income Clearing Corporation (FICC), with FICC acting as the central counterparty. Since its inception in 2008, RCap has provided us greater depth and diversity of repurchase agreement funding while also limiting our counterparty



exposure.

Our borrowings pursuant to repurchase transactions include repurchase agreements that have maturities that extend beyond two years. To reduce our liquidity risk we maintain a laddered approach to our repurchase agreements and a conservative weighted average days to maturity. As of June 30, 2016, the weighted average days to maturity was 129 days.

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## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

## Item 2. Management's Discussion and Analysis

Our repurchase agreements generally provide that in the event of a margin call we must provide additional securities or cash on the same business day that a margin call is made. Should prepayment speeds on the mortgages underlying our Agency and Residential mortgage-backed securities and/or market interest rates or other factors move suddenly and cause declines in the market value of assets posted as collateral, resulting margin calls may cause an adverse change in our liquidity position.

We maintain access to FHLB funding through our captive insurance subsidiary Truman. We finance eligible Agency, residential and commercial investments through the FHLB and maintain a required margin balance. While a recent FHFA ruling requires captive insurance companies to terminate their FHLB membership, given the length of its membership, Truman has been granted a five year sunset provision whereby its membership will expire in February 2021.

We utilize diverse funding sources to finance our commercial investments. Aside from FHLB funding, we maintain credit facilities, securitization funding and, in the case of investments in commercial real estate, mortgage financing and note sales.

At June 30, 2016, we had total financial instruments and cash pledged as collateral for secured financing arrangements and interest rate swaps of \$64.1 billion. The weighted average haircut was approximately 5% on repurchase agreements. The quality and character of the Agency mortgage-backed securities that we pledge as collateral under the repurchase agreements, other secured financing and interest rate swaps did not materially change at June 30, 2016 compared to December 31, 2015, and our counterparties did not materially alter any requirements, including required haircuts, related to the collateral we pledge under repurchase agreements and interest rate swaps during the quarter ended June 30, 2016.

The table below presents our quarterly average and quarter-end repurchase agreement and reverse repurchase agreement balances outstanding for the periods presented:

	Repurchase Agreements		Reverse Repurchase Agreements	
	Average Daily Amount Outstanding	Ending Amount Outstanding	Average Daily Amount Outstanding	Ending Amount Outstanding
Quarter Ended:	(dollars in thousands)			
June 30, 2016	54,647,175	53,868,385	1,159,341	-
March 31, 2016	55,753,041	54,448,141	1,294,505	-
December 31, 2015	57,483,870	56,230,860	214,674	-
September 30, 2015	57,102,712	56,449,364	931,522	-
June 30, 2015	60,643,597	57,459,552	1,779,121	-
March 31, 2015	68,572,119	60,477,378	100,000	100,000
December 31, 2014	72,117,895	71,361,926	10,870	100,000
September 30, 2014	71,312,473	69,610,722	-	-
June 30, 2014	70,133,219	70,372,218	227,640	-

At June 30, 2016, the repurchase agreements and other secured financing outstanding had weighted average remaining maturities of 224 days and the following remaining maturities and weighted average rates:

	June 30, 2016		
	Principal	Weighted	% of
	Balance	Average	Total
		Rate	
	(dollars in thousands)		
1 day	\$7,506,405	0.91	% 13.1 %
2 to 29 days	12,706,560	0.81	% 22.1 %
30 to 59 days	7,014,305	0.95	% 12.2 %
60 to 89 days	5,970,102	0.86	% 10.4 %
90 to 119 days	6,179,055	0.82	% 10.8 %
Over 120 days <sup>(1)</sup>	18,080,284	1.28	% 31.4 %
Total	\$57,456,711	1.00	% 100.0%

(1) Approximately 15% of the total repurchase agreements and other secured financing had a remaining maturity over 1 year.

## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

## Item 2. Management's Discussion and Analysis

The table below presents our outstanding debt balances and associated weighted average rates and days to maturity as of June 30, 2016:

	Principal Balance (dollars in thousands)	Weighted Average Rate	Days to Maturity ( <sup>3</sup> )
Repurchase agreements	\$53,868,385	1.02 %	129
Other secured financing <sup>(1)</sup>	3,588,326	0.60 %	1,644
Securitized debt of consolidated VIEs <sup>(2)</sup>	3,754,642	0.86 %	2,385
Participation sold <sup>(2)</sup>	12,985	5.58 %	302
Mortgages payable <sup>(2)</sup>	331,046	4.20 %	3,035
Total indebtedness	\$61,555,384		

(1) Represents advances from the Federal Home Loan Bank of Des Moines.

(2) Non-recourse to Annaly.

(3) Determined based on estimated weighted-average lives of the underlying debt instruments.

## Excess Liquidity

Our primary source of liquidity is the availability of unencumbered assets which may be provided as collateral to support additional funding needs. We target minimum thresholds of available, unencumbered assets to maintain excess liquidity. The following table illustrates our asset portfolio available to support potential collateral obligations and funding needs. Assets are considered encumbered if pledged as collateral against an existing liability, and therefore no longer available to support additional funding. An asset is considered unencumbered if it has not been pledged or securitized. The following table also provides the carrying amount of our encumbered and unencumbered financial assets as of June 30, 2016:

## Encumbered and Unencumbered Assets

	Encumbered Assets (dollars in thousands)	Unencumbered Assets	Total
Financial Assets:			
Cash and cash equivalents	\$2,578,551	\$ 156,699	\$2,735,250
Investments, at carrying value: <sup>(1)</sup>			
Agency mortgage-backed securities	59,749,105	5,712,676	65,461,781
Credit risk transfer securities	167,549	352,772	520,321
Non-Agency mortgage-backed securities	1,057,899	132,933	1,190,832
Commercial real estate debt investments	4,361,972	-	4,361,972
Commercial real estate debt and preferred equity, held for investment	654,111	483,860	1,137,971
Loans held for sale	-	164,175	164,175
Corporate debt	-	669,612	669,612

Total financial assets	\$68,569,187	\$ 7,672,727	\$76,241,914
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(1) The amounts reflected in the table above are on a settlement date basis and may differ from the total positions reported on the Consolidated Statements of Financial Condition.

We maintain liquid assets in order to satisfy our current and future obligations in normal and stressed operating environments. These are held as the primary means of liquidity risk mitigation. The composition of our liquid assets is considered as well and is subject to certain parameters. The composition is monitored for concentration risk, asset type and ratings. We believe the assets we consider liquid can be readily converted into cash, through liquidation or by being used as collateral in financing arrangements (including as additional collateral to support existing financial arrangements). Our balance sheet also generates liquidity on an on-going basis through mortgage principal and interest repayments and net earnings held prior to payment of dividends. The following table presents our liquid assets as a percentage of total assets as of June 30, 2016.

## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

## Item 2. Management's Discussion and Analysis

Liquid Assets	Carrying Value <sup>(1)</sup> (dollars in thousands)
Cash and cash equivalents	\$2,735,250
Residential Investment Securities <sup>(2)</sup>	67,172,934
Commercial real estate debt investments	374,781
Commercial real estate debt and preferred equity, held for investment	469,609
Loans held for sale	164,175
Corporate debt	418,972
Total liquid assets	\$71,335,721
Percentage of liquid assets to total assets	91.79 %

Carrying value represents the market value of assets. The assets listed in this table include \$64.4 billion of assets (1) that have been pledged as collateral against existing liabilities as of June 30, 2016. Please refer to the Encumbered and Unencumbered Assets table for related information.

(2) The amounts reflected in the table above are on a settlement date basis and may differ from the total positions reported on the Consolidated Statements of Financial Condition.

## Maturity Profile

We consider the profile of our assets, liabilities and derivatives when managing both liquidity risk as well as investment/market risk employing a measurement of both the maturity gap and interest rate gap.

We determine the amount of liquid assets that are required to be held by monitoring several liquidity metrics. We utilize several modeling techniques to analyze our current and potential obligations including the expected cash flows from our assets, liabilities and derivatives. The following table illustrates the expected maturities of our assets, liabilities and derivatives. The table is based on a static portfolio and assumes no reinvestment of asset cash flows and no future liabilities are entered into. In assessing the maturity of our assets, liabilities and off balance sheet obligations, we use the stated maturities, or our prepayment expectations for assets that exhibit prepayment characteristics. Cash and cash equivalents are included in the 'within 3 months' maturity bucket, as they are typically held for a short period of time.

With respect to each maturity bucket, our maturity gap is considered negative when the amount of maturing liabilities exceeds the amount of maturing assets. A negative gap increases our liquidity risk as we must enter into future liabilities.

Our interest rate sensitivity gap is the difference between Interest Earning Assets and Interest Bearing Liabilities maturing or re-pricing within a given time period. Unlike the calculation of maturity gap, interest rate sensitivity gap includes the effect of our interest rate swaps. A gap is considered positive when the amount of interest-rate sensitive assets exceeds the amount of interest-rate sensitive liabilities. A gap is considered negative when the amount of interest-rate sensitive liabilities exceeds interest-rate sensitive assets. During a period of rising interest rates, a negative gap would tend to adversely affect net interest income, while a positive gap would tend to result in an increase in net interest income. During a period of falling interest rates, a negative gap would tend to result in an increase in net interest income, while a positive gap would tend to affect net interest income adversely. Because different types of assets and liabilities with the same or similar maturities may react differently to changes in overall

market rates or conditions, changes in interest rates may affect net interest income positively or negatively even if assets and liabilities were perfectly matched in each maturity category. The amount of assets and liabilities utilized to compute our interest rate sensitivity gap was determined in accordance with the contractual terms of the assets and liabilities, except that adjustable-rate loans and securities are included in the period in which their interest rates are first scheduled to adjust and not in the period in which they mature. The effects of interest rate swaps, which effectively lock in our financing costs for a longer term, are also reflected in our interest rate sensitivity gap. The interest rate sensitivity of our assets and liabilities in the table below could vary substantially based on actual prepayment experience.

## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

## Item 2. Management's Discussion and Analysis

	Less than 3 Months (dollars in thousands)	3-12 Months	More than 1 Year to 3 Years	3 Years and Over	Total
<b>Financial Assets:</b>					
Cash and cash equivalents	\$2,735,250	\$-	\$-	\$-	\$2,735,250
Agency mortgage-backed securities (principal)	351	5,966	1,508,813	57,708,279	59,223,409
Credit risk transfer securities (principal)	-	-	59,670	459,717	519,387
Non-Agency mortgage-backed securities (principal)	-	75,453	336,859	846,797	1,259,109
Commercial real estate debt investments (principal)	-	-	-	4,368,979	4,368,979
Corporate debt (principal)	-	-	-	677,460	677,460
Commercial real estate debt and preferred equity (principal)	128,426	294,668	606,225	114,512	1,143,831
Loans held for sale (principal)	-	-	165,000	-	165,000
<b>Total financial assets</b>	<b>\$2,864,027</b>	<b>\$376,087</b>	<b>\$2,676,567</b>	<b>\$64,175,744</b>	<b>\$70,092,425</b>
<b>Financial Liabilities:</b>					
Repurchase agreements	\$33,197,372	\$15,571,146	\$5,099,867	\$-	\$53,868,385
Other secured financing	-	-	-	3,588,326	3,588,326
Securitized debt of consolidated VIE (principal)	24,926	34,393	-	3,695,323	3,754,642
Participation sold (principal)	77	12,908	-	-	12,985
<b>Total financial liabilities</b>	<b>\$33,222,375</b>	<b>\$15,618,447</b>	<b>\$5,099,867</b>	<b>\$7,283,649</b>	<b>\$61,224,338</b>
Maturity gap	\$(30,358,348)	\$(15,242,360)	\$(2,423,300)	\$56,892,095	\$8,868,087
Cumulative maturity gap	\$(30,358,348)	\$(45,600,708)	\$(48,024,008)	\$8,868,087	
Interest rate sensitivity gap	\$(7,421,978)	\$(8,637,437)	\$328,362	\$24,599,140	\$8,868,087
Cumulative rate sensitivity gap	\$(7,421,978)	\$(16,059,415)	\$(15,731,053)	\$8,868,087	
Cumulative rate sensitivity gap as a % of total rate sensitive assets	(10.59 %)	(22.91 %)	(22.44 %)	12.65 %	

The methodologies we employ for evaluating interest rate risk include an analysis of our interest rate “gap,” measurement of the duration and convexity of our portfolio and sensitivities to interest rates and spreads.

## Stress Testing

We utilize liquidity stress testing to ensure we have sufficient liquidity under a variety of scenarios and stresses. These stress tests assist with the management of our pool of liquid assets and influence our current and future funding plans. Our stress tests are modeled over both short-term and longer time horizons. The stresses applied include market-wide and firm-specific stresses.

## Liquidity Management Policies



We utilize a comprehensive liquidity policy structure to inform our liquidity risk management practices including monitoring and measurement, along with well-defined key limits. Both quantitative and qualitative targets are utilized to measure the ongoing stability and condition of the liquidity position, and include the level and composition of unencumbered assets, as well as both short-term and long-term sustainability of the funding composition under stress conditions.

We also monitor early warning metrics designed to measure the quality and depth of liquidity sources based upon both company-specific and macro environmental conditions. The metrics assess both the short-term and long-term liquidity conditions and are integrated into our escalation protocol, with various liquidity ratings influencing management actions with respect to contingency planning and potential related actions.

#### Investment/Market Risk Management

One of the primary risks we are subject to is interest rate risk. Changes in the level of interest rates can affect our net interest income, which is the difference between the income we earn on our Interest Earning Assets and the interest expense incurred from Interest Bearing Liabilities and derivatives. Changes in the level of interest rates and spreads can also affect the value of our securities and potential realization of gains or losses from the sale of these assets. We may utilize a variety of financial instruments, including interest rate swaps, swaptions, options, futures and other hedges, in order to limit the adverse effects of interest rates on our results. Our portfolio and the value of our portfolio, including derivatives, may be adversely affected as a result of changing interest rates and spreads.

## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

## Item 2. Management's Discussion and Analysis

We simulate a wide variety of interest rate scenarios in evaluating our risk. Scenarios are run to capture our sensitivity to changes in interest rates, spreads and the shape of the yield curve. We also consider the assumptions affecting our analysis such as those related to prepayments. In addition to predefined interest rate scenarios, we utilize Value-at-Risk measures to estimate potential losses in the portfolio over various time horizons utilizing various confidence levels. The following tables estimate the potential changes in economic net interest income over a twelve month period and the immediate effect on our portfolio market value (inclusive of derivative instruments), should interest rates instantaneously increase or decrease by 25, 50 or 75 basis points, and the effect of portfolio market value if mortgage option-adjusted spreads instantaneously increase or decrease by 5, 15 or 25 basis points (assuming shocks are parallel and instantaneous). All changes to income and portfolio market value are measured as percentage changes from the projected economic net interest income and portfolio value at the base interest rate scenario. The base interest rate scenario assumes interest rates at June 30, 2016 and various estimates regarding prepayments and all activities are made at each level of rate shock. The economic net interest income simulations incorporate the interest expense effect of rate resets on assets, liabilities and derivatives as well as the amortization expense and reinvestment of principal based on the prepayments on our securities, which varies based on the level of rates. The results assume no management actions in response to the rate or spread changes. Actual results could differ significantly from these estimates.

	Projected Percentage Change in Economic Net Interest Income <sup>(1)</sup>	Estimated Percentage Change in Portfolio Value <sup>(2)</sup>	Estimated Change as a % on NAV <sup>(2)(3)</sup>
Change in Interest Rate			
-75 Basis Points	(19.9%)	0.3%	1.8%
-50 Basis Points	(14.7%)	0.3%	1.7%
-25 Basis Points	(7.4%)	0.2%	1.0%
Base Interest Rate	-	-	-
+25 Basis Points	7.3%	(0.2%)	(1.3%)
+50 Basis Points	16.3%	(0.5%)	(3.2%)
+75 Basis Points	26.2%	(0.9%)	(5.6%)

	Estimated Change in Portfolio Market Value	Estimated Change as a % on NAV <sup>(2)(3)</sup>
MBS Spread Shock		
-25 Basis Points	1.3%	7.8%
-15 Basis Points	0.8%	4.7%
-5 Basis Points	0.3%	1.6%
Base Interest Rate	-	-
+5 Basis Points	(0.3%)	(1.5%)
+15 Basis Points	(0.8%)	(4.6%)
+25 Basis Points	(1.3%)	(7.7%)

- Scenarios include Residential Investment Securities, commercial real estate investments, corporate debt,
- (1) repurchase agreements, other secured financing and interest rate swaps. Economic net interest income includes interest expense on interest rate swaps.
  - (2) Scenarios include Residential Investment Securities and derivative instruments.
  - (3) NAV represents book value of equity.

#### Credit Risk Management

Key risk parameters have been established to specify our credit risk appetite. We will seek to manage credit risk by making investments which conform within the firm's specific investment policy parameters and optimize risk-return attributes.

While we do not expect to encounter credit risk in our Agency investments, we face credit risk on the non-Agency mortgage-backed securities and CRT securities in our portfolio. In addition, we are also exposed to credit risk on commercial real estate investments and corporate debt. We are subject to risk of loss if an issuer or borrower fails to perform its contractual obligations.

We have established policies and procedures for mitigating credit risk, including establishing and reviewing limits for credit exposure. We will originate or purchase commercial investments that meet our comprehensive underwriting process and credit standards and are approved by the appropriate committee. Once a commercial investment is made, our ongoing surveillance process includes regular reviews, analysis and oversight of investments by our investment personnel and appropriate committee. We review credit and other risks of loss associated with each investment. Our management monitors the overall portfolio risk and determines estimates of provision for loss. Our portfolio composition as of June 30, 2016 and December 31, 2015 was as follows:

## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

## Item 2. Management's Discussion and Analysis

Asset Portfolio (using balance sheet values)			
Category	June		
	30, 2016	December 31, 2015	
Agency mortgage-backed securities <sup>(1)</sup>	88.3 %	90.3 %	
Agency debentures	0.0 %	0.2 %	
Credit risk transfer securities	0.7 %	0.6 %	
Non-Agency mortgage-backed securities	1.6 %	1.2 %	
Commercial real estate <sup>(2) (3)</sup>	8.5 %	7.0 %	
Corporate debt	0.9 %	0.7 %	

(1) Including TBAs held for delivery.

(2) Net of unamortized origination fees.

(3) Including loans held for sale, net.

## Counterparty Risk Management

Our use of repurchase and derivative agreements and trading activities create exposure to counterparty risk relating to potential losses that could be recognized if the counterparties to these agreements fail to perform their obligations under the contracts. In the event of default by a counterparty, we could have difficulty obtaining our assets pledged as collateral. A significant portion of our Agency mortgage-backed securities are financed with repurchase agreements by pledging our agency securities as collateral to the lender. The collateral we pledge usually exceeds the amount of the borrowings under each agreement. If the counterparty to the repurchase agreement defaults on its obligations and we are not able to recover our pledged asset, we are at risk of losing the over-collateralization or haircut. The amount of this exposure is the difference between the amount loaned to us plus interest due to the counterparty and the fair value of the collateral pledged by us to the lender including accrued interest receivable on such collateral.

We also use interest rate swaps and other derivatives to manage interest rate risk. Under these agreements, we pledge securities and cash as collateral as part of a margin arrangement. If a counterparty were to default on its obligations, we would be exposed to a loss to a derivative counterparty to the extent that the amount of our securities or cash pledged exceeded the unrealized loss on the associated derivative and we were not able to recover the excess collateral. Additionally, we would be exposed to a loss to a derivative counterparty to the extent that our unrealized gains on derivative instruments exceeds the amount of the counterparty's securities or cash pledged to us.

We monitor our exposure to counterparties across several dimensions including by type of arrangement, collateral type, counterparty type, ratings and geography.

The following table summarizes our exposure to counterparties by geography as of June 30, 2016:

Country	Number of Counterparties	Repurchase Agreement Fair Value (dollars in thousands)	Interest Rate Swaps at Fair Value	Exposure <sup>(1)</sup>
North America	17	\$41,951,006	\$(2,303,207)	\$2,694,336
Europe	10	8,524,899	(759,494 )	734,222

Asia (non-Japan)	1	320,641	-	19,593
Japan	4	3,071,839	-	244,798
Total	32	\$53,868,385	\$(3,062,701)	\$3,692,949

(1) Represents the amount of cash and/or securities pledged as collateral to each counterparty less the aggregate of repurchase agreement financing and unrealized loss on swaps for each counterparty.

### Operational Risk Management

We are subject to operational risk in each of our business and support functions. Operational risk may arise from internal or external sources including human error, fraud, systems issues, process change, vendors, business interruptions and other external events. Model risk considers potential errors with a model's results due to uncertainty in model parameters and inappropriate methodologies used. The result of these risks may include financial loss and reputational damage.

We manage operational risk through a variety of tools including policies and procedures which cover topics such as business continuity, personal conduct and vendor management. Other tools include training on topics such as cyber security awareness; testing, including disaster recovery testing; systems controls, including access controls; and monitoring, which includes the use of key risk indicators. Employee level lines of defense against operational risk include proper segregation of incompatible duties, activity-level internal controls over financial reporting, the empowerment of business units to identify and mitigate operational risk sources, an independent operational risk working group, testing by our internal audit staff, and our overall governance framework.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

Item 2. Management's Discussion and Analysis

Compliance, Regulatory and Legal Risk Management

Our business is organized as a REIT, and we plan to continue to meet the requirements for taxation as a REIT. The determination that we are a REIT requires an analysis of various factual matters and circumstances. Accordingly, we closely monitor our REIT status within our risk management program. The financial services industry is highly regulated and continues to receive increasing attention from regulators, which may impact both our company as well as our business strategy. We proactively monitor the potential impact regulation may have both directly and indirectly on us. We maintain a process to actively monitor both actual and potential legal action that may affect us. Our risk management framework is designed to identify, monitor and manage these risks under the oversight of the Enterprise Risk Committee.

We currently rely on the exemption from registration provided by Section 3(c)(5)(C) of the Investment Company Act, and we plan to continue to meet the requirements for this exemption from registration. The determination that we qualify for this exemption from registration depends on various factual matters and circumstances. Accordingly, in conjunction with our legal department, we closely monitor our compliance with Section 3(c)(5)(C) within our risk management program. The monitoring of this risk is also under the oversight of the Enterprise Risk Committee.

As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the U.S. Commodity Futures Trading Commission (or CFTC) gained jurisdiction over the regulation of interest rate swaps. The CFTC has asserted that this causes the operators of mortgage real estate investment trusts that use swaps as part of their business model to fall within the statutory definition of Commodity Pool Operator (or CPO), and, absent relief from the Division or the Commission, to register as CPOs. On December 7, 2012, as a result of numerous requests for no-action relief from the CPO registration requirement for operators of mortgage real estate investment trusts, the Division of Swap Dealer and Intermediary Oversight of the CFTC issued no-action relief entitled "No-Action Relief from the Commodity Pool Operator Registration Requirement for Commodity Pool Operators of Certain Pooled Investment Vehicles Organized as Mortgage Real Estate Investment Trusts" that permits a CPO to receive relief by filing a claim to perfect the use of the relief.

A claim submitted by a CPO will be effective upon filing, so long as the claim is materially complete. The conditions that must be met relate to initial margin and premiums requirements, net income derived annually from commodity interest positions that are not qualifying hedging transactions, marketing of interests in the mortgage real estate investment trust to the public, and identification of the entity as a mortgage real estate investment trust in its federal tax filings with the Internal Revenue Service. While we disagree that the CFTC's position that mortgage real estate investment trusts that use swaps as part of their business model fall within the statutory definition of a CPO, we have submitted a claim for the relief set forth in the no-action relief entitled "No-Action Relief from the Commodity Pool Operator Registration Requirement for Commodity Pool Operators of Certain Pooled Investment Vehicles Organized as Mortgage Real Estate Investment Trusts" and believe we meet the criteria for such relief set forth therein.

Critical Accounting Policies and Estimates

Our critical accounting policies that require us to make significant judgments or estimates are described below. For more information on these critical accounting policies and other significant accounting policies, see "Significant Accounting Policies" in the Notes to the Consolidated Financial Statements.

Valuation of Financial Instruments

Residential Investment Securities

There is an active market for our Agency mortgage-backed securities, Agency debentures, CRT securities and non-Agency mortgage-backed securities. Since we primarily invest in securities that can be valued using actively quoted prices, there is a high degree of observable inputs and less subjectivity in measuring fair value. Internal market values are determined using quoted prices from the To-Be-Announced (or TBA) security market, the Treasury curve and the underlying characteristics of the individual securities, which may include coupon, periodic and life caps, reset dates and the expected life of the security. Prepayment rates are difficult to predict and are a significant estimate requiring judgment in the valuation of Agency mortgage-backed securities. All internal market values are compared to external pricing sources and/or dealer quotes for reasonableness. Additionally, securities used as collateral for repurchase agreements are priced daily by counterparties to ensure sufficient collateralization, providing additional verification of our internal pricing.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

Item 2. Management's Discussion and Analysis

Commercial Real Estate Investments

A commercial mortgage-backed security classified as available-for sale must be evaluated for other-than-temporary impairment if the fair value of the security is lower than its amortized cost. Determining whether there is an other-than-temporary impairment may require us to exercise significant judgment and make estimates to determine expected cash flows incorporating assumptions such as changes in interest rates and loss expectations. For commercial real estate loans and preferred equity investments classified as held for investment, we apply significant judgment in evaluating the need for a loss reserve. Estimated net recoverable value of the commercial real estate loans and preferred equity investments and other factors such as the fair value of any collateral, the amount and status of senior debt, the prospects of the borrower and the competitive landscape where the borrower conducts business must be considered in determining the allowance for loan losses. For commercial real estate loans held for sale, significant judgment may need to be applied in determining fair value of the loans and whether a valuation allowance is necessary. Factors that may need to be considered to determine fair value of a loan held for sale include the borrower's credit quality, liquidity and other market factors, and the fair value of the underlying collateral.

Interest Rate Swaps

We use the overnight indexed swap (or OIS) curve as an input to value substantially all of our uncleared interest rate swaps. We believe using the OIS curve, which reflects the interest rate typically paid on cash collateral, enables us to most accurately determine the fair value of uncleared interest rate swaps. Consistent with market practice, we exchange collateral (also called margin) based on the fair values of our interest rate swaps. Through this margining process, we may be able to compare our recorded fair value with the fair value calculated by the counterparty, providing additional verification of our recorded fair value of the uncleared interest rate swaps. We value our cleared interest rate swaps using the prices provided by the derivatives clearing organization.

Revenue Recognition

Interest income from coupon payments is accrued based on the outstanding principal amounts of the Residential Investment Securities and their contractual terms. Premiums and discounts associated with the purchase of the Residential Investment Securities are amortized or accreted into interest income over the projected lives of the securities using the interest method. We use third-party model and market information to project prepayment speeds. Our prepayment speed projections incorporate underlying loan characteristics (e.g., coupon, term, original loan size, original loan to value, etc.) and market data, including interest rate and home price index forecasts, and expert judgment. Prepayment speeds vary according to the type of investment, conditions in the financial markets and other factors and cannot be predicted with any certainty. Changes to model assumptions, including interest rates and other market data, as well as periodic revisions to the model will cause changes in the results. Adjustments are made for actual prepayment activity as it relates to calculating the effective yield. The results computed by the model are compared to projections computed by third party models for reasonableness. Gains and losses on sales of Residential Investment Securities are recorded on trade date based on the specific identification method.

Consolidation of Variable Interest Entities

Determining whether an entity has a controlling financial interest in a VIE requires significant judgment related to assessing the purpose and design of the VIE and determination of the activities that most significantly impact its economic performance. We must also identify explicit and implicit variable interests in the entity and consider our involvement in both the design of the VIE and its ongoing activities. To determine whether consolidation of the VIE is required, we must apply judgment to assess whether we have the power to direct the most significant activities of the



VIE and whether we have either the rights to receive benefits or obligation to absorb losses that could be potentially significant to the VIE.

#### Use of Estimates

The use of 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.

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ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

Item 2. Management's Discussion and Analysis

Glossary of Terms

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A

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Adjustable-Rate Loan / Security

A loan / security on which interest rates are adjusted at regular intervals according to predetermined criteria. The adjustable interest rate is tied to an objective, published interest rate index.

Agency

Refers to a federally chartered corporation, such as the Federal National Mortgage Association, or the Federal Home Loan Mortgage Corporation, or an agency of the U.S. Government, such as the Government National Mortgage Association.

Agency Debentures

Debt issued by a federal agency or a government-sponsored enterprise (GSE) for financing purposes. These types of debentures are not backed by collateral, but by the integrity and credit-worthiness of the issuer. Agency debentures issued by a GSE are backed only by that GSE's ability to pay. The callable feature allows the Agency to repay the bond prior to maturity.

Agency Mortgage-Backed Securities

Refers to residential mortgage-backed securities that are issued or guaranteed by an Agency.

Amortization

Liquidation of a debt through installment payments. Amortization also refers to the process of systematically reducing a recognized asset or liability (e.g., a purchase premium or discount for a debt security) with an offset to earnings.

Average Life

On a mortgage-backed security, the average time to receipt of each dollar of principal, weighted by the amount of each principal prepayment, based on prepayment assumptions.

B

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Basis Point (BPs)

One hundredth of one percent, used in expressing differences in interest rates. One basis point is 0.01% of yield. For example, a bond's yield that changed from 3.00% to 3.50% would be said to have moved 50 basis points.

Benchmark

A bond or an index referencing a basket of bonds whose terms are used for comparison with other bonds of similar maturity. The global financial market typically looks to U.S. Treasury securities as benchmarks.

Beneficial Owner

One who benefits from owning a security, even if the security's title of ownership is in the name of a broker or bank.

**B-Note**

Subordinate mortgage notes and/or subordinate mortgage loan participations.

**B-Piece**

The most subordinate commercial mortgage-backed security bond class.

**Board**

Refers to the board of directors of Annaly.

**Bond**

The written evidence of debt, bearing a stated rate or stated rates of interest, or stating a formula for determining that rate, and maturing on a date certain, on which date and upon presentation a fixed sum of money plus interest (usually represented by interest coupons attached to the bond) is payable to the holder or owner. Bonds are long-term securities with an original maturity of greater than one year. For purposes of computations tied in to "per bond," a \$1,000 increment of an issue is used (no matter what the actual denominations are).

**Book Value Per Share**

Calculated by summing common stock, additional paid-in capital, accumulated other comprehensive income (loss) and accumulated deficit and dividing that number by the total common shares outstanding.

**Broker**

Generic name for a securities firm engaged in both buying and selling securities on behalf of customers or its own account.

**C**

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**Capital Buffer**

Includes unencumbered financial assets which can be either sold or utilized as collateral to meet liquidity needs.

**Capital Ratio**

Calculated as total stockholders' equity divided by total assets inclusive of outstanding market value of TBA derivatives and exclusive of consolidated VIEs associated with B-Piece commercial mortgage-backed securities.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

Item 2. Management's Discussion and Analysis

Carry

The amount an asset earns over its hedging and financing costs. A positive carry happens when the rate on the securities being financed is greater than the rate on the funds borrowed. A negative carry is when the rate on the funds borrowed is greater than the rate on the securities that are being financed.

Collateral

Securities, cash or property pledged by a borrower or party to a derivative contract to secure payment of a loan or derivative. If the borrower fails to repay the loan or defaults under the derivative contract, the secured party may take ownership of the collateral.

Collateralized Mortgage Obligation (CMO)

A multiclass bond backed by a pool of mortgage pass-through securities or mortgage loans.

Commodity Futures Trading Commission (CFTC)

An independent U.S. federal agency established by the Commodity Futures Trading Commission Act of 1974. The CFTC regulates the swaps, commodity futures and options markets. Its goals include the promotion of competitive and efficient futures markets and the protection of investors against manipulation, abusive trade practices and fraud.

Commercial Mortgage-Backed Security (CMBS)

Securities collateralized by a pool of mortgages on commercial real estate in which all principal and interest from the mortgages flow to certificate holders in a defined sequence or manner.

Constant Prepayment Rate (CPR)

The percentage of outstanding mortgage loan principal that prepays in one year, based on the annualization of the Single Monthly Mortality, which reflects the outstanding mortgage loan principal that prepays in one month.

Convertible Securities

Securities which may be converted into shares of another security under stated terms, often into the issuing company's common stock.

Convexity

A measure of the change in a security's duration with respect to changes in interest rates. The more convex a security is, the more its duration will change with interest rate changes.

Core Earnings and Core Earnings Per Common Share

Non-GAAP financial measure that is defined as net income (loss) excluding gains or losses on disposals of investments and termination of interest rate swaps, unrealized gains or losses on interest rate swaps and financial instruments measured at fair value through earnings, net gains or losses on trading assets, impairment losses, net income (loss) attributable to noncontrolling interest, the premium amortization adjustment resulting from the quarter-over-quarter change in estimated long-term CPR, corporate acquisition related expenses and certain other non-recurring gains or losses, and inclusive of dollar roll income (a component of Net gains (losses) on trading assets).

Core Interest Income

Non-GAAP financial measure that is comprised of GAAP interest income excluding the impact of the premium amortization adjustment.

Corporate Debt

Non-government debt instruments issued by corporations. Long-term corporate debt can be issued as bonds or loans.

**Counterparty**

One of two entities in a transaction. For example, in the bond market a counterparty can be a state or local government, a broker-dealer or a corporation.

**Coupon**

The interest rate on a bond that is used to compute the amount of interest due on a periodic basis.

**Credit and Counterparty Risk**

Risk to earnings, capital or business, resulting from an obligor's or counterparty's failure to meet the terms of any contract or otherwise failure to perform as agreed. Credit and counterparty risk is present in lending, investing, funding and hedging activities.

**Credit Risk Transfer (CRT) Securities**

Credit Risk Transfer securities are risk sharing transactions issued by Fannie Mae and Freddie Mac and similarly structured transactions arranged by third party market participants. The securities issued in the CRT sector are designed to synthetically transfer mortgage credit risk from Fannie Mae, Freddie Mac and/or third parties to private investors.

**Current Face**

The current remaining monthly principal on a mortgage security. Current face is computed by multiplying the original face value of the security by the current principal balance factor.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

Item 2. Management's Discussion and Analysis

D

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Dealer

Person or organization that underwrites, trades and sells securities, e.g., a principal market-maker in securities.

Default Risk

Possibility that a bond issuer will fail to pay principal or interest when due.

Derivative

A financial product that derives its value from the price, price fluctuations and price expectations of an underlying instrument, index or reference pool (e.g. futures contracts, options, interest rate swaps, interest rate swaptions and certain to-be-announced securities).

Discount Price

When the dollar price is below face value, it is said to be selling at a discount.

Duration

The weighted maturity of a fixed-income investment's cash flows (including principal and interest), used in the estimation of the price sensitivity of fixed-income securities for a given change in interest rates.

E

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Economic Capital

A measure of the risk a firm is subject to. It is the amount of capital a firm needs as a buffer to protect against risk. It is a probabilistic measure of potential future losses at a given confidence level over a given time horizon.

Economic Core Net Interest Income

Non-GAAP financial measure that is composed of GAAP net interest income adjusted for realized gains or losses on interest rate swaps used to hedge cost of funds and excluding the impact of the premium amortization adjustment.

Economic Interest Expense

Non-GAAP financial measure that is composed of GAAP interest expense adjusted for realized gains or losses on interest rate swaps used to hedge cost of funds.

Economic Leverage Ratio (Economic Debt-to-Equity Ratio)

Calculated as the sum of recourse debt, TBA derivative notional outstanding and net forward purchases of investments divided by total equity.

Economic Net Interest Income

Non-GAAP financial measure that is composed of GAAP net interest income adjusted for realized gains or losses on interest rate swaps used to hedge cost of funds.

Encumbered Assets

Assets on the company's balance sheet which have been pledged as collateral against a liability.

Eurodollar

A U.S. dollar deposit held in Europe or elsewhere outside the United States.

F

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Face Amount

The par value (i.e., principal or maturity value) of a security appearing on the face of the instrument.

Factor

A decimal value reflecting the proportion of the outstanding principal balance of a mortgage security, which changes over time, in relation to its original principal value.

Fannie Mae

Federal National Mortgage Association.

Federal Deposit Insurance Corporation (FDIC)

An independent agency created by the U.S. Congress to maintain stability and public confidence in the nation's financial system by insuring deposits, examining and supervising financial institutions for safety and soundness and consumer protection, and managing receiverships.

Federal Funds Rate

The interest rate charged by banks on overnight loans of their excess reserve funds to other banks.

Federal Home Loan Banks (FHLB)

U.S. Government-sponsored banks that provide reliable liquidity to member financial institutions to support housing finance and community investment.

Federal Housing Financing Agency (FHFA)

The FHFA is an independent regulatory agency that oversees vital components of the secondary mortgage market including Fannie Mae, Freddie Mac and the Federal Home Loan Banks.

Fixed-Rate Mortgage

A mortgage featuring level monthly payments, determined at the outset, which remain constant over the life of the mortgage.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

Item 2. Management's Discussion and Analysis

Floating Rate

A bond for which the interest rate is adjusted periodically according to a predetermined formula, usually linked to an index.

Floating Rate CMO

A CMO tranche which pays an adjustable rate of interest tied to a representative interest rate index, such as the LIBOR index.

Freddie Mac

Federal Home Loan Mortgage Corporation.

Futures Contract

A legally binding agreement to buy or sell a commodity or financial instrument in a designated future month at a price agreed upon at the initiation of the contract by the buyer and seller. Futures contracts are standardized according to the quality, quantity, and delivery time and location for each commodity. A futures contract differs from an option in that an option gives one of the counterparties a right and the other an obligation to buy or sell, while a futures contract represents an obligation of both counterparties, one to deliver and the other to accept delivery. A futures contract is part of a class of financial instruments called derivatives.

G

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GAAP

Accounting principles generally accepted in the United States of America.

Ginnie Mae

Government National Mortgage Association.

H

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Hedge

An investment made with the intention of minimizing the impact of adverse movements in financial instruments such as interest rates or securities prices.

I

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In-the-Money

Description for an option that has intrinsic value and can be sold or exercised for a profit; a call option is in-the-money when the strike price (execution price) is below the market price of the underlying security.

Interest Bearing Liabilities

Refers to repurchase agreements, FHLB Des Moines advances, Convertible Senior Notes, securitized debt of consolidated VIEs, participation sold, U.S. Treasury securities sold, not yet purchased and securities loaned. Average Interest Bearing Liabilities is based on daily balances.

Interest Earning Assets



Refers to Residential Investment Securities, securities borrowed, U.S. Treasury securities, reverse repurchase agreements, commercial real estate debt investments, commercial real estate debt and preferred equity interests and corporate debt. Average Interest Earning Assets is based on daily balances.

#### Interest Only (IO) Bond

The interest portion of mortgage, Treasury or bond payments, which is separated and sold individually from the principal portion of those same payments.

#### Interest Rate Risk

The risk that an investment's value will change due to a change in the absolute level of interest rates, in the spread between two rates, in the shape of the yield curve or in any other interest rate relationship. As market interest rates rise, the value of current fixed income investment holdings declines. Diversifying, deleveraging and hedging techniques are utilized to mitigate this risk. Interest rate risk is a form of market risk.

#### Interest Rate Swap

A binding agreement between counterparties to exchange periodic interest payments on some predetermined dollar principal, which is called the notional principal amount. For example, one party will pay fixed and receive a variable rate.

#### Interest Rate Swaption

Options on interest rate swaps. The buyer of a swaption has the right to enter into an interest rate swap agreement at some specified date in the future. The swaption agreement will specify whether the buyer of the swaption will be a fixed-rate receiver or a fixed-rate payer.

#### Internal Capital Adequacy Assessment Program (ICAAP)

The ongoing assessment and measurement of risks, and the amount of capital which is necessary to hold against those risks. The objective is to ensure that a firm is appropriately capitalized relative to the risks in its business.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

Item 2. Management's Discussion and Analysis

International Swaps and Derivatives Association (ISDA) Master Agreement

Standardized contract developed by ISDA used as an umbrella under which bilateral derivatives contracts are entered into.

Inverse IO Bond

An interest-only bond whose coupon is determined by a formula expressing an inverse relationship to a benchmark rate, such as LIBOR. As the benchmark rate changes, the inverse IO bond coupon adjusts in the opposite direction. When the benchmark rate is relatively low, the inverse IO bond pays a relatively high coupon payment, and vice versa.

Investment/Market Risk

Risk to earnings, capital or business resulting in the decline in value of our assets caused from changes in market variables, such as interest rates, which affect the values of residential investment securities and other investment instruments.

Investment Company Act

Refers to the Investment Company Act of 1940 as amended.

L

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Leverage

The use of borrowed money with the objective of increasing investing scale and economic returns.

Leverage Ratio (Debt-to-Equity Ratio)

Calculated as total debt to total stockholders' equity. For purposes of calculating this ratio total debt includes repurchase agreements, other secured financing, Convertible Senior Notes, securitized debt of consolidated VIEs, loan participation sold and mortgages payable.

LIBOR (London Interbank Offered Rate)

The rate banks charge each other for short-term Eurodollar loans. LIBOR is frequently used as the base for resetting rates on floating-rate securities and the floating-rate legs of interest rate swaps.

Liquidity Risk

Risk to earnings, capital or business arising from our inability to meet our obligations when they come due without incurring unacceptable losses because of inability to liquidate assets or obtain adequate funding.

Long-Term CPR

The Company's projected prepayment speeds for certain Agency mortgaged-backed securities using third-party model and market information. The Company's prepayment speed projections incorporate underlying loan characteristics (e.g., coupon, term, original loan size, original loan to value, etc.) and market data, including interest rate and home price index forecasts. Changes to model assumptions, including interest rates and other market data, as well as periodic revisions to the model will cause changes in the results.

Long-Term Debt

Debt which matures in more than one year.

M

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Monetary Policy

Action taken by the Board of Governors of the Federal Reserve System to influence the money supply or interest rates.

Mortgage-Backed Security (MBS)

A security representing a direct interest in a pool of mortgage loans. For a single-tranche MBS, the pass-through issuer or servicer collects the payments on the loans in the pool and "passes through" the principal and interest to the security holders on a pro rata basis.

Mortgage Loan

A mortgage loan granted by a bank, thrift or other financial institution that is based solely on real estate as security and is not insured or guaranteed by a government agency.

N

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NAV

Net asset value.

Net Equity Yield

Calculated using GAAP net income, excluding depreciation and amortization expense, divided by average net equity.

Net Interest Income

Represents interest income earned on our portfolio investments, less interest expense paid for borrowings.

Net Interest Margin

Represents annualized economic core net interest income, inclusive of interest expense on interest rate swaps used to hedge cost of funds, plus TBA dollar roll income less interest expense on interest rate swaps used to hedge dollar roll transactions divided by the sum of its average Interest Earning Assets plus average outstanding TBA derivative balances.

Net Interest Spread

Calculated by taking the average yield on Interest Earning Assets minus the average cost of Interest Bearing Liabilities, including the net interest payments on interest rate swaps used to hedge cost of funds.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

Item 2. Management's Discussion and Analysis

Non-Performing Loan (NPL)

A loan that is close to defaulting or is in default.

Notional Amount

A stated principal amount in a derivative contract on which the contract is based.

O

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Operational Risk

Risk to earnings, capital, reputation or business arising from inadequate or failed internal processes or systems, human factors or external events.

Option Contract

A contract in which the buyer has the right, but not the obligation, to buy or sell an asset at a set price on or before a given date. Buyers of call options bet that a security will be worth more than the price set by the option (the strike price), plus the price they pay for the option itself. Buyers of put options bet that the security's price will drop below the price set by the option. An option is part of a class of financial instruments called derivatives, which means these financial instruments derive their value from the worth of an underlying investment.

Original Face

The face value or original principal amount of a security on its issue date.

Out-of-the-Money

Description for an option that has no intrinsic value and would be worthless if it expired today; for a call option, this situation occurs when the strike price is higher than the market price of the underlying security; for a put option, this situation occurs when the strike price is less than the market price of the underlying security.

Over-The-Counter (OTC) Market

A securities market that is conducted by dealers throughout the country through negotiation of price rather than through the use of an auction system as represented by a stock exchange.

P

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Par

Price equal to the face amount of a security; 100%.

Par Amount

The principal amount of a bond or note due at maturity. Also known as par value.

Pass-Through Security

A securitization structure where a GSE or other entity "passes" the amount collected from the borrowers every month to the investor, after deducting fees and expenses.

Pool

A collection of mortgage loans assembled by an originator or master servicer as the underlying collateral for a security. In the case of Ginnie Mae, Fannie Mae, or Freddie Mac mortgage pass-through securities, pools are

identified by a number assigned by the issuing agency.

**Premium**

The amount by which the price of a security exceeds its principal amount. When the dollar price of a bond is above its face value, it is said to be selling at a premium.

**Premium Amortization Adjustment (PAA)**

The component of premium amortization representing the quarter-over-quarter change in estimated long-term CPR.

**Prepayment**

The unscheduled partial or complete payment of the principal amount outstanding on a mortgage loan or other debt before it is due.

**Prepayment Risk**

The risk that falling interest rates will lead to increased prepayments of mortgage or other loans, forcing the investor to reinvest at lower prevailing rates.

**Prime Rate**

The indicative interest rate on loans that banks quote to their best commercial customers.

**Principal and Interest**

The term used to refer to regularly scheduled payments of principal and payments of interest on a mortgage or other security.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

Item 2. Management's Discussion and Analysis

R

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Rate Reset

The adjustment of the interest rate on a floating-rate security according to a prescribed formula.

Real Estate Investment Trust (REIT)

A special purpose investment vehicle that provides investors with the ability to participate directly in the ownership or financing of real-estate related assets by pooling their capital to purchase and manage mortgage loans and/or income property.

Recourse Debt

Debt on which the economic borrower is obligated to repay the entire balance regardless of the value of the pledged collateral. By contrast, the economic borrower's obligation to repay non-recourse debt is limited to the value of the pledged collateral.

Reinvestment Risk

The risk that interest income or principal repayments will have to be reinvested at lower rates in a declining rate environment.

Re-Performing Loan (RPL)

A type of loan in which payments were previously delinquent by at least 90 days but have resumed.

Repurchase Agreement

The sale of securities to investors with the agreement to buy them back at a higher price after a specified time period; a form of short-term borrowing. For the party on the other end of the transaction (buying the security and agreeing to sell in the future) it is a reverse repurchase agreement.

Residential Investment Securities

Refers to Agency mortgage-backed securities, Agency debentures, CRT securities and non-Agency mortgage-backed securities.

Residual

In a CMO, the residual is the tranche that collects any cash flow from the collateral that remains after obligations to the other tranches have been met.

Return on Average Equity

Calculated by taking earnings divided by average stockholders' equity.

Reverse Repurchase Agreement

Refer to Repurchase Agreement. The buyer of securities effectively provides a collateralized loan to the seller.

Risk Appetite Statement

Defines the types and levels of risk we are willing to take in order to achieve our business objectives, and reflects our risk management philosophy.

S

**Secondary Market**

Ongoing market for bonds previously offered or sold in the primary market.

**Settlement Date**

The date securities must be delivered and paid for to complete a transaction.

**Short-Term Debt**

Generally, debt which matures in one year or less. However, certain securities that mature in up to three years may be considered short-term debt.

**Spread**

When buying or selling a bond through a brokerage firm, an individual investor will be charged a commission or spread, which is the difference between the market price and cost of purchase, and sometimes a service fee. Spreads differ based on several factors including liquidity.

**T**

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**Target Assets**

Includes Agency mortgage-backed securities, TBA forward contracts, Agency debentures, CRT securities, non-Agency mortgage-backed securities commercial real estate investments, and corporate debt.

**To-Be-Announced Securities (TBAs)**

A contract for the purchase or sale of a mortgage-backed security to be delivered at a predetermined price, face amount, issuer, coupon and stated maturity on an agreed-upon future date but does not include a specified pool number and number of pools.

**TBA Dollar Roll Income**

TBA dollar roll income is defined as the difference in price between two TBA contracts with the same terms but different settlement dates. Dollar roll income represents the equivalent of interest income on the underlying security less an implied cost of financing.

**Total Return**

Investment performance measure over a stated time period which includes coupon interest, interest on interest, and any realized and unrealized gains or losses.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

Item 2. Management's Discussion and Analysis

Total Return Swap

A derivative instrument where one party makes payments at a predetermined rate (either fixed or variable) while receiving a return on a specific asset (generally an equity index, loan or bond) held by the counterparty.

U

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Unencumbered Assets

Assets on our balance sheet which have not been pledged as collateral against a liability.

U.S. Government-Sponsored Enterprise (GSE) Obligations

Obligations of Agencies originally established or chartered by the U.S. government to serve public purposes as specified by the U.S. Congress, such as Fannie Mae and Freddie Mac; these obligations are not explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. government.

V

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Value-at-Risk (VaR)

A statistical technique which measures the potential loss in value of an asset or portfolio over a defined period for a given confidence interval.

Variable Interest Entity (VIE)

An entity in which equity investors (i) do not have the characteristics of a controlling financial interest, and/or (ii) do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties.

Volatility

A statistical measure of the variance of price or yield over time. Volatility is low if the price does not change very much over a short period of time, and high if there is a greater change.

W

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Warehouse Lending

A line of credit extended to a loan originator to fund or purchase loans. The line of credit typically lasts from the time the loan is originated or purchased to when the loan is sold into the secondary market, whether directly or through a securitization. Warehouse lending can provide liquidity to the loan origination market.

Weighted Average Coupon

The weighted average interest rate of the underlying mortgage loans or pools that serve as collateral for a security, weighted by the size of the principal loan balances.

Weighted Average Life (WAL)

The assumed weighted average amount of time that will elapse from the date of a security's issuance until each dollar of principal is repaid to the investor. The WAL will change as the security ages and depending on the actual realized rate at which principal, scheduled and unscheduled, is paid on the loans underlying the MBS.



Y

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**Yield-to-Maturity**

The expected rate of return of a bond if it is held to its maturity date; calculated by taking into account the current market price, stated redemption value, coupon payments and time to maturity and assuming all coupons are reinvested at the same rate; equivalent to the internal rate of return.

75

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ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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Quantitative and qualitative disclosures about market risk are contained within the section titled “Risk Management” of Item 2. “Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

ITEM 4. CONTROLS AND PROCEDURES

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Our management, including our Chief Executive Officer (the CEO) and Chief Financial Officer (the CFO), reviewed and evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) of the Exchange Act) as of the end of the period covered by this quarterly report. Based on that review and evaluation, the CEO and CFO have concluded that our current disclosure controls and procedures, as designed, (1) were effective in ensuring that information required to be disclosed by us in reports we file or submit under the Securities Exchange Act is accumulated and communicated to our management, including our CEO and CFO, by our employees, as appropriate to allow timely decisions regarding required disclosure and (2) were effective in ensuring that information required to be disclosed by us in reports we file or submit under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods specified by the SEC’s rules and forms.

There have been no changes in our internal controls over financial reporting that occurred during the quarter ended June 30, 2016 that have materially affected, or are reasonably likely to materially affect our internal control over financial reporting.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

PART II – OTHER INFORMATION

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ITEM 1. LEGAL PROCEEDINGS

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From time-to-time, we are involved in various claims and legal actions arising in the ordinary course of business. At June 30, 2016, we were not party to any pending material legal proceedings.

ITEM 1A. RISK FACTORS

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Other than the following risk factors, there have been no material changes to the risk factors disclosed in Item 1A – Risk Factors of our most recent annual report on Form 10-K. The materialization of any risks and uncertainties identified in our Special Note Regarding Forward-Looking Statements contained in this report together with those disclosed below and those previously disclosed in our most recent annual report on Form 10-K and subsequent quarterly reports on Form 10-Q or those that are presently unforeseen could result in significant adverse effects on our financial condition, results of operations and cash flows. See Item 2. “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Special Note Regarding Forward-Looking Statements” in this quarterly report or our most recent annual report on Form 10-K.

Risks Related to the Hatteras Acquisition

We may fail to realize all of the expected benefits of the Hatteras Acquisition or those benefits may take longer to realize than expected.

The full benefits of the Hatteras Acquisition may not be realized as expected or may not be achieved within the anticipated time-frame, or at all. Failure to achieve the anticipated benefits of the Hatteras Acquisition could adversely affect our results of operations or cash flows, cause dilution to our earnings per share or book value per share, decrease or delay the expected accretive effect of the Hatteras Acquisition, and negatively impact the share price of our common stock.

In addition, we are devoting significant attention and resources to successfully integrate the Hatteras portfolio and operating businesses into the existing Annaly structure. In particular, we have limited experience operating Hatteras’ servicing platforms and managing Hatteras’ mortgage servicing rights (or MSR) portfolio. These activities present additional regulatory constraints and pose operational risks different from those that we have successfully managed in the past. This integration process, coupled with managing new business lines, may disrupt our businesses and, if ineffective, would limit the anticipated benefits of the Hatteras Acquisition and could adversely affect our results of operations or cash flows, cause dilution to our earnings per share or book value per share, decrease or delay the expected accretive effect of the Hatteras Acquisition, and negatively impact the share price of our common stock. We have incurred direct and indirect costs as a result of the Hatteras Acquisition.

We have incurred substantial expenses in connection with and as a result of the Hatteras Acquisition and we expect to incur additional expenses in connection with combining the businesses, operations, policies and procedures of the two companies. Factors beyond our control could affect the total amount or timing of these expenses, many of which, by their nature, are difficult to estimate accurately.

Investments in MSRs may expose us to additional risks.

Our investments in MSRs may subject us to certain additional risks, including the following:

Investments in MSRs are highly illiquid and subject to numerous restrictions on transfer and, as a result, there is risk that we would be unable to locate a willing buyer or get required approval to sell MSRs in the future should we desire to do so.

We have limited experience operating a master servicer and while ownership of MSRs and the operation of a master servicer includes many of the same risks as our other target assets, including risks related to prepayments, borrower credit, defaults, interest rates, hedging, and regulatory changes, there can be no assurance that we will be able to successfully operate a master servicer subsidiary and integrate it into our business operations.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

Our subsidiary's status as a Fannie Mae, Freddie Mac and Ginnie Mae approved servicer is subject to compliance with each of their respective selling and servicing guidelines, minimum capital requirements and other conditions they may impose from time to time at their discretion. The failure to meet such guidelines and conditions could result in the unilateral termination of our subsidiary's status as an approved servicer.

Our subsidiary is presently licensed in all states to hold MSR's, and to purchase whole loans, where a license is necessary to carry on such activities. Such state licenses may be revoked by a state regulatory authority.

Our rights to the excess servicing spread are subordinate to the interests of Fannie Mae, Freddie Mac and Ginnie Mae, and are subject to extinguishment. Fannie Mae and Freddie Mac each require approval of the sale of excess servicing spreads pertaining to their respective MSR's. We have entered into acknowledgement agreements or subordination of interest agreements with them, which acknowledge our subordinated rights.

Changes in minimum servicing compensation for agency loans could occur at any time and could negatively impact the value of the income derived from MSR's.

If we are not able to successfully manage these and other risks related to investing and managing MSR's, it may adversely affect our business, results of operations and financial condition.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

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On August 5, 2015 we announced that our Board of Directors authorized the repurchase of up to \$1.0 billion of our outstanding common shares through December 31, 2016. No shares were repurchased during the quarter ended June 30, 2016. As of June 30, 2016, the maximum dollar value of shares that may yet be purchased under this plan was \$783.0 million.

## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

## Item 6. Exhibits

## ITEM 6. EXHIBITS

## Exhibits:

The exhibits required by this item are set forth on the Exhibit Index attached hereto.

Exhibit Number	Exhibit Description
2.1	Agreement and Plan of Merger, by and among the Registrant, Ridgeback Merger Sub Corporation and Hatteras Financial Corp., dated as of April 10, 2016 (incorporated by reference to Exhibit 2.1 to the Registrant's Form 8-K filed with the Securities and Exchange Commission on April 11, 2016).
10.1	Amended and Restated Management Agreement, by and between the Registrant and Annaly Capital Management LLC, dated as of April 12, 2016 (incorporated by reference to Exhibit 10.1 to the Registrant's Form 8-K filed with the Securities and Exchange Commission on April 12, 2016).
31.1	Certification of Kevin G. Keyes, Chief Executive Officer and President (Principal Executive Officer) of the Registrant, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Glenn A. Votek, Chief Financial Officer (Principal Financial Officer) of the Registrant, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Kevin G. Keyes, Chief Executive Officer and President (Principal Executive Officer) of the Registrant, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Glenn A. Votek, Chief Financial Officer (Principal Financial Officer) of the Registrant, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
Exhibit 101.INS XBRL	Instance Document †
Exhibit 101.SCH XBRL	Taxonomy Extension Schema Document †
Exhibit 101.CAL XBRL	Taxonomy Extension Calculation Linkbase Document †
Exhibit 101.DEF XBRL	Additional Taxonomy Extension Definition Linkbase Document Created†
Exhibit 101.LAB XBRL	Taxonomy Extension Label Linkbase Document †
Exhibit 101.PRE	Taxonomy Extension Presentation Linkbase Document †

XBRL

† Submitted electronically herewith. Attached as Exhibit 101 to this report are the following documents formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Statements of Financial Condition at June 30, 2016 (Unaudited) and December 31, 2015 (Derived from the audited Consolidated Statement of Financial Condition at December 31, 2015); (ii) Consolidated Statements of Comprehensive Income (Loss) (Unaudited) for the quarters and six months ended June 30, 2016 and 2015; (iii) Consolidated Statements of Stockholders' Equity (Unaudited) for the six months ended June 30, 2016 and 2015; (iv) Consolidated Statements of Cash Flows (Unaudited) for the six months ended June 30, 2016 and 2015; and (v) Notes to Consolidated Financial Statements (Unaudited).

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

Signatures

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the city of New York, State of New York.

ANNALY CAPITAL MANAGEMENT, INC.

Dated: August 4, 2016 By: /s/ Kevin G. Keyes  
Kevin G. Keyes  
Chief Executive Officer, President and Director  
(Principal Executive Officer)

Dated: August 4, 2016 By: /s/ Glenn A. Votek  
Glenn A. Votek  
Chief Financial Officer (Principal Financial Officer)