

Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-K

Western Asset Mortgage Capital Corp  
Form 10-K  
March 29, 2018

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2017

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: 001-35543

WESTERN ASSET MORTGAGE CAPITAL CORPORATION

(Exact name of registrant as specified in its charter)

Delaware 27-0298092

(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification No.)

Western Asset Mortgage Capital Corporation

385 East Colorado Boulevard

Pasadena, California 91101

(Address of principal executive offices)

(626) 844-9400

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
---------------------	---

Common Stock, \$0.01 par value	New York Stock Exchange
--------------------------------	-------------------------

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes  No

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

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

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

Non-accelerated filer  
(Do not check if a smaller reporting company)  Smaller reporting company

Emerging growth company

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

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

The aggregate market value of the registrant's common stock held by non-affiliates was \$416,414,035 based on the closing sales price on the New York Stock Exchange on June 30, 2017.

On March 28, 2018, the registrant had a total of 41,679,679 shares of common stock outstanding.

---

TABLE OF CONTENTS

	Page
PART I	
<u>ITEM 1. Business</u>	<u>2</u>
<u>ITEM 1A. Risk Factors</u>	<u>8</u>
<u>ITEM 1B. Unresolved Staff Comments</u>	<u>32</u>
<u>ITEM 2. Properties</u>	<u>32</u>
<u>ITEM 3. Legal Proceedings</u>	<u>32</u>
<u>ITEM 4. Mine Safety Disclosures</u>	<u>32</u>
PART II	
<u>ITEM 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	<u>33</u>
<u>ITEM 6. Selected Financial Data</u>	<u>36</u>
<u>ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>37</u>
<u>ITEM 7A. Quantitative and Qualitative Disclosures About Market Risk</u>	<u>72</u>
<u>ITEM 8. Financial Statements and Supplementary Data</u>	<u>77</u>
<u>ITEM 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	<u>138</u>
<u>ITEM 9A. Controls and Procedures</u>	<u>138</u>
<u>ITEM 9B. Other Information</u>	<u>139</u>
PART III	
<u>ITEM 10. Directors, Executive Officers and Corporate Governance</u>	<u>139</u>
<u>ITEM 11. Executive Compensation</u>	<u>139</u>
<u>ITEM 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	<u>139</u>
<u>ITEM 13. Certain Relationships and Related Transactions and Director Independence</u>	<u>139</u>
<u>ITEM 14. Principal Accountant Fees and Services</u>	<u>139</u>
PART IV	
<u>ITEM 15. Exhibits and Financial Statement Schedule</u>	<u>139</u>
<u>SIGNATURES</u>	<u>142</u>

## FORWARD-LOOKING INFORMATION

The Company makes forward-looking statements herein and will make forward-looking statements in future filings with the Securities and Exchange Commission (the "SEC"), press releases or other written or oral communications within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act"), and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). For these statements, the Company claims the protections of the safe harbor for forward-looking statements contained in such sections. Forward-looking statements are subject to substantial risks and uncertainties, many of which are difficult to predict and are generally beyond the Company's control. These forward-looking statements include information about possible or assumed future results of the Company's business, financial condition, liquidity, results of operations, plans and objectives. When the Company uses the words "believe," "expect," "anticipate," "estimate," "plan," "continue," "intend," "should," "may" or similar expressions, the Company intends to identify forward-looking statements. Statements regarding the following subjects, among others, may be forward-looking: market trends in the Company's industry, interest rates, real estate values, the debt securities markets, the U.S. housing and the U.S. and foreign commercial real estate markets or the general economy or the market for residential and/or commercial mortgage loans; the Company's business and investment strategy; the Company's projected operating results; actions and initiatives of the U.S. Government and changes to U.S. Government policies and the execution and impact of these actions, initiatives and policies; the state of the U.S. and to a lesser extent, international economy generally or in specific geographic regions; economic trends and economic recoveries; the Company's ability to obtain and maintain financing arrangements, including under the Company's repurchase agreements, a form of secured financing, and securitizations; the current potential return dynamics available in residential mortgage-backed securities ("RMBS"), and commercial mortgage-backed securities ("CMBS" and collectively with RMBS, "MBS"); the level of government involvement in the U.S. mortgage market; the anticipated default rates on Non-Agency MBS (as defined herein), Residential and Commercial Whole-Loans and Residential Bridge Loans; the loss severity on Non-Agency MBS; the return of the Non-Agency RMBS, Non-Agency CMBS and asset-backed securities ("ABS") securitization markets; the general volatility of the securities markets in which the Company participates; changes in the value of the Company's assets; the Company's expected portfolio of assets; the Company's expected investment and underwriting process; interest rate mismatches between the Company's target assets and any borrowings used to fund such assets; changes in interest rates and the market value of the Company's target assets; changes in prepayment rates on the Company's target assets; effects of hedging instruments on the Company's target assets; rates of default or decreased recovery rates on the Company's target assets; the degree to which the Company's hedging strategies may or may not protect the Company from interest rate volatility; the impact of and changes in governmental regulations, tax law and rates, accounting guidance and similar matters; the Company's ability to maintain the Company's qualification as a real estate investment trust for U.S. federal income tax purposes; the Company's ability to maintain its exemption from registration under the Investment Company Act of 1940, as amended (the "1940 Act"); the availability of opportunities to acquire Agency RMBS, Non-Agency RMBS, CMBS, Residential and Commercial Whole-Loans, Residential and Commercial Bridge Loans and other mortgage assets; the availability of qualified personnel; estimates relating to the Company's ability to make distributions to its stockholders in the future; and the Company's understanding of its competition.

The forward-looking statements are based on the Company's beliefs, assumptions and expectations of its future performance, taking into account all information currently available to it. Forward-looking statements are not predictions of future events. These beliefs, assumptions and expectations can change as a result of many possible events or factors, not all of which are known to the Company. Some of these factors, are described in "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" of this annual report on Form 10-K. These and other risks, uncertainties and factors, including those described in the annual, quarterly and current reports that the Company files with the SEC, could cause its actual results to differ materially from those included in any forward-looking statements the Company makes. All forward-looking statements speak only as of the date they are made. New risks and uncertainties arise over time and it is not possible to predict those events or how they may affect the Company. Except as required by law, the Company is not obligated to, and does not intend to, update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.



## Part I

### Item 1. Business

#### Our Company

Western Asset Mortgage Capital Corporation, a Delaware corporation, and Subsidiary (the “Company” unless otherwise indicated or except where the context otherwise requires “we”, “us” or “our”) commenced operations in May 2012, focused on investing in, financing and managing a diversified portfolio of real estate related securities, whole-loans and other financial assets, which we collectively refer to as our target assets. We are externally managed by Western Asset Management (our “Manager”) pursuant to the terms of a management agreement. We conduct our operations to qualify and be taxed as a real estate investment trust, or REIT, for U.S. federal income tax purposes. Accordingly, we generally will not be subject to U.S. federal income taxes on our taxable income that we distribute currently to our stockholders as long as we maintain our intended qualification as a REIT. However, certain activities that we may perform may cause us to earn income which will not be qualifying income for REIT purposes. We have designated our subsidiary as taxable REIT subsidiary, or TRS, to engage in such activities. We also intend to operate our business in a manner that permits us to maintain our exemption from registration under the 1940 Act, as amended, or the Investment Company Act. Our common stock is traded on the New York Stock Exchange, or the NYSE, under the symbol “WMC”.

Our objective is to provide attractive risk adjusted returns to our shareholders primarily through an attractive dividend, we intend to support with sustainable core earnings, as well as the potential for higher returns through capital appreciation. Our investment strategy is based on our Manager's perspective of which mix of our target assets it believes provides us with the best risk-reward opportunities at any given time. We also deploy leverage as part of our investment strategy to increase potential returns. We primarily finance our investments through short-term repurchase agreements.

#### Our Manager

We are externally managed and advised by our Manager, an SEC-registered investment advisor and a wholly-owned subsidiary of Legg Mason, Inc., headquartered in Pasadena, California, that specializes in fixed-income asset management. From offices in Pasadena, Dubai, Hong Kong, London, Melbourne, New York, São Paulo, Singapore and Tokyo, our Manager's 862 employees provide investment services for a wide variety of global clients, including mutual funds, corporate, public, insurance, health care, union organizations and charitable foundations. In addition, two of our directors, James W. Hirschmann III and Jennifer W. Murphy, are also employees of our Manager. Our Manager is responsible for, among other duties: (i) performing all of our day-to-day functions; (ii) determining investment criteria in conjunction with our Board of Directors; (iii) sourcing, analyzing and executing investments, asset sales and financings; (iv) performing asset management duties; and (v) performing financial and accounting management.

#### Our Competitive Advantages

Our competitive advantages in the marketplace stems from our relationship with our Manager. As of December 31, 2017, our Manager had approximately \$442.2 billion in assets under management. Our Manager's scale makes it an important trading partner for many of the largest broker-dealers and banks, which provides our investment team the ability to source real estate related opportunities directly from originators as well as access attractive financing.

#### Our Investment Strategy

Our Manager’s investment philosophy, which developed from a singular focus in fixed-income asset management over a variety of credit cycles and conditions, is to provide clients with a diversified, long-term value-oriented portfolio. We benefit from the breadth and depth of our Manager’s overall investment philosophy, which focuses on a macroeconomic analysis as well as an in-depth analysis of individual assets and their relative value. In making investment decisions on our behalf, our Manager seeks to identify assets across the broad mortgage universe with attractive risk adjusted returns, which incorporates its view on the outlook for the mortgage markets, including relative

valuation, supply and demand trends, the level of interest rates, the shape of the yield curve, prepayment rates, financing and liquidity, commercial and residential real estate prices, delinquencies, default rates, recovery of various segments of the economy and vintage of collateral, subject to maintaining our REIT qualification and our exemption from registration under the 1940 Act.

Our target assets are comprised of Agency CMBS, Agency RMBS (including TBAs), Non-Agency CMBS, Non-Agency RMBS, Residential and Commercial Whole-Loans, Residential Bridge Loans, Commercial Mezzanine Loans, CMO's, GSE Risk Sharing Securities, Non U.S. CMBS and ABS, each of which is described below.

#### Our Target Assets

**Agency CMBS.** — Fixed and floating rate CMBS, for which the principal and interest payments are guaranteed by a U.S. Government agency or U.S. Government-sponsored entity, but for which the underlying mortgage loans are secured by real property other than single family residences. These may include, but are not limited to Fannie Mae DUS (Delegated Underwriting and Servicing) MBS, Freddie Mac Multifamily Mortgage Participation Certificates, Ginnie Mae project loan pools, and/or CMOs structured from such collateral.

**Agency RMBS.** — Agency RMBS, which are RMBS for which the principal and interest payments are guaranteed by a U.S. Government agency, such as the Government National Mortgage Association (“GNMA” or “Ginnie Mae”), or a U.S. Government-sponsored entity (“GSE”), such as the Federal National Mortgage Association (“FNMA” or “Fannie Mae”) or the Federal Home Loan Mortgage Corporation (“FHLMC” or “Freddie Mac”). The Agency RMBS we acquire can be secured by fixed-rate mortgages, adjustable-rate mortgages or hybrid adjustable-rate mortgages. Fixed-rate mortgages have interest rates that are fixed for the term of the loan and do not adjust. The interest rates on adjustable-rate mortgages generally adjust annually (although some may adjust more frequently) to an increment over a specified interest rate index. Hybrid adjustable-rate mortgages have interest rates that are fixed for a specified period of time (typically three, five, seven or ten years) and, thereafter, adjust to an increment over a specified interest rate index. Adjustable-rate mortgages and hybrid adjustable-rate mortgages generally have periodic and lifetime constraints on the amount by which the loan interest rate can change on any predetermined interest rate reset date.

**Non-Agency RMBS.** — RMBS that are not guaranteed by a U.S. Government agency or U.S. Government-sponsored entity, with an emphasis on securities that when originally issued were rated in the highest rating category by one or more of the nationally recognized statistical rating organizations. The mortgage loan collateral for Non-Agency RMBS consists of residential mortgage loans that do not generally conform to underwriting guidelines issued by a U.S. Government agency or U.S. Government-sponsored entity due to certain factors, including mortgage balances in excess of Agency underwriting guidelines, borrower characteristics, loan characteristics and/or level of documentation, and therefore are not issued or guaranteed by a U.S. Government agency or U.S. Government-sponsored entity. The mortgage loan collateral may be classified as subprime, Alternative-A or prime depending on the borrower’s credit rating and the underlying level of documentation. Non-Agency RMBS collateral may also include reperforming loans, which are conventional mortgage loans that were current at the time of the securitization, but had been delinquent in the past. Non-Agency RMBS may be secured by fixed-rate mortgages, adjustable-rate mortgages or hybrid adjustable-rate mortgages.

**Non-Agency CMBS.** — Fixed and floating rate CMBS for which the principal and interest payments are not guaranteed by a U.S. Government agency or U.S. Government-sponsored entity. We do not have an established minimum current rating requirement for such investments.

**Non U.S. CMBS.** — CMBS which is not guaranteed by a U.S. Government agency or U.S. Government-sponsored entity and which is secured by commercial real estate located outside of the U.S. Although our Manager believes that these investments can provide attractive risk-reward opportunities and offer additional asset diversification, investing in international real estate has a number of additional risks, including but not limited to currency risk, political risk and the legal risk of investing in jurisdictions with varying laws and regulations and potential tax implications.



GSE Risk Sharing Securities Issued by Fannie Mae and Freddie Mac. — From time to time we have and may in the future continue to invest in risk sharing securities issued by Fannie Mae and Freddie Mac. Principal and interest payments on these securities are based on the performance of a specified pool of Agency residential mortgages. The payments due on these securities, however, are not secured by the referenced mortgages, the payments due are full faith and credit obligations of Fannie Mae or Freddie Mac respectively, but neither agency guarantees full payment of the underlying mortgages. Investments in these securities generally are not qualifying assets for purposes of the 75% real estate asset test applicable to REITs and generally do not generate qualifying income for purposes of the 75% real estate income test applicable to REITs. As a result, we may be limited in our ability to invest in such assets.

TBAs. — We may utilize TBAs, in order to invest in Agency RMBS. Pursuant to these TBAs, we agree to purchase (or deliver), for future settlement, Agency RMBS with certain principal and interest terms and certain underlying collateral, but the particular Agency RMBS to be delivered is not identified until shortly before the TBA settlement date. Our ability to invest in Agency RMBS through TBAs may be limited by the 75% real estate income and asset tests applicable to REITs.

**Mortgage pass-through certificates.** — Mortgage pass-through certificates are securities representing interests in “pools” of mortgage loans secured by residential real property where payments of both interest and scheduled principal, plus pre-paid principal, on the underlying loan pools are made monthly to holders of the securities, in effect “passing through” monthly payments made by the individual borrowers on the mortgage loans that underlie the securities, net of fees paid to the issuer/guarantor of the securities and servicers of the underlying mortgages.

**Interest-Only Strips or IOs.** — This type of security entitles the holder only to payments of interest based on a notional principal balance. The yield to maturity of Interest-Only Strips is extremely sensitive to the rate of principal payments (particularly prepayments) on the underlying pool of mortgages. We invest in these types of securities primarily to take advantage of particularly attractive prepayment-related or structural opportunities in the MBS markets, as well as to help manage the duration of our overall portfolio.

**Inverse Interest-Only Strips or IIOs.** — This type of security has a coupon with an inverse relationship to its index and is subject to caps and floors. Inverse Interest-Only MBS entitles the holder to interest only payments based on a notional principal balance, which is typically equal to a fixed rate of interest on the notional principal balance less a floating rate of interest on the notional principal balance that adjusts according to an index subject to set minimum and maximum rates. The current yield of Inverse Interest-Only MBS will generally decrease when its related index rate increases and increase when its related index rate decreases.

**Agency and Non-Agency CMBS IO and IIO Securities.** — Interest-Only and Inverse Interest-Only securities for which the underlying collateral is commercial mortgages the principal and interest on which may or may not be guaranteed by a U.S. Government agency or U.S. Government-sponsored entity. Unlike single family residential mortgages in which the borrower, generally, can prepay at any time, commercial mortgages frequently limit the ability of the borrower to prepay, thereby providing a certain level of prepayment protection. Common restrictions include yield maintenance and prepayment penalties, the proceeds of which are generally at least partially allocable to these securities, as well as, defeasance.

**Principal-Only Strips or POs.** — This type of security generally only entitles the holder to receive cash flows that are derived from principal repayments of an underlying loan pool, but in the case of Non-Agency Principal-Only Strips will also include cash flows from default recoveries and excess interest. The yield to maturity of Principal-Only Strips is extremely sensitive to the rate of principal payments (particularly prepayments) on the underlying pool of mortgages. We invest in these types of securities primarily to take advantage of structural opportunities in the MBS markets.

**Residential Whole-Loans.** — Residential Whole-Loans are mortgages secured by single family residences held directly by us or through structured Non-Agency RMBS programs crafted specifically for us and other clients of our Manager. To date our Residential Whole-Loans have been mostly adjustable rate loans that do not qualify for the Consumer Finance Protection Bureau’s (or CFPB) safe harbor provision for “qualifying mortgages”. However, our Manager’s review, relating to possible purchases of loans, includes an analysis of the loan originator’s procedures and documentation for compliance with Ability to Repay requirements. These loans are held in consolidated trusts with us holding the beneficial interest in the trusts. We may in the future securitize the whole-loan interests, selling more senior interests in the pool of loans and retaining residual portions. The characteristics of our Residential Whole-Loans may vary going forward.

**Residential Bridge Loans.** — Residential Bridge Loans are mortgages secured by non owner occupied single family and multi-family residences, typically short-term, held directly by us or through structured Non-Agency RMBS programs crafted specifically for us and other clients of our Manager. These loans are held in a consolidated trust with us

holding the beneficial interest in the trust.

**Commercial Whole-Loans.** — Our Manager is also actively exploring opportunities to invest in small balance, \$2.5 million to \$25.0 million, Commercial Whole-Loans, including commercial mortgages and Small Business Administration or SBA loans secured primarily by real estate. While our Manager has experience in CMBS and we currently invest in Agency and Non-Agency CMBS, as well as, Non U.S. CMBS, investing in Whole-Loans backed or secured by commercial real estate assets involves complex investment, structural, regulatory and accounting issues. Some of these issues are unique to Commercial Whole-Loans as opposed to residential mortgages. Accordingly, there is no assurance of the prevalence such investments will have in our overall portfolio in the future.

**Commercial Mezzanine Loans.** — Commercial mezzanine loans are generally structured to represent a senior position in the borrower's equity in, and subordinate to a first mortgage loan, on a property. These loans are generally secured by pledges of ownership interests, in whole or in part, in entities that directly or indirectly own the real property. At times, mezzanine loans may be secured by additional collateral, including letters of credit, personal guarantees, or collateral unrelated to the property.

Mezzanine loans may be structured to carry either fixed or floating interest rates as well as carry a right to participate in a percentage of gross revenues and a percentage of the increase in the fair market value of the property securing the loan. Mezzanine loans may also contain prepayment lockouts, penalties, minimum profit hurdles and other mechanisms to protect and enhance returns to the lender. Mezzanine loans usually have maturities that match the maturity of the related mortgage loan but may have shorter or longer terms.

Collateralized Mortgage Obligations or CMOs. — These are securities, which can be Agency or Non-Agency, that are structured from residential and/or commercial pass-through certificates, which receive monthly payments of principal and interest. CMOs divide the cash flows which come from the underlying mortgage pass-through certificates into different classes of securities that may have different maturities and different weighted average lives than the underlying pass-through certificates.

ABS. — Debt and/or equity tranches of securitizations backed by various asset classes including, but not limited to, aircrafts, automobiles, credit cards, equipment, franchises, recreational vehicles and student loans. Investments in ABS generally are not qualifying assets for purposes of the 75% real estate asset test applicable to REITs and generally do not generate qualifying income for purposes of the 75% real estate income test applicable to REITs. As a result, we may be limited in our ability to invest in such assets.

Other investments. — In addition to MBS, our principal investment, and ABS from time to time, we may also make other investments in securities, which our Manager believes will assist us in meeting our investment objective and are consistent with our overall investment policies. These investments will normally be limited by the REIT requirements that 75% our assets be real estate assets and that 75% of our income be generated from real estate, thereby limiting our ability to invest in such assets.

#### Our Investment Portfolio

Our investment portfolio composition at December 31, 2017.

#### Our Financing Strategy

We deploy leverage to increase potential returns to our stockholders and to fund the acquisition of our target assets. While we are not required to maintain any particular leverage ratio, we expect to maintain a debt-to-equity ratio of three to ten times the amount of our stockholders' equity. To the extent the Agency MBS percentage of our portfolio decreases, our overall leverage is likely to decrease. The amount of leverage we use for our portfolio depends upon a variety of factors, such as, general economic, political and financial market conditions, the anticipated liquidity and price volatility of our assets, the availability and

cost of financing the assets, the credit worthiness of financing counterparties and the health of the U.S. residential mortgage and housing markets. At December 31, 2017, our aggregate debt-to-equity ratio was approximately 7.2 to 1. The debt-to-equity ratio is not a comprehensive statement of overall investment portfolio leverage which is affected by any leverage embedded in TBAs and derivative instruments.

#### Repurchase Agreements

We primarily finance our investments through repurchase agreements for which we pledge our assets. Our repurchase agreements have maturities generally ranging from one to three months, but in some cases longer. Repurchase agreements involve the transfer of the pledged collateral to a counterparty at an agreed upon price in exchange for such counterparty's simultaneous agreement to return the same security back to the borrower at a future date (i.e., the maturity of the borrowing). Under our repurchase agreements, we retain beneficial ownership of the pledged collateral, while the counterparty maintains custody of such collateral. At the maturity of a repurchase financing, unless the repurchase financing is renewed with the same counterparty, we are required to repay the loan, including any accrued interest, and concurrently reacquire custody of the pledged collateral or, with the consent of the counterparty, we may renew the repurchase financing at the then prevailing market interest rate and terms. The amount borrowed under our repurchase agreements is a specified percentage of the asset's applicable fair value, which is dependent on the collateral type. Our repurchase agreement counterparties generally require collateral in excess of the loan amount, or haircuts. As of December 31, 2017, our haircuts range from a low of 3.0% to a high of 5.0% for Agency RMBS, exclusive of IOs and IIOs for which the haircuts are as high as 20.0%, and Agency CMBS haircuts are 5.0%, exclusive of IOs and IIOs for which haircuts are as high as 15.0%. For Non-Agency RMBS, haircuts range from a low of 20.0% to a high of 26.0% and for Non-Agency CMBS, haircuts range from a low of 20.0% to a high of 40.0%. Haircuts for Whole-Loans are 20.0% and other securities range from a low of 22.5% to a high of 30.0%.

A significant decrease in asset value, advance rate, or an increase in the haircut could result in us having to sell assets in order to meet additional margin calls by our repurchase agreement counterparties. Our inability to post adequate collateral for a margin call by the counterparty could result in a condition of default under our repurchase agreements. We expect to mitigate our risk to margin calls by deploying leverage at the portfolio level at amounts below our available financing under our repurchase agreements.

In order to reduce our exposure of risk associated with concentration to any one repurchase agreement counterparty, we seek to diversify our exposure by entering into repurchase agreements with multiple counterparties. At December 31, 2017, we had repurchase agreements with 28 counterparties and outstanding borrowings with 16. Our total outstanding borrowings under our repurchase agreements was \$3.3 billion, with a maximum net exposure to any single repurchase agreement counterparty of \$65.5 million, or 14.1% of equity.

#### Convertible Senior Unsecured Notes

In October 2017, we issued \$115.0 million aggregate principal amount of 6.75% convertible senior unsecured notes, which included the underwriter's option to purchase \$15.0 million aggregate principal amount of the notes, for net proceeds to us of \$111.1 million. The notes mature on October 1, 2022, unless earlier converted, redeemed or repurchased by the holders pursuant to their terms, and are not redeemable by the Company except during the final three months prior to maturity. We view this financing as an attractive source of longer-term capital, which we believe was more cost efficient than issuing straight equity. We have and will continue to deploy the proceeds from the offering of the notes to acquire our target assets.

#### Our Hedging and Risk Management Strategy

Our overall portfolio strategy is designed to generate attractive returns to our investors through various economic cycles. We believe our broad approach to investing in the real estate market, which considers all categories of real estate assets, allows us to invest in a diversified portfolio and help mitigate our portfolio from risks that arise from investing in a single or limited collateral type. In connection with our risk management activities, we enter into a variety of derivative and non-derivative instruments. Our primary objective for acquiring these derivatives and non-derivative instruments is to mitigate our exposure to future events that are outside our control. Our derivative instruments are designed to mitigate the effects market risk and cash flow volatility associated with interest rate risk, including associated prepayment risk. As part of our hedging strategy, we may enter into, but not limited to, interest rate swaps, including forward starting swaps, interest rate swaptions, U.S. Treasury options, future contracts, TBAs, total return swaps, credit default swaps and foreign current swaps and forwards.

## Regulation

6

---

### REIT Qualification

We elected to be taxed as a REIT under Section 856 through 860 of the Internal Revenue Code of 1986, as amended (the "Code"), commencing with our taxable year ended December 31, 2012. We will generally not be subject to corporate U.S. federal income tax to the extent that we make qualifying distributions to stockholders, and provided that we satisfy, on a continuing basis, through actual investment and operating results, the REIT requirements including certain asset, income, distribution and stock ownership tests. If we fail to qualify as a REIT, and do not qualify for certain statutory relief provisions, we will be subject to U.S. federal, state and local income taxes and may be precluded from qualifying as a REIT for the subsequent four taxable years following the year in which we lost our REIT qualification. The failure to qualify as a REIT could have a material adverse impact on our results of operations and amounts available for distribution to stockholders.

### Investment Company Act Exemption

We conduct our operations so that we are not considered an investment company under the 1940 Act in reliance on the exemption provided by Section 3(c)(5)(C) of the 1940 Act. Section 3(c)(5)(C), as interpreted by the staff of the SEC, requires that: (i) at least 55% of our investment portfolio consist of "mortgages and other liens on and interest in real estate," or "qualifying real estate interests," and (ii) at least 80% of our investment portfolio consist of qualifying real estate interests plus "real estate-related assets." We have relied, and intend to continue to rely on current interpretations of the staff of the SEC in an effort to continue to qualify for an exemption from registration under the 1940 Act. For more information on the exemptions that we utilize refer to Item 1A, "Risk Factors" of this annual report on Form 10-K.

### Competition

Our net income depends, in part, on our ability to acquire assets at favorable spreads over our borrowing costs. In acquiring our target assets, we compete with other REITs, specialty finance companies, savings and loan associations, banks, mortgage bankers, insurance companies, mutual funds, institutional investors, investment banking firms, financial institutions, governmental bodies and other entities. In addition, other REITs with similar asset acquisition objectives, including a number that have been recently formed and others that may be organized in the future, compete with us in acquiring assets and obtaining financing. These competitors may be significantly larger than us, may have access to greater capital and other resources or may have other advantages. In addition, some competitors may have higher risk tolerances or different risk assessments, which could allow them to consider a wider variety of investments, and establish more relationships, than us. Current market conditions may attract more competitors, which may increase the competition for sources of financing. An increase in the competition for sources of funding could adversely affect the availability and cost of financing, and thereby adversely affect the market price of our common stock.

### Employees

We are externally managed pursuant to the management agreement dated May 9, 2012. We have no employees. All of our officers and two of our directors, James W. Hirschmann III and Jennifer W. Murphy, are employees of our Manager. Our Manager is responsible for, among other duties: (i) performing all of our day-to-day functions; (ii) determining investment criteria in conjunction with our Board of Directors; (iii) sourcing, analysing and executing investments, asset sales and financings; (iv) performing asset management duties; and (v) performing financial and accounting management.

### Corporate Governance and Internet Address

We emphasize the importance of professional business conduct and ethics through our corporate governance initiatives. In 2014, the Board took additional steps to enhance governance by appointing a lead independent director and adding a fourth independent director so that our Board of Directors consists of two-thirds independent directors. The audit, nominating and corporate governance, and compensation committees of our Board of Directors are composed entirely of independent directors. We have adopted corporate governance guidelines and a code of business conduct and ethics, which delineate our standards for our officers and directors.

Our internet address is [www.westernassetmcc.com](http://www.westernassetmcc.com). The information on our website is not incorporated by reference in this Annual Report on Form 10-K. We make available, free of charge through a link on our site, our annual reports on

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-K

Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to such reports, if any, as filed or furnished with the SEC, as soon as reasonably practicable after such filing or furnishing. Our site also contains our code of business conduct and ethics, corporate governance guidelines and the charters of our audit committee, nominating and corporate governance committee and compensation committee of our Board of Directors. Within the time period required by the rules of the SEC and the New York Stock Exchange, or NYSE, we will post on our website any amendment to our code of business conduct and ethics as defined in the code. Our documents filed with, or furnished to, the SEC are also available for review and copying by the public at the SEC's Public Reference Room at 100 F Street, NE., Washington, DC 20549 and at the SEC's website at [www.sec.gov](http://www.sec.gov). Information regarding the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330.



#### Item 1A. Risk Factors

Our business and operations are subject to a number of risks and uncertainties, the occurrence of which could adversely affect our business, financial condition, results of operations and ability to make distributions to stockholders and could cause the value of our capital stock to decline.

##### Risks related to our business

We may not be able to successfully operate our business or generate sufficient revenue to make or sustain distributions to our stockholders.

We cannot assure you that we will be able to continue to operate our business successfully or implement our operating policies and strategies as described herein. The results of our operations depend on several factors, including the availability of opportunities for the acquisition of assets, the level and volatility of interest rates, the availability of adequate short and long-term financing, conditions in the financial markets and economic conditions.

We may change any of our strategies, policies or procedures without stockholder consent.

We may change any of our strategies, policies or procedures with respect to investments, acquisitions, growth, operations, indebtedness, capitalization, distributions, financing strategy and leverage at any time without the consent of our stockholders, which could result in an investment portfolio with a different risk profile. A change in our investment strategy may increase our exposure to interest rate risk, default risk and real estate market fluctuations. Furthermore, a change in our asset allocation could result in our making investments in asset categories different from those described herein. These changes could adversely affect our financial condition, results of operations, the market price of our common stock and our ability to make distributions to our stockholders.

We may be unable to operate within the parameters that allow us to be excluded from regulation as a commodity pool operator, which would subject us to additional regulation and compliance requirements, and could materially adversely affect our business and financial condition.

As a result of regulatory changes prompted by the Dodd-Frank Act, any investment fund that trades in swaps may be considered a "commodity pool," which would cause its operators to be regulated as a "commodity pool operator" (CPO). In December 2012, the Commodity Futures Trading Commission issued a no-action letter giving relief to operators of mortgage REITs from the requirements applicable to CPOs. In order to qualify, we must, among other non-operational requirements: (1) limit our initial margin and premiums for commodity interests (swaps and exchange-traded futures) to no more than 5% of the fair market value of our total assets; and (2) limit our net income from commodity interests that are not "qualifying hedging transactions" to less than 5% of our gross income. These parameters could limit the use of swaps by us below the level that our Manager would otherwise consider optimal or may lead to the registration of our Manager or directors as commodity pool operators, which will subject us to additional regulatory oversight, compliance and costs.

Changes to derivatives regulation may increase the costs of hedging for the Company.

The Dodd-Frank Act established a comprehensive new regulatory framework for derivative contracts commonly referred to as "swaps" which requires that many swaps be executed on a regulated exchange or trading platform ("mandatory exchange trading") and cleared through a central counterparty ("mandatory clearing"). In particular, certain of the swaps that the Manager may want to use to hedge the Company's exposure to fluctuations in interest rates are now subject to clearing and mandatory exchange trading. In addition, beginning in 2017, new requirements to variation margins apply to over-the-counter swaps and other derivatives not centrally cleared. For swaps that are subject to mandatory clearing, the Company is forced to pledge some of its assets to a clearing broker as initial margin, and for the life of such swaps, the assets pledged as initial margin generally will not be available to the Company for investment. For swaps that are subject to mandatory clearing and mandatory exchange trading, the Company likely will incur additional fees and costs for transactions in such swaps. Together, these requirements may make our Manager's hedging strategies more costly or may induce our Manager to change its hedging strategies. We cannot assure you that our internal controls over financial reporting will consistently be effective.

We are responsible for establishing and maintaining adequate internal control over financial reporting designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Because of its inherent limitations,

internal control over financial reporting may not prevent or detect misstatements. We cannot ensure you that there will not be any material weaknesses or significant deficiencies in our internal control over financial reporting in the future.

8

---

Cybersecurity risk and cyber incidents may adversely affect our business by causing a disruption to our operations, a compromise or corruption of our confidential information and/or damage to our business relationships, all of which could negatively impact our financial results.

A cyber incident is considered to be any adverse event that threatens the confidentiality, integrity or availability of our information resources. These incidents may be an intentional attack or an unintentional event and could involve gaining unauthorized access to our information systems for purposes of misappropriating assets, stealing confidential information, corrupting data or causing operational disruption. The result of these incidents may include disrupted operations, misstated or unreliable financial data, liability for stolen assets or information, increased cybersecurity protection and insurance cost, litigation and damage to our investor relationships. As our reliance on technology has increased, so have the risks posed to both our information systems, both internal and those provided by our Manager and third party service providers. Our Manager has implemented processes, procedures and internal controls to help mitigate cybersecurity risks and cyber intrusions, but these measures, as well as our increased awareness of the nature and extent of a risk of a cyber incident, do not guarantee that our financial results, operations or confidential information will not be negatively impacted by such an incident.

Risks related to our investing strategy

Mortgage loan modification, refinancing programs, reduction in mortgage insurance premiums and minimum down payments and future legislative action may adversely affect the value of, and our returns on, Agency RMBS, Non-Agency RMBS and our additional portfolio assets.

The U.S. Government, through the U.S. Federal Reserve, the Federal Housing Administration, or the FHA, and the Federal Deposit Insurance Corporation, has implemented a number of federal programs designed to assist homeowners, including the Home Affordable Modification Program, or HAMP, which provides homeowners with assistance in avoiding residential mortgage loan foreclosures, the Hope for Homeowners Program, or H4H Program, which allowed certain distressed borrowers to refinance their mortgages into FHA-insured loans in order to avoid residential mortgage loan foreclosures, and the Home Affordable Refinance Program, or HARP, which allows borrowers who are current on their mortgage payments to refinance and reduce their monthly mortgage payments at loan-to-value ratios up to 125% (and, in some cases, above 125%) without new mortgage insurance. A number of these homeowners' assistance programs have been enhanced or expanded. HAMP expired on December 31, 2016, and borrowers who had requested assistance or to whom an offer of assistance had been extended as of that date had until September 30, 2017 to finalize their modification. HARP, which was scheduled to expire on December 31, 2016, has been extended to December 31, 2018. In addition, it is uncertain whether the new administration and Congressional majority will make any changes to these programs or any amendments to the bankruptcy laws to permit the modification of mortgage loans in bankruptcy proceedings. A significant number of loan modifications could result in a significant reduction in cash flows to the holders of the mortgage securities on an ongoing basis.

Amendments to the bankruptcy laws that result in the modification of outstanding mortgage loans may adversely affect the value of and the returns on, the assets that we may intend to acquire and the assets we currently hold. Especially with Non-Agency RMBS, a significant number of loan modifications with respect to a given security, including, but not limited to, those related to principal forgiveness and coupon reduction, resulting in increased prepayment rates, could negatively impact the realized yields and cash flows on such security. These loan modification programs, future legislative or regulatory actions, including possible amendments to the bankruptcy laws, which result in the modification of outstanding residential mortgage loans, as well as changes in the requirements necessary to qualify for refinancing mortgage loans with FNMA, FHLMC or GNMA may adversely affect the value of, and the returns on, Agency RMBS and Non-Agency RMBS.

In October 2014, the FHA announced that it would allow FNMA and FHLMC to purchase loans with three percent (3%) down payments, thereby reducing the down payment requirement for borrowers to access mortgage loans which are eligible for purchase and/or guarantee by these U.S. Government sponsored entities or GSEs. Further, in January 2015, the Obama administration announced a 50 basis point (0.50%) reduction in the annual mortgage insurance premium imposed by the FHA on mortgage loans guaranteed by GNMA. The reduction in the minimum down payment along with lowering all-in mortgage interest rates on GSE sponsored residential mortgage loans will likely

increase the attractiveness of refinancing as well as purchases of new and existing homes, thereby increasing the prepayment rates on the mortgage loans underlying our existing RMBS. This may adversely affect the value of, and the returns on, these assets, especially those which we acquired at a premium.

The payments of principal and interest we receive on our Agency RMBS, which depend directly upon payments on the mortgages underlying such securities, are guaranteed by FNMA, FHLMC and GNMA. FNMA and FHLMC are U.S. Government-sponsored entities, or GSEs, but their guarantees are not backed by the full faith and credit of the United States. GNMA is part of a U.S. Government agency and its guarantees are backed by the full faith and credit of the United States.

In response to general market instability and more specifically, the financial conditions of FNMA and FHLMC, in July 2008, the Housing and Economic Recovery Act of 2008, or HERA, established a new regulator for FNMA and FHLMC, the U.S. Federal Housing Finance Agency, or the FHFA. In September 2008, the U.S. Treasury, the FHFA and the U.S. Federal Reserve announced a comprehensive action plan to help stabilize the financial markets, support the availability of mortgage financing and protect taxpayers. Under this plan, among other things, the FHFA was appointed as conservator of both FNMA and FHLMC, allowing the FHFA to control the actions of the two GSEs, without forcing them to liquidate, which would be the case under receivership. Importantly, the primary focus of the plan was to increase the availability of mortgage financing by allowing these GSEs to continue to grow their guarantee business without limit, while limiting the size of their retained mortgage and Agency security portfolios and requiring that these portfolios be reduced over time.

Although the U.S. Government has committed to support the positive net worth of FNMA and FHLMC, there can be no assurance that these actions will be adequate for their needs. These uncertainties lead to questions about the availability of, and trading market for, Agency RMBS. Despite the steps taken by the U.S. Government, FNMA and FHLMC could default on their guarantee obligations which would materially and adversely affect the value of our Agency RMBS. Accordingly, if these government actions are inadequate and the GSEs continue to suffer losses or cease to exist, our business, operations and financial condition could be materially and adversely affected.

In recent year, lawmakers have proposed new legislations that would wind down the GSEs. In addition, the U.S. Government under the Trump Administration has made public comments regarding housing policy reforms, of which the scope and nature of the actions would be difficult to predict. These planned actions, including the eventual adoption of new legislations by the U.S. government, create market uncertainty with respect to the GSEs which could have a material and adverse effect on the quality and value of our Agency RMBS. The future roles of FNMA and FHLMC could be significantly reduced and the nature of their guarantee obligations could be considerably limited relative to historical measurements. Any such changes to the nature of their guarantee obligations could redefine what constitutes an Agency security and could have broad adverse implications for the market and our business, operations and financial condition. If FNMA or FHLMC were eliminated, or their structures were to change radically (i.e., limitation or removal of the guarantee obligation), or their market share reduced because of required price increases or lower limits on the loans they can guarantee, we could be unable to acquire additional Agency RMBS and our existing Agency RMBS could be materially and adversely impacted.

We are subject to the risk that U.S. Government agencies and/or GSEs may not be able to fully satisfy their guarantees of Agency RMBS or that these guarantee obligations may be repudiated, which may adversely affect the value of our assets and our ability to sell or finance these securities.

The interest and principal payments we receive on the Agency RMBS in which we invest are guaranteed by FNMA, FHLMC or GNMA. Unlike the GNMA securities in which we may invest, the principal and interest on securities issued by FNMA and FHLMC are not guaranteed by the U.S. government. All of the Agency RMBS in which we invest depend on a steady stream of payments on the mortgages underlying the securities.

As conservator of FNMA and FHLMC, the FHFA may disaffirm or repudiate contracts (subject to certain limitations for qualified financial contracts) that FHLMC or FNMA entered into prior to the FHFA's appointment as conservator if it determines, in its sole discretion, that performance of the contract is burdensome and that disaffirmation or repudiation of the contract promotes the orderly administration of its affairs. The HERA requires the FHFA to exercise its right to disaffirm or repudiate most contracts within a reasonable period of time after its appointment as conservator. FNMA and FHLMC have disclosed that the FHFA has disaffirmed certain consulting and other contracts that these entities entered into prior to the FHFA's appointment as conservator. FHLMC and FNMA have also disclosed that the FHFA has advised that it does not intend to repudiate any guarantee obligation relating to FNMA's and FHLMC's mortgage-related securities, because the FHFA views repudiation as incompatible with the goals of the conservatorship. In addition, the HERA provides that mortgage loans and mortgage-related assets that have been transferred to a FHLMC or FNMA securitization trust must be held for the beneficial owners of the related mortgage-related securities, and cannot be used to satisfy the general creditors of FHLMC or FNMA.

If the guarantee obligations of FHLMC or FNMA were repudiated by the FHFA, payments of principal and/or interest to holders of Agency RMBS issued by FHLMC or FNMA would be reduced in the event of any borrowers' late payments or failure to pay or a servicer's failure to remit borrower payments to the trust. In that case, trust administration and servicing fees could be paid from mortgage payments prior to distributions to holders of Agency RMBS. Any actual direct compensatory damages owed due to the repudiation of FHLMC or FNMA's guarantee obligations may not be sufficient to offset any shortfalls experienced by holders of Agency RMBS. The FHFA also has the right to transfer or sell any asset or liability of FHLMC or FNMA, including its guarantee obligation, without any approval, assignment or consent. If the FHFA were to transfer FHLMC or FNMA's guarantee obligations to another party, holders of Agency RMBS would have to rely on that party for satisfaction of the guarantee obligation and would be exposed to the credit risk of that party.

Beginning in 2014, we have invested in GSE Risk Sharing Securities issued by FNMA and FHLMC. Principal and interest payments on these securities are based on the performance of a specified pool of Agency residential mortgages. The payments due on these securities, however, are not secured by the referenced mortgages, but are full faith and credit obligations of Fannie Mae or Freddie Mac respectively. There is no implicit or explicit guarantee of these obligations by FHFA or that FHFA would satisfy such obligations if FNMA and/or FHLMC were to default. We operate in a highly competitive market for investment opportunities and competition may limit our ability to acquire desirable investments in our portfolio assets and could also affect the pricing of these securities.

We operate in a highly competitive market for investment opportunities. Currently, our profitability depends, in large part, on our ability to acquire our portfolio assets at attractive prices. In acquiring these assets, we compete with a variety of institutional investors, including other REITs, specialty finance companies, public and private funds (including other funds managed by our Manager), commercial and investment banks, commercial finance and insurance companies and other financial institutions. Many of our competitors are substantially larger and have considerably greater financial, technical, marketing and other resources than we do. Other REITs have recently raised, or may raise, additional capital, and may have investment objectives that overlap with ours, which may create additional competition for investment opportunities. Some competitors may have a lower cost of funds and access to funding sources that may not be available to us, such as funding from the U.S. Government. Many of our competitors are not subject to the operating constraints associated with REIT tax compliance or maintenance of an exemption from the 1940 Act. In addition, some of our competitors may have higher risk tolerances or different risk assessments, which could allow them to consider a wider variety of investments and establish more relationships than us.

Furthermore, competition for investments in our portfolio assets may lead to the price of such assets increasing, which may further limit our ability to generate desired returns. We cannot assure you that the competitive pressures we face will not have a material adverse effect on our business, financial condition and results of operations. Also, as a result of this competition, desirable investments in these assets may be limited in the future and we may not be able to take advantage of attractive investment opportunities from time to time, as we can provide no assurance that we will be able to identify and make investments that are consistent with our investment objectives.

A lack of liquidity in our investments may adversely affect our business. Liquidity in fixed income markets has declined in recent years.

The assets we acquire are not publicly traded. A lack of liquidity may result from the absence of a willing buyer or an established market for these assets, as well as legal or contractual restrictions on resale or the unavailability of financing for these assets. In addition, mortgage-related assets generally experience periods of illiquidity, especially during periods of economic stress such as the recent economic recession which resulted in increased delinquencies and defaults with respect to residential and commercial mortgage loans. The illiquidity of our investments may make it difficult for us to sell such investments if the need or desire arises. In addition, if we are required to liquidate all or a portion of our portfolio quickly, we may realize significantly less than the value at which we have previously recorded our investments. Further, we may face other restrictions on our ability to liquidate an investment in a business entity to the extent that we or our Manager has or could be attributed with material, non-public information regarding such business entity. As a result, our ability to vary our portfolio in response to changes in economic and other conditions may be relatively limited, which could adversely affect our results of operations and financial condition.

These risks have increased in recent years due to general declines in liquidity in fixed income markets. As a result of both the experience of dealers and other counterparties during the 2007-2010 credit issues and the resulting changes in regulatory and capital burdens on these entities, especially banks, market liquidity in fixed income has generally declined. Dealers and other market intermediaries are less likely to be prepared to hold bonds in inventory and take balance sheet risks, resulting in a significant reduction in market making activity. In addition, many dealers have exited one or more sectors of the fixed income markets.

Adverse developments in the broader residential mortgage market may adversely affect the value of the assets in which we invest.

Since 2007, the residential mortgage market in the United States has experienced a variety of unprecedented difficulties and changed economic conditions, including defaults, credit losses and liquidity concerns. Certain

commercial banks, investment banks and insurance companies announced extensive losses from exposure to the residential mortgage market. These losses reduced financial industry capital, leading to reduced liquidity for some institutions. These factors have impacted investor perception of the risk associated with real estate-related assets, including Agency RMBS and other high-quality RMBS assets. As a result, values for RMBS assets, including some Agency RMBS and other AAA-rated RMBS assets, have experienced a certain amount of volatility. Further increased volatility and deterioration in the broader residential mortgage and RMBS markets may adversely affect the performance and market value of the Agency RMBS and Non-Agency RMBS in which we invest.

Our most significant investments, to date, have been Agency RMBS and to a lesser extent Non-Agency RMBS and Agency and Non-Agency CMBS. We need to rely on our securities as collateral for our financings. Any decline in their value, or perceived market uncertainty about their value, would likely make it difficult for us to obtain financing on favorable terms or at all, or



maintain our compliance with terms of any financing arrangements already in place. The securities we acquire are classified for accounting purposes as available-for-sale. All assets classified as available-for-sale are reported at fair value, based on market prices from third party sources. We have elected to include any unrealized gains and losses in our earnings. If market conditions result in a decline in the fair value of our assets, our financial position and results of operations could be adversely affected.

A prolonged economic recession and further declining real estate values could impair our assets and harm our operations.

The risks associated with our business are more severe during economic recessions and are compounded by declining real estate values. The Non-Agency RMBS, Non-Agency CMBS and Whole-Loans in which we invest a part of our capital will be particularly sensitive to these risks. Declining real estate values will likely reduce the level of new mortgage loan originations since borrowers often use appreciation in the value of their existing properties to support the purchase of additional properties. Borrowers will also be less able to pay principal and interest on loans underlying the securities in which we invest if the value of residential and commercial real estate weakens further. Further, declining real estate values significantly increase the likelihood that we will incur losses on Non-Agency RMBS, Non-Agency CMBS and Whole-Loans in the event of default because the value of collateral on the mortgages underlying such securities may be insufficient to cover the outstanding principal amount of the loan. Any sustained period of increased payment delinquencies, foreclosures or losses could adversely affect our net interest income from Non-Agency RMBS, Non-Agency CMBS and Whole-Loans in our portfolio, which could have an adverse effect on our financial condition, results of operations and our ability to make distributions to our stockholders.

Our investments in Non-Agency RMBS are generally subject to losses.

In general, losses on a mortgaged property securing a mortgage loan included in a securitization will be borne first by the equity holder of the property, then by a cash reserve fund or letter of credit, if any, then by the "first loss" subordinated security holder and then by the holder of a higher-rated security. In the event of default and the exhaustion of any equity support, reserve fund, letter of credit, mezzanine loans or B-Notes, and any classes of securities junior to those in which we invest, we will not be able to recover all of our investment in the securities we purchase. In addition, if the underlying mortgage portfolio has been overvalued by the originator, or if the values subsequently decline, less collateral is available to satisfy interest and principal payments due on the related Non-Agency RMBS. The prices of lower credit quality securities are generally less sensitive to interest rate changes than more highly rated investments, but more sensitive to adverse economic downturns or individual issuer developments.

The mortgage loans underlying the Non-Agency RMBS that we invest in are subject to defaults, foreclosure timeline extension, fraud and residential price depreciation and unfavorable modification of loan principal amount, interest rate and amortization of principal, which could result in losses to us.

Our investments in Non-Agency RMBS are subject to the risks of defaults, foreclosure timeline extension, fraud and home price depreciation and unfavorable modification of loan principal amount, interest rate and amortization of principal, accompanying the underlying residential mortgage loans. The ability of a borrower to repay a mortgage loan secured by a residential property is dependent upon the income or assets of the borrower. A number of factors may impair borrowers' abilities to repay their loans, including:

- adverse changes in national and local economic and market conditions;
- changes in governmental laws and regulations, fiscal policies and zoning ordinances and the related costs of compliance with laws and regulations, fiscal policies and ordinances;
- costs of remediation and liabilities associated with environmental conditions such as indoor mold;
- the potential for uninsured or under-insured property losses;
- acts of God, including earthquakes, floods and other natural disasters, which may result in uninsured losses; and
- acts of war or terrorism, including the consequences of terrorist attacks, such as those that occurred on September 11, 2001.

In the event of defaults on the residential mortgage loans that underlie our investments in Non-Agency RMBS and the exhaustion of any underlying or any additional credit support, we may not realize our anticipated return on our

investments and we may incur a loss on these investments. In addition, our investments in Non-Agency RMBS will be backed by residential real property but, in contrast to Agency RMBS, the principal and interest will not be guaranteed by a U.S. Government agency or a GSE. The ability of a borrower to repay these loans or other financial assets is dependent upon the income or assets of these borrowers.

We may be affected by deficiencies in foreclosure practices of third parties, as well as related delays in the foreclosure process.

Allegations of deficiencies in foreclosure documentation and servicing and foreclosure practices by several large mortgage servicers have raised various concerns relating to foreclosure practices. As a result of these alleged deficiencies in foreclosure practices, a number of servicers temporarily suspended foreclosure proceedings beginning in the second half of 2010 while they evaluated their foreclosure practices. In addition, on February 9, 2012, a group consisting of state attorneys general and state bank and mortgage regulators in 49 states reached a settlement with the largest mortgage servicers regarding foreclosure practices in the states' various jurisdictions. On January 7, 2013, the Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System announced a settlement with a number of mortgage servicers in lieu of continuing a foreclosure review process, under which borrowers who believed they were financially harmed by the foreclosure process in 2009 and 2010 were able to request an independent review of the process. The settlement, which includes funds for both direct payments to eligible borrowers and for other assistance such as loan modifications and forgiveness of deficiency judgments, ended the case-by-case reviews. Although servicers have generally ended their suspension of foreclosures, the processing of foreclosures continues to be slow in many states due to continuing issues in the servicer foreclosure process, including efforts by servicers to comply with regulatory consent orders and requirements, recent changes in the state foreclosure laws, court rules and proceedings and the pipeline of foreclosures resulting from these delays as well as the elevated level of foreclosures caused by the housing market downturn. We may incur substantial legal fees and court costs in acquiring a property through contested foreclosure or bankruptcy proceedings. We intend to continue to monitor and review the issues raised by the alleged improper foreclosure practices.

Prior to making investments in RMBS, our Manager carefully considers many factors, including housing prices and foreclosure timelines, and estimate loss assumptions. The concerns about deficiencies in foreclosure practices of servicers and related delays in the foreclosure process may impact our loss assumptions and affect the values of, and our returns on, our investments in RMBS. We cannot predict exactly how the servicing and foreclosure matters or the resulting litigation or settlement agreements will affect our business and cannot assure you that these matters will not impair our performance and reduce the return on our investments.

The commercial mortgage loans underlying the CMBS we may acquire are subject to defaults, foreclosure timeline extension, fraud and commercial price depreciation and unfavorable modification of loan principal amount, interest rate and amortization of principal, which could result in losses to us.

CMBS may be secured by a single commercial mortgage loan or a pool of commercial mortgage loans. Commercial mortgage loans may be secured by multifamily or commercial property and are subject to risks of delinquency and foreclosure, and risks of loss that may be greater than similar risks associated with loans made on the security of residential property. The ability of a borrower to repay a loan secured by an income-producing property typically is dependent primarily upon the successful operation of such property rather than upon the existence of independent income or assets of the borrower. If the net operating income of the property is reduced, the borrower's ability or willingness to repay the loan may be impaired. Net operating income of an income-producing property can be affected by, among other things,

- tenant mix;
- success of tenant businesses;
- property management decisions;
- property location and condition;
- competition from comparable types of properties;
- changes in laws that increase operating expenses or limit rents that may be charged;
- any need to address environmental contamination at the property or the occurrence of any uninsured casualty at the property;
- changes in national, regional or local economic conditions and/or specific industry segments;
- declines in regional or local real estate values;
- declines in regional or local rental or occupancy rates;
- increases in interest rates;
- real estate tax rates and other operating expenses;

•changes in governmental rules, regulations and fiscal policies, including environmental legislation; and

13

---

acts of God, terrorist attacks, social unrest and civil disturbances.

If our Manager overestimates the loss-adjusted yields of our CMBS investments, we may experience losses.

Our Manager will analyze any CMBS investments we may acquire based on loss-adjusted yields, taking into account estimated future losses on the mortgage loans included in the securitization's pool of loans, and the estimated impact of these losses on expected future cash flows. Our Manager's loss estimates may not prove accurate, as actual results may vary from estimates. In the event that our Manager underestimates the pool level losses relative to the price we pay for a particular CMBS investment, we may experience losses with respect to such investment.

We do not control the special servicing of the mortgage loans included in the CMBS in which we invest and, in such cases, the special servicer may take actions that could adversely affect our interests.

With respect to CMBS in which we invest, overall control over the special servicing of the related underlying mortgage loans will be held by a "directing certificateholder" or a "controlling class representative," which is appointed by the holders of the most subordinate class of CMBS in such series. We may not have the right to appoint the directing certificateholder. In connection with the servicing of the specially serviced mortgage loans, the related special servicer may, at the direction of the directing certificateholder, take actions with respect to the specially serviced mortgage loans that could adversely affect our interests.

The residential and/or commercial mortgages which we may acquire in the form of whole-loans are subject to individual borrower credit risk.

To the extent we acquire residential or commercial first lien mortgages or whole-loans; we will be subject to individual credit risk. While such mortgages will be secured by single family residences or commercial properties, we will rely on the borrower's willingness to make timely payments. In certain states our ability to recover against a borrower on a residential property may be limited to either recovering from the borrower or foreclosing on the property. In either case, depending on state and local laws, such recovery could take an extended period of time and expense, during which period we would not be receiving any payments, thereby negatively impacting our cash flow. Similarly, to the extent a commercial loan is non-recourse, our recovery will be limited to the underlying real property which depending on several factors, including the location of such property, could take an extended period of time and expense, thereby negatively impacting our cash flow.

The receivables underlying the ABS we may acquire are subject to credit exposure, which could result in losses to us. ABS are securities backed by various asset classes including auto loans, student loans, credit card loans, equipment loans, floor plan loans and small business loans fully guaranteed as to principal and interest by the U.S. Small Business Administration, or the SBA. ABS remain subject to the credit exposure of the underlying receivables. In the event of increased rates of delinquency with respect to any receivables underlying our ABS, we may not realize our anticipated return on these investments.

Our investments are recorded at fair value, and quoted prices or observable inputs may not be available to determine such value, resulting in the use of significant unobservable inputs to determine value.

We expect that the values of some of our investments may not be readily determinable. We measure the fair value of these investments on at least a monthly basis. The fair value at which our assets are recorded may not be an indication of their realizable value. Ultimate realization of the value of an asset depends to a great extent on economic and other conditions that are beyond the control of our Manager, our Company or our Board of Directors. Further, fair value is only an estimate based on good faith judgment of the price at which an investment can be sold since market prices of investments can only be determined by negotiation between a willing buyer and seller. If we were to liquidate a particular asset, the realized value may be more than or less than the amount at which such asset is valued.

Accordingly, the value of our common stock could be adversely affected by our determinations regarding the fair value of our investments, whether in the applicable period or in the future. Additionally, such valuations may fluctuate over short periods of time.

Our determination of the fair value of our investments for GAAP includes inputs provided by third party dealers and pricing services. Valuations of certain investments in which we invest are often difficult to obtain. In general, dealers and pricing services heavily disclaim their valuations. Dealers may claim to furnish valuations only as an accommodation and without special compensation, and so they may disclaim any and all liability for any direct,

incidental, or consequential damages arising out of any inaccuracy or incompleteness in valuations, including any act of negligence or breach of any warranty. Depending on the complexity and illiquidity of a security, valuations of the same security can vary substantially from one dealer or pricing service to another. Therefore, our results of operations for a given period could be adversely affected if our determinations regarding the fair market value of these investments are materially different than the values that we ultimately realize upon their disposal. Due to an overall increase in market volatility, the valuation process has been particularly challenging recently as market events have made valuations of certain assets more difficult, unpredictable and volatile.

Declines in value of the assets in which we invest will adversely affect our financial position and results of operations, and make it more costly to finance these assets.

We use our investments as collateral for our financings. Any decline in their value, or perceived market uncertainty about their value, would likely make it difficult for us to obtain financing on favorable terms or at all, or maintain our compliance with terms of any financing arrangements already in place. Our investments in mortgage-backed securities are recorded at fair value under a fair value option election at the time of purchase with changes in fair value reported in earnings. As a result, a decline in fair values of our mortgage-backed securities could reduce both our earnings and stockholders' equity. If market conditions result in a decline in the fair value of our assets, our financial position and results of operations could be adversely affected.

An increase in interest rates may cause a decrease in the availability of certain of our portfolio assets, which could adversely affect our ability to acquire assets that satisfy our investment objectives and to generate income and make distributions.

Rising interest rates generally reduce the demand for mortgage loans due to the higher cost of borrowing. A reduction in the volume of mortgage loans originated may affect the volume of our portfolio assets available to us, which could adversely affect our ability to acquire assets that satisfy our investment objectives. Rising interest rates may also cause our assets that were issued prior to an interest rate increase to provide yields that are below prevailing market interest rates. If rising interest rates cause us to be unable to acquire a sufficient volume of our portfolio assets with a yield that is above our borrowing cost, our ability to satisfy our investment objectives and to generate income and make distributions may be materially and adversely affected.

The relationship between short-term and longer-term interest rates is often referred to as the "yield curve." Ordinarily, short-term interest rates are lower than longer-term interest rates. If short-term interest rates rise disproportionately relative to longer-term interest rates (a flattening of the yield curve), our borrowing costs may increase more rapidly than the interest income earned on our assets. Because our investments, on average, generally bear interest based on longer-term rates than our borrowings, a flattening of the yield curve would tend to decrease our net income and the market value of our net assets. Additionally, to the extent cash flows from investments that return scheduled and unscheduled principal are reinvested, the spread between the yields on the new investments and available borrowing rates may decline, which would likely decrease our net income. It is also possible that short-term interest rates may exceed longer-term interest rates (a yield curve inversion); in which event our borrowing costs may exceed our interest income and we could incur operating losses.

Increases in interest rates could adversely affect the value of our investments and cause our interest expense to increase, which could result in reduced earnings or losses and negatively affect our profitability as well as the cash available for distribution to our stockholders.

In a normal yield curve environment, generally our investments decline in value if long-term interest rates increase. Declines in market value may ultimately reduce earnings or result in losses to us, which may negatively affect cash available for distribution to our stockholders.

A significant risk associated with our portfolio assets is the risk that both long-term and short-term interest rates will increase significantly. If long-term rates increased significantly, the market value of these investments would decline, and the duration and weighted average life of the investments would increase. We could realize a loss if the securities were sold. At the same time, an increase in short-term interest rates would increase the amount of interest owed on any repurchase agreements we may enter into, thereby potentially reducing the net interest margin we earn on our investments and the income available for distribution to our shareholders.

Market values of our investments may decline without any general increase in interest rates for a number of reasons, such as increases or expected increases in defaults, or increases or expected increases in voluntary prepayments for those investments that are subject to prepayment risk or widening of credit spreads.

In addition, our operating results depend in large part on the difference between the income from our assets and our financing costs. We anticipate that, in most cases in a period of rising interest rates, the income from such assets will respond more slowly to interest rate fluctuations than the cost of our borrowings. Consequently, changes in interest rates, particularly short-term interest rates, may significantly influence our net income. Increases in these rates will

tend to decrease our net income and market value of our assets.

Interest rate mismatches between our RMBS backed by ARMs or hybrid ARMs and our borrowings used to fund our purchases of these assets may cause us to suffer losses.

We may fund our RMBS with borrowings that have interest rates that adjust more frequently than the interest rate indices and repricing terms of RMBS backed by adjustable-rate mortgages, or ARMs, or hybrid ARMs. Accordingly, if short-term interest rates increase, our borrowing costs may increase faster than the interest rates on RMBS backed by ARMs or hybrid ARMs adjust. As a result, in a period of rising interest rates, we could experience a decrease in net income or a net loss.



In most cases, the interest rate indices and repricing terms of RMBS backed by ARMs or hybrid ARMs and our borrowings will not be identical, thereby potentially creating an interest rate mismatch between our investments and our borrowings. While the historical spread between relevant short-term interest rate indices has been relatively stable, there have been periods when the spread between these indices was volatile. During periods of changing interest rates, these interest rate index mismatches could reduce our net income or produce a net loss, and adversely affect the level of our dividends and the market price of our common stock.

In addition, RMBS backed by ARMs or hybrid ARMs will typically be subject to lifetime interest rate caps that limit the amount an interest rate can increase through the maturity of the RMBS. However, our borrowings under repurchase agreements typically are not subject to similar restrictions. Accordingly, in a period of rapidly increasing interest rates, the interest rates paid on our borrowings could increase without limitation while caps could limit the interest rates on these types of RMBS. This problem is magnified for RMBS backed by ARMs or hybrid ARMs that are not fully indexed. Further, some RMBS backed by ARMs or hybrid ARMs may be subject to periodic payment caps that result in a portion of the interest being deferred and added to the principal outstanding. As a result, we may receive less cash income on these types of RMBS than we need to pay interest on our related borrowings. These factors could reduce our net interest income and cause us to suffer a loss during periods of rising interest rates.

As of December 31, 2017, none of our Agency RMBS, excluding Interest-Only Strips, were secured by ARMs or hybrid ARMs. Our Non-Agency RMBS, however, were secured by ARMs, Hybrid ARMS, pay option ARMs and fixed-rate mortgages. Further, there can be no assurance that this will not change in the future.

Interest rate fluctuations may adversely affect the level of our net income and the value of our assets and common stock.

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 our control. Interest rate fluctuations present a variety of risks, including the risk of a narrowing of the difference between asset yields and borrowing rates, flattening or inversion of the yield curve and fluctuating prepayment rates, and may adversely affect our income and the value of our assets and common stock.

Increases in interest rates may negatively affect the market value of the fixed-rate mortgages and hybrid ARMs in which we may invest. Our investments in these mortgage-backed securities are recorded at fair value under a fair value option election at the time of purchase with changes in fair value reported in earnings and any decrease in our earnings could cause the market value of our common stock to decline. In addition, rising interest rates generally reduce the demand for consumer and commercial credit, including mortgage loans, due to the higher cost of borrowing. A reduction in the volume of mortgage loans originated may affect the volume of MBS available to us, which could affect our ability to acquire assets that satisfy our investment objectives.

Since the onset of the economic recession in 2008, the Federal Reserve has maintained an accommodative monetary policy. Recent improvements in the U.S. labor market and overall U.S. economy have led to a discussion of the return of monetary policy to a more "normal" stature. According to its meeting in January 2018, the Federal Open Market Committee, or FOMC, left the federal funds rate at 1.5% since inflation is still below target, even though unemployment is low. The FOMC expects inflation to meet its 2% target in 2018 and expects to gradually raise the federal funds rate to its normal level of 2%. The FOMC will allow \$12 billion of Treasury securities to mature without replacing them. It will do the same with \$8 billion of mortgage-backed securities. The Federal Reserve is gradually winding down the \$4 trillion in holdings it acquired during quantitative easing. In determining the timing and size of future adjustments to the target range for the federal funds rate, the FOMC intends to assess realized and expected economic conditions relative to its objectives of maximum employment and 2% inflation. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments. Accordingly, we expect potentially three rate increases in 2018. We cannot project with certainty when and the rate at which the Federal Reserve will continue to increase the federal funds rate and what impact that will have on our business and operating results.

Changes in prepayment rates may adversely affect our profitability.

The RMBS assets we acquire are backed by pools of residential mortgage loans. We receive payments, generally, from the payments that are made on these underlying residential mortgage loans. While commercial mortgages frequently include limitations on the ability of the borrower to prepay, residential mortgages generally do not. When borrowers prepay their residential mortgage loans at rates that are faster than expected, the net result is prepayments that are faster than expected on the related RMBS. These faster than expected payments may adversely affect our profitability.

We may purchase RMBS assets that have a higher interest rate than the then prevailing market interest rate. In exchange for this higher interest rate, we may pay a premium to par value to acquire the asset. In accordance with accounting rules, we amortize this premium over the expected term of the asset based on our prepayment assumptions. If the asset is prepaid in whole or in part

at a faster than expected rate, however, we must expense all or a part of the remaining unamortized portion of the premium that was paid at the time of the purchase, which will adversely affect our profitability.

Prepayment rates generally increase when interest rates fall and decrease when interest rates rise, but changes in prepayment rates are difficult to predict. House price appreciation, while increasing the value of the collateral underlying our RMBS, may increase prepayment rates as borrowers may be able to refinance at more favorable terms. Prepayments can also occur when borrowers default on their residential mortgages and the mortgages are prepaid from the proceeds of a foreclosure sale of the property (an involuntary prepayment), or when borrowers sell the property and use the sale proceeds to prepay the mortgage as part of a physical relocation. Prepayment rates also may be affected by conditions in the housing and financial markets, increasing defaults on residential mortgage loans, which could lead to an acceleration of the payment of the related principal, general economic conditions and the relative interest rates on fixed-rate mortgages and ARMs. While we seek to manage prepayment risk, in selecting RMBS investments we must balance prepayment risk against other risks, the potential returns of each investment and the cost of hedging our risks. No strategy can completely insulate us from prepayment or other such risks, and we may deliberately retain exposure to prepayment or other risks.

In addition, a decrease in prepayment rates may adversely affect our profitability. When borrowers prepay their residential mortgage loans at slower than expected rates, prepayments on the RMBS may be slower than expected. These slower than expected payments may adversely affect our profitability. We may purchase RMBS assets that have a lower interest rate than the then prevailing market interest rate. In exchange for this lower interest rate, we may pay a discount to par value to acquire the asset. In accordance with accounting rules, we accrete this discount over the expected term of the asset based on our prepayment assumptions. If the asset is prepaid at a slower than expected rate, however, we must accrete the remaining portion of the discount at a slower than expected rate. This will extend the expected life of the asset and result in a lower than expected yield on assets purchased at a discount to par. We could be materially and adversely affected by poor market conditions where the properties securing the mortgage loans underlying our investments are geographically concentrated.

Our performance depends on the economic conditions in markets in which the properties securing the mortgage loans underlying our investments are concentrated. As of December 31, 2017, a substantial portion of our investments had underlying properties in California. Our financial condition, results of operations, the market price of our common stock and our ability to make distributions to our stockholders could be materially and adversely affected by this geographic concentration if market conditions, such as an oversupply of space or a reduction in demand for real estate in an area, deteriorate in California. Moreover, due to the geographic concentration of properties securing the mortgages underlying our investments, the Company may be disproportionately affected by general risks such as natural disasters, including major wildfires, floods and earthquakes, severe or inclement weather, and acts of terrorism should such developments occur in or near the markets in California in which such properties are located.

We may make investments in non U.S. dollar denominated securities, which will be subject to currency rate exposure and risks associated with the uncertainty of foreign laws and markets.

Some of our real estate-related securities investments may be denominated in foreign currencies, and therefore, we expect to have currency risk exposure to any such foreign currencies. A change in foreign currency exchange rates may have an adverse impact on returns on our non U.S. dollar denominated investments. Although we may hedge our foreign currency risk subject to the REIT income tests, we may not be able to do so successfully and may incur losses on these investments as a result of exchange rate fluctuations. To the extent that we invest in non U.S. dollar denominated securities, in addition to risks inherent in the investment in securities generally discussed in this Form 10-K, we will also be subject to risks associated with the uncertainty of foreign laws and markets including, but not limited to, unexpected changes in regulatory requirements, political and economic instability in certain geographic locations, difficulties in managing international operations, currency exchange controls, potentially adverse tax consequences, additional accounting and control expenses and the administrative burden of complying with a wide variety of foreign laws.

We are highly dependent on information systems and systems failures could significantly disrupt our business, which may, in turn, negatively affect the market price of our common stock and our ability to make distributions to all stockholders.

Our business is highly dependent on communications and information systems of our Manager and other third party service providers. Any failure or interruption of our Manager's or other third party service providers' systems could cause delays or other problems in our securities trading activities, which could have a material adverse effect on our operating results and negatively affect the market price of our common stock and our ability to make distributions to our stockholders.

Loss of our exemption from regulation pursuant to the 1940 Act would adversely affect us.

We conduct our business so as not to become regulated as an investment company under the 1940 Act in reliance on the exemption provided by Section 3(c)(5)(C) of the 1940 Act. Section 3(c)(5)(C), as interpreted by the staff of the SEC, requires that: (i) at least 55% of our investment portfolio consist of "mortgages and other liens on and interest in real estate," or "qualifying real estate interests," and (ii) at least 80% of our investment portfolio consist of qualifying real estate interests plus "real estate-related assets." In satisfying this 55% requirement, based on pronouncements of the SEC staff, we may treat whole pool Agency RMBS as qualifying real estate interests. The SEC staff has not issued guidance with respect to whole pool Non-Agency RMBS. Accordingly, based on our own judgment and analysis of the SEC's pronouncements with respect to whole pool Agency RMBS, we may also treat Non-Agency RMBS issued with respect to an underlying pool of mortgage loans in which we hold all of the certificates issued by the pool as qualifying real estate interests. We currently treat partial pool Agency, Non-Agency RMBS and partial pool CMBS as real estate-related assets. We treat any ABS, interest rate swaps or other derivative hedging transactions we enter into as miscellaneous assets that will not exceed 20% of our total assets. We rely on guidance published by the SEC staff or on our analyses of guidance published with respect to other types of assets to determine which assets are qualifying real estate assets and real estate-related assets.

The SEC in 2011 solicited public comment on a wide range of issues relating to Section 3(c)(5)(C), including the nature of the assets that qualify for purposes of the exemption and whether mortgage REITs should be regulated in a manner similar to investment companies. To date the staff has not issued any additional guidance. There can be no assurance that the laws and regulations governing the 1940 Act status of REITs, including the guidance of the Division of Investment Management of the SEC regarding this exemption, will not change in a manner that adversely affects our operations. To the extent that the SEC or its staff publishes new or different guidance with respect to these matters, we may be required to adjust our strategy accordingly. In addition, we may be limited in our ability to make certain investments and these limitations could require us to hold assets we might wish to sell or to sell assets we might wish to hold. To the extent that the SEC staff provides more specific guidance regarding any of the matters bearing upon the exemption we rely on from the 1940 Act, we may be required to adjust our strategy accordingly. Any additional guidance from the SEC staff could provide additional flexibility to us, or it could further inhibit our ability to pursue the strategies we have chosen.

The mortgage related investments that we acquire are limited by the provisions of the 1940 Act and the rules and regulations promulgated thereunder. If the SEC determines that any of these securities are not qualifying interests in real estate or real estate-related assets, adopts a contrary interpretation with respect to these securities or otherwise believes we do not satisfy the above exceptions or changes its interpretation of the above exceptions, we could be required to restructure our activities or sell certain of our assets. We may be required at times to adopt less efficient methods of financing certain of our mortgage related investments and we may be precluded from acquiring certain types of higher yielding securities. The net effect of these factors would be to lower our net interest income. If we fail to qualify for an exemption from registration as an investment company or an exclusion from the definition of an investment company, our ability to use leverage would be substantially reduced. Further, if the SEC determined that we were an unregistered investment company, we could be subject to monetary penalties and injunctive relief in an action brought by the SEC, we would potentially be unable to enforce contracts with third parties which could seek to obtain rescission of transactions undertaken during the period for which it was established we were an unregistered investment company. If we were required to register as an investment company, it would result in a change of our financial statement requirements. Our business will be materially and adversely affected if we fail to qualify for this exemption from regulation pursuant to the 1940 Act. In addition, the loss of our 1940 Act exemption would also permit our Manager to terminate the Management Agreement, which could result in material adverse effect on our business and results of operations.

Compliance with our 1940 Act exemption will limit our ability to invest in certain of our target assets.

At times the Manager may be limited in allocating equity to target that do not qualify as real estate or real estate related assets for purposes of the 1940 Act exemption. This limitation could adversely affect the performance of our portfolio if these non qualifying assets presents more attractive investment opportunities. Among the current target assets that are not real estate assets are ABS, non pool Agency and Non-Agency MBS, GSE Risk Sharing Securities

and certain Commercial Mezzanine Loans.

The downgrade of the U.S. government's or certain European countries' credit ratings and any future downgrades of the U.S. government's or certain European countries' credit ratings may materially adversely affect our business, financial condition and results of operations.

On August 5, 2011, Standard & Poor's downgraded the U.S. government's credit rating for the first time in history. More recently, concerns over economic recession, geopolitical issues, the ability of certain European sovereigns to honor their debt obligations and the exposure of certain European financial institutions to such debt, potential deflationary pressures in Europe, slowing growth in China, rapid decline in the price of oil and certain other commodities, the availability and cost of financing, the mortgage market, uncertainty related to political events such as the government spending and tax policy and uncertain real estate market have contributed to volatility and relatively low expectations for the world economy and domestic and international markets. Europe remains vulnerable to volatile financial and credit markets due to economic and political uncertainties, including the United Kingdom's decision to withdraw from the European Union, the ongoing refugee crisis, financial uncertainty in Greece

and a lack of confidence in the European Union's banking system. Because FNMA and FHLMC are in conservatorship of the U.S. government, downgrades to the U.S. government's credit rating could impact the credit risk associated with Agency MBS and, therefore, decrease the value of the Agency MBS in which we invest. In addition, the downgrade of the U.S. government's credit rating and the credit ratings of certain European countries has created broader financial turmoil and uncertainty, which has recently weighed heavily on the global banking system. Therefore, the downgrade of the U.S. government's credit rating and the credit ratings of certain European countries and any future downgrades of the U.S. government's credit rating or the credit ratings of certain European countries may materially adversely affect our business, financial condition and results of operations.

#### Risks related to financing and hedging

Our strategy involves significant leverage, which may amplify losses.

Our current target leverage generally ranges between three to ten times the amount of our stockholders' equity (calculated in accordance with U.S. GAAP). We incur this leverage by borrowing against a substantial portion of the market value of our assets. By utilizing this leverage, we can enhance our returns. Nevertheless, this leverage, which is fundamental to our investment strategy, also creates significant risks.

As a result of our significant leverage, we may incur substantial losses if our borrowing costs increase. Our borrowing costs may increase for any of the following reasons:

- short-term interest rates increase;
- the market value of our securities decreases;
- interest rate volatility increases; or
- the availability of financing in the market decreases.

There can be no assurance that our Manager will be able to prevent mismatches in the maturities of our assets and liabilities.

Because we employ financial leverage in funding our portfolio, mismatches in the maturities of our assets and liabilities can create risk in the need to continually renew or otherwise refinance our liabilities. Our net interest margins are dependent upon a positive spread between the returns on our asset portfolio and our overall cost of funding. Our Manager actively employs portfolio-wide and security-specific risk measurement and management processes in our daily operations. Our Manager's risk management tools include software and services licensed or purchased from third parties, in addition to proprietary systems and analytical methods developed internally. There can be no assurance that these tools and the other risk management techniques described above will protect us from asset/liability risks.

We may be subject to margin calls under our master repurchase agreements, which could result in defaults or force us to sell assets under adverse market conditions or through foreclosure.

We have entered into master repurchase agreements with various financial institutions and borrow under these master repurchase agreements to finance the acquisition of assets for our investment portfolio. Pursuant to the terms of borrowings under our master repurchase agreements, a decline in the value of the subject assets may result in our lenders initiating margin calls. A margin call means that the lender requires us to pledge additional collateral to re-establish the ratio of the value of the collateral to the amount of the borrowing. The specific collateral value to borrowing ratio that would trigger a margin call is not set in the master repurchase agreements and will not be determined until we engage in a repurchase transaction under these agreements. Our fixed-rate securities generally are more susceptible to margin calls as increases in interest rates tend to have a greater negative affect on the market value of fixed-rate securities. If we are unable to satisfy margin calls, our lenders may foreclose on our collateral. The threat of or occurrence of a margin call could force us to sell our assets, either directly or through a foreclosure, under adverse market conditions. Because of the significant leverage we have, we may incur substantial losses upon the threat or occurrence of a margin call.

If a counterparty to our repurchase transactions defaults on its obligation to resell the underlying security back to us at the end of the transaction term, or if the value of the underlying security has declined as of the end of that term, or if we default on our obligations under the repurchase agreement, we will lose money on our repurchase transactions.

When we engage in repurchase transactions, we generally sell securities to lenders (repurchase agreement counterparties) and receive cash from these lenders. The lenders are obligated to resell the same securities back to us at the end of the term of the transaction. Because the cash we receive from the lender when we initially sell the securities to the lender will be less than the value of those securities (this difference is the haircut), if the lender defaults on its obligation to resell the same securities back to us we may incur a loss on the transaction equal to the amount of the haircut (assuming there was no change in the value of the



securities). We would also lose money on a repurchase transaction if the value of the underlying securities has declined as of the end of the transaction term, as we would have to repurchase the securities based on their initial value but would receive securities worth less than that amount. Further, if we default on one of our obligations under a repurchase transaction, the lender can terminate the transaction and cease entering into any other repurchase transactions with us. Our inability to post adequate collateral for a margin call by the counterparty, in a time frame as short as the close of the same business day, could result in a condition of default under our repurchase agreements, thereby enabling the counterparty to liquidate the collateral pledged by us, which may have a material adverse effect on our financial position, results of operations and cash flows. Certain of our repurchase agreements contain cross-default provisions, such that if a default occurs under an agreement with any specific lender, that lender could also declare a default under other repurchase agreements or other financing or derivative contracts, if any, with such lender. Further, 14 of the counterparties to our repurchase agreements held, as of December 31, 2017, collateral valued in excess of 5% of our stockholders' equity as security for our obligations under the applicable repurchase agreements. Any losses we incur on our repurchase transactions could adversely affect our earnings and thus our cash available for distribution to our stockholders.

If a counterparty to one of our swap agreements or TBAs defaults on its obligations, we may incur losses.

If a counterparty to one of the bilateral swap agreements that we enter into or TBAs that we enter into defaults on its obligations under the agreement, we may not receive payments due under the agreement, and thus, we may lose any unrealized gain associated with the agreement. In the case of a swap agreement, the fact that such swap agreement hedged a liability means that the liability could cease to be hedged upon the default of a counterparty. Additionally, we may also risk the loss of any collateral we have pledged to secure our obligations under a bilateral swap agreement if the counterparty, or in the case of a cleared swap, if our clearing broker, becomes insolvent or files for bankruptcy. Failure to procure adequate repurchase agreement financing, which generally have short terms, or to renew or replace repurchase agreement financing as it matures, would adversely affect our results of operations.

We use repurchase agreement financing as a strategy to increase the return on our investment portfolio. However, we may not be able to achieve our desired leverage ratio for a number of reasons, including if the following events occur:

- our lenders do not make repurchase agreement financing available to us at acceptable rates;
- certain of our lenders exit the repurchase market;
- our lenders require that we pledge additional collateral to cover our borrowings, which we may be unable to do; or
- we determine that the leverage would expose us to excessive risk.

We cannot assure you that any, or sufficient, repurchase agreement financing will be available to us on terms that are acceptable to us. In recent years, investors and financial institutions that lend in the securities repurchase market, have tightened lending standards in response to the difficulties and changed economic conditions that have materially adversely affected the MBS market. These market disruptions have been most pronounced in the Non-Agency MBS market, and the impact has also extended to Agency MBS, which has made the value of these assets unstable and relatively illiquid compared to prior periods. Any decline in their value, or perceived market uncertainty about their value, would make it more difficult for us to obtain financing on favorable terms or at all, or maintain our compliance with terms of any financing arrangements then in place.

As of December 31, 2017, we had amounts outstanding under repurchase agreements with 16 separate lenders and had repurchase agreements with 28 different lenders. Prior to entering into a lending relationship with any financial institution, our Manager does a thorough credit review of such potential lender. Notwithstanding the foregoing, a material adverse development involving one or more major financial institutions or the financial markets in general, in addition to the regulatory changes, could result in our lenders reducing our access to funds available under our repurchase agreements or terminating such agreements altogether.

Furthermore, because we rely primarily on short-term borrowings, our ability to achieve our investment objective will depend not only on our ability to borrow money in sufficient amounts and on favorable terms, but also on our ability to renew or replace on a continuous basis our maturing short-term borrowings. If we are not able to renew or replace maturing borrowings due to changes in the regulatory environment or for any other reason, we will have to sell some or all of our assets, possibly under adverse market conditions which may have a material adverse effect on our

financial position, results of operations and cash flows. In addition, the aforementioned changes to the regulatory capital requirements imposed on our lenders may significantly increase the cost of the financing that they provide to us. Our lenders also may revise their eligibility requirements for the types of assets they are willing to finance or the terms of such financings, based on, among other factors, the recent changes in the regulatory environment and their management of perceived risk, particularly with respect to assignee liability.

Our repurchase agreement financing may require us to provide additional collateral and may restrict us from leveraging our assets as fully as desired.

We use repurchase agreements to finance acquisitions of our investments. If the market value of the asset pledged or sold by us to a financing institution pursuant to a repurchase agreement declines, we may be required by the financing institution to provide additional collateral or pay down a portion of the funds advanced, but we may not have the funds available to do so, which could result in defaults. Posting additional collateral to support our credit will reduce our liquidity and limit our ability to leverage our assets, which could adversely affect our business. In the event we do not have sufficient liquidity to meet such requirements, financing institutions can accelerate repayment of our indebtedness, increase interest rates, liquidate our collateral or terminate our ability to borrow. Such a situation would likely result in a rapid deterioration of our financial condition and possibly necessitate a filing for bankruptcy protection.

On the date each month that principal payments are announced (i.e., the factor day for our Agency RMBS), the value of our Agency RMBS pledged as collateral under our repurchase agreements is reduced by the amount of the prepaid principal and, as a result, our lenders will typically initiate a margin call requiring the pledge of additional collateral or cash, in an amount equal to such prepaid principal, in order to re-establish the required ratio of borrowing to collateral value under such repurchase agreements. Accordingly, with respect to our Agency RMBS the announcement on factor day of principal prepayments is in advance of our receipt of the related scheduled payment, thereby creating a short-term receivable for us in the amount of such principal prepayments; however, under our repurchase agreements, we may receive a margin call relating to the related reduction in value of our Agency RMBS and prior to receipt of this short-term receivable, be required to post additional collateral or cash in an amount equal to the product of the advance rate of such repurchase agreement and the principal prepayment on or about factor day, which would reduce our liquidity during the period in which the short term receivable is outstanding. As a result, in order to meet any such margin calls, we could be forced to sell assets in order to maintain liquidity. Forced sales under adverse market conditions may result in lower sales prices than ordinary market sales in the normal course of business.

Further, financial institutions providing the repurchase facilities may require us to maintain a certain amount of cash uninvested or to set aside non-levered assets sufficient to maintain a specified liquidity position which would allow us to satisfy our collateral obligations. As a result, we may not be able to leverage our assets as fully as we would choose which could reduce our return on equity. If we are unable to meet these collateral obligations, our financial condition could deteriorate rapidly.

Lenders may require us to enter into restrictive covenants relating to our operations.

When we obtain further financing, lenders could impose restrictions on us that would affect our ability to incur additional debt, our capability to make distributions to stockholders and our flexibility to determine our operating policies. Loan documents we execute may contain negative covenants that limit, among other things, our ability to repurchase stock, distribute more than a certain amount of our funds from operations, and employ leverage beyond certain amounts.

Our rights under repurchase agreements may be subject to the effects of the bankruptcy laws in the event of the bankruptcy or insolvency of us or our counterparties under the repurchase agreements.

In the event of our insolvency or bankruptcy, certain repurchase agreements may qualify for special treatment under the U.S. Bankruptcy Code, the effect of which, among other things, would be to allow the lender under the applicable repurchase agreement to avoid the automatic stay provisions of the U.S. Bankruptcy Code and to take possession of and liquidate the assets that we have pledged under their repurchase agreements. In the event of the insolvency or bankruptcy of a lender during the term of a repurchase agreement, the lender may be permitted, under applicable insolvency laws, to repudiate the contract, and our claim against the lender for damages may be treated simply as the claim of an unsecured creditor. In addition, if the lender is a broker or dealer subject to the Securities Investor Protection Act of 1970, or an insured depository institution subject to the Federal Deposit Insurance Act, our ability to exercise our rights to recover our securities under a repurchase agreement or to be compensated for any damages resulting from the lender's insolvency may be further limited by those statutes. These claims would be subject to significant delay and, if and when received, may be substantially less than the damages we actually incur.

An increase in our borrowing costs relative to the interest that we receive on our portfolio investments may adversely affect our profitability and cash available for distribution to our stockholders.

As long as we earn a positive spread between interest and other income we earn on our leveraged assets and our borrowing costs, we believe that we can generally increase our profitability by using greater amounts of leverage. We cannot, however, assure you that repurchase financing will remain an efficient source of long-term financing for our assets. The amount of leverage that we use may be limited because our lenders might not make funding available to us or they may require that we provide additional collateral to secure our borrowings. If our financing strategy is not viable, we will have to find alternative forms of financing for our assets which may not be available to us on acceptable terms or at acceptable rates. In addition, in response to certain interest rate and investment environments or to changes in the market liquidity, we could adopt a strategy of reducing our leverage by selling assets or not reinvesting principal payments as MBS amortize and/or prepay, thereby decreasing the outstanding amount

of our related borrowings. Such an action could reduce interest income, interest expense and net income, the extent of which would be dependent on the level of reduction in assets and liabilities as well as the sale prices for which assets were sold.

As our financings mature, we will be required either to enter into new borrowings or to sell certain of our investments. Since we rely primarily on borrowings under repurchase agreements to finance our assets, our ability to achieve our investment objectives depends on our ability to borrow funds in sufficient amounts and on acceptable terms, and on our ability to renew or replace maturing borrowings on a continuous basis. Our repurchase agreement credit lines are renewable at the discretion of our lenders and, as such, do not contain guaranteed roll-over terms. Our ability to enter into repurchase transactions in the future will depend on the market value of our assets pledged to secure the specific borrowings, the availability of acceptable financing and market liquidity and other conditions existing in the lending market at that time. If we are unable to renew or replace maturing borrowings, we could be forced to sell assets in order to maintain liquidity. Forced sales under adverse market conditions could result in lower sales prices than ordinary market sales in the normal course of business. Further, an increase in short-term interest rates at the time that we seek to enter into new borrowings would reduce the spread between our returns on our assets and the cost of our borrowings. This would adversely affect our returns on our assets, which might reduce earnings and, in turn, cash available for distribution to our stockholders.

We may enter into hedging transactions that could expose us to contingent liabilities in the future.

Subject to maintaining our qualification as a REIT and exemption from registration under the 1940 Act, part of our investment strategy may involve entering into economic hedging transactions that could require us to fund cash payments in certain circumstances (such as the early termination of the hedging instrument caused by an event of default or other early termination event, or the decision by a counterparty to request margin securities it is contractually owed under the terms of the hedging instrument). The amount due would be equal to the unrealized loss of the open swap positions with the respective counterparty and could also include other fees and charges. These economic losses will be reflected in our results of operations, and our ability to fund these obligations will depend on the liquidity of our assets and access to capital at the time, and the need to fund these obligations could adversely impact our financial condition.

Hedging against interest rate exposure may adversely affect our earnings, which could reduce our cash available for distribution to our stockholders.

Subject to maintaining our qualification as a REIT and exemption from registration under the 1940 Act, we may pursue various economic hedging strategies to seek to reduce our exposure to adverse changes in interest rates. Our hedging activity varies in scope based on the level and volatility of interest rates, the type of assets held and other changing market conditions. Interest rate hedging may fail to protect or could adversely affect us because, among other things:

- interest rate hedging can be expensive, particularly during periods of rising and volatile interest rates;
- available interest rate hedges may not correspond directly with the interest rate risk for which protection is sought;
- due to a credit loss, the duration of the hedge may not match the duration of the related liability;
- the amount of income that a REIT may earn from hedging transactions (other than hedging transactions that satisfy certain requirements of the Code or that are done through a TRS) to offset interest rate losses is limited by U.S. federal tax provisions governing REITs;
- the value of derivatives used for hedging may be adjusted from time to time in accordance with accounting rules to reflect changes in fair value. Downward adjustments or "mark-to-market losses," would reduce our stockholders' equity;
- the credit quality of the hedging counterparty owing money on the hedge may be downgraded to such an extent that it impairs our ability to sell or assign our side of the hedging transaction; and
- the hedging counterparty owing money in the hedging transaction may default on its obligation to pay.

Our hedging transactions, which are intended to limit losses, may actually adversely affect our earnings, which could reduce our cash available for distribution to our stockholders.

While the majority of our interest rate swaps are traded on a regulated exchange, certain hedging instruments are traded over the counter and do not trade on regulated exchanges and, therefore, are not guaranteed by an exchange or a clearing house. In addition, over the counter instruments are more lightly regulated by U.S. and foreign governmental authorities. Consequently, there may be no requirements with respect to record keeping, financial responsibility or segregation of customer funds and positions. Furthermore, the enforceability of agreements underlying hedging transactions may depend on compliance with applicable statutory and commodity and other regulatory requirements and, depending on the identity of the counterparty, applicable international

requirements. The business failure of a hedging counterparty with whom we enter into a hedging transaction which did not clear through a clearing house would most likely result in its default. Default by a party with whom we enter into a hedging transaction may result in the loss of unrealized profits and force us to cover our commitments, if any, at the then current market price. Although generally we seek to reserve the right to terminate our hedging positions, it may not always be possible to dispose of or close out a hedging position without the consent of the hedging counterparty and we may not be able to enter into an offsetting contract in order to cover our risk. There can be no assurance that a liquid secondary market will exist for any hedging instruments purchased or sold, and we may be required to maintain a position until exercise or expiration, which could result in losses.

Risks associated with our relationship with our Manager

Our Board of Directors has approved very broad investment guidelines for our Manager and does not approve each investment and financing decision made by our Manager.

Our Manager is authorized to follow very broad investment guidelines. Our Board of Directors periodically reviews our investment guidelines and our investment portfolio but does not, and is not required to review all of our proposed investments, except that an investment in a security structured or issued by another entity managed by our Manager must be approved by at least two-thirds (2/3) of our independent directors prior to such investment. In addition, in conducting periodic reviews, our Board of Directors may rely primarily on information provided to them by our Manager. Furthermore, our Manager may use complex strategies, and transactions entered into by our Manager may be costly, difficult or impossible to unwind by the time they are reviewed by our Board of Directors. Our Manager has great latitude within the broad parameters of our investment guidelines in determining the types and amounts of Agency and Non-Agency RMBS, CMBS, ABS and other portfolio investments it may decide are attractive investments for us, which could result in investment returns that are substantially below expectations or that result in losses, which would materially and adversely affect our business operations and results. Further, decisions made and investments and financing arrangements entered into by our Manager may not fully reflect the best interests of our stockholders.

There are conflicts of interest in our relationship with our Manager that could result in decisions that are not in the best interests of our stockholders.

We are subject to conflicts of interest arising out of our relationship with our Manager. We do not have any employees. All of our executive officers and two of our directors, James W. Hirschmann III and Jennifer W. Murphy, are employees of our Manager. Our Management Agreement with our Manager was negotiated between related parties and its terms, including fees and other amounts payable, may not be as favorable to us as if it had been negotiated at arm's length with an unaffiliated third party. In addition, the obligations of our Manager and its officers and personnel to engage in other business activities may reduce the time our Manager and its officers and personnel spend managing us.

We compete for investment opportunities directly with other client portfolios managed by our Manager. Clients of our Manager have investment mandates and objectives that target the same assets as us. A substantial number of client accounts managed by our Manager have exposure to RMBS, CMBS and our other portfolio investments and may have similar investment mandates and objectives. While our Manager has only a limited number of client accounts investing in Whole-Loans, the supply of Whole-Loan investments meeting the Manager's investment criteria are extremely limited. In addition, our Manager may have additional clients that compete directly with us for investment opportunities in the future. Our Manager has an investment allocation policy in place that is intended to ensure that no single client is intentionally favored over another and that trades are allocated in a fair and equitable manner. We may compete with our Manager or its other clients for investment or financing opportunities sourced by our Manager; however, we may either not be presented with the opportunity or have to compete with our Manager to acquire these investments or have access to these sources of financing. Our Manager and our executive officers may choose to allocate favorable investments to itself or to its or other clients instead of to us. Further, at times when there are turbulent conditions in the mortgage markets or distress in the credit markets or other times when we will need focused support and assistance from our Manager, our Manager's other clients will likewise require greater focus and

attention, placing our Manager's resources in high demand. In such situations, we may not receive the level of support and assistance that we may receive if we were internally managed or if our Manager did not act as a manager for other entities. There is no assurance that our Manager's allocation policies that address some of the conflicts relating to our access to investment and financing sources will be adequate to address all of the conflicts that may arise.

We pay our Manager a management fee that is not tied to our performance. The management fee may not sufficiently incentivize our Manager to generate attractive risk-adjusted returns for us. This could hurt both our ability to make distributions to our stockholders and the market price of our common stock. Furthermore, the compensation payable to our Manager will increase as a result of future issuances of our equity securities, even if the issuances are dilutive to existing stockholders.



As of December 31, 2017, our Manager owned 1,314,838 shares of our common stock. To the extent our Manager elects to sell all or a portion of these shares in the future, our Manager's interests may be less aligned with our interests.

We are dependent on our Manager and its key personnel for our success.

We have no separate facilities and are completely reliant on our Manager. All of our executive officers and two of our directors, are employees of our Manager. Our Manager has significant discretion as to the implementation of our investment and operating policies and strategies. Accordingly, we believe that our success will depend to a significant extent upon the efforts, experience, diligence, skill and network of business contacts of the executive officers and key personnel of our Manager. The executive officers and key personnel of our Manager evaluate, negotiate, close and monitor our investments; therefore, our success depends on their continued service. The departure of any of the executive officers or key personnel of our Manager could have a material adverse effect on our performance. In addition, we offer no assurance that our Manager will remain our investment manager or that we will continue to have access to our Manager's principals and professionals. The term of our Management Agreement with our Manager expires on May 16, 2019, with automatic one-year renewals thereafter. If the Management Agreement is terminated and no suitable replacement is found to manage us, we may not be able to execute our business plan. Moreover, our Manager is not obligated to dedicate any of its personnel exclusively to us nor is it obligated to dedicate any specific portion of its time to our business, and none of our Manager's personnel are contractually dedicated to us under our Management Agreement with our Manager.

The Management Agreement with our Manager was not negotiated on an arm's-length basis, may not be as favorable to us as if it had been negotiated with an unaffiliated third party and may be costly and difficult to terminate.

All of our executive officers and two of our directors are employees of our Manager. Our Management Agreement with our Manager was negotiated between related parties and its terms, including fees payable, may not be as favorable to us as if it had been negotiated with an unaffiliated third party.

Termination of the Management Agreement with our Manager without cause is difficult and costly. Our independent directors review our Manager's performance and any fees payable to our Manager annually and the Management Agreement may be terminated annually upon the affirmative vote of at least two-thirds (2/3) of our independent directors based upon: (i) our Manager's unsatisfactory performance that is materially detrimental to us; or (ii) our determination that any fees payable to our Manager are not fair, subject to our Manager's right to prevent termination based on unfair fees by accepting a reduction of management fees agreed to by at least two-thirds (2/3) of our independent directors. We are required to provide our Manager 180 days prior notice of any such termination. Unless terminated for cause, we are required to pay our Manager a termination fee equal to three times the average annual management fee earned by our Manager during the prior 24-month period immediately preceding such termination, calculated as of the end of the most recently completed fiscal quarter before the date of termination. This provision increases the effective cost to us of electing not to renew, or defaulting in our obligations under, the Management Agreement, thereby adversely affecting our inclination to end our relationship with our Manager, even if we believe our Manager's performance is not satisfactory.

Our Manager is only contractually committed to serve us until May 16, 2019. The Management Agreement is automatically renewable for one-year terms; provided, however, that our Manager may terminate the Management Agreement annually upon 180 days prior notice. If the Management Agreement is terminated and no suitable replacement is found to manage us, we may not be able to execute our business plan.

Pursuant to the Management Agreement, our Manager does not assume any responsibility other than to render the services called for thereunder and is not responsible for any action of our Board of Directors in following or declining to follow its advice or recommendations. Our Manager maintains a contractual as opposed to a fiduciary relationship with us. Under the terms of the Management Agreement, our Manager, its officers, stockholders, members, managers, directors, personnel, any person controlling or controlled by our Manager and any person providing sub-advisory services to our Manager are not liable to us, our directors, our stockholders or any partners for acts or omissions performed in accordance with and pursuant to the Management Agreement, except because of acts constituting bad faith, willful misconduct, gross negligence, or reckless disregard of their duties under the Management Agreement. In

addition, we indemnify our Manager, its officers, stockholders, members, managers, directors, personnel, any person controlling or controlled by our Manager and any person providing sub-advisory services to our Manager with respect to all expenses, losses, damages, liabilities, demands, charges and claims arising from acts of our Manager not constituting bad faith, willful misconduct, gross negligence, or reckless disregard of duties, performed in good faith in accordance with and pursuant to the Management Agreement.

Our Manager's management fee is payable regardless of our performance.

We pay our Manager a management fee regardless of the performance of our portfolio. Our Manager's entitlement to non-performance-based compensation might reduce its incentive to devote its time and effort to seeking assets that provide attractive

risk-adjusted returns for our portfolio. This in turn could hurt both our ability to make distributions to our stockholders and the market price of our common stock.

Our Manager is subject to extensive regulation as an investment advisor, which could adversely affect its ability to manage our business.

Our Manager is subject to regulation as an investment advisor by various regulatory authorities that are charged with protecting the interests of its clients, including us. Instances of criminal activity and fraud by participants in the investment management industry and disclosures of trading and other abuses by participants in the financial services industry have led the U.S. government and regulators to the rules and regulations governing, and oversight of, the U.S. financial system, including the investment management industry and more aggressive enforcement of the existing laws and regulations. Our Manager could be subject to civil liability, criminal liability, or sanction, including revocation of its registration as an investment adviser, revocation of the licenses of its employees, censures, fines, or temporary suspension or permanent bar from conducting business, if it is found to have violated any of these laws or regulations. Any such liability or sanction could adversely affect its ability to manage our business. Our Manager must continually address conflicts between its interests and those of its clients, including us. In addition, the SEC and other regulators have increased their scrutiny of potential conflicts of interest. We believe our Manager has procedures and controls that are reasonably designed to address these issues. However, appropriately dealing with conflicts of interest is complex and difficult and if our Manager fails, or appears to fail, to deal appropriately with conflicts of interest, it could face litigation or regulatory proceedings or penalties, any of which could adversely affect its ability to manage our business.

In fact, in January 2014 settlements of two separate and unrelated regulatory matters involving our Manager with the United States Department of Labor and the Securities and Exchange Commission were announced. The first matter involved the trading of Non-Agency RMBS and whether certain trades complied with the cross trading rules applicable to pension plans subject to Employee Retirement Income Security Act ("ERISA") and to SEC registered funds under the 1940 Act. Our Manager settled that matter without admitting or denying the charges and paying approximately \$7.4 million in compensation to clients and approximately \$1.6 million in fines to the regulators. The second matter involved the handling of an investment which prohibited ERISA accounts from holding it which was allocated in error to certain ERISA accounts. Our Manager settled that matter without admitting or denying the charges and paying \$10 million in compensation and \$2 million in fines. Neither matter related to the Company. The settlements will not adversely affect our Manager's ability to manage the Company's affairs.

Risks related to our common stock

The market price and trading volume of our common stock may vary substantially.

Our common stock is listed on the NYSE under the symbol "WMC". The stock markets, including the NYSE, have experienced significant price and volume fluctuations over the past several years. As a result, the market price of our common stock is likely to be similarly volatile, and investors in our common stock may experience a decrease in the value of their shares. Accordingly, no assurance can be given as to the ability of our stockholders to sell their common stock or the price that our stockholders may obtain for their common stock.

Some of the factors that could negatively affect the market price of our common stock include:

- actual or anticipated variations in our quarterly operating results;
- changes in our earnings estimates or publication of research reports about us or the real estate industry;
- changes in market valuations of similar companies;
- adverse market reaction to any increased indebtedness we incur in the future;
- additions to or departures of our Manager's key personnel;
- actions by our stockholders;
- changes in our dividend policy or payments; and
- speculation in the press or investment community.

Market factors unrelated to our performance could also negatively impact the market price of our common stock. One of the factors that investors may consider in deciding whether to buy or sell our common stock is our distribution rate as a percentage of our stock price relative to market interest rates. If market interest rates increase, prospective

investors may seek alternative investments paying higher dividends or interest. As a result, interest rate fluctuations and conditions in the capital markets can

25

---

affect the market value of our common stock. For instance, if interest rates rise, it is likely that the market price of our common stock will decrease as market rates on interest-bearing securities increase.

Investing in our common stock may involve a high degree of risk.

The investments that we make in accordance with our investment objectives may result in a high amount of risk when compared to alternative investment options and volatility or loss of principal. Our investments may be highly speculative and aggressive, and therefore an investment in our common stock may not be suitable for someone with lower risk tolerance.

Common stock eligible for future sale may have adverse effects on our share price.

We cannot predict the effect, if any, of future sales of our common stock, or the availability of shares for future sales, on the market price of our common stock. The market price of our common stock may decline significantly when the restrictions on resale (or lock up agreements), which may attach to future sales of our common stock, by certain of our stockholders lapse. Sales of substantial amounts of common stock or the perception that such sales could occur may adversely affect the prevailing market price for our common stock.

Also, we may issue additional shares in follow-on public offerings or private placements to make new investments or for other purposes. We are not required to offer any such shares to existing stockholders on a preemptive basis.

Therefore, it may not be possible for existing stockholders to participate in such future share issuances, which may dilute the existing stockholders' interests in us.

We have not established a minimum distribution payment level and we cannot assure you of our ability to pay distributions in the future.

We intend to pay quarterly distributions and to make distributions to our stockholders in an amount such that we distribute all or substantially all of our net taxable income, calculated in accordance with the REIT regulations, each year. We have not established a minimum distribution payment level and our ability to pay distributions may be adversely affected by a number of factors, including the risk factors described herein. All distributions will be made at the discretion of our Board of Directors and will depend on our earnings, our financial condition, debt covenants, maintenance of our REIT qualification and other factors as our Board of Directors may deem relevant from time to time. We believe that a change in any one of the following factors could adversely affect our results of operations and impair our ability to pay distributions to our stockholders:

- the profitability of our existing investments and the investment of net proceeds of any subsequent offering;

- our ability to make profitable investments;

- margin calls or other expenses that reduce our cash flow;

- decreases in the value of our portfolio or defaults in our asset portfolio; and

- the fact that anticipated operating expense levels may not prove accurate, as actual results may vary from estimates.

We cannot assure you that we will achieve investment results that will allow us to make a specified level of cash distributions or year-to-year increases in cash distributions in the future. In addition, some of our distributions may include a return in capital.

Future offerings of debt or equity securities, which would rank senior to our common stock, may adversely affect the market price of our common stock.

If we decide to issue debt or equity securities in the future, which would rank senior to our common stock, it is likely that they will be governed by an indenture or other instrument containing covenants restricting our operating flexibility. Additionally, any convertible or exchangeable securities that we issue in the future may have rights, preferences and privileges more favorable than those of our common stock and may result in dilution to owners of our common stock. We and, indirectly, our stockholders, will bear the cost of issuing and servicing such securities.

Because our decision to issue debt or equity securities in any future offering will depend on market conditions and other factors beyond our control, we cannot predict or estimate the amount, timing or nature of our future offerings.

Thus holders of our common stock will bear the risk of our future offerings reducing the market price of our common stock and diluting the value of their stock holdings in us. Furthermore, the compensation payable to our Manager will increase as a result of future issuances of our equity securities, including issuances upon exercise of the warrants, described below, even if the issuances are dilutive to existing stockholders.



The dilutive effect of our outstanding warrants, including in certain circumstances, upon the future issuance of common stock, could have an adverse effect on the future market price of our common stock or otherwise adversely affect the interests of our common stockholders.

On May 15, 2012, we issued and sold to certain institutional investors a number of warrants, which expire on May 15, 2019, entitling them to purchase up to an aggregate of 1,115,893 shares of our common stock. These warrants had an initial exercise price of \$20.50 per share (subject to adjustment and limitation on exercise in certain circumstances) and are exercisable for seven years after the date of the warrants' issuance, or earlier upon notice of redemption by us. As a result of two follow on public offerings on October 3, 2012 and April 3, 2014 and the stock portion of our dividend declared on December 19, 2013 the exercise price of each of the outstanding warrants has been reduced to \$16.70 and the number of shares purchasable has increased to 1,232,916. The exercise of the warrants in the future would be dilutive to holders of our common stock if our book value per share or the market price of our common stock is higher than the exercise price at the time of exercise. The potential for dilution from the warrants could have an adverse effect on the future market price of our common stock.

Further, the exercise price of the warrants will be adjusted under certain circumstances, including, subject to certain exceptions, if we sell common stock (or other securities convertible into or exchangeable for our common stock) in a public offering or private placement, for cash at a price per share (after deduction of underwriting discounts or placement fees and other expenses incurred by us that are attributable to the offering) that is less than the closing price of our common stock immediately prior to: (i) the announcement of the proposed sale in the case of public offerings; or (ii) the execution of the purchase agreement in the case of private placements. Accordingly, the exercise price will be adjusted downward in connection with any future offering, which would increase the dilutive effect of the warrants. Furthermore, any similar public offerings or private placements of our common stock we conduct in the future will likely increase the dilutive effect of the warrants.

Conversion of the notes may dilute the ownership interest of existing shareholders, including holders who had previously converted their notes.

In October 2017, the Company issued \$115.0 million aggregate principal amount of 6.75% convertible senior unsecured notes, which included the underwriter's option to purchase \$15.0 million aggregate principal amount of the notes for net proceeds of \$111.1 million. The notes mature on October 1, 2022, unless earlier converted, redeemed or repurchased by the holders pursuant to their terms, and are not redeemable by the Company except during the final three months prior to maturity.

The notes are convertible into, at the Company's election, cash, shares of the Company's common stock or a combination of both, subject to the satisfaction of certain conditions and during specified periods. The conversion rate is subject to adjustment upon the occurrence of certain specified events and the holders may require the Company to repurchase all or any portion of their notes for cash equal to 100% of the principal amount of the notes, plus accrued and unpaid interest, if the Company undergoes a fundamental change as specified in the agreement. The initial conversion rate was 83.1947 shares of common stock per \$1,000 principal amount of notes and represented a conversion price of \$12.02 per share of common stock.

To the extent we issue shares of our common stock upon conversion of the notes, the conversion of some or all of our notes will dilute the ownership interests of existing shareholders. Any sales in the public market of shares of our common stock issuable upon such conversion of the notes could adversely affect the prevailing market price.

#### Risks related to our organization and structure

Our authorized but unissued shares of common and preferred stock may prevent a change in our control.

Our amended and restated certificate of incorporation authorizes us to issue additional authorized but unissued shares of common or preferred stock. In addition, our Board of Directors may, without stockholder approval, amend our amended and restated certificate of incorporation to increase the aggregate number of our shares of stock or the number of shares of stock of any class or series that we have authority to issue and classify or reclassify any unissued

shares of common or preferred stock and set the preferences, rights and other terms of the classified or reclassified shares. As a result, our Board of Directors may establish a series of shares of common or preferred stock that could delay or prevent a transaction or a change in control that might involve a premium price for our shares of common stock or otherwise be in the best interest of our stockholders.

Ownership limitations may restrict change of control or business combination opportunities in which our stockholders might receive a premium for their shares.

In order for us to qualify as a REIT for each taxable year after 2012, no more than 50% in value of our outstanding capital stock may be owned, directly or indirectly, by five or fewer individuals during the last half of any calendar year. "Individuals" for



this purpose include natural persons, private foundations, some employee benefit plans and trusts, and some charitable trusts. To assist us in maintaining our qualification as a REIT, our amended and restated certificate of incorporation generally prohibits any person from directly or indirectly owning more than 9.8% in value or in number of shares, whichever is more restrictive, of the outstanding shares of our capital stock or more than 9.8% in value or in number of shares, whichever is more restrictive, of the outstanding shares of our common stock. This ownership limitation could have the effect of discouraging a takeover or other transaction in which holders of our common stock might receive a premium for their shares over the then prevailing market price or which holders might believe to be otherwise in their best interests.

Provisions in our amended and restated certificate of incorporation, our amended and restated bylaws and Delaware law may have the effect of preventing or hindering a change in control and adversely affecting the market price of our common stock.

Provisions in our amended and restated certificate of incorporation and our amended and restated bylaws and applicable provisions of the Delaware General Corporation Law may make it more difficult and expensive for a third party to acquire control of us even if a change of control would be beneficial to the interests of our stockholders. These provisions could discourage potential takeover attempts and could adversely affect the market price our common stock.

We may pay distributions from offering proceeds, borrowings or the sale of assets to the extent that distributions exceed earnings or cash flow from our operations.

We may pay distributions from offering proceeds, borrowings or the sale of assets to the extent that distributions exceed earnings or cash flow from our operations. Such distributions would reduce the amount of cash we have available for investing and other purposes and could be dilutive to our financial results. In addition, funding our distributions from our net proceeds may constitute a return of capital to our investors, which would have the effect of reducing each stockholder's basis in its shares of common stock.

#### Risks Related to REIT Status

If we do not qualify as a REIT or fail to remain qualified as a REIT, we will be subject to U.S. federal income tax as a regular corporation and could face a substantial tax liability, which would reduce the amount of cash available for distribution to our stockholders.

We believe we have operated and intend to continue to operate in a manner that allows us to qualify as a REIT. Our ability to satisfy the asset tests depends upon our analysis of the characterization and fair market values of our assets, some of which are not susceptible to a precise determination, and for which we will not obtain independent appraisals. Our compliance with the annual REIT income and quarterly asset requirements also depends upon our ability to successfully manage the composition of our income and assets on an ongoing basis. Accordingly, there can be no assurance that the IRS will not contend that our interests in the subsidiary or in securities of other issuers will not cause a violation of the REIT requirements.

If we were to fail to qualify as a REIT in any taxable year, and we do not qualify for certain statutory relief provisions, we would be subject to U.S. federal income tax, including any applicable alternative minimum tax, on our taxable income at regular corporate rates, and dividends paid to our stockholders would not be deductible by us in computing our taxable income. Any resulting corporate tax liability could be substantial and would reduce the amount of cash available for distribution to our stockholders, which in turn could have an adverse impact on the value of our common stock. Unless we were entitled to relief under certain Code provisions, we also would be disqualified from taxation as a REIT for the four taxable years following the year in which we failed to qualify as a REIT.

Dividends payable by REITs do not qualify for the reduced tax rates available for some dividends.

The maximum tax rate applicable to income from "qualified dividends" payable to U.S. stockholders that are individuals, trusts and estates is currently 20%, exclusive of the 3.8% investment tax surcharge, resulting from the Tax Cuts and Jobs Act of 2017, which was signed into law on December 22, 2017, thereby making significant changes to the Internal Revenue Code. Dividends payable by REITs, however, generally are not eligible for the qualified dividend reduced rates. For taxable years beginning after December 31, 2017 and before January 1, 2026, generally stockholders that are individuals, trusts or estates may deduct 20% of the aggregate amount of ordinary dividends

distributed by us, subject to certain limitations. While the qualified dividend rules do not adversely affect the taxation of REITs or dividends payable by REITs, the more favorable rates applicable to regular corporate qualified dividends could cause investors who are individuals, trusts and estates to perceive investments in REITs to be relatively less attractive than investments in the stocks of non-REIT corporations that pay dividends, which could adversely affect the value of the stock of REITs, including our common stock.

REIT distribution requirements could adversely affect our ability to execute our business plan.

We generally must distribute annually at least 90% of our net taxable income, determined without regard to the dividends paid deduction and excluding net capital gains, in order for U.S. federal corporate income tax not to apply to earnings that we distribute. To the extent that we satisfy this distribution requirement, but distribute less than 100% of our REIT taxable income, we will be subject to U.S. federal corporate income tax on our undistributed REIT taxable income. In addition, we will be subject to a nondeductible 4% excise tax if the actual amount that we pay out to our stockholders in a calendar year is less than a minimum amount specified under U.S. federal tax laws. We intend to continue to make distributions to our stockholders to comply with the REIT requirements of the Code.

From time to time, we may generate taxable income greater than our income for financial reporting purposes prepared in accordance with U.S. GAAP, or differences in timing between the recognition of taxable income and the actual receipt of cash may occur. For example, the tax code limits our ability to use capital losses to offset ordinary income, thereby requiring us to distribute such ordinary income. If we do not have other funds available in these situations we could be required to borrow funds on unfavorable terms, sell investments at disadvantageous prices or distribute amounts that would otherwise be invested in future acquisitions to make distributions sufficient to enable us to pay out enough of our taxable income to satisfy the REIT distribution requirement and to avoid corporate income tax and the nondeductible 4% excise tax in a particular year. These alternatives could increase our costs or reduce our equity.

Thus, compliance with the REIT requirements may hinder our ability to grow, which could adversely affect the value of our common stock.

Even if we remain qualified as a REIT, we may face other tax liabilities that reduce our cash flow.

Even if we remain qualified for taxation as a REIT, we may be subject to certain U.S. federal, state and local taxes on our income and assets, including taxes on any undistributed income, tax on income from some activities conducted as a result of a foreclosure, excise taxes, state or local income, property and transfer taxes, such as mortgage recording taxes, and other taxes. In addition, in order to meet the REIT qualification requirements, prevent the recognition of certain types of non-cash income, or to avert the imposition of a 100% tax that applies to certain gains derived by a REIT from dealer property or inventory, we hold some of our assets through a TRS or other consolidated entities that will be subject to corporate-level income tax at regular corporate rates. The payment of any of these taxes would decrease cash available for distribution to our stockholders.

Complying with REIT requirements may cause us to liquidate or forgo otherwise attractive opportunities.

To qualify as a REIT, we must ensure that at the end of each calendar quarter, at least 75% of the value of our assets consists of cash, cash items, government securities and qualified real estate assets, including certain mortgage loans and securities. The remainder of our investments in securities (other than government securities and qualified real estate assets) generally cannot include more than 10% of the outstanding voting securities of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer. In addition, in general, no more than 5% of the value of our total assets (other than government securities and qualified real estate assets) can consist of the securities of any one issuer, and no more than 20% of the value of our total assets can be represented by securities of one or more TRS. If we fail to comply with these requirements at the end of any calendar quarter, we must correct the failure within 30 days after the end of the calendar quarter or qualify for certain statutory relief provisions to avoid losing our REIT qualification and suffering adverse tax consequences. As a result, we may be required to liquidate otherwise attractive investments from our investment portfolio. These actions could have the effect of reducing our income and amounts available for distribution to our stockholders.

In addition to the asset tests set forth above, to qualify as a REIT we must continually satisfy tests concerning, among other things, the sources of our income, the nature and diversification of our assets, the amounts we distribute to our stockholders and the ownership of our stock. We may be required to make distributions to stockholders at disadvantageous times or when we do not have funds readily available for distribution and may be unable to pursue investments that would be otherwise advantageous to us in order to satisfy the source-of-income or asset-diversification requirements for qualifying as a REIT. Thus, compliance with the REIT requirements may hinder our ability to make and, in certain cases, to maintain ownership of, certain attractive investments.

We may be required to report taxable income for certain investments in excess of the economic income we ultimately realize from them.

We have acquired and may acquire in the future mortgage-backed securities and other portfolio instruments in the secondary market for less than their face amount. In addition, pursuant to our ownership of certain mortgage-backed securities, we may be treated as holding certain debt instruments acquired in the secondary market for less than their face amount. The discount at which such securities or debt instruments are acquired may reflect doubts about their ultimate collectability rather than current market interest rates. The amount of such discount will nevertheless generally be treated as "market discount" for U.S. federal income tax purposes. Under general tax rules, accrued market discount is reported as income when, and to the extent that, any payment of principal of the mortgage-backed security or debt instrument is made. If we collect less on the mortgage-backed security or

debt instrument than our purchase price plus the market discount we had previously reported as income, we may not be able to benefit from any offsetting capital loss deductions to the extent we do not have offsetting capital gains. In addition, pursuant to our ownership of certain mortgage-backed securities or debt instruments, we may be treated as holding distressed debt investments that are subsequently modified by agreement with the borrower. If the amendments to the outstanding debt are "significant modifications" under applicable Treasury regulations, the modified debt may be considered to have been reissued to us at a gain in a debt-for-debt exchange with the borrower. In that event, we may be required to recognize taxable gain to the extent the principal amount of the modified debt exceeds our adjusted tax basis in the unmodified debt, even if the value of the debt or the payment expectations have not changed.

Moreover, some of the mortgage-backed securities or debt instruments that we acquire may have been issued with original issue discount. Under general tax rules, we are required to report such original issue discount based on a constant yield method and will be taxed based on the assumption that all future projected payments due on such mortgage-backed securities will be made. If such mortgage-backed securities turn out not to be fully collectable, an offsetting loss deduction will become available only in the later year that uncollectability is provable.

Under the recently enacted Tax Cuts and Jobs Act (the "Act"), we generally will be required to take certain amounts in income no later than the time such amounts are reflected on certain financial statements. The application of this rule may require the accrual of income with respect to certain of debt instruments or mortgage-backed securities, such as original issue discount or market discount, earlier than would be the case under the general tax rules, although the precise application of this rule is unclear at this time. This rule generally will be effective for tax years beginning after December 31, 2017 or, for debt instruments or mortgage-backed securities issued with original issue discount, for tax years beginning after December 31, 2018.

Finally, in the event that mortgage-backed securities or any debt instruments we are treated as holding pursuant to our investments in mortgage-backed securities are delinquent as to mandatory principal and interest payments, we may nonetheless be required to continue to recognize the unpaid interest as taxable income as it accrues, despite doubt as to its ultimate collectability. Similarly, we may be required to accrue interest income with respect to subordinate mortgage-backed securities at the stated rate regardless of whether corresponding cash payments are received or are ultimately collectable. In each case, while we would in general ultimately have an offsetting loss deduction available to us when such interest was determined to be uncollectable, the utility of that deduction could depend on our having taxable income in that later year or thereafter.

Certain apportionment rules may affect our ability to comply with the REIT asset and gross income tests.

The Code provides that a regular or a residual interest in a real estate mortgage investment conduit, or REMIC, is generally treated as a real estate asset for the purpose of the REIT asset tests, and any amount includible in our gross income with respect to such an interest is generally treated as interest on an obligation secured by a mortgage on real property for the purpose of the REIT gross income tests. If, however, less than 95% of the assets of a REMIC in which we hold an interest consist of real estate assets (determined as if we held such assets), we will be treated as holding our proportionate share of the assets of the REMIC for the purpose of the REIT asset tests and receiving directly our proportionate share of the income of the REMIC for the purpose of determining the amount of income from the REMIC that is treated as interest on an obligation secured by a mortgage on real property. In connection with the expanded Agency RMBS-backed HARP loan program in which we may invest, the IRS issued guidance providing that, among other things, if a REIT holds a regular interest in an "eligible REMIC," or a residual interest in an "eligible REMIC" that informs the REIT that at least 80% of the REMIC's assets constitute real estate assets, then the REIT may treat 80% of the interest in the REMIC as a real estate asset for the purpose of the REIT income and asset tests. Although the portion of the income from such a REMIC interest that does not qualify for purposes of the REIT 75% gross income test would likely be qualifying income for the purpose of the 95% REIT gross income test, the remaining 20% of the REMIC interest generally would not qualify as a real estate asset, which could adversely affect our ability to satisfy the REIT asset tests. Accordingly, owning such a REMIC interest could adversely affect our ability to qualify as a REIT.

The "taxable mortgage pool" rules may increase the taxes that we or our stockholders may incur, and may limit the manner in which we effect future securitizations.

Securitizations could result in the creation of taxable mortgage pools for U.S. federal income tax purposes. As a REIT, so long as we own 100% of the equity interests in a taxable mortgage pool, we generally would not be adversely affected by the characterization of the securitization as a taxable mortgage pool. Certain categories of stockholders, however, such as foreign stockholders eligible for treaty or other benefits, stockholders with net operating losses, and certain tax-exempt stockholders that are subject to unrelated business income tax, could be subject to increased taxes on a portion of their dividend income from us that is attributable to the taxable mortgage pool. In addition, to the extent that our stock is owned by tax-exempt "disqualified organizations," such as certain government-related entities and charitable remainder trusts that are not subject to tax on unrelated business income, we may incur a corporate level tax on a portion of our income from the taxable mortgage pool. In that case, we may reduce the amount of our distributions to any disqualified organization whose stock ownership gave rise to the tax. Moreover,

we would be precluded from selling equity interests in these securitizations to outside investors, or selling any debt securities issued in connection with these securitizations that might be considered to be equity interests for tax purposes. These limitations may prevent us from using certain techniques to maximize our returns from securitization transactions.

Our ability to invest in and dispose of "to be announced" securities could be limited by our election to be subject to tax as a REIT.

We may purchase Agency RMBS through "to-be-announced" forward contracts, or TBAs. In certain instances, rather than take delivery of the Agency RMBS subject to a TBA, we may dispose of the TBA through a dollar roll transaction in which we agree to purchase similar securities in the future at a predetermined price or otherwise, which may result in the recognition of income or gains. We account for dollar roll transactions as purchases and sales of securities. The law is unclear regarding whether TBAs will be qualifying assets for the 75% asset test and whether income and gains from dispositions of TBAs will be qualifying income for the 75% gross income test. Accordingly, our ability to purchase Agency RMBS through TBAs and to dispose of TBAs, through dollar roll transactions or otherwise, could be limited.

The failure of securities subject to repurchase agreements to qualify as real estate assets could adversely affect our ability to qualify as a REIT.

We enter into financing arrangements that are structured as sale and repurchase agreements pursuant to which we nominally sell certain of our securities to a counterparty and simultaneously enter into an agreement to repurchase these securities at a later date in exchange for a purchase price. Economically, these agreements are financings which are secured by the securities sold pursuant thereto. We believe that we will be treated for REIT asset and income test purposes as the owner of the securities that are the subject of any such sale and repurchase agreement notwithstanding that such agreement may transfer record ownership of the securities to the counterparty during the term of the agreement. It is possible, however, that the IRS could assert that we did not own the securities during the term of the sale and repurchase agreement, in which case we could fail to qualify as a REIT.

Liquidation of assets may jeopardize our REIT qualification or create additional tax liability for us.

To qualify as a REIT, we must comply with requirements regarding the composition of our assets and our sources of income. If we are compelled to liquidate our investments to repay obligations to our lenders, we may be unable to comply with these requirements, ultimately jeopardizing our qualification as a REIT, or we may be subject to a 100% tax on any resultant gain if we sell assets that are treated as dealer property or inventory.

Complying with REIT requirements may limit our ability to hedge effectively and may cause us to incur tax liabilities. The REIT provisions of the Code substantially limit our ability to hedge our assets and liabilities. Any income from a hedging transaction we enter into to manage risk of interest rate changes with respect to borrowings made or to be made to acquire or carry real estate assets does not constitute "gross income" for purposes of the 75% or 95% gross income tests. To the extent that we enter into other types of hedging transactions, the income from those transactions is likely to be treated as non-qualifying income for purposes of both of the gross income tests. As a result of these rules, we limit our use of advantageous hedging techniques, and we may implement those hedges through a domestic TRS. This could increase the cost of our hedging activities because our TRS would be subject to tax on gains or expose us to greater risks associated with changes in interest rates than we would otherwise want to bear. In addition, losses in our TRS will generally not provide any tax benefit, except for being carried forward against future taxable income in the TRS.

Qualifying as a REIT involves highly technical and complex provisions of the Code.

Qualification as a REIT involves the application of highly technical and complex Code provisions for which only limited judicial and administrative authorities exist. Even a technical or inadvertent violation could jeopardize our REIT qualification. Our qualification as a REIT will depend on our satisfaction of certain asset, income, organizational, distribution, stockholder ownership and other requirements on a continuing basis. In addition, our ability to satisfy the requirements to qualify as a REIT depends in part on the actions of third parties over which we have no control or only limited influence, including in cases where we own an equity interest in an entity that is classified as a partnership for U.S. federal income tax purposes.

Changes to U.S. federal income tax laws could materially and adversely affect us and our stockholders. The recently enacted Tax Cuts and Jobs Act makes substantial changes to the Code. Among those changes are a significant permanent reduction in the generally applicable corporate tax rate, changes in the taxation of individuals and other non-corporate taxpayers that generally but not universally reduce their taxes on a temporary basis subject to “sunset” provisions, the elimination or modification of various currently allowed deductions (including substantial limitations on the deductibility of interest and, in the case of individuals, the deduction for personal state and local taxes), certain additional limitations on the deduction of net operating losses, and preferential rates of taxation on most ordinary REIT dividends and certain business income derived by non-corporate taxpayers in comparison to other ordinary income recognized by such taxpayers. The effect of these, and the many other,



changes made in the Tax Cuts and Jobs Act is highly uncertain, both in terms of their direct effect on the taxation of an investment in our common stock and their indirect effect on the value of our assets or market conditions generally. Furthermore, many of the provisions of the Tax Cuts and Jobs Act will require guidance through the issuance of Treasury regulations in order to assess their effect. There may be a substantial delay before such regulations are promulgated, increasing the uncertainty as to the ultimate effect of the statutory amendments on us. It is also likely that there will be technical corrections legislation proposed with respect to the Tax Cuts and Jobs Act this year, the effect of which cannot be predicted and may be adverse to us or our stockholders.

Item 1B. Unresolved Staff Comment

None

Item 2. Properties

We do not own any properties. Our executive and administrative offices are located in Pasadena, California in office space shared with our Manager.

Item 3. Legal Proceedings

None.

Item 4. Mine Safety Disclosures.

Not applicable.

## PART II

## Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Our common stock is listed on the NYSE under the symbol "WMC". The following table sets forth the high, low and last sales prices for our common stock, as reported on the NYSE:

Period	High	Low	Close
2017			
First Quarter	\$ 10.55	\$ 9.43	\$ 9.77
Second Quarter	\$ 10.84	\$ 9.58	\$ 10.30
Third Quarter	\$ 10.95	\$ 10.02	\$ 10.47
Fourth Quarter	\$ 10.75	\$ 9.50	\$ 9.95
2016			
First Quarter	\$ 10.95	\$ 8.04	\$ 10.05
Second Quarter	\$ 10.18	\$ 8.71	\$ 9.39
Third Quarter	\$ 11.03	\$ 9.22	\$ 10.42
Fourth Quarter	\$ 11.18	\$ 9.63	\$ 10.07

The following table summarizes our dividends declared on common stock, on a per share basis, for the years ended December 31, 2017 and 2016:

Declaration Date	Record Date	Payment Date	Common Stock Dividend
2017			
December 21, 2017	January 2, 2018	January 26, 2018	\$0.31
September 21, 2017	October 2, 2017	October 26, 2017	\$0.31
June 20, 2017	June 30, 2017	July 26, 2017	\$0.31
March 23, 2017	April 3, 2017	April 26, 2017	\$0.31
2016			
December 22, 2016	January 3, 2017	January 26, 2017	\$0.31
September 22, 2016	October 4, 2016	October 25, 2016	\$0.31
June 23, 2016	July 5, 2016	July 26, 2016	\$0.31
March 24, 2016	April 4, 2016	April 26, 2016	\$0.45

In order to maintain our qualification as a REIT, we must make annual distributions to our stockholders of at least 90% of our taxable income (not including net capital gains). We have adopted a policy of paying regular quarterly dividends on our common stock. Refer to Note 11- "Stockholders' Equity" to our Consolidated Financial Statements included in Item 8 of this annual report on Form 10-K for details on the tax characterization of our dividend.

A combination of cash and stock dividends has been paid on our common stock since our initial public offering. Dividends are declared at the discretion of the Board of Directors and depend on actual and anticipated cash from operations, our financial condition, capital requirements, the annual distribution requirements under the REIT provisions of the Internal Revenue Code and other factors the Board of Directors may consider relevant.

As of March 28, 2018, we had 7 registered holders of our common stock and 41,679,679 shares outstanding.

#### Securities Authorized for Issuance Under Equity Compensation Plans

In conjunction with our IPO and concurrent private placement, our Board of Directors approved the Western Asset Mortgage Capital Corporation Equity Plan (the "Equity Plan") and the Western Asset Manager Equity Plan (the "Manager Equity Plan" and collectively the "Equity Incentive Plans"). For further details, see Note 10 "Share-Based Payments" to the Consolidated Financial Statements included under Item 8 in this Form 10-K.

The following table presents certain information about the Equity Incentive Plans as of December 31, 2017:

Award	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans
Restricted common stock	N/A	N/A	512,262
Total	—	—	512,262

#### Stockholder Return Performance

The following graph is a comparison of the cumulative total stockholder return on the Company's common stock, the Standard & Poor's 500 Index (the "S&P 500 Index"), the Russell 2000 Index (the "Russell 2000") and the FTSE NAREIT Mortgage REITs Index (the "FTSE Mortgage REIT"), a peer group index for a five year period from December 31, 2012 to December 31, 2017, and accordingly does not take into account the dividend the Company declared on December 21, 2017 and paid on January 26, 2018. The graph assumes that \$100 was invested on December 31, 2012 in the Company's common stock, the S&P 500 Index, the Russell 2000 and the FTSE Mortgage REIT and that all dividends were reinvested without the payment of any commissions. There can be no assurance that the performance of the Company's shares will continue in line with the same or similar trends depicted in the graph below.

Index	12/31/12	12/31/13	12/31/14	12/31/15	12/31/16	12/31/17
Western Asset Mortgage Capital Corp	100.00	101.28	120.08	100.83	113.75	126.73
S&P 500	100.00	132.39	150.51	152.59	170.84	208.14
Russell 2000	100.00	138.82	145.62	139.19	168.85	193.58
FTSE NAREIT Mortgage REIT	100.00	98.04	115.57	105.31	129.38	154.98

## Recent Sales of Unregistered Securities: Use of Proceeds from Registered Securities

Not applicable.

## Purchase of Equity Securities by the Issuer

On December 21, 2017, the Board of Directors of the Company reauthorized its repurchase program of up to 2,100,000 shares of its common stock through December 31, 2019. The previous reauthorization announced on February 25, 2016 of the Company's repurchase program of up to 2,050,000 shares of its common stock expired on December 31, 2017. The original authorization expired on December 31, 2015. Purchases made pursuant to the program will be made in the open market, in privately negotiated transactions, or pursuant to any trading plan that may be adopted in accordance with Rules 10b5-1 and 10b-18 of the Securities and Exchange Commission. The authorization does not obligate the Company to acquire any particular amount of common shares and the program may be suspended or discontinued at the Company's discretion without prior notice.

The following table shows common shares repurchase activity during the year ended December 31, 2017:

Month	Total Number of Shares Purchased	Average Price Paid Per Share <sup>(1)</sup>	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs at the end of period <sup>(1)</sup>
October 1 - 31, 2017	—		—	2,100,000
November 1- 30, 2017	107,707	\$ 9.76	107,707	1,992,293
December 1 - 31, 2017	18,015	\$ 10.02	18,015	1,974,278
Total	125,722		125,722	

(1) Includes brokers commission of \$0.03 per share.

## Item 6. Selected Financial Data

The information below should be read in conjunction with "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and our consolidated financial statements and related notes included in Item 8. "Financial Statements and Supplementary Data," included in this annual report on Form 10-K.

in thousands—except share and per share data	Year ended December 31, 2017	Year ended December 31, 2016	Year ended December 31, 2015	Year ended December 31, 2014	Year ended December 31, 2013
<b>Operating Data:</b>					
<b>Net Interest Income</b>					
Interest income	\$124,291	\$123,756	\$152,704	\$149,110	\$125,328
Interest expense	48,373	32,430	27,605	22,263	18,019
Net Interest Income	75,918	91,326	125,099	126,847	107,309
<b>Other Income (Loss):</b>					
Realized gain (loss) on sale of investments, net	20,598	(21,991)	8,279	(2,178)	(110,712)
Other than temporary impairment	(22,873)	(32,286)	(19,791)	(17,014)	(11,858)
Unrealized gain (loss), net	28,396	(17,107)	(34,011)	189,011	(160,109)
Gain (loss) on derivative instruments, net	3,292	(20,735)	(68,895)	(180,496)	157,547
Gain on linked transactions, net	—	—	—	1,870	4,137
Other, net	1,031	180	2,318	1,433	91
Other Income (Loss)	30,444	(91,939)	(112,100)	(7,374)	(120,904)
Operating expenses	10,519	11,493	12,888	10,394	8,485
General and administrative expenses	7,259	9,753	9,595	8,366	5,775
Income (loss) before income taxes	88,584	(21,859)	(9,484)	100,713	(27,855)
Income tax provision (benefit)	3,487	3,156	—	—	—
Net Income (loss)	\$85,097	\$(25,015)	\$(9,484)	\$100,713	\$(27,855)
Net income (loss) per Common Share—Basic	\$2.03	\$(0.61)	\$(0.25)	\$2.67	\$(1.19)
Net income (loss) per Common Share—Diluted	\$2.03	\$(0.61)	\$(0.25)	\$2.67	\$(1.19)
Dividends Declared per Share of Common Stock	\$1.24	\$1.38	\$2.49	\$2.74	\$5.10 (1)
<b>Balance Sheet Data (at period end):</b>					
Total assets	\$3,886,906	\$3,156,016	\$3,414,429	\$4,909,277	\$3,094,877
Total liabilities	\$3,420,868	\$2,725,534	\$2,902,781	\$4,286,065	\$2,684,783
Total stockholders' equity	\$466,038	\$430,482	\$511,648	\$623,212	\$410,094
<b>Other Data:</b>					
<b>Cash flow provided by (used in):</b>					
Operating activities	\$59,382	\$11,546	\$133,898	\$107,374	\$179,341
Investing activities	\$(1,202,572)	\$504,631	\$1,359,855	\$(1,311,678)	\$2,002,411
Financing activities	\$1,145,043	\$(494,799)	\$(1,516,439)	\$1,203,001	\$(2,189,519)

(1) Includes \$2.35 dividend per share declared on December 19, 2013, consisting of cash and stock.

#### ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion provides the reader a narrative from the perspective of management and should be read in conjunction with our consolidated financial statements and related notes included in Item 8, "Financial Statements and Supplementary Data" of this annual report on Form 10-K.

##### Overview

The size and composition of our portfolio depend on investment strategies implemented by our Manager, the accessibility to capital and overall market conditions, including availability of attractively priced target assets and financing. Our objective is to provide an attractive risk adjusted return to our shareholders over the long term. Our Manager has built a diversified portfolio of our target assets to better enable us to deliver attractive returns through market cycles. Our portfolio is mainly comprised of Agency CMBS, Agency RMBS, Non-Agency RMBS, Non-Agency CMBS and Residential Whole-Loans and Residential Bridge Loans. To a significantly lesser extent, we have invested in other securities including certain GSE Risk Sharing Securities, as well as certain Non U.S. CMBS and ABS investments secured by a portfolio of private student loans. In addition, our holdings include a securitized commercial loan from a consolidated VIE.

We use leverage as part of our business strategy in order to increase potential returns to our stockholders. We accomplish this by borrowing against existing investments primarily through repurchase agreements. We may also change our financing strategy and leverage without the consent of our stockholders.

We operate and elected to be taxed as a REIT, commencing with our taxable year ended December 31, 2012. We generally will not be subject to U.S. federal income taxes on our taxable income to the extent that we annually distribute, in accordance with the REIT regulations, all of our net taxable income to stockholders and maintain our intended qualification as a REIT. Certain of our non-qualifying investments were held in our taxable REIT subsidiary or "TRS". Net income generated in our TRS is taxable and subject to federal, state and local income tax at the applicable corporate tax rates.

We also intend to operate our business in a manner that will permit us to maintain our exemption from registration under the 1940 Act.

##### Factors Impacting Our Operating Results

Our operating results can be affected by a number of factors and primarily depend on, among other things, the size of our investment portfolio, our net interest income, changes in the market value of our investments, derivative instruments and to a lesser extent realized gains and losses on the sale of our investments and termination of our derivative instruments. Our overall performance is also impacted by the supply and demand for our target assets in the market, the terms and availability of financing for such assets, general economic conditions, the impact of U.S. Government actions that affect the real estate and mortgage sectors, and the unanticipated credit events experienced by borrowers whose loans are included in our MBS, as well as our Residential Whole and Bridge Loan borrowers.

Our net interest income, which includes the amortization of purchase premiums and accretion of discounts, will vary primarily as a result of changes in interest rates, defaults and loss severity rates, borrowing costs, and prepayment speeds on our MBS and other Target Assets (as defined herein) investments. Similarly, the overall value of our investment portfolio will be impacted by these factors as well as changes in the value of residential and commercial real estate and continuing regulatory changes.

See the Item 1A. "Risk Factors" in this annual report on Form 10-K for additional factors that may impact our operating results.

##### Recent Market Conditions

Our business is affected by general U.S. residential real estate fundamentals, domestic and foreign commercial real estate fundamentals and the overall U.S. and international economic environment. In particular, our strategy is influenced by the specific characteristics of these markets, including but not limited to prepayment rates and interest rate levels. We expect the results of our operations to be affected by various factors, many of which are beyond our control.

Our Manager's global outlook for 2017 was in line with market expectations for both robust growth and improving inflation has proven more optimistic than anticipated. The consensus transitioned from expectations for secular stagnation before the US election to global reflation afterward, to a more moderate tone today focusing on central bank monetary policy normalization. Our Manager's current expectations for 2018 is for ongoing slow but steady economic growth and moderate inflation, both in the U.S. and abroad. During the fourth quarter of 2017, the Federal Reserve raised the federal funds rate a quarter point, which indicates

the central bank is confident in the strength of the economy and ready to push rates to more normal levels. President Trump's nomination of Jerome Powell as the next Federal Reserve chair is predicted to bring little change to the central bank's incremental rate increases and monetary policy normalization but we have yet to see how the FOMC might react to unexpected inflation. At the meeting in January 2018, the FOMC, left the federal funds rate at 1.5% since inflation is still below target, although unemployment is low. The FOMC expects inflation to meet its 2% target in 2018 and expects to gradually raise the federal funds rate to its normal level of 2%. At the March 2018 meeting, the FOMC raised the rate another quarter point from 1.5% to 1.75%, with two more rate hikes anticipated in 2018. The FOMC, as part of its balance sheet reduction plan, will allow \$12 billion of Treasury securities to mature without replacing them. It will do the same with \$8 billion of mortgage-backed securities. The Federal Reserve is gradually winding down the \$4 trillion in holdings it acquired during quantitative easing. Accordingly, we expect potentially three rate increases in 2018. We believe the Agency RMBS sector is at risk for spread widening in the longer term. Against this backdrop, the fundamentals in the U.S. housing market remain strong and spreads for most mortgages remained supported during the fourth quarter of 2017 despite three significant hurricanes.

The market conditions outlined above may have a meaningful impact on our operating results and our existing portfolio and may cause us to adjust our investment and financing strategies over time as new opportunities emerge and the risk profiles of our business changes.

#### Critical Accounting Policies

The consolidated financial statements include our accounts, those of our consolidated wholly-owned TRS and certain variable interest entities ("VIEs") in which we are the primary beneficiary. All intercompany amounts have been eliminated in consolidation. In accordance with GAAP, our consolidated financial statements require the use of estimates and assumptions that involve the exercise of judgment and use of assumptions as to future uncertainties. In accordance with SEC guidance, the following discussion addresses the accounting policies that we currently apply. Our most critical accounting policies will involve decisions and assessments that could affect our reported assets and liabilities, as well as our reported revenues and expenses. We believe that all of the decisions and assessments upon which our consolidated financial statements have been based were reasonable at the time made and based upon information available to us at that time. For a review of recent accounting pronouncements that may impact our results of operations, refer Note 2 - "Summary of Significant Accounting Policies" contained in this annual report on Form 10-K.

#### Valuation of Financial Instruments

We disclose the fair value of our financial instruments according to a fair value hierarchy (Levels I, II, and III, as defined below). ASC 820 "Fair Value Measurements and Disclosures" establishes a framework for measuring fair value and expands financial statement disclosure requirements for fair value measurements. ASC 820 further specifies a hierarchy of valuation techniques, which is based on whether the inputs into the valuation technique are observable or unobservable. The hierarchy is as follows:

Level I — Quoted prices in active markets for identical assets or liabilities.

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

Level III — Prices are determined using significant unobservable inputs. In situations where quoted prices or observable inputs are unavailable, for example, when there is little or no market activity for an investment at the end of the period, unobservable inputs may be used.



The level in the fair value hierarchy within which a fair value measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety. Transfers between levels are determined by us at the end of the reporting period.

#### Mortgage-Backed Securities and Other Securities

Our mortgage-backed securities and other securities portfolio primarily consists of Agency RMBS, Non-Agency RMBS, Agency CMBS, Non-Agency CMBS, ABS and other real estate related assets, these investments are recorded in accordance with ASC 320, "Investments - Debt and Equity Securities", ASC 325-40, "Beneficial Interests in Securitized Financial Assets" or ASC 310-30, "Loans and Debt Securities Acquired with Deteriorated Credit Quality". We have chosen to make a fair value election pursuant to ASC 825, "Financial Instruments" for our mortgage-backed securities and other securities portfolio. Electing the fair

value option allows us to record changes in fair value in the Consolidated Statements of Operations as a component of "Unrealized gain (loss), net".

If we purchase securities with evidence of credit deterioration, we will analyze to determine if the guidance found in ASC 310-30, "Loans and Debt Securities Acquired with Deteriorated Credit Quality" is applicable.

We evaluate securities for other-than-temporary impairment ("OTTI") on at least a quarterly basis. The determination of whether a security is other-than-temporarily impaired involves judgments, estimates and assumptions based on subjective and objective factors. As a result, the timing and amount of an OTTI constitutes an accounting estimate that may change materially over time.

When the fair value of an investment security is less than its amortized cost at the balance sheet date, the security is considered impaired, and the impairment is designated as either "temporary" or "other-than-temporary." When a security is impaired, an OTTI is considered to have occurred if (i) if we intend to sell the security (i.e., a decision has been made as of the reporting date) or (ii) it is more likely than not that we will be required to sell the security before recovery of its amortized cost basis. If we intend to sell the security or if it is more likely than not that we will be required to sell the security before recovery of its amortized cost basis, the entire amount of the impairment loss, if any, is recognized in earnings as OTTI and the cost basis of the security is adjusted to its fair value. Additionally, for securities accounted for under ASC 325-40 an OTTI is deemed to have occurred when there is an adverse change in the expected cash flows to be received and the fair value of the security is less than its carrying amount. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a "market participant" would use and are discounted at a rate equal to the current yield used to accrete interest income. Any resulting OTTI adjustments are reflected in "Other than temporary impairment" in our Consolidated Statements of Operations.

Increases in interest income may be recognized on a security on which we have previously recorded an OTTI charge if the cash flow of such security subsequently improves.

In addition, unrealized losses on our Agency securities, with explicit guarantee of principal and interest by the governmental sponsored entity ("GSE"), are not credit losses but rather were due to changes in interest rates and prepayment expectations. These securities would not be considered other than temporarily impaired provided we did not intend to sell the security.

#### Residential Whole-Loans

Investments in Residential Whole-Loans are recorded in accordance with ASC 310-20, "Nonrefundable Fees and Other Costs". We have chosen to make the fair value election pursuant to ASC 825 for our entire Residential Whole-Loan portfolio. Residential Whole-Loans are recorded at fair value with periodic changes in fair market value being recorded in earnings as a component of "Unrealized gain (loss), net". All other costs incurred in connection with acquiring Residential Whole-Loans or committing to purchase these loans are charged to expense as incurred.

On a quarterly basis, we evaluate the collectability of both interest and principal of each loan, if circumstances warrant, to determine whether such loan is impaired. A loan is impaired when, based on current information and events, it is probable that we will be unable to collect all amounts due according to the existing contractual terms. When a loan is impaired, we do not record an allowance for loan loss as we have elected the fair value option. However, income recognition is suspended for loans at the earlier of the date at which payments become 90-days past due or when, in the opinion of management, a full recovery of income and principal becomes doubtful. When the

ultimate collectability of the principal of an impaired loan is in doubt, all payments are applied to principal under the cost recovery method. When the ultimate collectability of the principal of an impaired loan is not in doubt, contractual interest is recorded as interest income when received, under the cash basis method until an accrual is resumed when the loan becomes contractually current and performance is demonstrated to be resumed. A loan is written off when it is no longer realizable and/or legally discharged.

#### Residential Bridge Loans

For the Bridge Loans acquired prior to October 25, 2017, we did not elect the fair value option pursuant to ASC 825 and accordingly these loans are recorded at their principal amount outstanding, net of any premium or discount in the Consolidated Balance Sheets. Commencing with purchases subsequent to October 25, 2017, we decided to elected the fair value option pursuant to ASC 825 to be consistent with the accounting of our other investments, which are all carried at fair value. These loans are recorded at fair value with periodic changes in fair market value being recorded in earnings as a component of "Unrealized gain

(loss), net". All other costs incurred in connection with acquiring the Residential Bridge Loans or committing to purchase these loans are charged to expense as incurred.

A loan is impaired when, based on current information and events, it is probable that we will be unable to collect all amounts due according to the existing contractual terms. We evaluate each of Residential Bridge Loans that we did not elect the fair value option on a quarterly basis. These loans are individually specific as they relate to the borrower, collateral type, interest rate, LTV and term as well as geographic location. We evaluate the collectability of both principal and interest of each loan. When a loan is impaired, the impairment is then measured based on fair value of the collateral, since these loans are collateral dependent. Upon measurement of impairment, we record an allowance to reduce the carrying value of the loan with a corresponding charge to net income. Significant judgments are required in determining impairment, including assumptions regarding the value of the loan, the value of the underlying collateral and other provisions such as guarantees. We will not record an allowance for loan loss for the Residential Bridge Loans that Company has elected the fair value option.

Income recognition is suspended for loans at the earlier of the date at which payments become 90-days past due or when, in the opinion of management, a full recovery of income and principal becomes doubtful. When the ultimate collectability of the principal of an impaired loan is in doubt, all payments are applied to principal under the cost recovery method. When the ultimate collectability of the principal of an impaired loan is not in doubt, contractual interest is recorded as interest income when received, under the cash basis method until an accrual is resumed when the loan becomes contractually current and performance is demonstrated to be resumed. A loan is written off when it is no longer realizable and/or it is legally discharged.

#### Interest Income Recognition

Agency MBS, Non-Agency MBS and other securities, excluding Interest-Only Strips, rated AA and higher at the time of purchase

Interest income on mortgage-backed and other securities is accrued based on the respective outstanding principal balances and corresponding contractual terms. We record interest income in accordance with ASC subtopic 835-30 "Imputation of Interest", using the effective interest method. As such premiums and discounts associated with Agency MBS, Non-Agency MBS and other securities, excluding Interest-Only Strips, rated AA and higher at the time of purchase, are amortized into interest income over the estimated life of such securities. Adjustments to premium and discount amortization are made for actual prepayment activity. We estimate prepayments at least quarterly for our securities and, as a result, if the projected prepayment speed increases, we will accelerate the rate of amortization on premiums or discounts and make a retrospective adjustment to historical amortization. Alternatively, if projected prepayment speeds decrease, we will reduce the rate of amortization on the premiums or discounts and make a retrospective adjustment to historical amortization.

Non-Agency MBS and other securities that are rated below AA at the time of purchase and Interest-Only Strips that are not classified as derivatives

Interest income on Non-Agency MBS and other securities that are rated below AA at the time of purchase and Interest-Only Strips that are not classified as derivatives are also recognized in accordance with ASC 835, using the effective yield method. The effective yield on these securities is based on the projected cash flows from each security, which is estimated based on our observation of the then current information and events, where applicable, and will include assumptions related to interest rates, prepayment rates and the timing and amount of credit losses. On at least a quarterly basis, we review and, if appropriate, make adjustments to our cash flow projections based on input and analysis received from external sources, internal models, and our judgment about interest rates, prepayment rates, the

timing and amount of credit losses, and other factors. Where appropriate, we may include in our cash flow projections the U.S. Department of Justice's settlements with the major residential mortgage originators, regarding certain lending practices. Changes in cash flows from those originally projected, or from those estimated at the last evaluation, may result in a prospective change in the yield/interest income recognized on such securities. Actual maturities of the securities are affected by the contractual lives of the underlying collateral, periodic payments of scheduled principal, and prepayments of principal. Therefore, actual maturities of the securities will generally be shorter than stated contractual maturities.

Based on the projected cash flow of such securities purchased at a discount to par value, we may designate a portion of such purchase discount as credit protection against future credit losses and, therefore, not accrete such amount into interest income. The amount designated as credit discount may be adjusted over time, based on the actual performance of the security, its underlying collateral, actual and projected cash flow from such collateral, economic conditions and other factors. If the performance of a security with a credit discount is more favorable than forecasted, a portion of the amount designated as credit discount may be accreted into interest income prospectively.

Residential Whole-Loans and Residential Bridge Loans

Interest income on our residential loan portfolio is recorded in accordance with ASC 835 using the effective interest method based on the contractual payment terms of the loan. Any premium amortization or discount accretion will be reflected as a component of "Interest income" in our Consolidated Statements of Operations.

#### Variable Interest Entities ("VIEs")

VIEs are defined as entities that by design either lack sufficient equity for the entity to finance its activities without additional subordinated financial support or are unable to direct the entity's activities or are not exposed to the entity's losses or entitled to its residual returns. We evaluate all of our interests in VIEs for consolidation. When the interests are determined to be variable interests, we assess whether we are deemed the primary beneficiary. The primary beneficiary of a VIE is determined to be the party that has both the power to direct the activities of a VIE that most significantly impact the VIE's economic performance and the obligation to absorb losses or the right to receive benefits of the VIE that could potentially be significant to the VIE.

To assess whether we have the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, we consider all facts and circumstances, including our role in establishing the VIE and our 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 is deemed to have the power to direct the activities of a VIE.

To assess whether we have 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, we consider all of our economic interests. This assessment requires that we apply 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 us.

In instances when a VIE is owned by both us and related parties, we consider whether there is a single party in the related party group that meets both the power and losses or benefits criteria on its own as though no related party relationship existed. If one party within the related party group meets both these criteria, such reporting entity is the primary beneficiary of the VIE and no further analysis is needed. If no party within the related party group on its own meets both the power and losses or benefits criteria, but the related party group does as a whole meets these two criteria, the determination of primary beneficiary within the related party group is based upon an analysis of the facts and circumstances with the objective of determining which party is most closely associated with the VIE.

Determining the primary beneficiary within the related party group requires significant judgement.

In instances when we are required to consolidate a VIE that is determined to be a qualifying collateralized financing entity, under GAAP, we will measure both the financial assets and financial liabilities of the VIE using the fair value of either the VIE's financial assets or financial liabilities, whichever is more observable.

Ongoing assessments of whether an enterprise is the primary beneficiary of a VIE is required.

#### Derivatives and Hedging Activities

Subject to maintaining our qualification as a REIT for U.S. federal income tax purposes, as part of our hedging strategy, we may enter into, but not limited to, interest rate swaps, including forward starting swaps, interest rate swaptions, U.S. Treasury options, future contracts, TBAs, Agency and Non-Agency interest only strips total return

swaps, credit default swaps and foreign current swaps and forwards. Derivatives, subject to REIT requirements, are used for hedging purposes rather than speculation. We determine the fair value of our derivative positions and obtain quotations from third parties, including the Chicago Mercantile Exchange or CME, to facilitate the process of determining such fair values. If our hedging activities do not achieve the desired results, reported earnings may be adversely affected.

GAAP requires an entity to recognize all derivatives as either assets or liabilities on the balance sheet and to measure those instruments at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative. The fair value adjustment will affect either other comprehensive income in stockholders' equity until the hedged item is recognized in earnings or net income depending on whether the derivative instrument is designated and qualifies as a hedge for accounting purposes and if so, the nature of the hedging activity. We have elected not to apply hedge accounting for our derivative instruments. Accordingly, we record the change in fair value of our derivative instruments, which includes net interest rate swap payments/receipts (including accrued amounts) and net currency payments/receipts (including accrued amounts) related

to interest rate swaps and currency swaps, respectively in "Gain (loss) on derivative instruments, net" in our Consolidated Statements of Operations.

In January 2017, the CME amended its rulebooks to legally characterize variation margin payments and receipts for over-the-counter derivatives they clear as settlements of the derivatives' exposure rather than collateral against exposure. As a result of the change in legal characterization, effective January 1, 2017, variation margin is no longer classified as collateral in the Consolidated Balance Sheets in either "Due from counterparties" or "Due to counterparties", but rather a component of the respective "Derivative asset, at fair value" or "Derivative liability, at fair value" in the Consolidated Balance Sheets. The variation margin is now considered partial settlements of the derivative contract and will result in realized gains or losses which prior to January 1, 2017 were classified as unrealized gains or losses on derivatives. Prior to the CME rulebook change variation margin was included in financing activities in our Consolidated Statement of Cash Flows in either "Due from counterparties, net" or "Due to counterparties, net". Commencing in January 2017, cash postings for variation margin are included in operating activities in the Consolidated Statements of Cash Flows.

Proceeds and payments on settlement of swaptions, mortgage put options, futures contracts credit default swaps and TBAs are included in cash flows from investing activities. Proceeds and payments on settlement of forward contracts are reflected in cash flows from financing activities in our Consolidated Statements of Cash Flows. For Agency and Non-Agency Interest-Only Strips accounted for as derivatives, the purchase, sale and recovery of basis activity is included with MBS and other securities under cash flows from investing activities in our Consolidated Statements of Cash Flows.

We evaluate the terms and conditions of our holdings of Agency and Non-Agency Interest-Only Strips, interest rate swaptions, currency forwards, futures contracts and TBAs to determine if these instruments have the characteristics of an investment or should be considered a derivative under GAAP. In determining the classification of our holdings of Interest-Only Strips, we evaluate the securities to determine if the nature of the cash flows has been altered from that of the underlying mortgage collateral. Interest-Only Strips, for which the underlying mortgage collateral has been included into a structured security that alters the cash flows from the underlying mortgage collateral, are accounted for as derivatives. The carrying value of our Agency and Non-Agency Interest-Only Strips, accounted for as derivatives, is included in "Mortgage-backed securities and other securities, at fair value" in our Consolidated Balance Sheets. The carrying value of interest rate swaptions, currency forwards, futures contracts and TBAs is included in "Derivative assets, at fair value" or "Derivative liability, at fair value" in our Consolidated Balance Sheets. Interest earned or paid along with the change in fair value of these instruments accounted for as derivatives is recorded in "Gain (loss) on derivative instruments, net" in our Consolidated Statements of Operations".

We evaluate all of our financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. An embedded derivative is separated from the host contract and accounted for separately when all of the guidance criteria are met. Hybrid instruments that are remeasured at fair value through earnings, including the fair value option, are not bifurcated. Derivative instruments, including derivative instruments accounted for as liabilities are recorded at fair value and are re-valued at each reporting date, with changes in the fair value together with interest earned or paid (including accrued amounts) reported in "Gain (loss) on derivative instruments, net" in our Consolidated Statements of Operations.

#### 2017 Activity





## Investment Activity

In December of 2016, we evaluated our investments in Agency RMBS and Non-Agency RMBS, focusing on expected future prepayment trends, supply of and demand, costs of financing, costs of hedging, expected future interest rate volatility and the overall shape of the U.S. Treasury and interest rate swap yield curves. Based on our evaluation and our long-term views of the Agency RMBS sector, we decided to reposition our portfolio, reducing our exposure to Agency RMBS and legacy Non-Agency RMBS and deployed capital to acquire Agency CMBS, Non-Agency CMBS, Residential Whole and Bridge Loans and Non-Agency RMBS collateralized by reperforming loan pools.

The following table presents our investing activity for the year ended December 31, 2017 (dollars in thousands):

Investment Type	Balance at December 31, 2016	Purchases	Principal Payments and Basis	Proceeds from Sales	Realized Gain/(Loss)	Unrealized Gain/(loss)	Premium and discount amortization, net	OTTI	Balance at December 31, 2017
Agency RMBS and Agency RMBS IOs	\$1,469,970	\$632,100	\$(138,811)	\$(1,254,559)	\$(2,483)	\$7,202	\$(9,084)	\$(6,302)	\$698,033
Non-Agency RMBS	308,242	37,668	(11,634)	(246,033)	22,208	(12,969)	2,072	—	99,554
Agency CMBS and Agency CMBS IOs	371,624	1,787,174	(5,254)	—	—	6,398	717	(92)	2,160,567
Non-Agency CMBS	358,919	51,511	(84,303)	(54,875)	740	13,453	8,276	(15,117)	278,604
Other securities <sup>(1)</sup>	67,762	81,000	(783)	(38,447)	659	12,297	1,559	(1,982)	122,065
Total MBS and other securities	2,576,517	2,589,453	(240,785)	(1,593,914)	21,124	26,381	3,540	(23,493)	3,358,823
Residential Whole-Loans	192,136	88,879	(43,221)	—	—	723	(1,094)	—	237,423
Residential Bridge Loans	—	143,666	(37,175)	—	—	558	(376)	—	106,673
Securitized commercial loan	24,225	—	(154)	—	—	805	—	—	24,876
Total Investments	\$2,792,878	\$2,821,998	\$(321,335)	\$(1,593,914)	\$21,124	\$28,467	\$2,070	\$(23,493)	\$3,727,795

(1) Other securities includes \$89.8 million of GSE CRTs and \$32.2 million of ABS at December 31, 2017.

We increased Agency CMBS holdings from 13.3% in 2016 to 57.9% in 2017, reducing our Agency RMBS holdings by 52.5%. The underlying collateral for the Agency CMBS are multifamily residential loans guaranteed by Fannie Mae and Freddie Mac. We find this sector attractive because the underlying loans have built in prepayment protection and therefore are less sensitive to interest rate risk and have a lower cost of hedging compared to Agency RMBS. In

addition, since Agency CMBS are not held on the Federal Reserve's balance sheet, these securities will not be subject to potential spread widening from the Federal Reserve's balance sheet reduction plan.

We continue to see favorable risk-adjusted return opportunities in credit sensitive investments, particularly Residential Whole and Bridge Loans, securitized pools of prime jumbo loans and commercial mezzanine loans, including junior tranches. We intend to continue to deploy capital into credit sensitive investments. At December 31, 2017, we held \$869.2 million in credit sensitive investments, primarily consisting of 32.1% Non-Agency CMBS, 27.3% Residential Whole-Loans, 12.3% Residential Bridge Loans, 11.5% Non-Agency RMBS, which includes investments in securitized reperforming loans of \$37.2 million and 10.3% GSE credit risk transfer securities. We work to mitigate the credit risk on our credit sensitive holdings by developing relationships with originators that adhere to our investment guidelines for our Residential Whole and Bridge Loans and for the other investments we perform a detailed credit analysis on the underlying collateral at the time of purchase.

## Portfolio Characteristics

## Agency Portfolio

The following table summarizes certain characteristics of our Agency portfolio by issuer and investment category as of December 31, 2017 (dollars in thousands):

	Principal Balance	Amortized Cost	Fair Value	Net Weighted Average Coupon <sup>(1)</sup>	
Agency RMBS 20-Year, 30-Year and 40-Year					
Fannie Mae	\$ 572,185	\$ 597,210	\$598,895	3.8	%
Freddie Mac	68,859	72,710	73,282	4.2	%
Total Agency RMBS 20-Year, 30-Year and 40-Year	641,044	669,920	672,177	3.9	%
Agency RMBS IOs and IIOs <sup>(2)</sup>					
Fannie Mae	N/A	6,051	6,626	3.4	%
Freddie Mac	N/A	5,148	5,203	2.4	%
Ginnie Mae	N/A	3,551	3,608	3.1	%
Total Agency RMBS IOs and IIOs <sup>(2)</sup>	N/A	14,750	15,437	2.9	%
Agency RMBS IOs and IIOs accounted for as derivatives <sup>(2)</sup>					
Fannie Mae	N/A	N/A	7,989	2.6	%
Freddie Mac	N/A	N/A	1,370	3.2	%
Ginnie Mae	N/A	N/A	1,060	4.4	%
Total Agency RMBS IOs and IIOs accounted for as derivatives <sup>(2)</sup>	N/A	N/A	10,419	2.9	%
Total: Agency RMBS	641,044	684,670	698,033	3.6	%
Agency CMBS					
Fannie Mae	2,145,139	2,147,281	2,154,800	2.9	%
Agency CMBS IOs and IIOs <sup>(2)</sup>					
Fannie Mae	N/A	—	10	3.2	%
Agency CMBS IOs and IIOs accounted for as derivatives <sup>(2)</sup>					
Ginnie Mae	N/A	N/A	5,757	0.5	%
Total: Agency CMBS	2,145,139	2,147,281	2,160,567	2.7	%
Total	\$ 2,786,183	\$ 2,831,951	\$2,858,600	3.0	%

(1) Net weighted average coupon as of December 31, 2017 is presented net of servicing and other fees.

(2) IOs and IIOs have no principal balances and bear interest based on a notional balance. The notional balance is used solely to determine interest distributions on the interest-only class of securities.

Credit Sensitive Portfolio

The following table presents information by vintage<sup>(1)</sup> as it relates to our credit sensitive investment portfolio at December 31, 2017:

Credit Securities	Pre 2006	2006	2007	2010	2011	2012	2013	2014	2015	2016	2017	Total
Non-Agency RMBS	3.0%	2.7%	1.4%	—%	—%	—%	—%	—%	—%	—%	3.3%	10.4%
Non-Agency RMBS IOs	—%	—%	—%	—%	—%	—%	—%	—%	—%	—%	1.0%	1.0%
Non-Agency CMBS	—%	6.2%	6.6%	—%	4.0%	0.8%	0.4%	2.5%	8.7%	—%	2.9%	32.1%
Other securities	1.1%	—%	—%	—%	—%	—%	—%	1.1%	1.6%	4.4%	6.0%	14.2%
Residential Whole-Loans	0.2%	—%	—%	0.1%	0.6%	1.0%	8.8%	4.3%	0.2%	6.3%	5.7%	27.2%
Residential Bridge Loans	—%	—%	—%	—%	—%	—%	—%	—%	0.3%	2.4%	9.5%	12.2%
Securitized commercial loan	—%	—%	—%	—%	—%	—%	—%	—%	—%	2.9%	—%	2.9%
Total	4.3%	8.9%	8.0%	0.1%	4.6%	1.8%	9.2%	7.9%	10.8%	16.0%	28.4%	100.0%

(1)Based on carrying amount of the investments.

Non-Agency RMBS

The following table presents the fair value and weighted average purchase price for each of our Non-agency RMBS categories, including IOs accounted for as derivatives, together with certain of their respective underlying loan collateral attributes and current performance metrics as of December 31, 2017 (fair value dollars in thousands):

Category	Fair Value	Weighted Average		Original LTV	Original FICO	60+ Day Delinquent	6-Month CPR
		Purchase Price	Life (Years)				
Alt-A	\$ 91,417	\$70.60	8.1	77.5%	689	11.0%	11.6%
Subprime	8,137	58.57	8.1	77.4%	598	19.9%	6.3%
Total	\$ 99,554	\$69.62	8.1	77.5%	682	11.8%	11.2%

Non-Agency CMBS

The following table presents certain characteristics of our Non-Agency CMBS portfolio as of December 31, 2017 (dollars in thousands):

Type	Vintage	Principal		Weighted Average		
		Balance	Fair Value	Life (Years)	Original LTV	CPR
Conduit:				0		
	2006-2009	\$140,538	\$ 111,661	2.8	72.1%	
	2010-2016	177,245	111,065	7.8	64.0%	
		317,783	222,726	5.3	68.1%	
Single Asset:						
	2010-2016	61,400	55,878	3.8	62.7%	
Total		\$379,183	\$ 278,604	5.0	67.0%	

Residential Whole-Loans

The following table presents certain information about our Residential Whole-Loan investment portfolio as of December 31, 2017 (dollars in thousands):

45

---

Current Coupon Rate	Number of Loans	Principal Balance	Weighted Average			Contractual Maturity (years)	Coupon Rate
			Original LTV	Original FICO Score <sup>(1)</sup>	Expected Life (years)		
3.01 - 4.00%	142	\$55,593	55.5%	751	1.7	29.1	3.9 %
4.01 - 5.00%	338	125,860	56.9%	725	1.4	26.5	4.5 %
5.01 - 6.00%	132	48,553	58.2%	728	1.6	27.0	5.2 %
6.01 - 7.00%	4	2,264	71.1%	758	1.3	20.5	6.3 %
Total	616	\$232,270	57.0%	734	1.5	27.1	4.5 %

(1) The original FICO score is not available for 141 loans with a principal balance of approximately \$56.5 million at December 31, 2017. We have excluded these loans from the weighted average computations.

As of December 31, 2017, there was one Residential Whole-Loan over 90-days past due with a current unpaid principal balance of \$579 thousand and a fair value of \$570 thousand. This nonperforming Residential Whole Loans represent approximately 0.2% of the total outstanding principal balance. No allowance and provision for credit losses was recorded for these loans as of and for the twelve months ended December 31, 2017 since we elected the fair value option for this loan. We stopped accruing interest income for this loan when it became contractually 90 days delinquent.

#### Residential Bridge Loans

Our Residential Bridge Loans are comprised of short-term fixed rate mortgages secured by non owner occupied single and multi-family residences with low LTVs, generally up to 85%. The following table presents certain information about our Residential Bridge Loans investment portfolio at December 31, 2017 (dollars in thousands):

Current Coupon Rate	Number of Loans	Principal Balance	Weighted Average			Coupon Rate
			Original LTV	Contractual Maturity (months)	Weighted Average	
5.01 - 6.00%	9	\$4,016	64.5%	10.8	5.9 %	
6.01 - 7.00%	64	18,420	67.8%	10.6	6.7 %	
7.01 - 8.00%	98	25,608	66.4%	9.5	7.6 %	
8.01 - 9.00%	56	19,728	70.3%	11.9	8.9 %	
9.01 - 10.00%	67	25,001	73.3%	6.8	9.7 %	
10.01 - 11.00%	36	10,656	75.4%	5.0	10.8 %	
11.01 - 12.00%	2	919	89.8%	8.2	11.4 %	
17.01 - 18.00%	8	1,520	73.8%	5.9	18.0 %	
Total	340	\$105,868	70.1%	9.0	8.6 %	

As of December 31, 2017, there were nine Residential Bridge Loans over 90-days past due with an unpaid principal balance of approximately \$1.8 million. These nonperforming Residential Bridge Loans represent approximately 1.7% of the total outstanding principal balance. Since we did not elect the fair value option for these loans, we are required to review for impairment. Therefore, we reviewed the estimated fair value of the collateral to determine if an allowance and provision of credit loss was required. Based upon our evaluation we expect full recovery of the principal and interest and accordingly no allowance and provision for credit losses was recorded for these loans as of and for the twelve months ended December 31, 2017. We stopped accruing interest income for these loans when they became contractually 90 days delinquent.





## Geographic Concentration

The mortgages underlying our Non-Agency RMBS and Non-Agency CMBS are located in various states across the United States and other countries. The following table presents the five largest concentrations by location for the mortgages collateralizing our Non-Agency RMBS and Non-Agency CMBS as of December 31, 2017, based on fair value (dollars in thousands):

Non-Agency RMBS			Non-Agency CMBS		
	Concentration	Fair Value		Concentration	Fair Value
California	28.3 %	\$ 28,152	California	8.1 %	\$ 22,525
Florida	11.1 %	11,081	New York	8.0 %	22,410
New York	8.0 %	8,009	Florida	7.4 %	20,609
Virginia	7.3 %	7,275	Illinois	7.3 %	20,257
Maryland	4.7 %	4,711	North Carolina	7.2 %	20,196

The following table presents the various states across the United States in which the collateral securing our Residential Whole-Loans and Residential Bridge Loans at December 31, 2017, based on principal balance, is located (dollars in thousands):

Residential Whole-Loans			Residential Bridge Loans		
	Concentration	Principal Balance		Concentration	Principal Balance
California	62.2 %	\$ 144,321	California	48.2 %	\$ 51,080
New York	24.4 %	56,631	Florida	13.4 %	14,199
Georgia	4.3 %	10,061	Washington	6.3 %	6,645
Washington	4.0 %	9,244	New York	4.4 %	4,703
Massachusetts	3.9 %	9,114	Texas	4.4 %	4,660
Other	1.2 %	2,899	Other	23.3 %	24,581
Total	100.0 %	\$ 232,270	Total	100.0 %	\$ 105,868

## Financing Activity

## Repurchase Agreements

At December 31, 2017, we had repurchase agreements with 28 counterparties and outstanding borrowings with 16 of such counterparties. The following table summarizes our 2017 financing activity under our repurchase agreements for the twelve months ended December 31, 2017 (dollars in thousands):

Collateral	Balance at December 31, 2016	Proceeds	Repayments	Balance at December 31, 2017
Agency RMBS	\$1,427,674	\$5,229,691	\$(5,991,446)	\$665,919
Agency CMBS	56,365	8,855,845	(6,876,988)	2,035,222
Non-Agency RMBS	218,712	300,905	(473,087)	46,530
Non-Agency CMBS	255,656	1,172,392	(1,273,723)	154,325
Residential Whole-Loans <sup>(1)</sup>	154,391	2,052,319	(2,017,440)	189,270
Securitized commercial loan <sup>(1)</sup>	6,790	61,255	(68,045)	—
Residential Bridge Loans <sup>(1)</sup>	—	295,479	(195,296)	100,183
Other securities	36,056	470,280	(446,099)	60,237
Borrowings under repurchase agreements	\$2,155,644	\$18,438,166	\$(17,342,124)	\$3,251,686

(1)

Repurchase borrowings and collateral pledged attributed to loans owned through trust certificates. The trust certificates are eliminated upon consolidation.

At December 31, 2017, we had outstanding repurchase agreement borrowings with the following counterparties:

(dollars in thousands) Repurchase Agreement Counterparties	Amount Outstanding	Percent of Total Company		Counterparty Rating <sup>(1)</sup>
		Amount Outstanding	Investments Held as Collateral	
Citigroup Global Markets Inc.	\$ 843,680	26.0	%	\$ 889,203 A+
Royal Bank of Canada	390,374	12.0	%	411,268 AA-
Jefferies & Company, Inc.	303,527	9.3	%	319,410 BBB-
UBS Securities LLC	267,175	8.2	%	280,509 A+
Merrill Lynch Pierce Fenner & Smith Inc.	232,090	7.1	%	241,277 A+
Mizuho Securities USA Inc.	197,557	6.1	%	209,733 A
Credit Suisse AG, Cayman Islands Branch	189,270	5.8	%	237,423 A
UBS AG, London Branch	150,165	4.6	%	214,962 A+
TD Securities (USA) LLC	148,603	4.6	%	154,398 AA-
JP Morgan Securities LLC	118,558	3.6	%	124,192 A+
KGS-Alpha Capital Markets, L.P.	116,868	3.6	%	122,428 Unrated
Nomura Securities International, Inc.	100,183	3.1	%	106,673 Unrated <sup>(2)</sup>
RBC (Barbados) Trading Bank Corporation	96,627	3.0	%	120,729 P-1
The Bank of Nova Scotia	76,096	2.3	%	77,184 A+
All other counterparties <sup>(3)</sup>	20,913	0.7	%	24,314
Total	\$ 3,251,686	100.0	%	\$ 3,533,703

The counterparty ratings presented above are the long-term issuer credit ratings as rated at December 31, 2017 by (1) S&P, except for RBC (Barbados) Trading Bank Corporation which is the short-term issuer credit rating by Moody's at December 31, 2017.

(2) Nomura Holdings, Inc., the parent company of Nomura Securities International, Inc., is rated A- by S&P at December 31, 2017.

Represents amount outstanding with two counterparties, which each holds collateral valued less than 5% of our (3) stockholders' equity as security for our obligations under the applicable repurchase agreements as of December 31, 2017.

The following table presents our average repurchase agreement borrowings, excluding unamortized debt issuance costs, by type of collateral pledged for the years ended December 31, 2017 and December 31, 2016 (dollars in thousands):

Collateral	Year ended	Year ended
	December 31, 2017	December 31, 2016
Agency RMBS	\$875,600	\$1,678,450
Agency CMBS	1,289,755	19,866
Non-Agency RMBS	65,765	291,681
Non-Agency CMBS	207,423	281,679
Residential Whole-Loans	168,776	162,067
Securitized commercial loan	5,425	6,958
Residential Bridge Loans	46,135	—
Other securities	54,320	34,789
Total	\$2,713,199	\$2,475,490

Maximum borrowings during the period<sup>(1)</sup> \$3,336,256 \$3,059,579

(1) Amount represents the maximum borrowings at month-end during each of the respective periods.

### Convertible Senior Unsecured Notes

In October 2017, we issued \$115.0 million aggregate principal amount of 6.75% convertible senior unsecured notes, which included the underwriter's option to purchase \$15.0 million aggregate principal amount of the notes for net proceeds to us of \$111.1 million. The notes mature on October 1, 2022, unless earlier converted, redeemed or repurchased by the holders pursuant to their terms, and are not redeemable by the Company except during the final three months prior to maturity. The notes are convertible into, at the Company's election, cash, shares of the Company's common stock or a combination of both, subject to the satisfaction of certain conditions and during specified periods. The conversion rate is subject to adjustment upon the occurrence of certain specified events and the holders may require the Company to repurchase all or any portion of their notes for cash equal to 100% of the principal amount of the notes, plus accrued and unpaid interest, if the Company undergoes a fundamental change as specified in the agreement. The initial conversion rate was 83.1947 shares of common stock per \$1,000 principal amount of notes and represented a conversion price of \$12.02 per share of common stock. We believe that this financing is an attractive source of longer term capital, which we believe was more cost efficient than issuing straight equity.

### Hedging Activity

In connection with our risk management activities, we enter into a variety of derivative and non-derivative instruments. Our primary objective for acquiring these derivatives and non-derivative instruments is to mitigate our exposure to future events that are outside our control. Our derivative instruments are designed to mitigate the effects market risk and cash flow volatility associated with interest rate risk, including associated prepayment risk. As part of our hedging strategy, we may enter into, but not limited to, interest rate swaps, including forward starting swaps, interest rate swaptions, U.S. Treasury options, Eurodollar, Volatility Index and U.S. Treasury futures, TBAs, total return swaps, credit default swaps and foreign current swaps and forwards.

In the second quarter of 2017, we restructured our hedges in connection with our portfolio repositioning. As a result, we entered into compression trades to terminate approximately \$3.3 billion of fixed pay rate interest rate swaps and approximately \$2.0 billion of variable pay rate interest rate swaps realizing a net loss on termination of approximately \$155.8 million. Since the change in fair value of our interest rate swaps is reflected in the statement of operations as an unrealized loss the compression trade had only a \$2.3 million negative impact to net income and book value. These "compression trades" reduce the number of interest rate swaps outstanding.

The following tables summarize the hedging activity during the twelve months ended December 31, 2017 (dollars in thousands):

Derivative Instrument	Notional Amount at December 31, 2016	Acquisitions	Settlements, Terminations or Expirations	Notional Amount at December 31, 2017
Fixed pay interest swaps	\$4,662,200	\$5,748,400	\$(7,158,400)	\$3,252,200
Variable pay interest rate swaps	2,682,400	694,900	(3,377,300)	—
Interest rate swaptions	—	200,000	(200,000)	—
Options - long positions	—	6,285,100	(5,965,100)	320,000
Options - short positions	—	4,984,500	(4,664,500)	320,000
Futures contracts - long positions	56,900	452,900	(509,800)	—
Futures contracts - short positions	176,300	1,430,300	(1,126,600)	480,000
Total return swaps	47,059	—	(47,059)	—
Foreign currency forward contracts	2,316	5,955	(8,271)	—
Credit default swaps	—	14,815	—	14,815
TBA securities - long positions	—	5,843,200	(5,718,200)	125,000
TBA securities - short positions	—	5,718,200	(5,718,200)	—
Total derivative instruments	\$7,627,175	\$31,378,270	\$(34,493,430)	\$4,512,015



Derivative Instrument	Fair Value at December 31, 2016	Acquisitions	Settlements, Terminations or Expirations	Realized Gains / Losses	Mark-to-market	Fair Value at December 31, 2017
Fixed pay interest swaps	\$(114,603)	\$(25,919 )	\$ 131,145	\$(100,651)	\$ 105,837	\$(4,191 )
Variable pay interest rate swaps	(42,860 )	—	29,448	(29,698 )	43,110	—
Interest rate swaptions	—	115		(115 )		—
Options - long positions	—	15,130	(10,401 )	(4,029 )	(600 )	100
Options - short positions	—	(5,694 )	2,768	2,576	300	(50 )
Futures contracts - long positions	71	—	1,426	(1,426 )	(71 )	—
Futures contracts - short positions	(2,487 )	—	7,704	(7,704 )	3,115	628
Total return swaps	(1,673 )	—	552	(552 )	1,673	—
Foreign currency forward contracts	(35 )	—	(32 )	32	35	—
Credit default swaps	—	(73 )	—	—	(22 )	(95 )
TBA securities	—	—	(4,049 )	4,049	(10 )	(10 )
Total derivative instruments	\$(161,587)	\$(16,441 )	\$ 158,561	\$(137,518)	\$ 153,367	\$(3,618 )

For the year ended December 31, 2017, we had approximately \$1.7 billion of fixed pay rate interest rate swaps, excluding \$1.5 billion of forward starting fixed pay interest rate swaps (weighted average forward starting dates of 4.0 months). The following table provides additional information on our interest rate swaps (dollars in thousands):

December 31, 2017

Remaining Interest Rate Swap Term	Notional Amount	Average		Average Maturity (Years)	Forward Starting <sup>(1)</sup>	
		Fixed Pay Rate	Floating Receive Rate			
Greater than 1 year and less than 3 years	\$600,000	1.6 %	1.5 %	1.8	—	%
Greater than 3 years and less than 5 years	960,000	2.0 %	1.4 %	4.3	—	%
Greater than 5 years	1,692,200	2.5 %	1.4 %	10.5	90.2	%
Total	\$3,252,200	2.2 %	1.4 %	7.1	46.9	%

(1) Represents the percentage of notional that is forward starting  
Currency Swaps and Forwards

We have invested in and, in the future, may invest in additional securities which are denominated in a currency or currencies other than U.S. dollars. Similarly, it has and may in the future, finance such assets in a currency or currencies other than U.S. dollars. In order to mitigate the impact to us, we may enter into derivative financial instruments, including foreign currency swaps and foreign currency forwards, to manage fluctuations in the valuation between U.S. dollars and such foreign currencies. Foreign currency swaps involve the payment of a foreign currency at fixed interest rate on a fixed notional amount and the receipt of U.S. dollars at a fixed interest rate on a fixed notional amount. Foreign currency forwards provide for the payment of a fixed amount of a foreign currency in exchange for a fixed amount of U.S. dollars at a date certain in the future. We had no foreign currency swaps at December 31, 2017.

#### Capital Markets Activity

The following is a summary of activity during 2017:

In December 2017, our Board of Directors reauthorized the repurchase of up to 2,100,000 shares of our common stock through December 31, 2019. Pursuant to the repurchase plan we acquired approximately 125,722 shares with an average price, including commission, of \$9.80 per share, totaling approximately \$1.2 million;

In October 2017, we issued \$115.0 million aggregate principal amount of 6.75% convertible senior unsecured notes, which mature on October 1, 2022;

In April 2017, we entered into an equity distribution agreement with JMP Securities LLC under which we may offer and sell up to \$100.0 million of common stock in an At-The-Market equity offering, or ATM. We have not sold any shares under this agreement during 2017;

50

---



In March 2017, we filed and the SEC declared effective a new universal shelf registration statement for \$400.0 million of common stock, preferred stock; and

The dividend remained stable at \$0.31 for each of the four quarters of 2017, generating a dividend yield of approximately 12.5% based on the stock price of \$9.95 at December 31, 2017.

#### Book Value

The following chart reflects our book value per common and diluted shares over five consecutive quarters:

Our book value, net of our annual dividends was \$11.15 at December 31, 2017, an increase of \$0.88 or 8.6% when compared to our December 31, 2016 book value of \$10.27. The appreciation in book value reflects the benefits of the portfolio repositioning that we began in December 2016 and the restructuring of our hedges in the second quarter of 2017. Our performance was driven by contributions across our holdings and reflects the benefit of our strategy of investing in a diversified portfolio. Our Agency CMBS and RMBS portfolio performed as expected with spreads generally tighter in both sectors. Our credit sensitive portfolio continued to perform well under the ongoing favorable environment in both residential and commercial real estate.

#### Results of Operations

##### General

Our operating results mainly depend upon the difference between the yield on our investments, the cost of our borrowing, including our hedging activity, and the composition and changes in market prices of our portfolio. For the year ended December 31, 2017, we had net income of \$85.1 million or \$2.03 per basic and diluted weighted average common share, compared to net loss of \$25.0 million or \$0.61 per basic and diluted weighted average common share for the year ended December 31, 2016. Our results of operations, for the year ended December 31, 2017, was positively impacted by the reposition of our portfolio, the restructuring of our hedges, generally tighter spreads on our Agency portfolio and our credit sensitive portfolio continued to perform well with the favorable environment in both residential and commercial real estate. In addition in October 2017, we issued \$115.0 million of convertible senior unsecured notes which enabled us to significantly increase the size of our investment portfolio.

Comparison of the year ended December 31, 2017 to the year ended December 31, 2016

Net Interest Income

The following tables set forth certain information regarding our net interest income on our investment portfolio for the years ended December 31, 2017 and December 31, 2016 (dollars in thousands):

Year ended December 31, 2017	Average Amortized Cost of Assets	Total Interest Income	Yield on Average Assets
<b>Investments</b>			
Agency RMBS	\$898,883	\$25,050	2.79 %
Agency CMBS	1,354,720	40,571	2.99 %
Non-Agency RMBS	88,566	6,127	6.92 %
Non-Agency CMBS	323,769	27,455	8.48 %
Residential Whole-Loans	207,786	8,515	4.10 %
Residential Bridge Loans	52,696	4,487	8.51 %
Securitized commercial loan	24,964	2,247	9.00 %
Other securities	116,683	9,839	8.43 %
Total investments	\$3,068,067	\$124,291	4.05 %
	Average Carrying Value	Total Interest Expense	Average Cost of Funds
<b>Borrowings</b>			
Repurchase agreements	\$2,713,199	\$45,128	1.66 %
Convertible senior unsecured notes, net <sup>(1)</sup>	108,743	2,264	8.34 %
Securitized debt	10,984	981	8.93 %
Total borrowings	\$2,832,926	\$48,373	1.76 %
Net interest income and net interest margin		\$75,918	2.47 %

(1) The convertible senior unsecured notes, net are reflected at the balance as of December 31, 2017. The average cost of financing is calculated based on annualized interest expense divided by the average carrying value for the period outstanding.

Year ended December 31, 2016	Average Amortized Cost of Assets	Total Interest Income	Yield on Average Assets
<b>Investments</b>			
Agency RMBS	\$1,700,801	\$45,633	2.68 %
Agency CMBS	16,445	917	5.58 %
Non-Agency RMBS	394,880	29,978	7.59 %
Non-Agency CMBS	411,505	32,324	7.86 %
Residential Whole-Loans	193,810	7,102	3.66 %
Securitized commercial loan	25,000	2,288	9.15 %
Other securities	66,211	5,514	8.33 %
Total investments	\$2,808,652	\$123,756	4.41 %

Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-K

	Average Carrying Value	Total Interest Expense	Average Cost of Funds	
Borrowings				
Repurchase agreements	\$2,475,490	\$31,432	1.27	%
Securitized debt	11,000	998	9.07	%
Total borrowings	\$2,486,490	\$32,430	1.30	%
Net interest income and net interest margin		\$91,326	3.25	%

52

---

### Interest Income

For the years ended December 31, 2017 and December 31, 2016, we earned interest income on our investments of approximately \$124.3 million and \$123.8 million, respectively. The increase interest income for the year ended December 31, 2017 as compared to the year ended December 31, 2016 was primarily the result of an overall larger investment portfolio, which was offset by a lower yield on our investment portfolio. The lower yield on our investments was a result of the repositioning of our investment from Agency RMBS and legacy Non-Agency RMBS to Agency CMBS and credit sensitive investments, which in combination were slightly low yielding assets. We believe this investments mix will provide greater book value stability than the portfolio prior to repositioning. The interest income on our Agency RMBS investments is impacted by changes in prepayment speeds and interest rates. Projected prepayment speeds are estimated on a quarterly basis. Changes in the prepayment speeds impacts the amount of premium and/or discount amortization is recognized in interest income. In a rising interest rate environment prepayments speeds will decrease, resulting in a decrease in premium amortization with a retrospective adjustment that increases interest income. The projected prepayment speeds was 10.0 at December 31, 2017, which resulted in a retrospective adjustment that increased interest income by \$92 thousand for the three month ended December 31, 2017.

The following table details the constant prepayment rates for our Agency portfolio as of December 31, 2017, based on our Manager's estimates which are based on third party models, as adjusted by our Manager, and are updated quarterly on a prospective basis:

Constant Prepayment Rates	Low	High
Agency RMBS		
20-Year mortgage	9.68 %	11.98 %
30-Year mortgage	7.46 %	16.99 %
40-Year mortgage	9.13 %	9.69 %
Agency RMBS IOs and IIOs	9.66 %	24.96 %
Agency RMBS IOs and IIOs accounted for as derivatives	6.66 %	22.34 %

Other factors impacting interest income include assumptions on our Non-Agency RMBS and other securities pertaining to prepayments, defaults and loss severity. The following table details information for our Non-Agency and other securities portfolio as of December 31, 2017, based on our Manager's estimates which are based on third party models, as adjusted by our Manager, and are updated quarterly on a prospective basis:

	Cumulative Default		Cumulative Severity		Cumulative 5-Year CRR <sup>(1)</sup>	
	Low	High	Low	High	Low	High
Non-Agency RMBS	0.22 %	7.75 %	23.71 %	113.88 %	3.24 %	11.46 %
Non-Agency RMBS IOs and IIOs	2.00 %	2.00 %	30.00 %	30.00 %	10.00 %	10.00 %
Risk Sharing Securities Issued by Fannie Mae and Freddie Mac	0.71 %	0.99 %	— %	19.15 %	7.79 %	10.05 %
Other securities	1.00 %	2.00 %	90.00 %	100.00 %	10.00 %	10.00 %

### Interest Expense

Interest expense increased from \$32.4 million for the year ended December 31, 2016 to \$48.4 million for the year ended December 31, 2017. Our higher borrowing costs reflect: (i) Higher outstanding borrowings due to larger investment portfolio. Our outstanding borrowings increased by \$1.2 billion for the year ended December 31, 2017 ; (ii) Generally higher interest rates on our repurchase agreements in 2017 coupled with higher costs associated with financing our credit-sensitive investments, which generally have higher interest rates. Our cost of funds on our repurchase agreements increased from 1.27% for the year ended December 31, 2016 to 1.66% for the year ended December 31, 2017; and (iii) The issuance of \$115.0 million million aggregate principal amount of 6.75% convertible senior unsecured notes in October 2017.



Other income (loss)  
Realized gain (loss) on investments

Realized gain (loss) on investments represent the net gain (loss) on sales from our investment portfolio. Our Manager regularly reviews the characteristics of our portfolio and may make changes to our portfolio in order to adjust such portfolio characteristics in response to and/or anticipation of changing market conditions in an effort to achieve the appropriate risk reward ratio. Accordingly, due to changes in market conditions or expected changes in market conditions, we repositioned our portfolio and sold Agency RMBS and Legacy Non-Agency RMBS and redeployed our capital into Agency CMBS and credit sensitive investments in order to adjust the overall characteristics of our portfolio.

The following table presents the sales and realized gains (loss) of our investments for the years ended December 31, 2017 and December 31, 2016 (dollars in thousands):

	Year ended December 31, 2017				Year ended December 31, 2016			
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS <sup>(1)</sup>	\$ 1,251,985	\$ 5,020	\$ (7,936 )	\$ (2,916 )	\$ 1,239,350	\$ 6,214	\$ (25,818 )	\$ (19,604 )
Agency CMBS	—	—	—	—	22,939	54	(66 )	(12 )
Non-Agency RMBS	243,838	24,356	(2,241 )	22,115	177,996	6,470	(4,560 )	1,910
Non-Agency CMBS	54,875	2,543	(1,803 )	740	50,418	137	(5,810 )	(5,673 )
Other securities	38,447	713	(54 )	659	764,711	3,496	(2,108 )	1,388
Total	\$ 1,589,145	\$ 32,632	\$ (12,034 )	\$ 20,598	\$ 2,255,414	\$ 16,371	\$ (38,362 )	\$ (21,991)

(1) Excludes Interest-Only Strips, accounted for as derivatives.

#### Other than temporary impairment

We evaluate securities for OTTI on at least a quarterly basis. The determination of whether a security is other-than-temporarily impaired involves judgments, estimates and assumptions based on subjective and objective factors. As a result, the timing and amount of an OTTI constitutes an accounting estimate that may change materially over time.

The decrease in OTTI was mainly attributable to the sale of legacy Non-Agency RMBS securities as part of repositioning our portfolio. We significantly reduced our exposure to Non-Agency RMBS from \$308.2 million at December 31, 2016 to \$99.6 million at December 31, 2017 thereby reducing OTTI by \$9.5 million year over year. The current Non-Agency RMBS portfolio did not recognize OTTI for the year ending December 31, 2017.

The following table presents the other-than-temporary impairments we recorded on our securities portfolio (dollars in thousands):

	Year ended December 31, 2017	Year ended December 31, 2016
Agency RMBS <sup>(1)</sup>	\$ 5,774	\$ 6,090
Non-Agency RMBS	—	9,511

Non-Agency CMBS	15,117	13,025
Other securities	1,982	3,660
Total	\$ 22,873	\$ 32,286

(1) Normally unrealized losses on Agency securities, with explicit guarantee of principal and interest by the governmental sponsored entity are not credit losses but rather due to changes in interest rates and prepayment expectations. These securities would not be considered other than temporarily impaired provided we did not intend to sell the security.

Unrealized gain (loss), net

Our investments and securitized debt, for which we have elected the fair value option, are recorded at fair value with the periodic changes in fair value being recorded in earnings. The change in unrealized gain (loss) is directly attributable to changes in market pricing on the underlying investments and securitized debt during the period. For the year ended December 31, 2017, unrealized gain (loss) increased to a net unrealized gain of \$28.4 million from a net unrealized loss of \$17.1 million for the year

ended December 31, 2016. The increase in net unrealized gain was a result the repositioning of our investment portfolio resulting in improved valuations, a larger investment portfolio coupled with tighter mortgage spreads.

The following table presents the net unrealized gains (losses) we recorded on our investments and securitized debt (dollars in thousands):

	Year ended December 31, 2017	Year ended December 31, 2016
Agency RMBS	\$ 7,207	\$(10,432)
Agency CMBS	5,747	1,344
Non-Agency RMBS	(12,040)	849
Non-Agency CMBS	13,453	(9,748)
Residential Whole-Loans	723	(42)
Residential Bridge Loans	558	—
Securitized commercial loan	805	(775)
Other securities	12,297	1,356
Securitized debt	(354)	341
Total	\$ 28,396	\$(17,107)

Gain (loss) on derivatives, net

In order to mitigate interest rate risk resulting from our repurchase agreement borrowings, we enter into a variety of derivative and non-derivative instruments. Our primary objective for acquiring these derivatives and non-derivative instruments is to mitigate our exposure to future events that are outside our control.

Effective January 2017, variation margin of CME cleared derivatives are treated as settlements of the derivative contract rather than cash collateral, accordingly variation margin is treated as a gain or loss of partial settlement of the underlying derivative contract and reported in "Gain (loss) on derivative instruments, net" in the Consolidated Statements of Operations. Also, included in "Gain (loss) on derivative instruments, net" in our Consolidated Statements of Operations are the net interest rate swap payments, since we do not apply hedge accounting and currency payments (including accrued amounts) associated with these instruments.

In April 2017, we restructured our hedge positions, effectively terminating fix-pay interest rate swaps with a notional value of approximately \$3.2 billion and variable-pay interest rate swaps with a notional value of approximately \$2.0 billion to more effectively hedge our debt and reduce swap related interest expense. The effects of the terminations is reflected in the table below for the year ended December 31, 2017 in interest rate swaps "Other Settlements/Expirations" and "Mark to Market".



The following table presents the components of gain (loss) on derivatives for the year ended December 31, 2017 and December 31, 2016 (dollars in thousands):

Description	Realized Gain (Loss), net					Total
	Other Settlements / Expirations	Variation Margin Settlement	Mark-to-market	Return (Recovery) of Basis	Contractual interest income(expense), net <sup>(1)</sup>	
Year ended December 31, 2017						
Interest rate swaps	\$(150,607)	\$ 20,258	\$ 148,947	\$ 524	\$ (14,606)	\$ 4,516
Interest rate swaptions	(115)	—	—	—	—	(115)
IOs and IIOs accounted for as derivatives	526	—	(902)	(5,995)	7,438	1,067
Options	(1,453)	—	(300)	—	—	(1,753)
Futures contracts	(9,130)	—	3,044	—	—	(6,086)
Foreign currency forwards	32	—	35	—	—	67
Total return swaps	(552)	—	1,673	—	469	1,590
Credit default swaps	(11)	—	(22)	—	—	(33)
TBAs	4,049	—	(10)	—	—	4,039
Total	\$(157,261)	\$ 20,258	\$ 152,465	\$(5,471)	\$ (6,699)	\$ 3,292
Year ended December 31, 2016						
Interest rate swaps	\$(33,999)	\$ —	\$ 11,013	\$ 672	\$ (27,903)	\$(50,217)
Interest rate swaptions	(1,035)	—	1,631	—	—	596
IOs and IIOs accounted for as derivatives	1,317	—	(4,726)	(11,438)	14,148	(699)
Options	4,756	—	—	—	—	4,756
Futures contracts	23,609	—	(1,781)	—	—	21,828
Foreign currency forwards	(66)	—	(56)	—	—	(122)
Foreign currency swaps	6,771	—	(7,168)	—	283	(114)
Total return swaps	38	—	(1,673)	—	1,121	(514)
TBAs	6,126	—	(2,375)	—	—	3,751
Total	\$7,517	\$ —	\$ (5,135)	\$(10,766)	\$ (12,351)	\$(20,735)

(1) Contractual interest income (expense), net on derivative instruments includes interest settlement paid or received.

Other, net

For the years ended December 31, 2017 and December 31, 2016, "Other, net" consisted of income of \$1.0 million and \$180 thousand, respectively, of which \$1 thousand and \$758 thousand was related to foreign currency loss, respectively, with the balance mainly comprised of interest income on cash collateral for our derivative and repurchase agreements. Generally, our foreign currency denominated investments are financed with repurchase agreements in the same currency. We recognize a gain or loss in foreign currency exchange, depending on the movement of the exchange rates during the period.

Expenses

Management Fee Expense

We incurred management fee expenses of approximately \$8.1 million and \$10.4 million for the years ended December 31, 2017 and December 31, 2016, respectively. Pursuant to the terms of the Management Agreement, our

Manager is paid a management fee equal to 1.5% per annum of our stockholders' equity (as defined in the Management Agreement), calculated and payable (in cash) quarterly in arrears. The decrease of 2.3 million or 22.5% in management fees for the year ended December 31, 2017 was a result of the restructuring of our interest rate swaps in April 2017, which effectively terminated the existing swaps. The effects of the terminations resulted in accumulated realized losses of approximately \$155.8 million, which were previously excluded from the "Equity" base used to calculate the management fee because they were unrealized losses.

The management fees, expense reimbursements and the relationship between our Manager and us are discussed further in Note 9, "Related Party Transactions," to the consolidated financial statements contained in this annual report on Form 10-K.

### Other Operating Expenses

We incurred other operating expenses of approximately \$2.4 million and \$1.0 million for the years ended December 31, 2017 and December 31, 2016, respectively. Other operating expenses is comprised of derivative transaction costs, custody, loan servicing fees, asset management fees and loan transaction costs. The increase was attributable to the following: derivative transaction costs from hedging our interest rate exposure for the financing of our 2017 acquisitions; Transaction costs related to the increased acquisition activity in 2017 of Residential Whole and Bridge Loans; and loan servicing and asset management fees related to our Residential Bridge Loans, which are a new target asset in 2017.

### General and Administrative Expenses

We incurred general and administrative expenses of approximately \$7.3 million and \$9.8 million for the years ended December 31, 2017 and December 31, 2016, respectively. The following describes the key components of general and administrative expenses.

#### Compensation Expense

Compensation expense decreased from \$3.0 million for the year ended December 31, 2016 to \$2.7 million for the year ended December 31, 2017. The decrease was primarily a result of lower stock based compensation, since we did not issue any stock awards to our Manager or executive officers in 2017 and 2016.

#### Professional Fees

Professional fees decreased to approximately \$3.2 million for the year ended December 31, 2017 from approximately \$4.8 million for the year ended December 31, 2016. The decrease was primarily related to operational efficiencies , resulting in a reduction in audit, tax, internal audit and outsourced accounting fees.

#### Other general and administrative expenses

Other general and administrative decreased approximately \$1.3 million for the year ended December 31, 2017 from approximately \$1.9 million for the year ended December 31, 2016. The decrease was attributable operational efficiencies around financial reporting and we did not incur excise in 2017 further reducing other general and administrative expenses by \$339 thousand.

Comparison of the year ended December 31, 2016 to the year ended December 31, 2015

Net Interest Income

The following tables set forth certain information regarding our net interest income on our investment portfolio for the years ended December 31, 2016 and December 31, 2015 (dollars in thousands):

Year ended December 31, 2016	Average Amortized Cost of Assets	Total Interest Income	Yield on Average Assets
Investments			
Agency RMBS	\$1,700,801	\$45,633	2.68 %
Agency CMBS	16,445	917	5.58 %
Non-Agency RMBS	394,880	29,978	7.59 %
Non-Agency CMBS	411,505	32,324	7.86 %
Residential Whole-Loans	193,810	7,102	3.66 %
Securitized commercial loan	25,000	2,288	9.15 %
Other Securities	66,211	5,514	8.33 %
Total	\$2,808,652	\$123,756	4.41 %

	Average Carrying Value	Total Interest Expense	Average Cost of Funds
Borrowings			
Repurchase agreements	\$2,475,490	\$31,432	1.27 %
Securitized debt	11,000	998	9.07 %
Total borrowings	\$2,486,490	\$32,430	1.30 %

Net interest income and net interest margin \$91,326 3.25 %

Year ended December 31, 2015	Average Amortized Cost of Assets	Total Interest Income	Yield on Average Assets
Investments			
Agency RMBS	\$2,713,994	\$71,673	2.64 %
Agency CMBS	28,814	1,498	5.20 %
Non-Agency RMBS	566,416	36,464	6.44 %
Non-Agency CMBS	448,236	30,248	6.75 %
Residential Whole-Loans	82,936	3,031	3.65 %
Commercial Whole-Loans	4,699	424	9.02 %
Securitized commercial loan	3,904	356	9.12 %
Other Securities	146,350	9,010	6.16 %
Total	\$3,995,349	\$152,704	3.82 %

	Average Carrying Value	Total Interest Expense	Average Cost of Funds
--	------------------------------	------------------------------	-----------------------------

Borrowings

Repurchase agreements	\$3,355,727	\$27,450	0.82	%
Securitized debt	1,718	155	9.02	%
Total borrowings	\$3,357,445	\$27,605	0.82	%

Net interest income and net interest margin \$125,099 3.13 %

Interest Income

For the year ended December 31, 2016 and December 31, 2015, we earned interest income on our investments of approximately \$123.8 million and \$152.7 million, respectively. The decrease in interest income for the year ended December 31,

2016 as compared to the year ended December 31, 2015 was primarily the result of an overall smaller investment portfolio, which was offset by a higher yield on our investment portfolio due to our strategic shift to deploy capital to our credit-sensitive investments generating higher yields and spreads, relative to our Agency RMBS, increasing the yield on average assets to 4.41% from 3.82%.

#### Interest Expense

We incurred interest expense, which primarily related to our repurchase agreements, of approximately \$32.4 million and \$27.6 million, for the years ended December 31, 2016 and December 31, 2015, respectively. Our higher borrowing costs reflect: (i) the increase in interest rates, and (ii) increased interest costs associated with financing our credit-sensitive investments, which generally have higher interest rates than repurchase agreements on Agency RMBS. Our cost of funds increased from 0.82% for the year ended December 31, 2015 to 1.30% for the year ended December 31, 2016. The increase in interest expense was partially offset by a decrease in our average repurchase agreement borrowings from \$3.4 billion to \$2.5 billion.

Other income (loss)

Realized gain (loss) on investments

The mortgage and structured securities markets remain dynamic and, at times, volatile markets. Our Manager regularly reviews the characteristics of our portfolio and may make changes to our portfolio in order to adjust such portfolio characteristics in response to and/or anticipation of changing market conditions in an effort to achieve the appropriate risk reward ratio. Accordingly, due to changes in market conditions or expected changes in market conditions, we sold these MBS and other assets in order to adjust the overall characteristics of our portfolio.

The following table presents the sales and realized gains (loss) of our investments for the years ended December 31, 2016 and December 31, 2015 (dollars in thousands):

	Year ended December 31, 2016				Year ended December 31, 2015			
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS <sup>(1)</sup>	\$ 1,239,350	\$ 6,214	\$ (25,818 )	\$ (19,604 )	\$ 1,293,120	\$ 12,054	\$ (12,449 )	\$ (395 )
Agency CMBS	22,939	54	(66 )	(12 )	—	—	—	—
Non-Agency RMBS	177,996	6,470	(4,560 )	1,910	233,257	11,066	(174 )	10,892
Non-Agency CMBS	50,418	137	(5,810 )	(5,673 )	161,985	2,123	(171 )	1,952
Other securities	764,711	3,496	(2,108 )	1,388	851,714	1,188	(5,358 )	(4,170 )
Total	\$ 2,255,414	\$ 16,371	\$ (38,362 )	\$ (21,991 )	\$ 2,540,076	\$ 26,431	\$ (18,152 )	\$ 8,279

(1) Excludes Interest-Only Strips, accounted for as derivatives.

#### Other than temporary impairment

With respect to our portfolio, OTTI is generally recorded when the credit quality of the underlying collateral deteriorates and or the expected payments on our IO securities, which are not characterized as derivatives, are faster than previously projected. The credit deterioration could be as a result of, but not limited to increased projected realized losses, foreclosures, delinquencies and the likelihood of the borrower being able to make payments in the future. The determination as to whether an OTTI exists is subjective, given that such determination is based on information available at the time of assessment as well as our estimate of the future performance and cash flow projections for the individual security. In the fourth quarter of 2016, we recognized approximately \$4.4 million of OTTI related to securities in an unrealized loss position that we had the intent to sell at December 31, 2016.



The following table presents the other-than-temporary impairments we recorded on our securities portfolio (dollars in thousands):

	Year ended December 31, 2016	Year ended December 31, 2015
Agency RMBS	\$ 6,090	\$ 4,005
Non-Agency RMBS	9,511	9,216
Non-Agency CMBS	13,025	4,061
Other securities	3,660	2,509
Total	\$ 32,286	\$ 19,791

Unrealized gain (loss), net

With respect to our investments and securitized debt, we elected the fair value option and, as a result, we record the change in fair value related to these investments and securitized debt in earnings. The change in unrealized gain (loss) is directly attributable to changes in market pricing on the underlying investments and securitized debt during the period. For the year ended December 31, 2016, unrealized gain (loss) increased to a net unrealized loss of \$17.1 million from a net unrealized loss of \$34.0 million for the year ended December 31, 2015. The decrease in net unrealized loss was a result of a smaller portfolio coupled with tighter mortgage spreads.

The following table presents the net unrealized gains and losses (dollars in thousands):

	Year ended December 31, 2016	Year ended December 31, 2015
Agency RMBS	\$(10,432 )	\$(17,428 )
Agency CMBS	1,344	54
Non-Agency RMBS	849	(3,024 )
Non-Agency CMBS	(9,748 )	(17,652 )
Residential Whole-Loans	(42 )	3,548
Securitized commercial loan	(775 )	—
Other securities	1,356	491
Securitized debt	341	—
Total	\$(17,107 )	\$(34,011 )

Gain (loss) on derivatives, net

In order to mitigate interest rate risk resulting from our future repurchase agreement borrowings, we entered into interest rate swaps, interest rate swaptions, future contracts, currency swaps and currency forwards. The fair value of our interest rate swaps declined as a result of the swap spreads tightening. While not designated as a hedge for accounting purposes, our current and future interest rate swaps, interest rate swaptions, foreign currency swaps and foreign currency forwards are, collectively treated as economic hedge on a portion of our floating-rate borrowings and foreign currency rate exposure, respectively. Since we do not apply hedge accounting for these instruments, we record the change in fair value related to such agreements in earnings in Gain (loss) on derivative instruments, net. Included in Gain (loss) on derivative instruments, net in our Consolidated Statement of Operations are the net interest rate swap payments and currency payments (including accrued amounts) associated with these instruments.



The following table presents the components of gain (loss) on derivatives for the year ended December 31, 2016 and December 31, 2015 (dollars in thousands):

Description	Year ended December 31, 2016					Year ended December 31, 2015				
	Realized Gain (Loss), net	Contractual interest income (expense), net <sup>(1)</sup>	Return (Recovery) of Basis	Mark-to-market	Unrealized	Realized Gain (Loss), net	Contractual interest income (expense), net <sup>(1)</sup>	Return (Recovery) of Basis	Mark-to-market	Total
Interest rate swaps	\$ (33,999)	\$ (27,903)	\$ 672	\$ 11,013	\$ (50,217)	\$ 23,680	\$ (20,366)	\$ 1,250	\$ (68,843)	\$ (64,279)
Interest rate swaptions	(1,035 )	—	—	1,631	596	(5,242 )	—	—	(1,486 )	(6,728 )
IOs and IIOs accounted for as derivatives	1,317	14,148	(11,438 )	(4,726 )	(699 )	595	21,872	(17,265 )	(4,283 )	919
Options	4,756	—	—	—	4,756	(711 )	—	—	—	(711 )
Futures contracts	23,609	—	—	(1,781 )	21,828	(527 )	—	—	105	(422 )
Foreign currency forwards	(66 )	—	—	(56 )	(122 )	(901 )	—	—	323	(578 )
Foreign currency swaps	6,771	283	—	(7,168 )	(114 )	—	795	—	3,311	4,106
Total return swaps	38	1,121	—	(1,673 )	(514 )	—	—	—	—	—
TBAAs	6,126	—	—	(2,375 )	3,751	1,524	—	—	(2,726 )	(1,202 )
Total	\$ 7,517	\$ (12,351)	\$ (10,766)	\$ (5,135)	\$ (20,735)	\$ 18,418	\$ 2,301	\$ (16,015)	\$ (73,599)	\$ (68,895)

(1) Contractual interest income (expense), net on derivative instruments includes interest settlement paid or received. Other, net

For the years ended December 31, 2016 and December 31, 2015 Other, net consisted of income of \$180 thousand and \$2.3 million, respectively, of which in 2016 \$758 thousand was related to foreign currency loss and in 2015 \$2.1 million was related to net foreign currency gain, respectively, with the balance comprised of interest income on cash collateral for our derivative and repurchase agreements. Generally, our foreign currency denominated investments are financed with repurchase agreements in the same currency. We recognize a gain or loss in foreign currency exchange, depending on the movement of the exchange rates during the period.

Expenses

#### Management Fee Expense

We incurred management fee expense of approximately \$10.4 million and \$10.9 million for the years ended December 31, 2016 and December 31, 2015, respectively. Pursuant to the terms of the Management Agreement, our Manager is paid a management fee equal to 1.5% per annum of our stockholders' equity (as defined in the Management Agreement), calculated and payable (in cash) quarterly in arrears.

The management fees, expense reimbursements and the relationship between our Manager and us are discussed further in Note 9, "Related Party Transactions," to the financial statements contained in this Annual Report on Form 10-K.

#### Other Operating Expenses

We incurred other operating expenses of approximately \$1.0 million and \$2.0 million for the years ended December 31, 2016 and December 31, 2015, respectively. The decrease was attributable to lower transaction costs related to our interest rate derivatives coupled with less activity.

#### General and Administrative Expenses

We incurred general and administrative expenses of approximately \$9.8 million and \$9.6 million for the years ended December 31, 2016 and December 31, 2015, respectively. The following describes the key components of general and administrative expenses.

#### Compensation Expense

Compensation expense decreased from \$3.8 million for the year ended December 31, 2015 to \$3.0 million for the year ended December 31, 2016. The decrease was primarily related to the outsourcing of our interim chief financial officer for the first five months of 2016. The outsourcing fees were recorded in professional fees.

#### Professional Fees

Professional fees increased to approximately \$4.8 million for the year ended December 31, 2016 from approximately \$4.4 million for the year ended December 31, 2015. The increase was primarily related to the following: (i) costs attributable to the outsourcing of interim chief financial officer through May 2016, which was included in professional fees, (ii) higher audit fees, and (iii) other one-time professional fees.

#### Other general and administrative expenses

Other general and administrative increased slightly to approximately \$1.9 million for the year ended December 31, 2016 from approximately \$1.5 million for the year ended December 31, 2015.

#### Non-GAAP Financial Measures

We believe that our non-GAAP measures (described below), when considered with GAAP, provide supplemental information useful to investors in evaluating the results of our operations. Our presentations of such non-GAAP measures may not be comparable to similarly-titled measures of other companies, who may use different calculations. As a result, such non-GAAP measures should not be considered as substitutes for our GAAP net income, as measures of our financial performance or any measure of our liquidity under GAAP.

The following tables set forth certain information regarding our net investment income for the years ended December 31, 2017, December 31, 2016 and December 31, 2015 (dollars in thousands):

Year ended December 31, 2017	Average Amortized Cost of Assets <sup>(1)</sup>	Total Interest Income <sup>(2)</sup>	Yield on Average Assets	
<b>Investments</b>				
Agency RMBS	\$912,211	\$ 26,197	2.87	%
Agency CMBS	1,363,269	40,827	2.99	%
Non-Agency RMBS	88,835	6,167	6.94	%
Non-Agency CMBS	323,769	27,455	8.48	%
Residential Whole-Loans	207,786	8,515	4.10	%
Residential Bridge Loans	52,696	4,487	8.51	%
Securitized commercial loan	24,964	2,247	9.00	%
Other securities	116,683	9,839	8.43	%
Total return swaps	3,629	469	12.92	%
Total investments	\$3,093,842	\$ 126,203	4.08	%
	Average Carrying Value	Total Interest Expense <sup>(3)</sup>	Average Effective Cost of Funds	
<b>Borrowings</b>				
Repurchase agreements	\$2,713,199	\$ 45,128	1.66	%
Convertible senior unsecured notes, net <sup>(4)</sup>	108,743	2,264	8.34	%
Securitized debt	10,984	981	8.93	%
Interest rate swaps	n/a	14,082	0.51	%
Total borrowings	\$2,832,926	\$ 62,455	2.27	%
Net interest income and net interest margin		\$ 63,748	2.06	%

(1) Includes Agency and Non-Agency Interest-Only Strips accounted for as derivatives.

(2) Refer to below table for components of interest income.

(3) Includes the net amount paid, including accrued amounts and premium amortization for MAC interest rate swaps during the periods included in loss on derivative instruments for GAAP.

The convertible senior unsecured notes, net are reflected at the balance as of December 31, 2017. The average cost (4) of financing is calculated based on annualized interest expense divided by the average carrying value for the period outstanding.

Year ended December 31, 2016	Average Amortized Cost of Assets <sup>(1)</sup>	Total Interest Income <sup>(2)</sup>	Yield on Average Assets	
<b>Investments</b>				
Agency RMBS	\$1,736,758	\$ 47,461	2.73	%
Agency CMBS	27,219	1,279	4.70	%
Non-Agency RMBS	397,633	30,498	7.67	%
Non-Agency CMBS	411,505	32,607	7.92	%
Residential Whole-Loans	193,810	7,102	3.66	%
Securitized commercial loan	25,000	2,288	9.15	%
Other securities	66,211	5,514	8.33	%
Total return swaps	8,840	1,121	12.68	%
Total investments	\$2,866,976	\$ 127,870	4.46	%

	Average Carrying Value	Total Interest Expense <sup>(3)</sup>	Average Effective Cost of Funds	
<b>Borrowings</b>				
Repurchase agreements	\$2,475,490	\$ 31,432	1.27	%
Securitized debt	11,000	998	9.07	%
Interest rate swaps	n/a	27,231	1.10	%
Total borrowings	\$2,486,490	\$ 59,661	2.40	%
Net interest income and net interest margin		\$ 68,209	2.38	%

(1) Includes Agency and Non-Agency Interest-Only Strips accounted for as derivatives.

(2) Refer to below table for components of interest income.

(3) Includes the net amount paid, including accrued amounts and premium amortization for MAC interest rate swaps during the periods included in loss on derivative instruments for GAAP.

Year ended December 31, 2015	Average Amortized Cost of Assets <sup>(1)</sup>	Total Interest Income <sup>(2)</sup>	Yield on Average Assets	
<b>Investments</b>				
Agency RMBS	\$2,778,106	\$ 75,205	2.71	%
Agency CMBS	43,381	2,090	4.82	%
Non-Agency RMBS	570,094	36,947	6.48	%
Non-Agency CMBS	448,236	31,043	6.93	%
Residential Whole-Loans	82,936	3,031	3.65	%
Commercial Whole-Loans	4,699	424	9.02	%
Securitized commercial loan	3,904	356	9.12	%
Other securities	146,350	9,010	6.16	%
Total investments	\$4,077,706	\$ 158,106	3.88	%

	Average Carrying Value	Total Interest Expense <sup>(3)</sup>	Average Effective Cost of Funds	
Borrowings				
Repurchase agreements	\$3,355,727	\$ 27,450	0.82	%
Securitized debt	1,718	155	9.02	%
Interest rate swaps	n/a	19,116	0.57	%
Total borrowings	\$3,357,445	\$ 46,721	1.39	%
Net interest income and net interest margin		\$ 111,385	2.73	%

(1) Includes Agency and Non-Agency Interest-Only Strips accounted for as derivatives.

(2) Refer to below table for components of interest income.

(3) Includes the net amount paid, including accrued amounts and premium amortization for MAC interest rate swaps during the periods included in loss on derivative instruments for GAAP.

The following table reconciles total interest income to interest income including interest income on our Interest-Only Strips classified as derivatives (Non-GAAP financial measure) for the years ended December 31, 2017, December 31, 2016 and December 31, 2015:

(dollars in thousands)	Year ended December 31, 2017	Year ended December 31, 2016	Year ended December 31, 2015
Coupon interest income:			
Agency RMBS	\$38,108	\$70,467	\$119,789
Agency CMBS	40,064	2,619	3,600
Non-Agency RMBS	5,602	35,221	44,473
Non-Agency CMBS	19,179	24,893	26,562
Residential Whole-Loans	9,609	9,147	4,105
Residential Bridge Loans	4,863	—	—
Commercial Whole-Loans	—	—	424
Securitized commercial loan	2,247	2,288	356
Other Securities	8,280	2,537	6,363
Subtotal coupon interest	\$127,952	\$147,172	\$205,672
Premium accretion, discount amortization and amortization of basis, net:			
Agency RMBS	\$(13,058 )	\$(24,836 )	\$(48,119 )
Agency CMBS	507	(1,701 )	(2,102 )
Non-Agency RMBS	525	(5,243 )	(8,008 )
Non-Agency CMBS	8,276	7,431	3,687
Residential Whole-Loans	(1,094 )	(2,044 )	(1,074 )
Residential Bridge Loans	(376 )	—	—
Other Securities	1,559	2,977	2,648
Subtotal accretion and amortization	\$(3,661 )	\$(23,416 )	\$(52,968 )
Interest income	\$124,291	\$123,756	\$152,704
Contractual interest income, net of amortization of basis on Agency and Non-Agency Interest-Only Strips, classified as derivatives <sup>(1)</sup> :			
Coupon interest income	\$7,438	\$14,148	\$21,872
Amortization of basis (Non-GAAP Financial Measure)	(5,995 )	(11,438 )	(17,265 )
Contractual interest income, net on Foreign currency swaps <sup>(1)</sup>	—	283	795
Total Return swaps	469	1,121	—
Subtotal	\$1,912	\$4,114	\$5,402
Total adjusted interest income	\$126,203	\$127,870	\$158,106

(1) Reported in "Gain (loss) on derivatives, net" in the Consolidated Statements of Operations.

Effective Cost of Funds includes the net interest component related to our interest rate swaps, as well as the impact of our foreign currency swaps and forwards. While we have not elected hedge accounting for these instruments, such derivative instruments are viewed by us as an economic hedge against increases in future market interest rates on our liabilities and changes in foreign currency exchange rates on our assets and liabilities and are characterized as hedges

for purposes of satisfying the REIT requirements and therefore the Effective Cost of Funds reflects interest expense adjusted to include the realized loss (i.e., the interest expense component) for all of our interest rate swaps and the impact of our foreign currency swaps and forwards.



The following table reconciles the Effective Cost of Funds (Non-GAAP financial measure) with interest expense for the years ended December 31, 2017, December 31, 2016 and December 31, 2015:

(dollars in thousands)	Year ended December 31, 2017			Year ended December 31, 2016			Year ended December 31, 2015		
	Reconciliation	Cost of Funds/Effective Borrowing Costs	%	Reconciliation	Cost of Funds/Effective Borrowing Costs	%	Reconciliation	Cost of Funds/Effective Borrowing Costs	%
Interest expense	\$48,373	1.76	%	\$32,430	1.30	%	\$27,605	0.82	%
Net interest paid—interest rate swaps	14,082	0.51	%	27,231	1.10	%	19,116	0.57	%
Effective Borrowing Costs	\$62,455	2.27	%	\$59,661	2.40	%	\$46,721	1.39	%
Weighted average borrowings	\$2,832,926			\$2,486,490			\$3,357,445		

#### Core Earnings

Our Core Earnings were approximately \$48.3 million, \$49.6 million and \$91.4 million for the years ended December 31, 2017, December 31, 2016 and December 31, 2015, respectively. Core Earnings is a Non-GAAP financial measure that is used by us to approximate cash yield or income associated with our portfolio and is defined as GAAP net income (loss) as adjusted, excluding: (i) net realized gain (loss) on investments and termination of derivative contracts; (ii) net unrealized gain (loss) on investments; (iii) net gain (loss) resulting from mark-to-market adjustments on derivative contracts; (iv) other than temporary impairment; (v) provision for taxes; (vi) non-cash stock-based compensation expense; (vii) non-cash amortization of the convertible senior unsecured notes discount; (viii) one-time charges such as acquisition costs and impairment on loans and (ix) one-time events pursuant to changes in GAAP and certain other non-cash charges after discussions between us, our Manager and our independent directors and after approval by a majority of the our independent directors.

We utilize Core Earnings as a key metric to evaluate the effective yield of the portfolio. Core Earnings allows us to reflect the net investment income of our portfolio as adjusted to reflect the net interest rate swap interest expense. Core Earnings allows us to isolate the interest expense associated with our interest rate swaps in order to monitor and project our borrowing costs and interest rate spread.

We believe that the Non-GAAP measure, when considered with GAAP, provides supplemental information useful to investors in evaluating the results of our operations. Our presentation of Core Earnings may not be comparable to similarly-titled measures of other companies, who may use different calculations. As a result, Core Earnings should not be considered as a substitute for our GAAP net income, as a measure of our financial performance or any measure of our liquidity under GAAP.

Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-K

The table below reconciles Net Income (Loss) to Core Earnings for the years ended December 31, 2017, December 31, 2016 and December 31, 2015:

(dollars in thousands)	Year ended December 31, 2017	Year ended December 31, 2016	Year ended December 31, 2015
Net Income (loss) — GAAP	\$ 85,097	\$(25,015 )	\$(9,484 )
Provision for income tax	3,487	3,156	—
Net Income (loss) before provision for income tax	88,584	(21,859 )	(9,484 )
Adjustments:			
Investments:			
Unrealized (gain) loss on investments and securitized debt	(28,396 )	17,107	34,011
Other than temporary impairment	22,873	32,286	19,791
Realized (gain) loss on sale of investments	(20,598 )	21,991	(8,279 )
Realized (gain) loss on foreign currency transactions	1	99	(2,253 )
Unrealized (gain) loss on foreign currency transactions	—	659	123
Whole-Loans acquisition costs	146	—	—
Derivative Instruments:			
Net realized (gain) loss on derivatives	136,992	(7,517 )	(18,418 )
Net unrealized (gain) loss on derivatives	(152,465 )	5,135	73,599
Amortization of discount on convertible unsecured senior notes	137	—	—
Non-cash stock-based compensation expense	981	1,699	2,301
Total adjustments	(40,329 )	71,459	100,875
Core Earnings — Non-GAAP Financial Measure	\$ 48,255	\$ 49,600	\$ 91,391

Alternatively, our Core Earnings can also be derived as presented in the table below by starting with Adjusted net interest income, which includes interest income on Interest-Only Strips accounted for as derivatives and other derivatives, and net interest expense incurred on interest rate swaps and foreign currency swaps and forwards (a Non-GAAP financial measure) subtracting Total expenses, adding Non-cash stock based compensation, adding Amortization of discount on convertible senior notes, and adding Interest income on cash balances and other income (loss), net:

(dollars in thousands)	Year ended December 31, 2017	Year ended December 31, 2016	Year ended December 31, 2015
Adjusted net interest income	\$ 63,748	\$ 68,209	\$ 111,385
Total expenses	(17,778 )	(21,246 )	(22,483 )
Non-cash stock based compensation	981	1,699	2,301
Whole-Loans acquisition costs	146	—	—
Amortization of discount on convertible senior notes	137	—	—
Interest income on cash balances and other income (loss), net	1,021	938	188
Core Earnings (a Non-GAAP financial measure)	\$ 48,255	\$ 49,600	\$ 91,391

Liquidity and Capital Resources  
General

Liquidity is a measure of our ability to meet potential cash requirements, including ongoing commitments to repay borrowings, fund and maintain our assets and operations, make distributions to our stockholders, and other general business needs. To maintain our REIT qualifications under the Internal Revenue Code, we must distribute annually at least 90% of our taxable

income, excluding capital gains, such distributions requirements limit our ability to retain earnings and increase capital for operations. We believe that our significant capital resources and access to financing will provide us with financial flexibility at levels sufficient to meet current and anticipated capital requirements, including funding new investment opportunities, paying distributions to our stockholders and servicing our debt obligations.

Our liquidity and capital resources are managed on a daily basis to ensure that we have sufficient liquidity to absorb market events that could negatively impact collateral valuations and result in margin calls as well as to ensure that we have the flexibility to manage our investment portfolio to take advantage of market opportunities. As of December 31, 2017, our principal sources of cash consist of borrowings under repurchase agreements, potential additional offering of our convertible unsecured senior notes, payments of principal and interest on our investment portfolio and cash generated from operations.

As part of our risk management process, our Manager closely monitors our liquidity position. This includes the development and evaluation of various alternative processes and procedures, which continue to be updated with regard to scenario testing for purposes of assessing our liquidity in the face of different economic and market developments. We believe we have sufficient current liquidity and access to additional liquidity to meet financial obligations for at least the next 12 months.

#### Sources of Liquidity

##### Principal Sources of Cash

We held cash of approximately \$48.0 million, \$46.2 million and \$24.7 million at December 31, 2017, December 31, 2016 and December 31, 2015, respectively. Our primary sources of cash currently consist of repurchase facility borrowings, investment income, principal repayments on investments and the proceeds from debt and equity offerings, to the extent available in the capital markets. In the future, we expect our primary sources of liquidity to consist of payments of principal and investment income, unused borrowing capacity under our financing sources and future issuances of equity and debt securities.

## Repurchase Agreements

As of December 31, 2017, we had master repurchase agreements with 28 counterparties and borrowings with 16 counterparties of approximately \$3.3 billion. The following table presents our repurchase agreement borrowings, by type of collateral pledged, as of December 31, 2017 and December 31, 2016, and the respective effective cost of funds (Non-GAAP financial measure) for the years ended December 31, 2017 and December 31, 2016, respectively.

Collateral	Borrowings Outstanding	Value of Collateral Pledged <sup>(1)</sup>	Weighted Average Interest Rate end of period	Weighted Average Cost of Funds	Weighted Average Effective Cost of Funds (Non-GAAP) <sup>(2)</sup>	Weighted Average Haircut end of period
December 31, 2017						
Agency RMBS	\$ 665,919	\$ 690,255	1.62 %	1.21 %	1.21 %	4.36 %
Agency CMBS	2,035,222	2,143,340	1.53 %	1.32 %	1.32 %	5.02 %
Non-Agency RMBS	46,530	58,127	2.76 %	2.70 %	2.70 %	23.64 %
Non-Agency CMBS	154,325	208,062	2.98 %	2.83 %	2.83 %	27.99 %
Whole-Loans <sup>(3)</sup>	189,270	237,423	3.66 %	3.48 %	3.48 %	20.00 %
Residential Bridge Loans <sup>(3)</sup>	100,183	106,673	4.05 %	4.47 %	4.47 %	20.00 %
Securitized commercial loan <sup>(3)</sup>	—	—	— %	3.28 %	3.28 %	— %
Other securities	60,237	89,823	2.94 %	3.28 %	3.28 %	27.96 %
Interest rate swaps	n/a	n/a	n/a	n/a	0.51 %	n/a
Total	\$ 3,251,686	\$ 3,533,703	1.86 %	1.66 %	2.18 %	8.00 %
December 31, 2016						
Agency RMBS	\$ 1,427,674	\$ 1,465,384	0.96 %	0.77 %	0.77 %	4.25 %
Agency CMBS	56,365	61,200	1.07 %	1.69 %	1.69 %	7.18 %
Non-Agency RMBS	218,712	308,165	2.53 %	2.24 %	2.24 %	29.43 %
Non-Agency CMBS	255,656	358,919	2.55 %	2.24 %	2.24 %	28.21 %
Whole-Loans <sup>(3)</sup>	154,391	192,136	2.90 %	2.63 %	2.63 %	20.00 %
Securitized commercial loan <sup>(3)</sup>	6,790	13,566	3.24 %	2.97 %	2.97 %	50.00 %
Other securities	36,056	67,762	2.32 %	2.74 %	2.74 %	45.02 %
Interest rate swaps	n/a	n/a	n/a	n/a	1.10 %	n/a
Total	\$ 2,155,644	\$ 2,467,132	1.48 %	1.27 %	2.37 %	11.68 %

(1) For the years ended December 31, 2017 and 2016, excludes approximately \$23.6 million and \$37.0 million of cash collateral posted.

The effective cost of funds for the period presented is calculated on an annualized basis and includes interest expense for the period and net periodic interest payments on interest rate swaps, net of premium amortization on MAC swaps, of approximately \$14.1 million and \$27.2 million for the years ended December 31, 2017 and 2016.

(2) While interest rate swaps are not accounted for using hedge accounting, such instruments are viewed by us as an economic hedge against increases in interest rates on our liabilities and are treated as hedges for purposes of satisfying the REIT requirements. See "Non-GAAP Financial Measures".

(3) Repurchase agreement borrowings collateralized by Whole-Loans and securitized commercial loan owned through trust certificates. The trust certificates are eliminated upon consolidation.

We are also required to pledge cash or securities as collateral as part of a margin arrangement for our derivative contracts, calculated daily, subject either to the terms of individual agreements for bilateral agreements and the clearinghouse rules in the case of cleared swaps. The amount of margin that we are required to post will vary and generally reflects collateral posted with respect to swaps that are in an unrealized loss position to us and a percentage of the aggregate notional amount of swaps per counterparty as well as margin posted with our clearing broker, pursuant to clearinghouse rules and practices, for cleared swaps. Conversely, if our bilateral swaps and swaptions are in an unrealized gain position, our counterparties are required to post collateral with us, under the same terms that we post collateral with them. On occasion we may enter into a MAC interest rate swap in which we may receive or make a payment at the time of entering such interest rate swap to compensate for the out of the market nature of such interest rate swap. Similar to all other interest rate swaps, these interest rate swaps are also subject to margin requirements.

### Convertible Senior Unsecured Notes

In October 2017, the Company completed the issuance of \$115.0 million aggregate principal amount of its 6.75% Convertible Senior Notes due October 1, 2022 (the "Convertible Notes") in a public offering, which included \$15.0 million aggregate principal amount sold by the Company to the underwriter on the same terms and conditions to cover over-allotments. The notes are unsecured, pay interest semiannually at a rate of 6.75% per annum and are convertible at the option of the holder into shares of our common stock. The notes will mature in October 2022, unless earlier converted or repurchased in accordance with their terms. We do not have the right to redeem the notes prior to maturity, but may be required to repurchase the notes from holders under certain circumstances. The notes have an initial conversion rate of 83.1947 shares of common stock per \$1,000 principal amount of the notes (equivalent to an initial conversion price of \$12.02 per share), subject to adjustment. The net proceeds from the offering were approximately \$111.1 million after deducting underwriting discounts and offering expenses.

### At-The-Market Program

In April 2017, the Company entered into an equity distribution agreement with JMP Securities LLC, or "JMP", under which the Company may offer and sell up to \$100.0 million of common stock in an At-The-Market equity offering from time to time through JMP. We did not sell any shares under this agreement during 2017.

### Cash Generated from Operations

For the year ended December 31, 2017, operating activities increased our cash balance by approximately \$59.4 million. This was primarily attributable to the net income we earned on our investments net of adjustments pertaining to the amortization/accretion of premiums and discounts and other non-cash items. For the year ended December 31, 2016, operating activities increased our cash balance by approximately \$11.5 million. This was primarily attributable to the net income we earned on our investments net of adjustments pertaining to the amortization/accretion of premiums and discounts and other non-cash items. For the year ended December 31, 2015, operating activities increased our cash balance by approximately \$133.9 million. This was primarily attributable to the net income we earned on our investments net of adjustments pertaining to the amortization/accretion of premiums and discounts and other non-cash items.

### Cash Provided by and Used in Investing Activities

For the year ended December 31, 2017, our investing activities decreased our cash balance by approximately \$1.2 billion. This was primarily attributable to our investment acquisitions, which was partially offset by proceeds from sales and receipts of principal payments on our investments. For the year ended December 31, 2016, our investing activities increased our cash balance by approximately \$504.6 million. This was primarily attributable to our proceeds from sales of MBS and other securities and by our receipt of principal payments on MBS and other securities, partially offset by cash expenditures to acquire MBS and other securities and payments made on reverse repurchase agreements. For the year ended December 31, 2015, our investing activities increased our cash balance by approximately \$1.4 billion. This was primarily attributable to our proceeds from sales of MBS and other securities and by our receipt of principal payments on MBS and other securities, partially offset by cash expenditures to acquire MBS and other securities and payments made on reverse repurchase agreement.

### Cash Provided by and Used in Financing Activities

For the year ended December 31, 2017, our financing activities increased our cash balance by approximately \$1.1 billion. This was primarily attributable to higher weighted average borrowings and proceeds from the issuance of the convertible senior unsecured notes, partially offset by dividends paid on our common stock. For the year ended December 31, 2016, our financing activities decreased our cash balance by approximately \$494.8 million. This was primarily attributable to a decrease in our net borrowings under repurchase agreements. For the year ended December 31, 2015, our financing activities decreased our cash balance by approximately \$1.5 billion. This was primarily attributable to a decrease in our net borrowings under repurchase agreements.

## Contractual Obligations and Commitments

Our contractual obligations as of December 31, 2017 are as follows (dollars in thousands):

	Less than 1 year	1 to 3 years	3 to 5 years	More than 5 years	Total
Borrowings under repurchase agreements	\$3,251,686	\$—	\$—	\$	—\$3,251,686
Contractual interest on repurchase agreements	14,697	—	—	—	14,697
Convertible senior unsecured notes	—	—	115,000	—	115,000
Contractual interest on convertible senior unsecured notes	7,763	15,525	15,525	—	38,813
Investment related payables	17,217	—	—	—	17,217
Total: GAAP Basis - Excluding TBA - long positions	3,291,363	15,525	130,525	—	3,437,413
TBA—long positions	128,350	—	—	—	128,350
Total: Non-GAAP Basis	\$3,419,713	\$15,525	\$130,525	\$	—\$3,565,763

(1) The table above does not include amounts due under the Management Agreement (as defined herein) with our Manager, as those obligations do not have fixed and determinable payments.

## Repurchase Agreements

At December 31, 2017, we had entered into repurchase agreement borrowings of approximately \$114.9 million, which settled by January 18, 2018, with a weighted average interest rate of 2.00%, a weighted average contractual maturity of 54 days and secured by collateral of approximately \$124.7 million. These borrowings are recorded as a liability in our Consolidated Balance Sheets when settled.

## Securitized Debt

At December 31, 2017, we had securitized debt related to the consolidated VIEs, with a balance of \$10.9 million (and a fair value of \$10.9 million). The securitized debt of the VIEs can only be settled with the commercial loan that serve as collateral of the VIE and is non-recourse to us.

## Management Agreement

On May 9, 2012, we entered into a management agreement (the "Management Agreement") with our Manager which describes the services to be provided by our Manager and compensation for such services. Our Manager is responsible for managing our operations, including: (i) performing all of our day-to-day functions; (ii) determining investment criteria in conjunction with our Board of Directors; (iii) sourcing, analyzing and executing investments, asset sales and financings; (iv) performing asset management duties; and (v) performing financial and accounting management, subject to the direction and oversight of our Board of Directors. Pursuant to the terms of the Management Agreement, our Manager is paid a management fee equal to 1.50% per annum of our stockholders' equity, (as defined in the Management Agreement), calculated and payable (in cash) quarterly in arrears. Refer to Note 9 - "Related Party Transactions" to our Consolidated Financial Statements included in Item 8 included in this annual report on Form 10-K.

## Off-Balance Sheet Arrangements

We do not have any relationships with any entities or financial partnerships, such as entities often referred to as structured investment vehicles, or special purpose or variable interest entities, established to facilitate off-balance sheet arrangements or other contractually narrow or limited purposes.

Further, other than guaranteeing certain obligations of our wholly-owned taxable REIT subsidiary or TRS, we have not guaranteed any obligations of any entities or entered into any commitment to provide additional funding to any such entities.

See Note 11 "Stockholder' Equity - Warrants" to the financial statements contained in this Annual Report on Form 10-K, for a description of our outstanding warrants.





## Dividends

We intend to make regular quarterly dividend distributions to holders of our common stock. U.S. federal income tax law generally requires that a REIT distribute annually, in accordance with the REIT regulations, at least 90% of its REIT taxable income for the taxable year, without regard to the deduction for dividends paid and excluding net capital gains as well as undistributed taxable income retained by a TRS. To the extent we distribute less than 100% of our net taxable income, in accordance with the REIT regulations, for any given year, we will pay tax on such amount at the regular corporate rates. We intend to pay regular quarterly dividends to our stockholders based on our net taxable income, if and to the extent authorized by our Board of Directors. Before we pay any dividend, whether for U.S. federal income tax purposes or otherwise, we must first meet both our operating requirements and debt service on our repurchase agreements and other debts payable. If our cash available for distribution is less than our net taxable income, we could be required to sell assets or borrow funds to make cash distributions or we may make a portion of the required distribution in the form of a taxable stock distribution or distribution of debt securities.

## Recent Developments

### ITEM 7A. Quantitative and Qualitative Disclosures about Market Risk.

We seek to manage the risks related to the credit quality of our assets, interest rates, liquidity, prepayment speeds and market values while, at the same time, seeking to provide an opportunity to stockholders to realize attractive risk-adjusted returns from our assets through ownership of our common stock. While we do not seek to avoid risk completely, our Manager seeks to actively manage risk for us, to earn sufficient compensation to justify taking those risks and to maintain capital levels consistent with the risks we undertake.

## Credit Risk

We are subject to varying degrees of credit risk in connection with our assets. Although we do not expect to encounter credit risk in our Agency RMBS and Agency CMBS, we are exposed to the risk of potential credit losses from general credit spread widening related to Non-Agency RMBS, CMBS and other portfolio investments in addition to unexpected increase in borrower defaults on these securities, as well as our Whole-Loans. Investment decisions are made following a bottom-up credit analysis and specific risk assumptions. As part of the risk management process, our Manager uses detailed proprietary models, applicable to evaluate, depending on the asset class, house price appreciation and depreciation by region, prepayment speeds and foreclosure/default frequency, cost and timing. If our Manager determines that the proposed investment can meet the appropriate risk and return criteria as well as complement our existing asset portfolio, the investment will undergo a more thorough analysis.

As of December 31, 2017, 14 of the counterparties that we had outstanding repurchase agreement borrowings held collateral which we posted as security for such borrowings in excess of 5% of our Stockholders' equity. Prior to entering into a repurchase agreement with any particular institution, our Manager does a thorough review of such potential counterparty. Such review, however, does not assure the creditworthiness of such counterparty nor that the financial wherewithal of the counterparty will not deteriorate in the future.

## Interest Rate Risk

Interest rates are highly sensitive to many factors, including fiscal and monetary policies and domestic and international economic and political considerations, as well as other factors beyond our control. We are subject to interest rate risk in connection with our assets and our related financing obligations. In general, we expect to finance the acquisition of our assets through financings in the form of repurchase agreements, warehouse facilities, securitizations, resecuritizations, bank credit facilities (including term loans and revolving facilities) and public and private equity and debt issuances in addition to transaction or asset specific funding arrangements. Subject to maintaining our qualification as a REIT for U.S. federal income tax purposes, we utilize derivative financial

instruments to hedge the interest rate risk associated with our borrowings. We also may engage in a variety of interest rate management techniques that seek to mitigate changes in interest rates or other potential influences on the values of our assets.

#### Interest Rate Effect on Net Interest Income

Our operating results will depend in large part on differences between the income earned on our assets and our borrowing costs. The cost of our borrowings is generally based on prevailing market interest rates. During a period of rising interest rates, our borrowing costs generally will increase and the yields earned on our leveraged fixed-rate mortgage assets will remain static. Further, the cost of such financing could increase at a faster pace than the yields earned on our leveraged ARM and hybrid ARM assets. This could result in a decline in our net interest spread and net interest margin. The severity of any such decline would depend on our asset/liability composition at the time as well as the magnitude and duration of the interest rate increase. Further,

an increase in short-term interest rates could also have a negative impact on the market value of our assets. If any of these events happen, we could experience a decrease in net income or incur a net loss during these periods, which could adversely affect our liquidity and results of operations.

### Interest Rate Cap Risk

To the extent we invest in adjustable-rate RMBS, such securities are generally subject to interest rate caps, which potentially could cause such RMBS to acquire many of the characteristics of fixed-rate securities if interest rates were to rise above the cap levels. This issue is magnified to the extent we acquire ARM and hybrid ARM assets that are not based on mortgages which are fully indexed. In addition, ARM and hybrid ARM assets may be subject to periodic payment caps that result in some portion of the interest being deferred and added to the principal outstanding or a portion of the incremental interest rate increase being deferred. To the extent we invest in such ARM and/or hybrid ARM assets, we could potentially receive less cash income on such assets than we would need to pay the interest cost on our related borrowings. To mitigate interest rate mismatches, we may utilize the hedging strategies discussed above under “Interest Rate Risk.”

### Interest Rate Effects on Fair value

Another component of interest rate risk is the effect that changes in interest rates will have on the market value of the assets that we acquire. We face the risk that the market value of our assets will increase or decrease at different rates than those of our liabilities, including our hedging instruments. See “Market Risk” below.

The impact of changing interest rates on fair value can change significantly when interest rates change materially. Therefore, the volatility in the fair value of our assets could increase significantly in the event interest rates change materially. In addition, other factors impact the fair value of our interest rate-sensitive investments and hedging instruments, such as the shape of the yield curve, market expectations as to future interest rate changes and other market conditions. Accordingly, changes in actual interest rates may have a material adverse effect on us.

### Market Risk

Market value risk. Our MBS and other assets are reflected at their fair value with unrealized gains and losses included in earnings. The fair value of our investments fluctuates primarily due to changes in interest rates and other factors. Generally, in a rising interest rate environment, the fair value of these assets would be expected to decrease; conversely, in a decreasing interest rate environment, the fair value of these securities would be expected to increase.

The sensitivity analysis table presented below shows the estimated impact of an instantaneous parallel shift in the yield curve, up and down 50 and 100 basis points, on the market value of our interest rate-sensitive investments, including interest rate swaps, Interest-Only Strips, and net interest income at December 31, 2017, assuming a static portfolio of assets. When evaluating the impact of changes in interest rates, prepayment assumptions and principal reinvestment rates are adjusted based on our Manager’s expectations. The analysis presented utilizes our Manager’s assumptions, models and estimates, which are based on our Manager’s judgment and experience.

Change in Interest Rates	Percentage Change in Projected		Percentage Change in Projected	
	Net Interest Income		Portfolio Value	
+1.00%	(7.08	)%	(0.32	)%
+0.50%	(4.74	)%	(0.11	)%
-0.50%	2.89	%	0.03	%
-1.00%	6.32	%	(0.07	)%

While the table above reflects the estimated immediate impact of interest rate increases and decreases on a static portfolio, we may rebalance our portfolio from time to time either to seek to take advantage of or reduce the impact of changes in interest rates. It is important to note that the impact of changing interest rates on market value and net interest income can change significantly when interest rates change beyond 100 basis points from current levels. Therefore, the volatility in the market value of our assets could increase significantly when interest rates change beyond amounts shown in the table above. In addition, other factors impact the market value of and net interest income from our interest rate-sensitive investments and derivative instruments, such as the shape of the yield curve, market expectations as to future interest rate changes and other market conditions. Accordingly, interest income would likely differ from that shown above and such difference might be material and adverse to our stockholders.

Certain assumptions have been made in connection with the calculation of the information set forth in the table above and, as such, there can be no assurance that assumed events will occur or that other events will not occur that would affect the outcomes. The base interest rate scenario assumes interest rates at December 31, 2017. The analysis presented utilizes assumptions and estimates based on our Manager's judgment and experience. Furthermore, while we generally expect to retain such assets and the associated interest rate risk, future purchases and sales of assets could materially change our interest rate risk profile.

#### Prepayment Risk

The value of our Agency and Non-Agency RMBS and our Residential Whole-Loans may be affected by prepayment rates on the underlying residential mortgage. We acquire RMBS and Residential Whole-Loans and anticipate that the underlying residential mortgages will prepay at a projected rate generating an expected yield. If we purchase assets at a premium to par value, when borrowers prepay their residential mortgage loans faster than expected, the corresponding prepayments may reduce the expected yield on our residential mortgage assets because we will have to amortize the related premium on an accelerated basis and, in the case of Agency RMBS, other than interest-only strips, and certain other investment grade rated securities, we are required to make a retrospective adjustment to historical amortization. Conversely, if we purchase assets at a discount to par value, when borrowers prepay their residential mortgage loans slower than expected, such decrease may reduce the expected yield on such assets because we will not be able to accrete the related discount as quickly as originally anticipated and, in the case of Agency RMBS, other than interest-only strips, and certain other investment grade rated securities, we will be required to make a retrospective adjustment to historical amortization.

The value of our Agency and Non-Agency CMBS, as well as, Commercial Whole-Loans will also be affected by prepayment rates, however, commercial mortgages frequently limit the ability of the borrower to prepay, thereby providing a certain level of prepayment protection. Common restrictions include yield maintenance and prepayment penalties, the proceeds of which are generally at least partially allocable to these securities, as well as defeasance.

Likewise, the value of our ABS and other structured securities will also be affected by prepayment rates. The collateral underlying such securities may, similar to most residential mortgages, allow the borrower to prepay at any time or, similar to commercial mortgages, limit the ability of the borrower to prepay by imposing lock-out provisions, prepayment penalties and/or make whole provisions.

#### Extension Risk

Most residential mortgage loans do not prohibit the partial or full prepayment of principal outstanding. Accordingly, while the stated maturity of a residential mortgage loan may be 30 years, or in some cases even longer, historically the vast majority of residential mortgage loans are satisfied prior to their maturity date. In periods of rising interest rates, borrowers have less incentive to refinance their existing mortgages and mortgage financing may not be as readily available. This generally results in a slower rate of prepayments and a corresponding longer weighted average life for RMBS. The increase, or extension, in weighted average life is commonly referred to as "Extension Risk" which can negatively impact our portfolio. To the extent we receive smaller pre-payments of principal; we will have less capital to invest in new assets. This is extremely detrimental in periods of rising interest rates as we will be unable to invest in new higher coupon investments and a larger portion of our portfolio will remain invested in lower coupon investments. Further, our borrowing costs are generally short-term and, even if hedged, are likely to increase in a rising interest rate environment, thereby reducing our net interest margin. Finally, to the extent we acquired securities at a discount to par, a portion of the overall return on such investments is based on the recovery of this discount. Slower principal prepayments will result in a longer recovery period and a lower overall return on our investment.

Prepayment rates on Agency and Non-Agency CMBS, as well as, Commercial Whole-Loans are generally less volatile than residential mortgage assets as commercial mortgages usually limit the ability of the borrower to prepay the mortgage prior to maturity or a period shortly before maturity. Accordingly, extension risk for Agency and Non-Agency CMBS and Commercial Whole-Loans is generally less than RMBS and Residential Whole-Loans as it is presumed that other than defaults (i.e. involuntary prepayments), most commercial mortgages will remain outstanding for the contractual term of the mortgage.

Prepayment rates on ABS and our other structured securities will be determined by the underlying collateral. The extension risk of such securities will generally be less than residential mortgages, but greater than commercial mortgages.

#### Real Estate Risk

Residential and commercial property values are subject to volatility and may be adversely affected by a number of factors, including, but not limited to: national, regional and local economic conditions (which may be adversely affected by industry slowdowns and other factors); local real estate conditions (such as the supply of housing stock); changes or continued weakness

in specific industry segments; construction quality, age and design; demographic factors; and retroactive changes to building or similar codes. In addition, decreases in property values reduce the value of the collateral and the potential proceeds available to a borrower to repay our loans, which could also cause us to suffer losses.

### Counterparty Risk

The following discussion on counterparty risk reflects how these transactions are structured, rather than how they are presented for financial reporting purposes.

When we engage in repurchase transactions, we generally sell securities to lenders (i.e., repurchase agreement counterparties) and receive cash from the lenders. The lenders are obligated to resell the same securities back to us at the end of the term of the transaction. Because the cash we receive from the lender when we initially sell the securities to the lender is less than the value of those securities (this difference is the haircut), if the lender defaults on its obligation to resell the same securities back to us, we could incur a loss on the transaction up to the amount of the haircut (assuming there was no change in the value of the securities).

If a counterparty to a bi-lateral interest rate swap cannot perform under the terms of the interest rate swap, we may not receive payments due under that agreement, and thus, we may lose any unrealized gain associated with the interest rate swap. We may also risk the loss of any collateral we have pledged to secure our obligations under interest rate swap if the counterparty becomes insolvent or files for bankruptcy. In the case of a cleared swap, if our clearing broker were to default, become insolvent or file for bankruptcy, we may also risk the loss of any collateral we have posted to the clearing broker unless we were able to transfer or “port” our positions and held collateral to another clearing broker. In addition, the interest rate swap would no longer mitigate the impact of changes in interest rates as intended. Most of our interest swaps are currently cleared through a central clearing house which reduces but does not eliminate the aforementioned risks. Also see “Liquidity Risk” below.

As of December 31, 2017, we have entered into five master securities forward trading agreements, or MSFTAs, which may govern the trading of some or all TBA transactions. Pursuant to the terms of these MSFTAs, we and our counterparties would be required to post margin to the other when the mark to market exposure of the TBA transactions executed under the agreement exceed certain thresholds. We expect to continue to negotiate and enter into MSFTAs with additional TBA counterparties. The margin provisions of the MSFTA help to mitigate, but do not eliminate, counterparty risk associated with TBA transactions. If a counterparty to a TBA transaction cannot perform under the terms of the trade, we may not receive securities we have agreed to purchase or payment for securities we have agreed to sell, and thus, we may lose any unrealized gain associated with such transaction.

Prior to entering into a trading agreement or transaction with any particular institution where we take on counterparty risk, our Manager does a thorough review of such potential counterparty. Such review, however, does not assure the creditworthiness of such counterparty nor that the financial wherewithal of the counterparty will not deteriorate in the future.

### Funding Risk

We have financed a substantial majority of our assets with repurchase agreement financing. Over time, as market conditions change, in addition to these financings, we may use other forms of leverage. Changes in the regulatory environment, as well as, weakness in the financial markets, the residential mortgage markets, the commercial mortgage markets, the asset-backed securitization markets and the economy generally could adversely affect one or more of our potential lenders and could cause one or more of our potential lenders to be unwilling or unable to provide us with financing or to increase the costs of that financing.



## Liquidity Risk

Our liquidity risk is principally associated with the financing of long-maturity assets with short-term borrowings in the form of repurchase agreements. Although the interest rate adjustments of these assets and liabilities fall within the guidelines established by our operating policies, maturities are not required to be, nor are they, matched.

Should the value of our assets pledged as collateral suddenly decrease, margin calls relating to our repurchase agreements could increase, causing an adverse change in our liquidity position. Our inability to post adequate collateral for a margin call by the counterparty could result in a condition of default under our repurchase agreements, thereby enabling the counterparty to liquidate the collateral pledged by us, which may have a material adverse consequence on our business and results of operations.

In an instance of severe volatility, or where the additional stress on liquidity resulting from volatility is sustained over an extended period of time, we could be required to sell securities, possibly even at a loss to generate sufficient liquidity to satisfy

collateral and margin requirements which could have a material adverse effect on our financial position, results of operations and cash flows.

Additionally, if one or more of our repurchase agreement counterparties chose not to provide on-going funding, our ability to finance would decline or exist at possibly less advantageous terms. Further, if we are unable to renew, replace or expand repurchase financing with other sources of financing on substantially similar terms, it may have a material adverse effect on our business, financial position, results of operations and cash flows, due to the long term nature of our investments and relatively short-term maturities of our repurchase agreements. As such, there is no assurance that we will always be able to roll over our repurchase agreements.

The costs associated with our borrowings are generally based on prevailing market interest rates. During a period of rising interest rates, our borrowing costs generally will increase while the yields earned on our existing portfolio of leveraged fixed-rate MBS and other fixed rate assets will remain static. Further, certain of our floating rate assets may contain annual or lifetime interest rate caps as well as limit the frequency or timing of changes to the underlying interest rate index. This could result in a decline in our net interest spread and net interest margin. The severity of any such decline would depend on our asset/liability composition at the time, as well as the magnitude and duration of the interest rate increase. Further, an increase in short-term interest rates could also have a negative impact on the market value of our assets. If any of these events happen, we could experience a decrease in net income or incur a net loss during these periods, which could have a material adverse effect on our liquidity and results of operations.

In addition, the assets that comprise our investment portfolio are not traded on a public exchange. A portion of these assets may be subject to legal and other restrictions on resale or will otherwise be less liquid than publicly-traded securities. The illiquidity of our assets may make it difficult for us to sell such assets if the need or desire arises, including in response to changes in economic and other conditions. Recent regulatory changes have imposed new capital requirements and other restrictions on banks and other market intermediaries' ability and desire to hold assets on their balance sheets and otherwise make markets in fixed income securities and other assets resulting in reduced liquidity in many sectors of the market. This regulatory trend is expected to continue. As a result of these developments, it may become increasingly difficult for us to sell assets in the market, especially in credit oriented sectors such as Non-Agency RMBS and CMBS, ABS and Whole-Loans.

We enter into interest rate swaps to manage our interest rate risk. We are required to pledge cash or securities as collateral as part of a margin arrangement, calculated daily, in connection with the interest rate swaps. The amount of margin that we are required to post will vary and generally reflects collateral required to be posted with respect to interest rate swaps that are in an unrealized loss position to us and is generally based on a percentage of the aggregate notional amount of interest rate swaps per counterparty. Margin calls could adversely affect our liquidity. Our inability to post adequate collateral for a margin call could result in a condition of default under our interest rate swap agreements, thereby resulting in liquidation of the collateral pledged by us, which may have a material adverse consequence on our business, financial position, results of operations and cash flows. Conversely, if our interest rate swaps are in an unrealized gain position, our counterparties to bilateral swaps are required to post collateral with us, under the same terms that we post collateral with them. On occasion, we may enter into a MAC interest rate swap in which we may receive or make a payment at the time of entering such interest rate swap to compensate for the out of the market nature of such interest rate swap. Similar to all other interest rate swaps, MAC interest rate swaps are also subject to the margin requirements previously described.

#### Inflation

Virtually all of our assets and liabilities are interest rate sensitive in nature. As a result, interest rates and other factors influence our performance far more so than does inflation. Changes in interest rates do not necessarily directly

correlate with inflation rates or changes in inflation rates. Our consolidated financial statements are prepared in accordance with GAAP and our distributions will be determined by our Board of Directors consistent with our obligation to distribute to our stockholders at least 90% of our net taxable income on an annual basis, in accordance with the REIT regulations, in order to maintain our REIT qualification. In each case, our activities and consolidated balance sheets are measured with reference to historical cost and/or fair market value without considering inflation.

## Foreign Investment risk

We have invested in Non U.S. CMBS transactions and, in the future, we may make other investments in non U.S. issuers and transactions. These investments present certain unique risks, including those resulting from future political, legal, and economic developments, which could include favorable or unfavorable changes in currency exchange rates, exchange control regulations (including currency blockage), expropriation, nationalization, or confiscatory taxation of assets, adverse changes in investment capital or exchange control regulations (which may include suspension of the ability to transfer currency from a country), political changes, diplomatic developments, difficulty in obtaining and enforcing judgments against non U.S. entities, the possible imposition of the applicable country's governmental laws or restrictions, and the reduced availability of public information concerning issuers. In the event of a nationalization, expropriation, or other confiscation of assets, we could lose our entire investment in a security. Legal remedies available to investors in certain jurisdictions may be more limited than those available to investors in the United States. Issuers of non U.S. securities may not be subject to the same degree of regulation as U.S. issuers.

Furthermore, non U.S. issuers are not generally subject to uniform accounting, auditing, and financial reporting standards or other regulatory practices and requirements comparable to those applicable to U.S. issuers. There is generally less government supervision and regulation of non U.S. exchanges, brokers, and issuers than there is in the United States, and there is greater difficulty in taking appropriate legal action in Non U.S. courts. There are also special tax considerations that apply to securities of non U.S. issuers and securities principally traded overseas.

To the extent that our investments are denominated in U.S. dollars, the investment is not affected directly by changes in currency exchange rates relative to the dollar and exchange control regulations. We are, however, subject to currency risk with respect to such investments to the extent that a decline in a non U.S. issuer's or borrower's own currency relative to the dollar may impair such issuer's or borrower's ability to make timely payments of principal and/or interest on a loan or other debt security. To the extent that our investments are in non-dollar denominated securities, the value of the investment and the net investment income available for distribution may be affected favorably or unfavorably by changes in currency exchange rates relative to the dollar and exchange control regulations.

Currency exchange rates can be volatile and affected by, among other factors, the general economics of a country, the actions of governments or central banks and the imposition of currency controls and speculation. In addition, a security may be denominated in a currency that is different from the currency where the issuer is domiciled.

## Currency Risk

We have and may continue in the future to invest in assets which are denominated in a currency other than U.S. dollars and may finance such investments with repurchase financing or other forms of financing which may also be denominated in a currency other than U.S. dollars. To the extent we make such investments and/or enter into such financing arrangements, we may utilize foreign currency swaps, forwards or other derivative instruments to hedge our exposure to foreign currency risk. Despite being economic hedges, we have elected not to treat such derivative instruments as hedges for accounting purposes and therefore the changes in the value of such instruments, including actual and accrued payments, will be included in our Consolidated Statement of Operations. While such transactions are entered into in an effort to minimize our foreign currency risk, there can be no assurance that they will perform as expected. If actual prepayments of the foreign denominated asset are faster, or slower, than expected, the hedge instrument is unlikely to fully protect us from changes in the valuation of such foreign currency. Further, as with interest rate swaps, there is counterparty risk associated with the future creditworthiness of such counterparty.



Table of Contents

Item 8. Financial Statements and Supplementary Data.

Index to Financial Statements

<u>Report of Independent Registered Public Accounting Firm</u>	<u>79</u>
<u>Consolidated Balance Sheets as of December 31, 2017 and 2016</u>	<u>81</u>
<u>Consolidated Statement of Operations for the years ended December 31, 2017, December 31, 2016 and December 31, 2015</u>	<u>83</u>
<u>Consolidated Statement of Changes in Stockholders' Equity for the years ended December 31, 2017, December 31, 2016 and December 31, 2015</u>	<u>84</u>
<u>Consolidated Statement of Cash Flow for the years ended December 31, 2017, December 31, 2016 and December 31, 2015</u>	<u>85</u>
<u>Notes to Consolidated Financial Statements</u>	<u>88</u>

Index to Financial Statement Schedules

<u>Schedule IV—Mortgage Loans on Real Estate</u>	<u>134</u>
--	------------

Financial Statements Schedules other than the one listed above are omitted because the required information is not applicable or deemed not material, or the required information is presented in the financial statements and/or in the notes to financial statements.

78

---

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of Western Asset Mortgage Capital Corporation:

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated balance sheets of Western Asset Mortgage Capital Corporation and its subsidiary as of December 31, 2017 and 2016, and the related consolidated statements of operations, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2017, including the related notes and accompanying schedule of mortgage loans on real estate as of December 31, 2017 (collectively referred to as the "consolidated financial statements"). We also have audited the Company's internal control over financial reporting as of December 31, 2017, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2017 and 2016, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2017 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2017, based on criteria established in Internal Control - Integrated Framework (2013) issued by the COSO.

Basis for Opinions

The Company's management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Report on Internal Control over Financial Reporting appearing under Item 9A. Our responsibility is to express opinions on the Company's consolidated financial statements and on the Company's internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the consolidated financial statements included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

Definition and Limitations of Internal Control over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.



Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

Los Angeles, California  
March 29, 2018

We have served as the Company's auditor since 2011.

Table of Contents

## Western Asset Mortgage Capital Corporation and Subsidiary

## Consolidated Balance Sheets

(in thousands—except share and per share data)

	December 31, 2017	December 31, 2016
Assets:		
Cash and cash equivalents	\$48,024	\$46,172
Agency mortgage-backed securities, at fair value (\$2,833,595 and \$1,526,584 pledged as collateral, at fair value, respectively)	2,858,600	1,841,594
Non-Agency mortgage-backed securities, at fair value (\$266,189 and \$667,084 pledged as collateral, at fair value, respectively)	378,158	667,161
Other securities, at fair value (\$89,823 and \$67,762 pledged as collateral, at fair value, respectively)	122,065	67,762
Residential Whole-Loans, at fair value (\$237,423 and \$192,136 pledged as collateral, at fair value, respectively)	237,423	192,136
Residential Bridge Loans (\$64,526 and \$0 at fair value and \$106,673 and \$0 pledged as collateral, respectively)	106,673	—
Securitized commercial loan, at fair value	24,876	24,225
Investment related receivable	7,665	33,600
Accrued interest receivable	13,603	18,812
Due from counterparties	86,930	243,585
Derivative assets, at fair value	728	20,571
Other assets	2,161	398
Total Assets <sup>(1)</sup>	\$3,886,906	\$3,156,016
Liabilities and Stockholders' Equity:		
Liabilities:		
Borrowings under repurchase agreements, net	\$3,251,686	\$2,155,644
Convertible senior unsecured notes, net	108,743	—
Securitized debt, at fair value	10,945	10,659
Accrued interest payable	8,322	16,041
Investment related payables	17,217	341,458
Due to counterparties	1,490	740
Derivative liability, at fair value	4,346	182,158
Accounts payable and accrued expenses	3,118	3,255
Payable to affiliate	2,041	2,584
Dividend payable	12,960	12,995
Total Liabilities <sup>(2)</sup>	3,420,868	2,725,534
Commitments and contingencies		
Stockholders' Equity:		
Common stock, \$0.01 par value, 500,000,000 shares authorized, and 41,794,079 and 41,919,801 outstanding, respectively	419	419
Preferred stock, \$0.01 par value, 100,000,000 shares authorized and no shares outstanding	—	—
Treasury stock, at cost 125,722 and 0 shares held, respectively	(1,232 )	—
Additional paid-in capital	768,763	765,042
Retained earnings (accumulated deficit)	(301,912 )	(334,979 )
Total Stockholders' Equity	466,038	430,482
Total Liabilities and Stockholders' Equity	\$3,886,906	\$3,156,016
See notes to consolidated financial statements.		



Table of Contents

Western Asset Mortgage Capital Corporation and Subsidiary

Consolidated Balance Sheets

(in thousands—except share and per share data)

(1) Assets of consolidated VIEs included in the total assets above:

	December 31, 2017	December 31, 2016
Residential Whole-Loans, at fair value (\$237,423 and \$192,136 pledged as collateral, at fair value, respectively)	\$ 237,423	\$ 192,136
Residential Bridge Loans (\$64,526 and \$0 at fair value and \$106,673 and \$0 pledged as collateral, respectively)	106,673	—
Securitized commercial loan, at fair value	24,876	24,225
Investment related receivable	7,665	1,241
Accrued interest receivable	3,358	1,622
Total assets of consolidated VIEs	\$ 379,995	\$ 219,224

(2) Liabilities of consolidated VIEs included in the total liabilities above:

Securitized debt, at fair value	\$ 10,945	\$ 10,659
Accrued interest payable	70	85
Accounts payable and accrued expenses	189	2
Total liabilities of consolidated VIEs	\$ 11,204	\$ 10,746

See notes to consolidated financial statements.

Western Asset Mortgage Capital Corporation and Subsidiary  
Consolidated Statements of Operations  
(in thousands—except share and per share data)

	For the years ended December 31,		
	2017	2016	2015
Net Interest Income			
Interest income	\$ 124,291	\$ 123,756	\$ 152,704
Interest expense	48,373	32,430	27,605
Net Interest Income	75,918	91,326	125,099
Other Income (Loss)			
Realized gain (loss) on sale of investments, net	20,598	(21,991 )	8,279
Other than temporary impairment	(22,873 )	(32,286 )	(19,791 )
Unrealized gain (loss), net	28,396	(17,107 )	(34,011 )
Gain (loss) on derivative instruments, net	3,292	(20,735 )	(68,895 )
Other, net	1,031	180	2,318
Other Income (Loss)	30,444	(91,939 )	(112,100 )
Expenses			
Management fee to affiliate	8,100	10,448	10,874
Other operating expenses	2,419	1,045	2,014
General and administrative expenses:			
Compensation expense	2,692	3,022	3,762
Professional fees	3,242	4,814	4,368
Other general and administrative expenses	1,325	1,917	1,465
Total general and administrative expenses	7,259	9,753	9,595
Total Expenses	17,778	21,246	22,483
Income (loss) before income taxes	88,584	(21,859 )	(9,484 )
Income tax provision (benefit)	3,487	3,156	—
Net income (loss)	\$85,097	\$(25,015 )	\$(9,484 )
Net income (loss) per Common Share—Basic	\$ 2.03	\$(0.61 )	\$(0.25 )
Net income (loss) per Common Share—Diluted	\$ 2.03	\$(0.61 )	\$(0.25 )

See notes to consolidated financial statements.

Western Asset Mortgage Capital Corporation and Subsidiary  
 Consolidated Statements of Changes in Stockholders' Equity  
 (in thousands—except shares and share data)

	Common Stock Outstanding		Additional Paid-In Capital	Retained Earnings (Accumulated) Deficit	Treasury Stock	Total
	Shares	Par				
Balance at December 31, 2014	41,719,801	\$417	\$760,925	\$ (138,130 )	\$—	\$623,212
Grants of restricted stock	200,000	2	(2 )	—	—	—
Vesting of restricted stock	—	—	2,301	—	—	2,301
Net income (loss)	—	—	—	(9,484 )	—	(9,484 )
Dividends on common stock	—	—	59	(104,440 )	—	(104,381 )
Balance at December 31, 2015	41,919,801	419	763,283	(252,054 )	—	511,648
Vesting of restricted stock	—	—	1,699	—	—	1,699
Net income (loss)	—	—	—	(25,015 )	—	(25,015 )
Dividends on common stock	—	—	60	(57,910 )	—	(57,850 )
Balance at December 31, 2016	41,919,801	419	765,042	(334,979 )	—	430,482
Vesting of restricted stock	—	—	981	—	—	981
Equity component of convertible senior unsecured notes	—	—	2,656	—	—	2,656
Treasury Stock	(125,722 )	—	—	—	(1,232 )	(1,232 )
Net income (loss)	—	—	—	85,097	—	85,097
Dividends on common stock	—	—	84	(52,030 )	—	(51,946 )
Balance at December 31, 2017	41,794,079	\$419	\$768,763	\$ (301,912 )	\$(1,232)	\$466,038

See notes to consolidated financial statements.

Table of ContentsWestern Asset Mortgage Capital Corporation and Subsidiary  
Consolidated Statements of Cash Flows  
(in thousands)

	For the year ended December 31,		
	2017	2016	2015
Cash flows from operating activities:			
Net income (loss)	\$85,097	\$(25,015)	\$(9,484)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Premium amortization and (discount accretion) on investments, net	(2,070)	(548)	5,086
Interest income earned added to principal of securities	(46)	(413)	(207)
Amortization of deferred financing costs	192	191	486
Amortization of discount on convertible senior unsecured notes	137	—	—
Restricted stock amortization	981	1,699	2,301
Premium amortization for MAC interest rate swaps	—	(658)	(1,250)
Interest payments and basis recovered on MAC interest rate swaps	525	658	1,595
Premium on purchase of Residential Whole-Loans	(1,239)	(574)	(3,329)
Premium on purchase of Residential Bridge Loans	(753)	—	—
Unrealized (gain) loss, net	(28,396)	17,107	34,011
Unrealized (gain) loss on derivative instruments, net	(148,308)	5,135	73,599
Other than temporary impairment	22,873	32,286	19,791
Realized (gain) loss on sale of investments, net	(20,598)	21,991	(8,279)
(Gain) loss on derivatives, net	156,076	(41,516)	13,920
Loss (gain) on foreign currency transactions, net	1	758	(2,130)
Changes in operating assets and liabilities:			
Decrease in accrued interest receivable	5,209	3,809	4,688
Increase in other assets	(1,763)	(16)	(56)
Increase (decrease) in accrued interest payable	(7,719)	(4,390)	2,858
Increase (decrease) in accounts payable and accrued expenses	(274)	1,477	(16)
Increase (decrease) in payable to related party	(543)	(435)	314
Net cash provided by operating activities	59,382	11,546	133,898
Cash flows from investing activities:			
Purchase of securities	(2,881,276)	(2,172,623)	(1,354,274)
Proceeds from sale of securities	1,593,914	2,273,922	2,547,364
Principal repayments and basis recovered on securities	240,785	344,937	397,073
Purchase of Residential Whole-Loans	(87,640)	(28,825)	(225,870)
Principal repayments on Residential Whole-Loans	42,176	52,473	20,355
Purchase of Commercial Whole-Loans	—	—	(8,750)
Principal repayments on Commercial Whole-Loans	—	—	8,750
Purchase of securitized commercial loan	—	—	(14,000)
Principal repayments on securitized commercial loan	154	—	—
Purchase of Residential Bridge Loans	(142,913)	—	—
Principal repayments on Residential Bridge Loans	31,794	—	—
Payment of premium for option derivatives	(16,355)	(17,951)	(16,064)
Premium received from option derivatives	14,553	22,707	15,354
Premium received from credit default swap	74	—	—
Net settlements of TBAs	4,035	6,140	3,710
Proceeds from (Payments on) termination of futures, net	(9,130)	23,609	(527)
Proceeds from sale of interest rate swaptions	—	2,075	32,186

See notes to consolidated financial statements.

85

---



Table of ContentsWestern Asset Mortgage Capital Corporation and Subsidiary  
Consolidated Statements of Cash Flows (Continued)  
(in thousands)

	For the year ended December 31,		
	2017	2016	2015
Premium for MAC interest rate swaps, net	—	465	(3,858 )
Payments on termination of MAC interest rate swaps	—	—	(186 )
Due from counterparties	8,449	(8,449 )	—
Proceeds from termination of foreign currency swaps	—	6,771	—
Payments on total return swaps	(552 )	38	—
Interest payments and basis recovered on MAC interest rate swaps	(525 )	(658 )	(1,193 )
Premium for interest rate swaptions, net	(115 )	—	(40,215 )
Net cash provided by (used in) investing activities	(1,202,572 )	504,631	1,359,855
Cash flows from financing activities:			
Payment of offering costs	(94 )	—	—
Repurchase of common stock	(1,094 )	—	—
Proceeds from repurchase agreement borrowings	18,438,166	15,977,505	17,544,060
Proceeds from convertible note offering	115,000	—	—
Repayments of repurchase agreement borrowings	(17,342,124 )	(16,407,929 )	(18,863,913 )
Proceeds from (Repayment of) cash overdraft	—	(300 )	300
Repayments of securitized debt	(68 )	—	—
Proceeds from forward contracts	8,246	112,574	242,279
Repayments of forward contracts	(8,214 )	(112,640 )	(243,180 )
Payments on termination of MAC interest rate swaps containing an other-than-insignificant financing element	—	—	(18,655 )
Interest payments and basis recovered on MAC interest rate swaps containing an other-than-insignificant financing element	—	—	(402 )
Payments made for deferred financing costs	(3,837 )	(58 )	(620 )
Due from counterparties, net	(9,707 )	14,427	(64,806 )
Due to counterparties, net	750	(9,210 )	(2,230 )
Dividends paid on common stock	(51,981 )	(69,168 )	(109,272 )
Net cash provided by (used in) financing activities	1,145,043	(494,799 )	(1,516,439)
Effect of exchange rate changes on cash and cash equivalents	(1 )	83	175
Net increase (decrease) in cash and cash equivalents	1,852	21,461	(22,511 )
Cash and cash equivalents beginning of period	46,172	24,711	47,222
Cash and cash equivalents end of period	\$48,024	\$46,172	\$24,711
Supplemental disclosure of operating cash flow information:			
Interest paid	\$43,032	\$32,041	\$27,515
Income taxes paid	\$4,966	\$2,093	\$—
Supplemental disclosure of non-cash financing/investing activities:			
Repurchase of common stock, not settled	\$(137 )	\$—	\$—
Principal payments of securities, not settled	\$—	\$—	\$572
Securities purchased, not settled	\$(17,217)	\$(309,086 )	\$(66,146 )

See notes to consolidated financial statements.

86

---

Table of Contents

Western Asset Mortgage Capital Corporation and Subsidiary  
 Consolidated Statements of Cash Flows (Continued)  
 (in thousands)

	For the year ended December 31,		
	2017	2016	2015
Assets of CSMC Trust	\$—	\$—	\$11,000
Liabilities of CSMC Trust	\$—	\$—	\$(11,000)
Net unsettled TBAs	\$—	\$(14 )	\$—
Derivative collateral offset against derivatives	\$(157,913)	\$—	\$—
Dividends and distributions declared, not paid	\$12,960	\$12,995	\$24,313
Principal payments of Residential Whole-Loans, not settled	\$2,286	\$1,241	\$—
Principal payments of Residential Bridge Loans, not settled	\$5,381	\$—	\$—

See notes to consolidated financial statements.

87

---

Western Asset Mortgage Capital Corporation and Subsidiary  
Notes to Consolidated Financial Statements  
(in thousands—except share and per share data)

The following defines certain of the commonly used terms in these Notes to Consolidated Financial Statements: "Agency" or "Agencies" refer to a federally chartered corporation, such as the Federal National Mortgage Association ("Fannie Mae" or "FNMA") or the Federal Home Loan Mortgage Corporation ("Freddie Mac" or "FHLMC"), or an agency of the U.S. Government, such as the Government National Mortgage Association ("Ginnie Mae" or "GNMA"); references to "MBS" refer to mortgage backed securities, including residential mortgage-backed securities or "RMBS", commercial mortgage-backed securities or "CMBS", and "Interest-Only Strips" (as defined herein); "Agency MBS" refer to RMBS, CMBS and Interest-Only Strips issued or guaranteed by the Agencies while "Non-Agency MBS" refer to RMBS, CMBS and Interest-Only Strips that are not issued or guaranteed by the Agencies; references to "ARMs" refers to adjustable rate mortgages; references to "Interest-Only Strips" refer to interest-only ("IO") and inverse interest-only ("IIO") securities issued as part of or collateralized with MBS; references to "TBA" refer to To-Be-Announced Securities; references to Residential Whole-Loans, Residential Bridge Loans and Commercial Whole-Loans (collectively "Whole-Loans") refer to individual mortgage loans secured either by single family, multi-family or commercial properties.

Note 1—Organization

Western Asset Mortgage Capital Corporation, is a Delaware corporation, and its subsidiary (the "Company") commenced operations in May 2012. The Company invests in, finances and manages a diversified portfolio of real estate related securities, whole-loans and other financial assets. The Company's portfolio is comprised of Agency CMBS, Agency RMBS (including TBAs), Non-Agency RMBS, Non-Agency CMBS and Whole-Loans. In addition, and to a significantly lesser extent, the Company has invested in other securities including certain Agency obligations that are not technically MBS as well as certain Non U.S. CMBS and in asset-backed securities ("ABS") investments secured by a portfolio of private student loans. The Company's investment strategy is based on Western Asset Management Company's (the "Manager") perspective of which mix of portfolio assets it believes provides the Company with the best risk-reward opportunities at any given time. The Manager will vary the allocation among various asset classes subject to maintaining the Company's qualification as a REIT and maintaining its exemption from the Investment Company Act of 1940 (the "1940 Act"). These restrictions limit the Company's ability to invest in non-qualifying MBS, non-real estate assets and/or assets which are not secured by real estate. Accordingly, the Company's portfolio will continue to be principally invested in qualifying MBS, Whole-Loans and other real estate related assets.

The Company is externally managed by the Manager, an investment advisor registered with the Securities and Exchange Commission ("SEC"). The Manager is a wholly-owned subsidiary of Legg Mason, Inc. The Company operates and has elected to be taxed as a real estate investment trust or "REIT" commencing with its taxable year ended December 31, 2012.

Note 2—Summary of Significant Accounting Policies

Basis of Presentation and Consolidation

The consolidated financial statements of the Company are prepared in accordance with generally accepted accounting principles in the United States ("GAAP"). The consolidated financial statements include accounts of the Company and its wholly -owned subsidiary and variable interest entities ("VIEs") in which it is considered the primary beneficiary. Refer to Note 5 - "Variable Interest Entities" for additional information regarding the impact of consolidation of these VIE's. All intercompany amounts between the Company and its subsidiary and consolidate VIE's have been eliminated in consolidation.

Variable Interest Entities

VIEs are defined as entities that by design either lack sufficient equity for the entity to finance its activities without additional subordinated financial support or are unable to direct the entity's activities or are not exposed to the entity's losses or entitled to its residual returns. The Company evaluates all of its interests in VIEs for consolidation. When the interests are determined to be variable interests, the Company assesses whether it is deemed the primary beneficiary.

The primary beneficiary of a VIE is determined to be the party that has both the power to direct the activities of a VIE that most significantly impact the VIE's economic performance and the obligation to absorb losses or the right to receive benefits of the VIE that could potentially be significant to the VIE.

To assess whether the Company has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, it considers all facts and circumstances, including its role in establishing the VIE and its 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

## Table of Contents

Western Asset Mortgage Capital Corporation and Subsidiary

Notes to Consolidated Financial Statements (Continued)

(in thousands—except share and per share data)

most significant decisions affecting the VIE or have the right to unilaterally remove those decision makers is 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, it considers all of its economic interests. This assessment requires the Company to apply 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.

In instances when a VIE is owned by both the Company and related parties, the Company considers whether there is a single party in the related party group that meets both the power and losses or benefits criteria on its own as though no related party relationship existed. If one party within the related party group meets both these criteria, such reporting entity is the primary beneficiary of the VIE and no further analysis is needed. If no party within the related party group on its own meets both the power and losses or benefits criteria, but the related party group does as a whole meets these two criteria, the determination of primary beneficiary within the related party group is based upon an analysis of the facts and circumstances with the objective of determining which party is most closely associated with the VIE. Determining the primary beneficiary within the related party group requires significant judgment.

In instances when the Company is required to consolidate a VIE that is determined to be a qualifying collateralized financing entity, under GAAP, the Company will measure both the financial assets and financial liabilities of the VIE using the fair value of either the VIE's financial assets or financial liabilities, whichever is more observable.

Ongoing assessments of whether an enterprise is the primary beneficiary of a VIE are required.

## Use of Estimates

The preparation of the consolidated financial statements 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 periods. Actual results could differ from those estimates.

## Earnings (Loss) Per Share

GAAP requires use of the two-class method in computing earnings per share for all periods presented for each class of common stock and participating securities as if all earnings for the period had been distributed. Under the two-class method, during periods of net income, the net income is first reduced for dividends declared on all classes of securities to arrive at undistributed earnings. During periods of net losses, the net loss is reduced for dividends declared on participating securities only if the security has the right to participate in the earnings of the entity and an objectively determinable contractual obligation to share in net losses of the entity. The Company's participating securities are not allocated a share of the net loss, as the participating securities do not have a contractual obligation to share in the net losses of the Company.

The remaining earnings are allocated to common stockholders and participating securities, to the extent that each security shares in earnings, as if all of the earnings for the period had been distributed. Each total is then divided by the applicable number of weighted average outstanding common shares to arrive at basic earnings per share. For the

diluted earnings, the denominator includes the weighted average outstanding common shares and all potential common shares assumed issued if they are dilutive. The numerator is adjusted for any changes in income or loss that would result from the assumed conversion of these potential common shares.

## Table of Contents

Western Asset Mortgage Capital Corporation and Subsidiary

Notes to Consolidated Financial Statements (Continued)

(in thousands—except share and per share data)

### Offering Costs

Offering costs borne by the Company in connection with common stock offerings and private placements are reflected as a reduction of additional paid-in-capital. Offering costs borne by the Company in connection with its shelf registration will be deferred and recorded in "Other assets" until such time the Company completes a common stock offering where all or a portion will be reclassified and reflected as a reduction of additional paid-in-capital. The deferred offering costs will be expensed upon the expiration of the shelf if the Company does not complete a equity offering.

### Cash and Cash Equivalents

The Company considers all highly-liquid short term investments with original maturities of 90 days or less when purchased to be cash equivalents. Cash and cash equivalents are exposed to concentrations of credit risk. The Company places its cash and cash equivalents with what it believes to be high credit quality institutions. At times such investments may be in excess of the Federal Deposit Insurance Corporation insurance limit.

### Valuation of Financial Instruments

The Company discloses the fair value of its financial instruments according to a fair value hierarchy (Levels I, II, and III, as defined below). ASC 820, "Fair Value Measurement and Disclosures" establishes a framework for measuring fair value and expands financial statement disclosure requirements for fair value measurements. ASC 820 further specifies a hierarchy of valuation techniques, which is based on whether the inputs into the valuation technique are observable or unobservable. The hierarchy is as follows:

Level I — Quoted prices in active markets for identical assets or liabilities.

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

Level III — Prices are determined using significant unobservable inputs. In situations where quoted prices or observable inputs are unavailable, for example, when there is little or no market activity for an investment at the end of the period, unobservable inputs may be used.

The level in the fair value hierarchy within which a fair value measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety. Transfers between levels are determined by the Company at the end of the reporting period. Refer to Note 3 - "Fair Value of Financial Instruments".

### Mortgage-Backed Securities and Other Securities

The Company's mortgage-backed securities and other securities portfolio primarily consists of Agency RMBS, Non-Agency RMBS, Agency CMBS, Non-Agency CMBS, ABS and other real estate related assets, these investments are recorded in accordance with ASC 320, "Investments - Debt and Equity Securities", ASC 325-40, "Beneficial Interests in Securitized Financial Assets" or ASC 310-30, "Loans and Debt Securities Acquired with Deteriorated Credit Quality". The Company has chosen to make a fair value election pursuant to ASC 825, "Financial Instruments" for its mortgage-backed securities and other securities portfolio. Electing the fair value option allows the Company to record



changes in fair value in the Consolidated Statements of Operations as a component of “Unrealized gain (loss), net”.

If the Company purchases securities with evidence of credit deterioration, it will analyze to determine if the guidance found in ASC 310-30, “Loans and Debt Securities Acquired with Deteriorated Credit Quality” is applicable.

The Company evaluates securities for other-than-temporary impairment (“OTTI”) on at least a quarterly basis. The determination of whether a security is other-than-temporarily impaired involves judgments, estimates and assumptions based on subjective and objective factors. As a result, the timing and amount of an OTTI constitutes an accounting estimate that may change materially over time.

Table of Contents

Western Asset Mortgage Capital Corporation and Subsidiary

Notes to Consolidated Financial Statements (Continued)

(in thousands—except share and per share data)

When the fair value of an investment security is less than its amortized cost at the balance sheet date, the security is considered impaired, and the impairment is designated as either “temporary” or “other-than-temporary.” When a security is impaired, an OTTI is considered to have occurred if (i) the Company intends to sell the security (i.e., a decision has been made as of the reporting date) or (ii) it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis. If the Company intends to sell the security or if it is more likely than not that the Company will be required to sell the real estate security before recovery of its amortized cost basis, the entire amount of the impairment loss, if any, is recognized in earnings as OTTI and the cost basis of the security is adjusted to its fair value. Additionally, for securities accounted for under ASC 325-40 an OTTI is deemed to have occurred when there is an adverse change in the expected cash flows to be received and the fair value of the security is less than its carrying amount. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a “market participant” would use and are discounted at a rate equal to the current yield used to accrete interest income. Any resulting OTTI adjustments are reflected in the “Other than temporary impairment” in the Consolidated Statements of Operations.

Increases in interest income may be recognized on a security on which the Company previously recorded an OTTI charge if the cash flow of such security subsequently improves.

In addition, unrealized losses on the Company's Agency securities, with explicit guarantee of principal and interest by the governmental sponsored entity (“GSE”), are not credit losses but rather were due to changes in interest rates and prepayment expectations. These securities would not be considered other than temporarily impaired provided we did not intend to sell the security.

#### Residential Whole-Loans

Investments in Residential Whole-Loans are recorded in accordance with ASC 310-20, “Nonrefundable Fees and Other Costs”. The Company has chosen to make the fair value election pursuant to ASC 825 for our entire Residential Whole-Loan portfolio. Residential Whole-Loans are recorded at fair value with periodic changes in fair market value being recorded in earnings as a component of “Unrealized gain (loss), net”. All other costs incurred in connection with acquiring Residential Whole-Loans or committing to purchase these loans are charged to expense as incurred.

On a quarterly basis, the Company evaluate the collectability of both interest and principal of each loan, if circumstances warrant, to determine whether such loan is impaired. A loan is impaired when, based on current information and events, it is probable that we will be unable to collect all amounts due according to the existing contractual terms. When a loan is impaired, the Company does not record an allowance for loan loss as we have elected the fair value option. However, income recognition is suspended for loans at the earlier of the date at which payments become 90-days past due or when, in the opinion of management, a full recovery of income and principal becomes doubtful. When the ultimate collectability of the principal of an impaired loan is in doubt, all payments are applied to principal under the cost recovery method. When the ultimate collectability of the principal of an impaired loan is not in doubt, contractual interest is recorded as interest income when received, under the cash basis method until an accrual is resumed when the loan becomes contractually current and performance is demonstrated to be resumed. A loan is written off when it is no longer realizable and/or legally discharged.

#### Residential Bridge Loans

For the Bridge Loans acquired prior to October 25, 2017, the Company did not elect the fair value option pursuant to ASC 825. These loans are recorded at their principal amount outstanding, net of any premium or discount . Commencing with purchases on October 25, 2017, the Company decided to elected the fair value option pursuant to ASC 825 to be consistent with the accounting of its other investments, which are all carried at fair value. These loans are recorded at fair value with periodic changes in fair market value being recorded in earnings as a component of "Unrealized gain (loss), net". All other costs incurred in connection with acquiring the Residential Bridge Loans or committing to purchase these loans are charged to expense as incurred.

A loan is impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the existing contractual terms. The Company evaluates each of its Residential Bridge Loans that it did not elect the fair value option on a quarterly basis. These loans are individually specific as they relate to the borrower, collateral type, interest rate, LTV and term as well as geographic location. The Company evaluates the collectability of both

Table of Contents

Western Asset Mortgage Capital Corporation and Subsidiary

Notes to Consolidated Financial Statements (Continued)

(in thousands—except share and per share data)

principal and interest of each loan. When a loan is impaired, the impairment is then measured based on fair value of the collateral, since these loans are collateral dependent. Upon measurement of impairment, the Company records an allowance to reduce the carrying value of the loan with a corresponding charge to earnings. Significant judgments are required in determining impairment, including assumptions regarding the value of the loan, the value of the underlying collateral and other provisions such as guarantees. The Company will not record an allowance for loan loss for the Residential Bridge Loans that it has elected the fair value option.

Income recognition is suspended for loans at the earlier of the date at which payments become 90-days past due or when, in the opinion of management, a full recovery of income and principal becomes doubtful. When the ultimate collectability of the principal of an impaired loan is in doubt, all payments are applied to principal under the cost recovery method. When the ultimate collectability of the principal of an impaired loan is not in doubt, contractual interest is recorded as interest income when received, under the cash basis method until an accrual is resumed when the loan becomes contractually current and performance is demonstrated to be resumed. A loan is written off when it is no longer realizable and/or it is legally discharged.

Interest Income Recognition

Agency MBS, Non-Agency MBS and other securities, excluding Interest-Only Strips, rated AA and higher at the time of purchase

Interest income on mortgage-backed and other securities is accrued based on the respective outstanding principal balances and corresponding contractual terms. The Company records interest income in accordance with ASC subtopic 835-30 "Imputation of Interest", using the effective interest method. As such premiums and discounts associated with Agency MBS, Non-Agency MBS and other securities, excluding Interest-Only Strips, are amortized into interest income over the estimated life of such securities. Adjustments to premium and discount amortization are made for actual prepayment activity. The Company estimates prepayments at least quarterly for its securities and, as a result, if the projected prepayment speed increases, the Company will accelerate the rate of amortization on premiums or discounts and make a retrospective adjustment to historical amortization. Alternatively, if projected prepayment speeds decrease, the Company will reduce the rate of amortization on the premiums or discounts and make a retrospective adjustment to historical amortization.

Non-Agency MBS and other securities that are rated below AA at the time of purchase and Interest-Only Strips that are not classified as derivatives

Interest income on Non-Agency MBS and other securities that are rated below AA at the time of purchase and Interest-Only Strips that are not classified as derivatives are also recognized in accordance with ASC 835, using the effective yield method. The effective yield on these securities is based on the projected cash flows from each security, which is estimated based on the Company's observation of the then current information and events, where applicable, and will include assumptions related to interest rates, prepayment rates and the timing and amount of credit losses. On at least a quarterly basis, the Company reviews and, if appropriate, makes adjustments to its cash flow projections based on input and analysis received from external sources, internal models, and its judgment about interest rates, prepayment rates, the timing and amount of credit losses, and other factors. Where appropriate, the Company may include in its cash flow projections the U.S. Department of Justice's settlements with the major residential mortgage originators, regarding certain lending practices. Changes in cash flows from those originally projected, or from those estimated at the last evaluation, may result in a prospective change in the yield/interest income recognized on such securities. Actual maturities of the securities are affected by the contractual lives of the underlying collateral, periodic

payments of scheduled principal, and prepayments of principal. Therefore, actual maturities of the securities will generally be shorter than stated contractual maturities.

Based on the projected cash flow of such securities purchased at a discount to par value, the Company may designate a portion of such purchase discount as credit protection against future credit losses and, therefore, not accrete such amount into interest income. The amount designated as credit discount may be adjusted over time, based on the actual performance of the security, its underlying collateral, actual and projected cash flow from such collateral, economic conditions and other factors. If the performance of a security with a credit discount is more favorable than forecasted, a portion of the amount designated as credit discount may be accreted into interest income prospectively.

Residential Whole-Loans and Residential Bridge Loans

## Table of Contents

Western Asset Mortgage Capital Corporation and Subsidiary

Notes to Consolidated Financial Statements (Continued)

(in thousands—except share and per share data)

Interest income on the Company's residential loan portfolio is recorded in accordance with ASC 835 using the effective interest method based on the contractual payment terms of the loan. Any premium amortization or discount accretion will be reflected as a component of "Interest income" in the Consolidated Statements of Operations.

### Purchases and Sales of Investments

The Company accounts for a contract for the purchase or sale of securities, or other securities that do not yet exist on a trade date basis, which it intends to take possession and thus recognizes the acquisition or disposition of the securities at the inception of the contract.

Sales of investments are driven by the Company's portfolio management process. The Company seeks to mitigate risks including those associated with prepayments and will opportunistically rotate the portfolio into securities and/or other investments the Company's Manager believes have more favorable attributes. Strategies may also be employed to manage net capital gains, which need to be distributed for tax purposes. Realized gains or losses on sales of investments, including Agency Interest-Only Strips not characterized as derivatives, are a component of "Realized gain (loss) on sale of investments, net" in the Consolidated Statements of Operations, and are recorded at the time of disposition. Realized gains or losses on Interest-Only Strips which are characterized as derivatives are a component of "Gain (loss) on derivative instruments, net" in the Consolidated Statements of Operations.

### Foreign Currency Transactions

The Company has and expects to continue to enter into transactions denominated in foreign currency from time to time. At the date the transaction is recognized, the asset and/or liability will be measured and recorded using the exchange rate in effect at the date of the transaction. At each balance sheet date, such foreign currency assets and liabilities are re-measured using the exchange rate in effect at the date of the balance sheet, resulting in unrealized foreign currency gains or losses, which are recorded in "Other, net" in the Consolidated Statements of Operations.

### Due From Counterparties/Due To Counterparties

"Due from counterparties" represents cash posted by the Company with its counterparties as collateral for the Company's interest rate and/or currency derivative financial instruments, repurchase agreements, and TBAs. "Due to counterparties" represents cash posted with the Company by its counterparties as collateral under the Company's interest rate and/or currency derivative financial instruments, repurchase agreements, and TBAs. Included in "Due from counterparties" and/or "Due to counterparties" are daily variation margin settlement amounts with counterparties which are based on the price movement of the Company's futures contracts. However, commencing in 2017, daily variation margin on only the Company's centrally cleared derivatives will be treated as a settlement and classified as either "Derivative assets, at fair value" or "Derivative liability, at fair value" in the Consolidated Balance Sheets. In addition, as provided below, "Due to counterparties" may include non-cash collateral in which the Company has the obligation to return and which the Company has either sold or pledged. To the extent the Company receives collateral other than cash from its counterparties, such assets are not included in the Company's Consolidated Balance Sheets. Notwithstanding the foregoing, if the Company either rehypothecates such assets or pledges the assets as collateral pursuant to a repurchase agreement, the cash received and the corresponding liability are reflected in the Consolidated Balance Sheets.

### Derivatives and Hedging Activities

Subject to maintaining its qualification as a REIT for U.S. federal income tax purposes, the Company as part of its hedging strategy, we may enter into, but not limited to, interest rate swaps, including forward starting swaps, interest rate swaptions, U.S. Treasury options, Eurodollar, Volatility Index and U.S. Treasury futures, TBAs, total return swaps, credit default swaps and foreign current swaps and forwards to hedge the interest rate and currency risk associated with its portfolio and related borrowings. Derivatives, subject to REIT requirements, are used for hedging purposes rather than speculation. The Company has also entered into a total return swap, which transfers the total return of the referenced security to the Company. The Company determines the fair value of its derivative positions and obtains quotations from third parties, including the Chicago Mercantile Exchange or CME, to facilitate the process of determining such fair values. The Company does not necessarily seek to hedge all such risks. In addition, if the Company's hedging activities do not achieve the desired results, reported earnings may be adversely affected.

Table of Contents

Western Asset Mortgage Capital Corporation and Subsidiary

Notes to Consolidated Financial Statements (Continued)

(in thousands—except share and per share data)

GAAP requires an entity to recognize all derivatives as either assets or liabilities on the balance sheet and to measure those instruments at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative. The fair value adjustment will affect either other comprehensive income in stockholders' equity until the hedged item is recognized in earnings or net income depending on whether the derivative instrument is designated and qualifies as a hedge for accounting purposes and if so, the nature of the hedging activity. The Company elected not to apply hedge accounting for its derivative instruments. Accordingly, the Company records the change in fair value of its derivative instruments, which includes net interest rate swap payments/receipts (including accrued amounts) and net currency payments/receipts (including accrued amounts) related to interest rate swaps and currency swaps, respectively, in "Gain (loss) on derivative instruments, net" in its Consolidated Statements of Operations.

In January 2017, the CME amended its rulebooks to legally characterize variation margin payments and receipts for over-the-counter derivatives they clear as settlements of the derivatives' exposure rather than collateral against exposure. As a result of the change in legal characterization, effective January 1, 2017, variation margin is no longer classified as collateral in the Consolidated Balance Sheets in either "Due from counterparties" or "Due to counterparties", but rather a component of the respective "Derivative asset, at fair value" or "Derivative liability, at fair value" in the Consolidated Balance Sheets. The variation margin is now considered partial settlements of the derivative contract and will result in realized gains or losses which prior to January 1, 2017 were classified as unrealized gains or losses on derivatives. Prior to the CME rulebook change variation margin was included in financing activities in the Company's Consolidated Statement of Cash Flows in either "Due from counterparties, net" or "Due to counterparties, net". Commencing in January 2017, cash postings for variation margin are included in operating activities in the Consolidated Statements of Cash Flows.

In the Company's Consolidated Statements of Cash Flows, premiums received or paid on termination of its interest rate swaps are included in cash flows from operating activities. Notwithstanding the foregoing, proceeds and payments on settlement of swaptions, mortgage put options, futures contracts and TBAs are included in cash flows from investing activities. Proceeds and payments on settlement of forward contracts are reflected in cash flows from financing activities in the Company's Consolidated Statements of Cash Flows. For Agency and Non-Agency Interest-Only Strips accounted for as derivatives, the purchase, sale and recovery of basis activity is included with MBS and other securities under cash flows from investing activities in the Company's Consolidated Statements of Cash Flows.

The Company evaluates the terms and conditions of its holdings of Agency and Non-Agency Interest-Only Strips, interest rate swaptions, currency forwards, futures contracts and TBAs to determine if these instruments have the characteristics of an investment or should be considered a derivative under GAAP. In determining the classification of its holdings of Interest-Only Strips, the Company evaluates the securities to determine if the nature of the cash flows have been altered from that of the underlying mortgage collateral. Interest-Only Strips, for which the underlying mortgage collateral has been included into a structured security that alters the cash flows from the underlying mortgage collateral, are accounted for as derivatives. The carrying value of the Agency and Non-Agency Interest-Only Strips, accounted for as derivatives, is included in "Mortgage-backed securities and other securities, at fair value" in the Consolidated Balance Sheets. The carrying value of interest rate swaptions, currency forwards, futures contracts and TBAs is included in "Derivative assets, at fair value" or "Derivative liability, at fair value" in the Consolidated Balance Sheets. Interest earned or paid along with the change in fair value of these instruments accounted for as derivatives is recorded in "Gain (loss) on derivative instruments, net" in its Consolidated Statements of Operations.



The Company evaluates all of its financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. An embedded derivative is separated from the host contract and accounted for separately when all of the guidance criteria are met. Hybrid instruments that are remeasured at fair value through earnings, including the fair value option are not bifurcated. Derivative instruments, including derivative instruments accounted for as liabilities, are recorded at fair value and are re-valued at each reporting date, with changes in the fair value together with interest earned or paid (including accrued amounts) reported in "Gain (loss) on derivative instruments, net" in the Consolidated Statements of Operations.

#### Repurchase Agreements and Reverse Repurchase Agreements

Investments sold under repurchase agreements are treated as collateralized financing transactions, unless they meet all the criteria for sales treatment. Securities financed through a repurchase agreement remain in the Company's Consolidated Balance Sheets as assets and cash received from the lender is recorded in the Company's Consolidated Balance Sheets as a liability. Interest payable in accordance with repurchase agreements is recorded as "Accrued interest payable" in the Consolidated Balance Sheets. Interest paid (including accrued amounts) in accordance with repurchase agreements is recorded as interest expense.

## Table of Contents

Western Asset Mortgage Capital Corporation and Subsidiary

Notes to Consolidated Financial Statements (Continued)

(in thousands—except share and per share data)

The Company may borrow securities under reverse repurchase agreements to deliver a security owned and sold by the Company but pledged to a different counterparty under a separate repurchase agreement when in the Manager's view terminating the outstanding repurchase agreement is not in the Company's best interest. Cash paid to the borrower is recorded in the Company's Consolidated Balance Sheets as an asset. Interest receivable in accordance with reverse repurchase agreements is recorded as accrued interest receivable in the Consolidated Balance Sheets. The Company reflects all proceeds on reverse repurchase agreement and repayment of reverse repurchase agreement, on a net basis in the Consolidated Statements of Cash Flows. Upon sale of a pledged security, the Company recognizes an obligation to return the borrowed security in the Consolidated Balance Sheet in "Due to counterparties". The Company establishes haircuts to ensure the market value of the underlying asset remains sufficient to protect the Company in the event of default by the counterparty. Realized gains and losses associated with the sale of the security are recognized in "Realized gain (loss) on sale of investments, net" in the Consolidated Statements of Cash Flows.

### Convertible Senior Unsecured Notes

Convertible senior unsecured notes include unsecured convertible debt that is carried at its unpaid principal balance, net of any unamortized deferred issuance costs, in the Company's Consolidated Balance Sheets. Interest on the notes is payable semiannually until such time the notes mature or are converted into shares of the Company's common stock. ASC 470-20 "Debt-Debt with Conversion and Other Options" requires that convertible debt instruments with cash settlement features, including partial cash settlement, account for the liability component and equity component (conversion feature) of the instrument separately. The initial value of the liability component will reflect the present value of the discounted cash flows using the nonconvertible debt borrowing rate at the time of issuance. The debt discount represents the difference between the proceeds received from the issuance and the initial carrying value of the liability component, which is accreted back to the notes principal amount through interest expense over the life of the notes.

### Securitized Debt

Securitized debt was issued at par by a consolidated securitization trust. The Company has chosen to make the fair value election pursuant to ASC 825 for the debt. The debt is recorded at fair value in the Consolidated Balance Sheets with the periodic change in fair value recorded in current period earnings in the Consolidated Statements of Operations as a component of "Unrealized gain (loss), net".

### Share-based Compensation

The Company accounts for share-based compensation to its independent directors, its Manager and to employees of its Manager and its affiliates using the fair value based methodology prescribed by GAAP. Compensation cost related to restricted common stock issued to the Company's independent directors and any employee of the Company including any such restricted stock which is subject to a deferred compensation program is measured at its fair value at the grant date, and amortized into expense over the service period on a straight-line basis. Compensation cost related to restricted common stock issued to the Manager and to employees of the Manager, including officers and certain directors, of the Company who are employees of the Manager and its affiliates, is initially measured at fair value at the grant date, and amortized into expense over the vesting period on a straight-line basis and re-measured on subsequent dates to the extent the awards are unvested.

### Warrants

For the Company's warrants, the Company uses a variation of the adjusted Black-Scholes option valuation model to record the financial instruments at their relative fair values at issuance. The warrants issued with the Company's common stock in the private placement to certain accredited institutional investors on May 15, 2012, were evaluated by the Company and were recorded at their relative fair value as a component of equity at the date of issuance.

#### Income Taxes

The Company operates and has elected to be taxed as a REIT commencing with its taxable year ended December 31, 2012. Accordingly, the Company will generally not be subject to corporate U.S. federal or state income tax to the extent that the Company makes qualifying distributions to stockholders, and provided that the Company satisfies, on a continuing basis, through actual investment and operating results, the REIT requirements including certain asset, income, distribution and stock ownership

Table of Contents

Western Asset Mortgage Capital Corporation and Subsidiary

Notes to Consolidated Financial Statements (Continued)

(in thousands—except share and per share data)

tests. If the Company fails to qualify as a REIT, and does not qualify for certain statutory relief provisions, the Company will be subject to U.S. federal, state and local income taxes and may be precluded from qualifying as a REIT for the subsequent four taxable years following the year in which the Company lost its REIT qualification. Accordingly, the failure to qualify as a REIT could have a material adverse impact in the Company's results of operations and amounts available for distribution to stockholders.

As a REIT, if the Company fails to distribute in any calendar year (subject to specific timing rules for certain dividends paid in January) at least the sum of (i) 85% of its ordinary income for such year, (ii) 95% of its capital gain net income for such year, and (iii) any undistributed taxable income from the prior year, the Company would be subject to a non-deductible 4% excise tax on the excess of such required distribution over the sum of (i) the amounts actually distributed and (ii) the amounts of income retained and on which the Company has paid corporate income tax.

The dividends paid deduction for qualifying dividends paid to stockholders is computed using the Company's taxable income as opposed to net income reported in the Consolidated Statements of Operations. Taxable income, generally, will differ from net income reported in the Consolidated Statements of Operations because the determination of taxable income is based on tax regulations and not GAAP.

The Company may create and elect to treat certain subsidiaries as Taxable REIT Subsidiaries ("TRS"). In general, a TRS may hold assets and engage in activities that the Company cannot hold or engage in directly and generally may engage in any real estate or non-real estate-related business. A domestic TRS is subject to U.S. federal, state and local corporate income taxes, and for 2017 its value may not exceed 25% of the value of the Company; however, commencing in taxable year 2018 its value may not exceed 20% of the value of the Company. If the TRS generates net income it may declare dividends to the Company, which will be included in the Company's taxable income and necessitate a distribution to its stockholders. Conversely, if the Company retains earnings at the TRS level, no distribution is required and it can increase book equity of the consolidated entity. As of December 31, 2017, the Company has a single wholly-owned subsidiary which it has elected to treat as a domestic TRS.

Current and deferred taxes are recorded on earnings (losses) recognized by the Company's TRS. Deferred income tax assets and liabilities are calculated based upon temporary differences between the Company's U.S. GAAP consolidated financial statements and the federal and state basis of assets and liabilities as of the Consolidated Balance Sheet date. The Company evaluates the realizability of its deferred tax assets and recognizes a valuation allowance if, based on available evidence, it is more likely than not that some or all of its deferred tax assets will not be realized. In evaluating the realizability of the deferred tax asset, the Company will consider the expected future taxable income, existing and projected book to tax differences as well as tax planning strategies. This analysis is inherently subjective, as it is based on forecasted earning and business and economic activity. Changes in estimates of deferred tax asset realizability, if any, are included in "Income tax provision (benefit)" in the Consolidated Statements of Operations.

Comprehensive Income (Loss)

The Company has none of the components of comprehensive income (loss) and therefore comprehensive income (loss) is not presented.

Recently adopted accounting pronouncements

Description

	Adoption Date	Effect on Financial Statements
<p>In March 2016, the FASB issued ASU 2016-9, “Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting.” This ASU is intended to simplify several aspects of accounting for share-based payments, including income tax consequences, classification of awards as either equity or liabilities and classification on the statement of cash flows.</p>	<p>First quarter 2017.</p>	<p>The adoption of this guidance did not have a material impact on the Company's consolidated financial statements.</p>

Recently issued accounting pronouncements

Description Effective Date Effect on Financial Statements

Table of Contents

Western Asset Mortgage Capital Corporation and Subsidiary  
 Notes to Consolidated Financial Statements (Continued)  
 (in thousands—except share and per share data)

In May 2014, the FASB issued ASU 2014-9, “Revenue from Contracts with Customers (Topic 606).” The guidance changes an entity’s recognition of revenue from contracts with customers. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In addition, the new guidance requires improved disclosures to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. In March 2016, the FASB issued implementation guidance which clarifies principal versus agent considerations in reporting revenue gross versus net (ASU 2016-8). In April 2016, the FASB issued implementation guidance which clarifies the identification of performance obligations (ASU 2016-10). In May 2016, the FASB issued amendments that affect only the narrow aspects of Topic 606 (ASU2016-12).

First quarter 2018 and permits the use of either the full retrospective or modified retrospective method.

The Company's revenue is mainly derived from interest income on our investments and to a lesser extent gains on sales of investments, which are not impacted by this standard. Therefore, the adoption of this standard is not expected to have a material impact on the Company's consolidated financial statements.

In January 2016, the FASB issued ASU 2016-1, “Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities.” The guidance improves certain aspects of recognition, measurement, presentation, and disclosure of financial instruments.

First quarter 2018.

The standard does not change the guidance for classifying and measuring investments in debt securities and loans as well nonrecourse liabilities of consolidated collateralized financing entities. Therefore, the adoption of this standard is not expected to have a material impact on the Company's consolidated financial statements when adopted.

In June 2016, the FASB issued ASU 2016-13, “Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.” This standard significantly changes how an entity will measure credit losses for most financial assets and certain other instruments that aren't measured at fair value through the income statement. The standard will replace the current "incurred loss" approach with an "expected loss" model for instruments measured at amortized cost. For available for sale debt securities, entities will be required to record an allowance rather than reduce the carrying amount, as is currently done under the other than temporary impairment model. It also simplifies the accounting model for purchased credit impaired debt securities and loans.

First quarter 2020.

The Company is currently evaluating the impact the standard may have on its consolidated financial statements when adopted.

<p>In August 2016, the FASB issued ASU 2016-15, "Statement of Cash Flows - Classification of Certain Cash Receipts and Cash Payments (Topic 230)." The guidance is intended to reduce diversity in practice in how certain transactions are classified on the statement of cash flows.</p>	<p>First quarter 2018 and requires retrospective adoption.</p>	<p>The Company does not believe the adoption of this standard will have a material impact on its consolidated Statement of Cash Flows.</p>
<p>In November 2016, the FASB issued ASU 2016-18 "Statement of Cash Flows (Topic 230): Restricted Cash, a consensus of the FASB's Emerging Issues Task Force." The guidance requires that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents as well as disclose information about the nature of the restrictions on its cash and cash equivalents.</p>	<p>First quarter 2018 and requires retrospective adoption.</p>	<p>The Company currently does not have restricted cash. Therefore, the adoption of this standard will not have a material impact on its Consolidated Statements of Cash Flows.</p>
<p>In January 2017, the FASB issued ASU 2017-01 "Business Combinations (Topic 805): Clarifying the Definition of a Business." This ASU provides a more robust framework to use in determining when a set of assets and activities constitutes a business.</p>	<p>First quarter 2018. The guidance should be applied prospectively on or after the effective date.</p>	<p>The Company does not believe the adoption of this standard will have a material impact on its consolidated financial statements.</p>
<p>In May 2017, the FASB issued ASU 2017-09 "Compensation-Stock Compensation (Topic 718): Scope of Modification Accounting." The amendments in this update provide guidance about which changes to the terms or conditions of a shared-based payment award require an entity to apply modification accounting in Topic 718.</p>	<p>First quarter 2018.</p>	<p>The Company does not believe the adoption of this standard will have a material impact on its consolidated financial statements.</p>

Table of Contents

Western Asset Mortgage Capital Corporation and Subsidiary  
Notes to Consolidated Financial Statements (Continued)  
(in thousands—except share and per share data)

In July 2017, the FASB issued ASU 2017-11 "Earnings Per Share (Topic 260), Distinguishing Liabilities from Equity (Topic 480), Derivative and Hedges (Topic 815): Part I - Accounting for Certain Financial Instruments with Down Round Features and Part II - Replacement of the Indefinite Deferral for Mandatory Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatory Redeemable Noncontrolling Interest with a Scope Exception". Part I of this update changes the classification analysis of certain financial instruments (such as warrants and convertible instruments) with down round features. Down round features are features of certain equity-linked financial instruments (or embedded features) that result in the strike price being reduced on the basis of the pricing of future equity offerings. When determining whether certain financial instruments should be classified as liabilities or equity instruments, a down round feature no longer precludes equity classification when assessing whether the instrument is indexed to an entity's own stock. Entities that present earnings per share are required to recognize the effect of the down round feature when it is triggered. The amendments in Part II of this update recharacterize the indefinite deferral of certain provisions of Topic 480 that now are presented as pending content in the Codification, to a scope exception. Those amendments do not have an accounting effect.

First  
quarter  
2019.

The Company is evaluating the impact this standard may have on its consolidated financial statements.



## Note 3—Fair Value of Financial Instruments

The following tables present the Company's financial instruments carried at fair value as of December 31, 2017 and December 31, 2016, based upon the valuation hierarchy (dollars in thousands):

Assets	December 31, 2017			Total
	Fair Value			
	Level I	Level II	Level III	
Agency RMBS:				
20-Year mortgage	\$—	\$53,783	\$—	\$53,783
30-Year mortgage	—	241,642	—	241,642
40-Year mortgage	—	376,752	—	376,752
Agency RMBS Interest-Only Strips	—	15,437	—	15,437
Agency RMBS Interest-Only Strips accounted for as derivatives, included in MBS	—	10,419	—	10,419
Agency CMBS	—	2,137,583	17,217	2,154,800
Agency CMBS Interest-Only Strips	—	10	—	10
Agency CMBS Interest-Only Strips accounted for as derivatives, included in MBS	—	5,757	—	5,757
Subtotal Agency MBS	—	2,841,383	17,217	2,858,600
Non-Agency RMBS	—	90,819	13	90,832
Non-Agency RMBS Interest-Only Strips	—	—	8,722	8,722
Non-Agency CMBS	—	278,604	—	278,604
Subtotal Non-Agency MBS	—	369,423	8,735	378,158
Other securities	—	112,826	9,239	122,065
Total mortgage-backed securities and other securities	—	3,323,632	35,191	3,358,823
Residential Whole-Loans	—	—	237,423	237,423
Residential Bridge Loans	—	—	64,526	64,526
Securitized commercial loan	—	—	24,876	24,876
Derivative assets	728	—	—	728
Total Assets	\$728	\$3,323,632	\$362,016	\$3,686,376
Liabilities				
Derivative liabilities	\$50	\$4,296	\$—	\$4,346
Securitized debt	—	—	10,945	10,945
Total Liabilities	\$50	\$4,296	\$10,945	\$15,291

	December 31, 2016			
	Fair Value			
	Level I	Level II	Level III	Total
<b>Assets</b>				
<b>Agency RMBS:</b>				
20-Year mortgage	\$—	\$498,470	\$—	\$498,470
30-Year mortgage	—	935,207	—	935,207
Agency RMBS Interest-Only Strips	—	19,790	—	19,790
Agency RMBS Interest-Only Strips accounted for as derivatives, included in MBS	—	16,503	—	16,503
Agency CMBS	—	290,605	73,059	363,664
Agency CMBS Interest-Only Strips	—	231	—	231
Agency CMBS Interest-Only Strips accounted for as derivatives, included in MBS	—	7,729	—	7,729
Subtotal Agency MBS	—	1,768,535	73,059	1,841,594
<b>Non-Agency RMBS</b>				
Non-Agency RMBS Interest-Only Strips	—	240,422	619	241,041
Non-Agency RMBS Interest-Only Strips accounted for as derivatives, included in MBS	—	—	64,116	64,116
Non-Agency RMBS Interest-Only Strips accounted for as derivatives, included in MBS	—	—	3,085	3,085
Non-Agency CMBS	—	351,163	7,756	358,919
Subtotal Non-Agency MBS	—	591,585	75,576	667,161
Other securities	—	36,406	31,356	67,762
Total mortgage-backed securities and other securities	—	2,396,526	179,991	2,576,517
Residential Whole-Loans	—	—	192,136	192,136
Securitized commercial loan	—	—	24,225	24,225
Derivative assets	71	20,500	—	20,571
Total Assets	\$71	\$2,417,026	\$396,352	\$2,813,449
<b>Liabilities</b>				
Derivative liabilities	\$2,487	\$177,998	\$1,673	\$182,158
Securitized debt	—	—	10,659	10,659
Total Liabilities	\$2,487	\$177,998	\$12,332	\$192,817

When available, the Company uses quoted market prices to determine the fair value of an asset or liability. If quoted market prices are not available, the Company will use independent pricing services and if the independent pricing service cannot price a particular asset or liability, the Company will obtain third party broker quotes. The Manager's pricing group, which functions independently from its portfolio management personnel, reviews the third party broker quotes by comparing the broker quotes for reasonableness to alternate sources when available. If independent pricing service, or third party broker quotes are not available, the Company determines the fair value of the securities using valuation techniques that use, when possible, current market-based or independently-sourced market parameters, such as interest rates and when applicable, estimates of prepayments and credit losses.

#### Mortgage-backed securities and other securities

In determining the proper fair value hierarchy or level the Company considers the amount of available observable market data for each security. Agency RMBS, given the amount of available observable market data, are classified in Level II. For Non-Agency RMBS, CMBS and other securities, to determine whether a security should be a Level II, the securities are grouped by security type and the Manager reviews the internal trade history, for the quarter, for each security type. If there is sufficient trade



data above a predetermined threshold of a security type, the Manager determines it has sufficient observable market data and the security will be categorized as a Level II.

Values for the Company's securities are based upon prices obtained from independent third party pricing services. The valuation methodology of the third party pricing services incorporates a commonly used market pricing method.

Depending on the type of asset and the underlying collateral, the primary inputs to the model include yields for TBAs, Agency RMBS, the U.S. Treasury market and floating rate indices such as LIBOR, the Constant Maturity Treasury rate and the prime rate as a benchmark yield. In addition, the model may incorporate the current weighted average maturity and additional pool level information such as prepayment speeds, default frequencies and default severities, if applicable. When the third party pricing service cannot adequately price a particular security, the Company utilizes a broker's quote which is reviewed for reasonableness by the Manager's pricing group.

#### Residential Whole-Loans and Residential Bridge Loans

Values for the Company's Residential Whole-Loans and Bridge Loans are based upon prices obtained from an independent third party pricing service that specializes in loans, utilizing a trade based valuation model. Their valuation methodology incorporates commonly used market pricing methods, including loan to value ("LTV"), debt to income, maturity, interest rates, collateral location, and unpaid principal balance, prepayment penalties, FICO scores, lien position and times late. Due to the inherent uncertainty of such valuation, the fair values established for residential loans held by the Company may differ from the fair values that would have been established if a readily available market existed for these loans. Accordingly, the Company's loans are classified as Level III.

#### Securitized commercial loan and securitized debt

Values for the Company's securitized commercial loan and securitized debt are based on which fair value is more observable of the fair value of the securitized commercial loan or the securitized debt. Since there is an extremely limited market for the securitized commercial loan, the Company determined the fair value of the securitized debt was more observable. The fair value of the securitized debt was based upon a third party broker quote, which is validated by the Manager's pricing group. Due to the inherent uncertainty of such valuation the Company classifies its securitized commercial loan and securitized debt as Level III.

#### Derivatives

Values for the Company's derivatives are based upon prices from third party pricing services, whose pricing is subject to review by the Manager's pricing committee. In valuing its over-the-counter interest rate derivatives, such as swaps and swaptions, and its currency derivatives, such as swaps and forwards and credit derivatives such as total return swaps, the Company considers the creditworthiness of both the Company and its counterparties, along with collateral provisions contained in each derivative agreement, from the perspective of both the Company and its counterparties. No credit valuation adjustment was made in determining the fair value of interest rate and/or currency derivatives for the years ended December 31, 2017 and December 31, 2016.

The Company performs quarterly reviews of the independent third party pricing data. These reviews may consist of a review of the daily change in the prices provided by the independent pricing vendor which exceed established tolerances or comparisons to executed transaction prices, utilizing the Manager's pricing group. The Manager's pricing group, which functions independently from its portfolio management personnel, reviews the price differences or changes in price by comparing the vendor price to alternate sources including other independent pricing services or broker quotations. If the price change or difference cannot be corroborated, the Manager's pricing group consults with the portfolio management team for market color in reviewing such pricing data as warranted. To the extent that the Manager has information, typically in the form of broker quotations that would indicate that a price received from the independent pricing service is outside of a tolerance range, the Manager generally challenges the independent pricing service price.

The following tables present additional information about the Company's financial instruments which are measured at fair value on a recurring basis for which the Company has utilized Level III inputs to determine fair value:

\$ in thousands	Year ended December 31, 2017							
	Agency MBS	Non-Agency MBS	Other Securities	Residential Whole-Loans	Residential Bridge Loans	Securitized Commercial Loan	Securitized Debt	Derivative Liability
Beginning balance	\$73,059	\$75,576	\$31,356	\$192,136	\$—	\$24,225	\$10,659	\$1,673
Transfers into Level III from Level II	—	—	9,470	—	—	—	—	—
Transfers from Level III into Level II	(73,714 )	(7,433 )	(33,080 )	—	—	—	—	—
Purchases	17,217	8,937	—	86,921	63,969	—	—	—
Sales and settlements	—	(60,132 )	—	—	—	—	—	552
Principal repayments	—	(378 )	(425 )	(41,312 )	—	(154 )	(68 )	—
Total net gains/losses included in net income								
Realized gains/(losses), net	—	2,623	—	—	—	—	—	(552 )
Other than temporary impairment	—	—	(1,823 )	—	—	—	—	—
Unrealized gains/(losses), net on assets <sup>(1)</sup>	635	(9,415 )	1,522	724	571	805	—	—
Unrealized (gains)/losses, net on liabilities <sup>(2)</sup>	—	—	—	—	—	—	354	(1,673 )
Premium and discount amortization, net	20	(1,043 )	2,219	(1,046 )	(14 )	—	—	—
Ending balance	\$17,217	\$8,735	\$9,239	\$237,423	\$64,526	\$24,876	\$10,945	\$—

For Agency MBS, Non-Agency MBS, other securities, Residential Whole-Loans, Residential Bridge Loans and Securitized commercial loan classified as Level III at December 31, 2017, the Company recorded gross unrealized (1) gains of approximately \$0, \$0, \$43 thousand, \$1.8 million, \$655 thousand and \$805 thousand and gross unrealized losses of approximately \$0, \$16 thousand, \$0, \$400 thousand, \$84 thousand and \$0, respectively. These gains and losses are included in "Unrealized gain (loss), net" in the Consolidated Statements of Operations.

For securitized debt and derivative liability classified as Level III at December 31, 2017, the Company recorded (2) gross unrealized gains of \$0 and \$0 and gross unrealized losses of \$354 thousand and \$0, respectively. These gains and losses are included in "Unrealized gain (loss), net" in the Consolidated Statements of Operations.

Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-K

\$ in thousands	Year ended December 31, 2016						
	Agency MBS	Non-Agency MBS	Other Securities	Residential Whole-Loans	Securitized commercial loan	Securitized debt	Derivative liability
Beginning balance	\$24,690	\$369,650	\$71,996	\$218,538	\$25,000	\$11,000	\$—
Transfers into Level III from Level II	—	—	—	—	—	—	—
Transfers from Level III into Level II	(16,730)	(198,078)	(6,079)	—	—	—	—
Purchases	72,642	94	—	28,226	—	—	—
Sales and settlements	(6,776)	(49,560)	(32,226)	—	—	—	(38)
Principal repayments	(141)	(15,508)	(2,049)	(52,573)	—	—	—
Total net gains / (losses) included in net income							
Realized gains/(losses), net	(56)	(9,345)	45	—	—	—	38
Other than temporary impairment	—	(3,436)	(3,301)	—	—	—	—
Unrealized gains/(losses), net on assets <sup>(1)</sup>	(570)	(4,889)	(86)	(42)	(775)	—	—
Unrealized (gains)/losses, net on liabilities <sup>(2)</sup>	—	—	—	—	—	(341)	1,673
Premium and discount amortization, net	—	(13,352)	3,056	(2,013)	—	—	—
Ending balance	\$73,059	\$75,576	\$31,356	\$192,136	\$24,225	\$10,659	\$1,673

For Agency MBS, Non-Agency MBS, other securities, Residential Whole-Loans and Securitized commercial loan classified as Level III at December 31, 2016, the Company recorded gross unrealized gains of approximately \$417 (1)thousand, \$492 thousand, \$420 thousand, \$1.2 million and \$0 and gross unrealized losses of approximately \$0, \$6.8 million, \$823 thousand, \$663 thousand and \$775 thousand, respectively. These gains and losses are included in "Unrealized gain (loss), net" in the Consolidated Statements of Operations.

For securitized debt and derivative liability classified as Level III at December 31, 2016, the Company recorded (2)gross unrealized gains of 341 thousand and \$0 and gross unrealized losses of \$0 and \$1.7 million, respectively.

These gains and losses are included in "Unrealized gain (loss), net" in the Consolidated Statements of Operations. Transfers between hierarchy levels during operations for the years ended December 31, 2017 and December 31, 2016 were based on the availability of sufficient observable inputs to meet Level II versus Level III criteria. The leveling of these assets was based on information received from a third party pricing service which, along with the back-testing of historical sales transactions performed by the Manager provided the sufficient observable data for the movement from Level III to Level II. The Company did not have transfers between Level I and Level II for the years ended December 31, 2017 and December 31, 2016.

#### Other Fair Value Disclosures

Certain Residential Bridge Loans, repurchase agreement borrowings and convertible senior unsecured notes are not carried at fair value in the consolidated financial statements. The following table presents the carrying value and estimated fair value of the Company's financial instruments that are not carried at fair value, as of December 31, 2017, in the consolidated financial statements (dollars in thousands):

	Carrying Value	Estimated Fair Value
Assets		
Residential Bridge Loans	\$42,147	\$42,881
Total	\$42,147	\$42,881

Liabilities

Borrowings under repurchase agreements	\$3,251,686	\$3,257,956
Convertible senior unsecured notes	108,743	114,819
Total	\$3,360,429	\$3,372,775

103

---

"Due from counterparties" and "Due to counterparties" in the Company's Consolidated Balance Sheets are reflected at cost which approximates fair value.

#### Residential Bridge Loans

The fair values of the Residential Bridge Loans are based upon prices obtained from an independent third party pricing service that specializes in whole loans, utilizing a trade based valuation model. Their valuation methodology incorporates commonly used market pricing methods, including loan to value ("LTV"), debt to income, maturity, interest rates, collateral location, and unpaid principal balance, prepayment penalties, FICO scores, lien position and times late. Due to the inherent uncertainty of such valuation, the fair values established for residential bridge loans held by the Company may differ from the fair values that would have been established if a readily available market existed for these loans. Accordingly, the Company's loans are classified as Level III.

#### Borrowings under repurchase agreements

The fair values of the borrowings under repurchase agreements are based on a net present value technique. This method discounts future estimated cash flows using rates the Company determined best estimates current market interest rates that would be offered for loans with similar characteristics and credit quality. The use of different market assumptions or estimation methodologies could have a material effect on the fair value amounts. This fair value measurement is based on observable inputs, and as such, are classified as Level II.

#### Convertible senior unsecured notes

The fair value of the convertible senior unsecured notes are based on quoted market prices. Accordingly, the Company's convertible senior unsecured notes are classified as Level I.

#### Note 4 - Mortgage-Backed Securities and other securities

The following tables present certain information about the Company's investment portfolio at December 31, 2017 and December 31, 2016 (dollars in thousands).



December 31, 2017

	Principal Balance	Unamortized Premium (Discount), net	Discount Designated as Credit Reserve and OTTI	Amortized Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value	Net Weighted Average Coupon <sup>(1)</sup>
Agency RMBS:								
20-Year mortgage	\$50,825	\$2,378	\$—	\$53,203	\$592	\$(12 )	\$53,783	4.0 %
30-Year mortgage	224,041	15,710	—	239,751	2,317	(426 )	241,642	4.4 %
40-Year mortgage	366,178	10,788		376,966	1,662	(1,876 )	376,752	3.5 %
Agency RMBS Interest-Only Strips <sup>(2)</sup>	N/A	N/A	N/A	14,750	878	(191 )	15,437	2.9 % <sup>(2)</sup>
Agency RMBS Interest-Only Strips, accounted for as derivatives <sup>(2)(3)</sup>	N/A	N/A	N/A	N/A	N/A	N/A	10,419	2.9 % <sup>(2)</sup>
Agency CMBS	2,145,139	2,142	—	2,147,281	16,913	(9,394 )	2,154,800	2.9 %
Agency CMBS Interest-Only Strips <sup>(2)</sup>	N/A	N/A	N/A	—	10	—	10	3.2 % <sup>(2)</sup>
Agency CMBS Interest-Only Strips, accounted for as derivatives <sup>(2)(3)</sup>	N/A	N/A	N/A	N/A	N/A	N/A	5,757	0.5 % <sup>(2)</sup>
Subtotal Agency MBS	2,786,183	31,018	—	2,831,951	22,372	(11,899 )	2,858,600	3.0 %
Non-Agency RMBS	119,748	5,263	(39,491 )	85,520	5,473	(161 )	90,832	3.8 %
Non-Agency RMBS Interest-Only Strips <sup>(2)</sup>	N/A	N/A	N/A	8,738	—	(16 )	8,722	0.9 % <sup>(2)</sup>
Non-Agency CMBS	379,183	(59,129 )	(28,020 )	292,034	1,702	(15,132 )	278,604	4.8 %
Subtotal Non-Agency MBS	498,931	(53,866 )	(67,511 )	386,292	7,175	(15,309 )	378,158	3.3 %
Other securities <sup>(4)</sup>	86,305	6,300	(5,404 )	110,091	12,161	(187 )	122,065	7.8 %
Total	\$3,371,419	\$(16,548 )	\$(72,915 )	\$3,328,334	\$41,708	\$(27,395 )	\$3,358,823	3.1 %

Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-K

December 31, 2016

	Principal Balance	Unamortized Premium (Discount), net	Discount Designated as Credit Reserve and OTTI	Amortized Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value	Net Weighted Average Coupon <sup>(1)</sup>
Agency RMBS:								
20-Year mortgage	\$470,975	\$ 25,741	\$—	\$496,716	\$ 3,689	\$(1,935 )	\$498,470	3.9 %
30-Year mortgage	878,599	63,608	—	942,207	5,209	(12,209 )	935,207	4.1 %
Agency RMBS Interest-Only Strips <sup>(2)</sup>	N/A	N/A	N/A	18,810	1,301	(321 )	19,790	3.0 % <sup>(2)</sup>
Agency RMBS Interest-Only Strips, accounted for as derivatives <sup>(2)(3)</sup>	N/A	N/A	N/A	N/A	N/A	N/A	16,503	3.2 % <sup>(2)</sup>
Agency CMBS	377,286	(15,383 )	—	361,903	2,021	(260 )	363,664	2.6 %
Agency CMBS Interest-Only Strips <sup>(2)</sup>	N/A	N/A	N/A	210	21	—	231	4.3 % <sup>(2)</sup>
Agency CMBS Interest-Only Strips, accounted for as derivatives <sup>(2)(3)</sup>	N/A	N/A	N/A	N/A	N/A	N/A	7,729	0.6 % <sup>(2)</sup>
Subtotal Agency MBS	1,726,860	73,966	—	1,819,846	12,241	(14,725 )	1,841,594	3.3 %
Non-Agency RMBS	340,759	(294 )	(108,399 )	232,066	11,210	(2,235 )	241,041	4.5 %
Non-Agency RMBS Interest-Only Strips <sup>(2)</sup>	N/A	N/A	N/A	55,754	8,362	—	64,116	5.6 % <sup>(2)</sup>
Non-Agency RMBS Interest-Only Strips, accounted for as derivatives <sup>(2)(3)</sup>	N/A	N/A	N/A	N/A	N/A	N/A	3,085	4.6 % <sup>(2)</sup>
Non-Agency CMBS	473,024	(69,436 )	(17,787 )	385,801	3,164	(30,046 )	358,919	5.0 %
Subtotal Non-Agency MBS	813,783	(69,730 )	(126,186 )	673,621	22,736	(32,281 )	667,161	5.0 %
Other securities <sup>(4)</sup>	44,838	4,435	(4,298 )	68,085	1,271	(1,594 )	67,762	8.2 %
Total	\$2,585,481	\$ 8,671	\$(130,484)	\$2,561,552	\$ 36,248	\$(48,600 )	\$2,576,517	3.9 %

(1) Net weighted average coupon as of December 31, 2017 and December 31, 2016 is presented, net of servicing and other fees.

(2) Agency RMBS IOs and IIOs, Non-Agency RMBS IOs and IIOs, Agency RMBS IOs and IIOs, accounted for as derivatives, Non-Agency RMBS IOs and IIOs, accounted for as derivatives, Agency CMBS IOs and IIOs, and Agency CMBS IOs and IIOs, accounted for as derivatives have no principal balances and bear interest based on a notional balance. The notional balance is used solely to determine interest distributions on interest-only class of securities. At December 31, 2017, the notional balance for Agency RMBS IOs and IIOs, Non-Agency RMBS IOs and IIOs, Agency RMBS IOs and IIOs, accounted for as derivatives, Agency

CMBS IOs and IIOs, accounted for as derivatives and Agency CMBS IOs and IIOs was \$165.5 million, \$278.4 million, \$122.0 million, \$192.5 million and \$3.3 million, respectively. At December 31, 2016, the notional balance for Agency RMBS IOs and IIOs, Non-Agency RMBS IOs and IIOs, Agency RMBS IOs and IIOs, accounted for as derivatives, Non-Agency RMBS IOs and IIOs, accounted for as derivatives, Agency CMBS IOs and IIOs, accounted for as derivatives and Agency CMBS IOs and IIOs was \$201.6 million, \$278.4 million, \$188.1 million, \$20.7 million, \$221.8 million and \$32.8 million, respectively.

(3) Interest on these securities is reported as a component of "Gain (loss) on derivative instruments, net" in the Consolidated Statements of Operations.

Other securities include residual interests in asset-backed securities which have no principal balance and an (4) amortized cost of approximately \$22.9 million and \$23.1 million, as of December 31, 2017 and December 31, 2016, respectively.

As of December 31, 2017 and December 31, 2016, the weighted average expected remaining term of the MBS and other securities investment portfolio was 8.6 years and 7.1 years, respectively.

The following table presents the changes in the components of the Company's purchase discount and amortizable premium on its Non-Agency RMBS, Non-Agency CMBS and other securities for the years ended December 31, 2017, December 31, 2016 and December 31, 2015 (dollars in thousands):

Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-K

	Year ended December 31, 2017			Year ended December 31, 2016			Year ended December 31, 2015		
	Discount Designated as Credit Reserve and OTTI	Accretable Discount <sup>(1)</sup>	Amortizable Premium <sup>(1)</sup>	Discount Designated as Credit Reserve and OTTI	Accretable Discount <sup>(1)</sup>	Amortizable Premium <sup>(1)</sup>	Discount Designated as Credit Reserve and OTTI	Accretable Discount <sup>(1)</sup>	Amortizable Premium <sup>(1)</sup>
Beginning balance	\$ (130,484)	\$ (109,822)	\$ 44,527	\$ (152,750)	\$ (145,532)	\$ 56,163	\$ (182,007)	\$ (105,804)	\$ 82,228
Securities previously accounted for as linked transactions <sup>(2)</sup>	—	—	—	—	—	—	(2,320 )	(1,393 )	4,587
Accretion of discount	—	10,715	—	—	17,431	—	—	18,465	—
Amortization of premium	—	—	(843 )	—	—	(5,470 )	—	—	(9,025 )
Realized credit losses	2,391	—	—	7,697	—	—	9,534	—	—
Purchases	(19,385 )	(1,205 )	7,259	(15,792 )	(2,945 )	5,266	(38,634 )	(96,380 )	18,544
Sales	89,628	33,166	(31,118 )	39,117	35,605	(12,156 )	60,747	44,232	(30,054 )
Net impairment losses recognized in earnings	(15,310 )	—	—	(22,413 )	—	—	(14,839 )	—	—
Transfers/release of credit reserve <sup>(3)</sup>	245	(1,292 )	1,047	13,657	(14,381 )	724	14,769	(4,652 )	(10,117 )
Ending balance	\$ (72,915 )	\$ (68,438 )	\$ 20,872	\$ (130,484)	\$ (109,822)	\$ 44,527	\$ (152,750)	\$ (145,532)	\$ 56,163

(1) Together with coupon interest, accretable purchase discount and amortizable premium is recognized as interest income over the life of the security.

(2) Resulting from the implementation of guidance issued by the FASB which eliminated the requirement to account for certain financial instruments as linked transactions.

(3) Subsequent reductions of a security's non-accretable discount results in a corresponding reduction in its amortizable premium.

Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-K

The following tables present the fair value and contractual maturities of the Company's investment securities at December 31, 2017 and December 31, 2016 (dollars in thousands):

	December 31, 2017				Total
	< or equal to 10 years	> 10 years and < or equal to 20 years	> 20 years and < or equal to 30 years	> 30 years	
Agency RMBS:					
20-Year mortgage	\$—	\$53,783	\$—	\$—	\$53,783
30-Year mortgage	—	2,445	239,197	—	241,642
40-Year mortgage	—	—	—	376,752	376,752
Agency RMBS Interest-Only Strips	3,920	4,591	6,926	—	15,437
Agency RMBS Interest-Only Strips, accounted for as derivatives	1,686	5,139	3,594	—	10,419
Agency CMBS	1,599,620	555,180	—	—	2,154,800
Agency CMBS Interest-Only Strips	10	—	—	—	10
Agency CMBS Interest-Only Strips, accounted for as derivatives	—	—	—	5,757	-5,757
Subtotal Agency	1,605,236	621,138	249,717	382,509	2,858,600
Non-Agency RMBS	13	51,092	4,184	35,543	90,832
Non-Agency RMBS Interest-Only Strips	—	—	—	8,722	8,722
Non-Agency CMBS	—	60,583	139,209	78,812	278,604
Subtotal Non-Agency	13	111,675	143,393	123,077	378,158
Other securities	—	99,062	—	23,003	122,065
Total	\$1,605,249	\$831,875	\$393,110	\$528,589	\$3,358,823
	December 31, 2016				
	< or equal to 10 years	> 10 years and < or equal to 20 years	> 20 years and < or equal to 30 years	> 30 years	Total
Agency RMBS:					
20-Year mortgage	\$—	\$498,470	\$—	\$—	\$498,470
30-Year mortgage	—	—	935,207	—	935,207
Agency RMBS Interest-Only Strips	499	10,434	8,857	—	19,790
Agency RMBS Interest-Only Strips, accounted for as derivatives	807	9,476	6,220	—	16,503
Agency CMBS	282,911	80,753	—	—	363,664
Agency CMBS Interest-Only Strips	231	—	—	—	231
Agency CMBS Interest-Only Strips, accounted for as derivatives	—	—	—	7,729	7,729
Subtotal Agency	284,448	599,133	950,284	7,729	1,841,594
Non-Agency RMBS	13	65,780	54,408	120,840	241,041
Non-Agency RMBS Interest-Only Strips	—	4,955	10,724	48,437	64,116
Non-Agency RMBS Interest-Only Strips, accounted for as derivatives	—	—	1,043	2,042	3,085

Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-K

Non-Agency CMBS	15,865	37,998	134,941	170,115	358,919
Subtotal Non-Agency	15,878	108,733	201,116	341,434	667,161
Other securities	—	40,360	5,346	22,056	67,762
Total	\$300,326	\$748,226	\$1,156,746	\$371,219	\$2,576,517

108

---

Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-K

The following tables present the gross unrealized losses and estimated fair value of the Company's MBS and other securities by length of time that such securities have been in a continuous unrealized loss position at December 31, 2017 and December 31, 2016 (dollars in thousands):

	December 31, 2017			12 Months or More			Total		
	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities
Agency RMBS:									
20-Year mortgage	\$3,000	\$(12)	3	\$—	\$—	—	\$3,000	\$(12)	3
30-Year mortgage	44,072	(291)	7	1,632	(135)	5	45,704	(426)	12
40-Year mortgage	283,187	(1,876)	1	—	—	—	283,187	(1,876)	1
Agency RMBS Interest-Only Strips	3,095	(142)	6	1,703	(49)	3	4,798	(191)	9
Agency CMBS	955,559	(9,394)	57	—	—	—	955,559	(9,394)	57
Subtotal Agency	1,288,913	(11,715)	74	3,335	(184)	8	1,292,248	(11,899)	82
Non-Agency RMBS	28,508	(161)	3	—	—	—	28,508	(161)	3
Non-Agency RMBS Interest-Only Strips	8,722	(16)	3	—	—	—	8,722	(16)	3
Non-Agency CMBS	69,661	(1,753)	15	119,729	(13,379)	35	189,390	(15,132)	50
Subtotal Non-Agency	106,891	(1,930)	21	119,729	(13,379)	35	226,620	(15,309)	56
Other securities	23,800	(187)	3	—	—	—	23,800	(187)	3
Total	\$1,419,604	\$(13,832)	98	\$123,064	\$(13,563)	43	\$1,542,668	\$(27,395)	141
December 31, 2016									
	Less than 12 Months			12 Months or More			Total		
	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities
Agency RMBS:									
20-Year mortgage	\$142,749	\$(1,935)	47	\$—	\$—	—	\$142,749	\$(1,935)	47
30-Year mortgage	432,949	(11,264)	54	22,586	(945)	13	455,535	(12,209)	67
Agency RMBS Interest-Only Strips	6,105	(227)	6	1,630	(94)	2	7,735	(321)	8
Agency CMBS	145,791	(260)	7	—	—	—	145,791	(260)	7
Subtotal Agency	727,594	(13,686)	114	24,216	(1,039)	15	751,810	(14,725)	129
Non-Agency RMBS	11,628	(50)	3	33,034	(2,185)	6	44,662	(2,235)	9
Non-Agency CMBS	59,529	(4,031)	17	208,288	(26,015)	47	267,817	(30,046)	64
Subtotal Non-Agency	71,157	(4,081)	20	241,322	(28,200)	53	312,479	(32,281)	73
Other securities	7,966	(415)	1	23,390	(1,179)	2	31,356	(1,594)	3
Total	\$806,717	\$(18,182)	135	\$288,928	\$(30,418)	70	\$1,095,645	\$(48,600)	205

At December 31, 2017, the Company did not intend to sell any of its MBS and other securities that were in an unrealized loss position, and it is "more likely than not" that the Company will not be required to sell these MBS and other securities before recovery of their amortized cost basis, which may be at their maturity.

Generally, the Company records OTTI when the credit quality of the underlying collateral deteriorates, and or the scheduled payments are faster than previously projected. The credit deterioration could be as a result of, but not limited to, increased projected realized losses, foreclosures, delinquencies and the likelihood of the borrower being

able to make payments in the future. Generally,

109

---



a prepayment occurs when a loan has a higher interest rate relative to current interest rates and lenders are willing to extend credit at the lower current interest rate or the underlying collateral for the loan is sold or transferred. Refer to Note 2 "Summary of Significant Accounting Policies - Mortgage-Backed Securities and Other Securities"

The following table presents the OTTI the Company recorded on its securities portfolio (dollars in thousands):

	For the year ended December 31, 2017	For the year ended December 31, 2016	For the year ended December 31, 2015
Agency RMBS	\$ 5,774	\$ 6,090	\$ 4,005
Non-Agency RMBS	—	9,511	9,216
Non-Agency CMBS	15,117	13,025	4,061
Other securities	1,982	3,660	2,509
Total	\$ 22,873	\$ 32,286	\$ 19,791

The following table presents components of interest income on the Company's MBS and other securities (dollars in thousands) for the three years ended December 31, 2017, December 31, 2016 and December 31, 2015, respectively:

	For the year ended December 31, 2017			For the year ended December 31, 2016			For the year ended December 31, 2015		
	Coupon Interest	Net (Premium Amortization/ Amortization/ Basis) Discount Amortization	Interest Income	Coupon Interest	Net (Premium Amortization/ Amortization/ Basis) Discount Amortization	Interest Income	Coupon Interest	Net (Premium Amortization/ Amortization/ Basis) Discount Amortization	Interest Income
Agency RMBS	\$38,108	\$(13,058 )	\$25,050	\$70,467	\$(24,836 )	\$45,631	\$119,789	\$(48,119 )	\$71,670
Agency CMBS	40,064	507	40,571	2,619	(1,701 )	918	3,600	(2,102 )	1,498
Non-Agency RMBS	5,602	525	6,127	35,221	(5,243 )	29,978	44,473	(8,008 )	36,465
Non-Agency CMBS	19,179	8,276	27,455	24,893	7,431	32,324	26,562	3,687	30,249
Other securities	8,280	1,559	9,839	2,537	2,977	5,514	6,363	2,648	9,011
Total	\$111,233	\$(2,191 )	\$109,042	\$135,737	\$(21,372 )	\$114,365	\$200,787	\$(51,894 )	\$148,893

The following tables present the sales and realized gains (losses) of the Company's MBS and other securities (dollars in thousands) for the three years ended December 31, 2017, December 31, 2016 and December 31, 2015, respectively:

	For the year ended December 31, 2017			
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS <sup>(1)</sup>	\$1,251,985	\$5,020	\$(7,936 )	\$(2,916 )
Non-Agency RMBS <sup>(2)</sup>	243,838	24,356	(2,241 )	22,115
Non-Agency CMBS	54,875	2,543	(1,803 )	740
Other securities	38,447	713	(54 )	659
Total	\$1,589,145	\$32,632	\$(12,034)	\$20,598

(1) Excludes proceeds for Agency RMBS Interest-Only Strips, accounted for as derivatives, of approximately \$2.6 million, gross realized gains of \$432 thousand and gross realized losses of \$0.



- (2) Excludes proceeds for Non-Agency RMBS Interest-Only Strips, accounted for as derivatives, of approximately \$2.2 million, gross realized gains of \$274 thousand and gross realized losses of \$180 thousand.

For the year ended December 31, 2016

	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS <sup>(1)</sup>	\$ 1,239,350	\$6,214	\$(25,818)	\$(19,604)
Agency CMBS	22,939	54	(66 )	(12 )
Non-Agency RMBS	177,996	6,470	(4,560 )	1,910
Non-Agency CMBS	50,418	137	(5,810 )	(5,673 )
Other securities	764,711	3,496	(2,108 )	1,388
Total	\$2,255,414	\$16,371	\$(38,362)	\$(21,991)

- (1) Excludes proceeds for Agency RMBS Interest-Only Strips, accounted for as derivatives, of approximately \$18.5 million, gross realized gains of approximately \$1.9 million and gross realized losses of \$595 thousand.

For the year ended December 31, 2015

	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS <sup>(1)</sup>	\$ 1,293,120	\$12,054	\$(12,449)	\$(395 )
Non-Agency RMBS	233,257	11,066	(174 )	10,892
Non-Agency CMBS	161,985	2,123	(171 )	1,952
Other securities	851,714	1,188	(5,358 )	(4,170 )
Total <sup>(2)</sup>	\$2,540,076	\$26,431	\$(18,152)	\$8,279

- (1) Excludes proceeds for Agency RMBS Interest-Only Strips, accounted for as derivatives, of approximately \$7.3 million, gross realized gains of \$626 thousand and gross realized losses of \$31 thousand.

#### Note 5—Variable Interest Entities

##### Residential Whole-Loan Trusts

The consolidated financial statements also include the consolidation of certain trusts that each meet the definition of a VIE related to the acquisition of Residential Whole-Loans in which the Company has determined itself to be the primary beneficiary of each such trust. The Company determined that it was the primary beneficiary of the two residential Whole-Loan trusts, which were merged into one trust during the first quarter of 2016, because it was involved in certain aspects of the design of each trust, has certain oversight rights on defaulted assets and has other significant decision making powers. In addition, the Company has the obligation to absorb losses to the extent of its ownership interest and the right to receive benefits from the trust that could potentially be significant to the trust. The trust has issued a trust certificate to the Company which represents the entire beneficial interest in pools of Residential Whole-Loans held by the trust. As of December 31, 2017 and 2016, the Company financed the trust certificate with \$189.3 million and \$154.4 million, respectively, of repurchase borrowings, which is a liability held outside the trust. The Company classifies the underlying Residential Whole-Loans owned by the trust in "Residential Whole-Loans, at fair value" in the Consolidated Balance Sheets and has eliminated the intercompany trust certificate in consolidation.

##### Residential Bridge Loan Trust

In February 2017, Revolving Mortgage Investment Trust 2017-BRQ1 ("RMI Trust") issued a trust certificate to the Company, which represents the beneficial interest in pools of Residential Bridge Loans held by the trust. Residential Bridge Loans are mortgage loans secured by non owner occupied residences, typically short-term. The Company

determined that RMI Trust was a VIE and itself the primary beneficiary because it was involved in certain aspects of the design of the trust, has certain oversight rights on defaulted assets and has other significant decision making powers. In addition, the Company has the obligation

to absorb losses to the extent of its ownership interest and the right to receive benefits from the trust that could potentially be significant to the trust. As of December 31, 2017, the Company financed the trust certificate with \$100.2 million of repurchase borrowings, which is a liability held outside the trust. The Company classifies both the underlying Residential Bridge Loans carried at amortized cost and the Residential Bridge Loans that it elected the fair value option in "Residential Bridge Loans" in the Consolidated Balance Sheets. The Company has eliminated the intercompany trust certificate in consolidation.

#### Commercial Loan Trust

In November 2015, the Company acquired a \$14.0 million interest in the trust certificate issued by CMSC Trust 2015—Longhouse MZ ("CMSC Trust"), with a fair value of \$13.9 million at December 31, 2017. The Company determined that CMSC Trust was a VIE and itself the primary beneficiary because it was involved in certain aspects of the design of the trust, has certain oversight rights on defaulted assets and has other significant decision making powers. In addition, the Company has the obligation to absorb losses to the extent of its ownership interest and the right to receive benefits from the trust that could potentially be significant to the trust. The CMSC Trust holds a \$24.8 million mezzanine loan collateralized by interests in commercial real estate. The mezzanine loan serves as collateral for the \$24.8 million of trust certificates issued. As of December 31, 2017, the Company classified the mezzanine loan at fair value in "Securitized commercial loan, at fair value" in the Consolidated Balance Sheets. The \$24.8 million of trust certificates, of which \$13.9 million was eliminated in consolidation and the remaining \$10.9 million held by an affiliate is carried at fair value of \$10.9 million and classified as "Securitized debt, at fair value" in the Consolidated Balance Sheets.

As of December 31, 2017 and December 31, 2016, the aggregate fair value of the securitized debt issued by the consolidated VIE was \$10.9 million and \$10.7 million which is classified as Securitized debt, at fair value in the Company's Consolidated Balance Sheets. The cost of financing the securitized debt is approximately 8.9% for each of the years ended December 31, 2017 and December 31, 2016.

#### Consolidated Loan Trusts

The Company assesses modifications to VIEs on an ongoing basis to determine if a significant reconsideration event has occurred that would change the Company's initial consolidation assessment. The three consolidated trusts hold 616 Residential Whole-Loans, 340 Residential Bridge Loans and one commercial loan as of December 31, 2017. The following table presents a summary of the assets and liabilities of the consolidated loan trusts included in the Consolidated Balance Sheets as of December 31, 2017 and December 31, 2016 (dollars in thousands):

	December 31, 2017	December 31, 2016
Residential Whole-Loans, at fair value	\$237,423	\$192,136
Residential Bridge Loans <sup>(1)</sup>	106,673	—
Securitized commercial loan, at fair value	24,876	24,225
Investment related receivable	7,665	1,241
Accrued interest receivable	3,358	1,622
Total assets	\$379,995	\$219,224
Securitized debt, at fair value	\$10,945	\$10,659
Accrued interest payable	70	85
Accounts payable and accrued expenses	189	2
Total liabilities	\$11,204	\$10,746

(1) Includes both Residential bridge loans for \$64.5 million which are carried at fair value and 42.1 million which are carried at amortized cost.

The Company's risk with respect to its investment in each trust is limited to its direct ownership in the trust. The Residential Whole-Loans, Residential Bridge Loans and securitized commercial loan held by the consolidated trusts are held solely to satisfy the liabilities of the trust, and creditors of the trust have no recourse to the general credit of the Company for the trust certificates issued by the trusts. The assets of a consolidated trust can only be used to satisfy the obligations of that trust. The Company is not contractually required and has not provided any additional financial support to the trusts for the years ended December 31, 2017



and December 31, 2016. The Company did not deconsolidate any trusts during the years ended December 31, 2017 and December 31, 2016.

The following table presents the components of the carrying value of Residential Whole-Loans, Residential Bridge Loans and securitized commercial loan as of December 31, 2017 and December 31, 2016 (dollars in thousands):

	Residential Whole-Loans, at Fair Value		Residential Bridge Loans, at Fair Value <sup>(1)</sup>		Residential Bridge Loans, at Amortized Cost <sup>(1)</sup>		Securitized Commercial Loan, at Fair Value	
	December 31, 2017	December 31, 2016	December 31, 2017	December 31, 2016	December 31, 2017	December 31, 2016	December 31, 2017	December 31, 2016
Principal balance	\$232,270	\$187,765	\$63,802	\$	—\$42,066	\$	—\$24,846	\$25,000
Unamortized premium	2,021	1,311	293	—	122	—	—	—
Unamortized discount	(1,190 )	(539 )	(128 )	—	(41 )	—	—	—
Amortized cost	233,101	188,537	63,967	—	42,147	—	24,846	25,000
Gross unrealized gains	4,463	3,643	655	—	N/A	N/A	30	—
Gross unrealized losses	(141 )	(44 )	(96 )	—	N/A	N/A	—	(775 )
Fair value	\$237,423	\$192,136	\$64,526	\$	—N/A	N/A	\$24,876	\$24,225

(1) These loans are classified in Residential Bridge Loans in the consolidated balance sheets

#### Residential Whole-Loans

The Residential Whole-Loans are comprised of non-qualifying, mostly adjustable rate mortgages with low loan to values (or "LTV's"). The following tables present certain information about the Company's Residential Whole-Loans investment portfolio at December 31, 2017 and December 31, 2016 (dollars in thousands):

December 31, 2017

Current Coupon Rate	Number of Loans	Principal Balance	Original LTV	Weighted Average			
				Original FICO Score <sup>(1)</sup>	Expected Life (years)	Contractual Maturity (years)	Coupon Rate
3.01 - 4.00%	142	\$55,593	55.5%	751	1.7	29.1	3.9 %
4.01 - 5.00%	338	125,860	56.9%	725	1.4	26.5	4.5 %
5.01 - 6.00%	132	48,553	58.2%	728	1.6	27.0	5.2 %
6.01 - 7.00%	4	2,264	71.1%	758	1.3	20.5	6.3 %
Total	616	\$232,270	57.0%	734	1.5	27.1	4.5 %

(1) The original FICO score is not available for 141 loans with a principal balance of approximately \$56.5 million at December 31, 2017. The Company has excluded these loans from the weighted average computations.

December 31, 2016

Current Coupon Rate	Number of Loans	Principal Balance	Original LTV	Weighted Average		Contractual Maturity (years)	Coupon Rate
				Original FICO Score <sup>(1)</sup>	Expected Life (years)		
3.01 - 4.00%	59	\$23,318	54.8%	732	1.4	26.5	4.2 %
4.01 - 5.00%	180	69,930	57.1%	728	1.5	27.3	4.6 %
5.01 - 6.00%	231	91,440	55.5%	723	1.6	27.1	5.0 %
6.01 - 7.00%	5	3,077	71.2%	738	1.3	21.1	6.3 %
Total	475	\$187,765	56.3%	726	1.5	27.0	4.8 %

(1) The original FICO score is not available for 153 loans with a principal balance of approximately \$66.7 million at December 31, 2016. The Company has excluded these loans from the weighted average computations.

The following table presents the various states across the United States in which the collateral securing the Company's Residential Whole-Loans at December 31, 2017 and December 31, 2016, based on principal balance, is located (dollars in thousands):

	December 31, 2017		December 31, 2016	
	State Concentration	Principal Balance	State Concentration	Principal Balance
California	62.2 %	\$144,321	California	85.2 % \$159,955
New York	24.4 %	56,631	Washington	5.6 % 10,591
Georgia	4.3 %	10,061	Massachusetts	5.4 % 10,161
Washington	4.0 %	9,244	New York	2.4 % 4,454
Massachusetts	3.9 %	9,114	Georgia	0.8 % 1,492
Other	1.2 %	2,899	Other	0.6 % 1,112
Total	100.0%	\$232,270	Total	100.0% \$187,765

#### Residential Bridge Loans

The Residential Bridge Loans are comprised of short-term non-owner occupied fixed rate loans secured by single or multi-unit residential properties, with LTVs generally not to exceed 85%. The following table presents certain information about the Company's Residential Bridge Loan investment portfolio at December 31, 2017 (dollars in thousands):



December 31, 2017

Current Coupon Rate	Number of Loans	Principal Balance	Weighted Average		Coupon Rate
			Original LTV	Contractual Maturity (months)	
5.01 - 6.00%	9	\$4,016	64.5%	10.8	5.9 %
6.01 - 7.00%	64	18,420	67.8%	10.6	6.7 %
7.01 - 8.00%	98	25,608	66.4%	9.5	7.6 %
8.01 - 9.00%	56	19,728	70.3%	11.9	8.9 %
9.01 - 10.00%	67	25,001	73.3%	6.8	9.7 %
10.01 - 11.00%	36	10,656	75.4%	5.0	10.8 %
11.01 - 12.00%	2	919	89.8%	8.2	11.4 %
17.01 - 18.00%	8	1,520	73.8%	5.9	18.0 %
Total	340	\$105,868	70.1%	9.0	8.6 %

The following table presents the various states across the United States in which the collateral securing the Company's Residential Bridge Loans at December 31, 2017, based on principal balance, is located (dollars in thousands):

December 31, 2017

State	Concentration	Principal Balance
California	48.2 %	\$ 51,080
Florida	13.4 %	14,199
Washington	6.3 %	6,645
New York	4.4 %	4,703
Texas	4.4 %	4,660
Other	23.3 %	24,581
Total	100.0 %	\$ 105,868

#### Non-performing Loans

##### Residential Whole Loans

As of December 31, 2017, there was one Residential Whole-Loan over 90-days past due with a current unpaid principal balance of \$579 thousand and a fair value of \$570 thousand. This non-performing loan represents approximately 0.2% of the total outstanding principal balance. No allowance and provision for credit losses was recorded for this loan as of and for the year ended December 31, 2017, since the Company elected the fair value option. The Company stopped accruing interest income for this loan when it became contractually 90 days delinquent.

##### Residential Bridge Loans

As of December 31, 2017, there were 9 Residential Bridge Loans, which are carried at amortized cost, over 90-days past due with an unpaid principal balance of approximately \$1.8 million. These nonperforming loans represent approximately 1.7% of the total outstanding principal balance, respectively. These loans are collateral dependent with a weighted average original LTV of 74%. No allowance and provision for credit losses was recorded for these loans as of and for the year ended December 31, 2017 since the fair value of the collateral balance less the cost to sell was in excess of the outstanding principal and interest balances.

##### Unconsolidated VIEs



The Company's economic interests held in unconsolidated VIEs are limited in nature to those of a passive holder of RMBS and CMBS issued by securitization trusts; the Company was not involved in the design or creation of the securitization trusts which issued its investments in MBS. As of December 31, 2017 and December 31, 2016, the Company had three investments in VIEs in which it was not the primary beneficiary, and accordingly, the VIEs were not consolidated in the Company's consolidated financial statements. As of December 31, 2017 and December 31, 2016, the Company's maximum exposure to loss from these investments did not exceed the sum of the \$62.1 million and \$60.5 million carrying value of the investments, respectively, which are classified in "Mortgage-backed securities and other securities, at fair value" in the Company's Consolidated Balance Sheets. Further, as of December 31, 2017 and December 31, 2016, the Company had not guaranteed any obligations of unconsolidated entities or entered into any commitment or intent to provide funding to any such entities.

#### Note 6—Borrowings

##### Repurchase agreements

The Company primarily finances its investment acquisitions with repurchase agreements. The repurchase agreements bear interest at a contractually agreed-upon rate and typically have terms ranging from one month to three months. The Company's repurchase agreement borrowings are accounted for as secured borrowings when the Company maintains effective control of the financed assets. Under the repurchase agreements, the respective counterparties retain the right to determine the fair value of the underlying collateral. A reduction in the value of pledged assets requires the Company to post additional securities as collateral, pay down borrowings or establish cash margin accounts with the counterparties in order to re-establish the agreed-upon collateral requirements, and is referred to as a margin call. The inability of the Company to post adequate collateral for a margin call by a counterparty, in a timeframe as short as the close of the same business day, could result in a condition of default under the Company's repurchase agreements, thereby enabling the counterparty to liquidate the collateral pledged by the Company, which may have a material adverse effect on the Company's financial position, results of operations and cash flows. Under the terms of the repurchase agreements the Company may rehypothecate pledged U.S. Treasury securities it receives from its repurchase agreement as incremental collateral in order to increase the Company's cash position. At December 31, 2017 and December 31, 2016, the Company did not have any rehypothecated U.S. Treasury securities.

Certain of the repurchase agreements provide the counterparty with the right to terminate the agreement if the Company does not maintain certain equity and leverage metrics, the most restrictive of which include a limit on leverage based on the composition of the Company's portfolio. For all the repurchase agreements with outstanding borrowings, the Company was in compliance with the terms of such financial tests as of December 31, 2017. As of December 31, 2017, the Company had master repurchase agreements with 28 counterparties. As of December 31, 2017, the Company had borrowings under repurchase agreements with 16 counterparties. The following table summarizes certain characteristics of the Company's repurchase agreements at December 31, 2017 and December 31, 2016 (dollars in thousands):

Securities Pledged	December 31, 2017				December 31, 2016			
	Repurchase Agreement Borrowings	Weighted Average Interest Rate on Borrowings Outstanding at end of period	Weighted Average Remaining Maturity (days)		Repurchase Agreement Borrowings	Weighted Average Interest Rate on Borrowings Outstanding at end of period	Weighted Average Remaining Maturity (days)	
Agency RMBS	\$665,919	1.62 %	61		\$1,427,674	0.96 %	38	
Agency CMBS	2,035,222	1.53 %	53		56,365	1.07 %	46	
Non-Agency RMBS	46,530	2.76 %	41		218,712	2.53 %	28	
Non-Agency CMBS	154,325	2.98 %	40		255,656	2.55 %	30	
Whole-loans <sup>(1)(2)</sup>	189,270	3.66 %	8		161,181	2.91 %	9	
Residential Bridge Loans <sup>(1)</sup>	100,183	4.05 %	59		—	— %	0	
Other securities	60,237	2.94 %	23		36,056	2.32 %	17	
Repurchase agreements borrowings	3,251,686	1.86 %	51		2,155,644	1.48 %	34	
Less unamortized debt issuance cost	—	N/A	N/A		—	N/A	N/A	
Repurchase agreements borrowings, net	\$3,251,686	1.86 %	51		\$2,155,644	1.48 %	34	

(1) Repurchase agreement borrowings on loans owned are through trust certificates. The trust certificates are eliminated in consolidation.

(2) Whole-loans consist of Residential Whole-Loans and securitized commercial loan.

For the years ended December 31, 2017 and December 31, 2016, the Company had average borrowings under its repurchase agreements of approximately \$2.7 billion and \$2.5 billion, respectively, and had a maximum month-end balance during the periods of approximately \$3.3 billion and \$3.1 billion, respectively. The Company had accrued interest payable at December 31, 2017 and December 31, 2016 of approximately \$6.3 million and \$3.2 million, respectively.

At December 31, 2017 and December 31, 2016, repurchase agreements collateralized by investments had the following remaining maturities:

(dollars in thousands)	December 31, 2017	December 31, 2016
Overnight	\$—	\$—
1 to 29 days	1,387,599	1,386,971
30 to 59 days	665,656	167,642
60 to 89 days	871,819	601,031
90 to 119 days	—	—
Greater than or equal to 120 days	326,612	—
Total	\$3,251,686	\$2,155,644

At December 31, 2017, the following table reflects amounts of collateral at risk under its repurchase agreements greater than 10% of the Company's equity with any counterparty (dollars in thousands):

Counterparty	December 31, 2017		
	Amount of Collateral	Weighted Average Remaining Maturity (days)	Percentage of Stockholders' Equity

	at Risk, at fair value		
UBS AG, London Branch	\$65,532	22	14.1 %
Credit Suisse AG, Cayman Islands Branch	49,455	8	10.6 %

Collateral for Borrowings under Repurchase Agreements

The following table summarizes the Company's collateral positions, with respect to its borrowings under repurchase agreements at December 31, 2017 and December 31, 2016 (dollars in thousands):

	December 31, 2017			December 31, 2016		
	Assets Pledged	Accrued Interest	Assets Pledged and Accrued Interest	Assets Pledged	Accrued Interest	Assets Pledged and Accrued Interest
Assets pledged for borrowings under repurchase agreements:						
Agency RMBS, at fair value	\$690,255	\$2,601	\$692,856	\$1,465,384	\$5,335	\$1,470,719
Agency CMBS, at fair value	2,143,340	5,454	2,148,794	61,200	353	61,553
Non-Agency RMBS, at fair value	58,127	160	58,287	308,165	682	308,847
Non-Agency CMBS, at fair value	208,062	1,100	209,162	358,919	1,845	360,764
Whole-loans, at fair value <sup>(1)(2)</sup>	237,423	1,754	239,177	205,702	1,518	207,220
Residential Bridge Loans <sup>(1)</sup>	106,673	1,443	108,116	—	—	—
Other securities, at fair value	89,823	105	89,928	67,762	57	67,819
Cash <sup>(3)</sup>	23,591	—	23,591	36,986	—	36,986
Total	\$3,557,294	\$12,617	\$3,569,911	\$2,504,118	\$9,790	\$2,513,908

(1) Loans owned through trust certificates are pledged as collateral. The trust certificates are eliminated upon consolidation.

(2) Whole-loans consist of Residential Whole-Loans and securitized commercial loan.

(3) Cash posted as collateral is included in "Due from counterparties" in the Company's Consolidated Balance Sheets.

A reduction in the value of pledged assets typically results in the repurchase agreement counterparties initiating a margin call. At December 31, 2017 and December 31, 2016, investments held by counterparties as security for repurchase agreements totaled approximately \$3.5 billion and approximately \$2.5 billion, respectively. Cash collateral held by repurchase agreement counterparties at December 31, 2017 and December 31, 2016 was approximately \$23.6 million and \$37.0 million, respectively. Cash posted by repurchase agreement counterparties at December 31, 2017 and December 31, 2016, was approximately \$1.5 million and \$270 thousand, respectively. In addition, at December 31, 2017 and December 31, 2016, the Company held securities with a fair value of \$306 thousand and \$357 thousand, respectively, received as collateral from its repurchase agreement counterparties to satisfy margin requirements. The Company has the ability to repledge collateral received from its repurchase counterparties.

Convertible Senior Unsecured Notes

In October 2017, the Company issued \$115.0 million aggregate principal amount of 6.75% convertible senior unsecured notes, which included the underwriter's option to purchase \$15.0 million aggregate principal amount of the notes for net proceeds of \$111.1 million. The notes mature on October 1, 2022, unless earlier converted, redeemed or repurchased by the holders pursuant to their terms, and are not redeemable by the Company except during the final three months prior to maturity.

The notes are convertible into, at the Company's election, cash, shares of the Company's common stock or a combination of both, subject to the satisfaction of certain conditions and during specified periods. The conversion rate is subject to adjustment upon the occurrence of certain specified events and the holders may require the Company to repurchase all or any portion of their notes for cash equal to 100% of the principal amount of the notes, plus accrued and unpaid interest, if the Company undergoes a fundamental change as specified in the agreement. The initial conversion rate was 83.1947 shares of common stock per \$1,000 principal amount of notes and represented a conversion price of \$12.02 per share of common stock.



## Note 7—Derivative Instruments

The Company's derivatives may include interest rate swaps, options, futures contracts, currency swaps and forwards, TBAs, Agency and Non-Agency Interest-Only Strips that are classified as derivatives, credit default swaps and total return swaps.

The following table summarizes the Company's derivative instruments at December 31, 2017 and December 31, 2016 (dollars in thousands):

Derivative Instrument	Designation	Balance Sheet Location	December 31, 2017		December 31, 2016		Accrued Interest Payable (receivable)
			Notional Amount <sup>(1)</sup>	Accrued Interest Payable (receivable)	Notional Amount	Fair Value <sup>(1)</sup>	
Interest rate swaps, asset	Non-Hedge	Derivative assets, at fair value	\$—	\$—	—\$2,298,300	\$20,466	\$ 1,145
Options, asset	Non-Hedge	Derivative assets, at fair value	320,000	—	—	—	—
Futures contracts, asset	Non-Hedge	Derivative assets, at fair value	486,200	—	56,900	71	—
Foreign currency forward contracts, asset	Non-Hedge	Derivative assets, at fair value	—	—	784	34	—
Total derivative instruments, assets			728	—		20,571	1,145
Interest rate swaps, liability	Non-Hedge	Derivative liability, at fair value	3,232,200	—	5,046,300	(177,929)	3,054
Options, liability	Non-Hedge	Derivative liability, at fair value	320,500	—	—	—	—
Total return swap, liability	Non-Hedge	Derivative liability, at fair value	—	—	47,059	(1,673)	(94)
Futures contracts, liability	Non-Hedge	Derivative liability, at fair value	—	—	176,300	(2,487)	—
Foreign currency forward contracts, liability	Non-Hedge	Derivative liability, at fair value	—	—	1,532	(69)	—
Credit default swaps, liability	Non-Hedge	Derivative liability, at fair value	14,955	—	—	—	—
TBA securities, liability	Non-Hedge	Derivative liability, at fair value	125,000	—	—	—	—
Total derivative instruments, liabilities			(4,346)	—		(182,158)	2,960
Total derivative instruments, net			\$(3,618)	\$—		\$(161,587)	\$ 4,105

(1) Fair value excludes accrued interest.

The following tables summarize the effect of the Company's derivative positions, including Interest-Only Strips characterized as derivatives and TBAs, which are reported in "Gain (loss) on derivative instruments, net" in the Consolidated Statements of Operations for the years ended December 31, 2017, December 31, 2016 and December 31, 2015 (dollars in thousands):



Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-K

Period End	Realized Gain (Loss), net					Total
	Other Settlements / Expirations	Variation Margin Settlement	Return (Recovery) of Basis	Mark-to-market adjustments	Contractual interest income (expense), net <sup>(1)</sup>	
Year ended December 31, 2017						
Interest rate swaps	\$(150,607)	\$ 20,258	\$ 524	\$ 148,947	\$(14,606 )	\$4,516
Interest rate swaptions	(115 )	—	—	—	—	(115 )
Interest-Only Strips—accounted for as derivatives	526	—	(5,995 )	(902 )	7,438	1,067
Options	(1,453 )	—	—	(300 )	—	(1,753 )
Futures contracts	(9,130 )	—	—	3,044	—	(6,086 )
Foreign currency forwards	32	—	—	35	—	67
Total return swap	(552 )	—	—	1,673	469	1,590
Credit default swaps	(11 )	—	—	(22 )	—	(33 )
TBAs	4,049	—	—	(10 )	—	4,039
Total	\$(157,261)	\$ 20,258	\$(5,471 )	\$ 152,465	\$(6,699 )	\$3,292
Year ended December 31, 2016						
Interest rate swaps	\$(33,999 )	\$ —	\$ 672	\$ 11,013	\$(27,903 )	\$(50,217)
Interest rate swaptions	(1,035 )	—	—	1,631	—	596
Interest-Only Strips—accounted for as derivatives	1,317	—	(11,438 )	(4,726 )	14,148	(699 )
Options	4,756	—	—	—	—	4,756
Futures contracts	23,609	—	—	(1,781 )	—	21,828
Foreign currency forwards	(66 )	—	—	(56 )	—	(122 )
Foreign currency swaps	6,771	—	—	(7,168 )	283	(114 )
Total return swap	38	—	—	(1,673 )	1,121	(514 )
TBAs	6,126	—	—	(2,375 )	—	3,751
Total	\$7,517	\$ —	\$(10,766 )	\$ (5,135 )	\$(12,351 )	\$(20,735)
Year ended December 31, 2015						
Interest rate swaps	\$23,680	\$ —	\$ 1,250	\$ (68,843 )	\$(20,366 )	\$(64,279)
Interest rate swaptions	(5,242 )	—	—	(1,486 )	—	(6,728 )
Interest-Only Strips—accounted for as derivatives	595	—	(17,265 )	(4,283 )	21,872	919
Options	(711 )	—	—	—	—	(711 )
Futures contracts	(527 )	—	—	105	—	(422 )
Foreign currency forwards	(901 )	—	—	323	—	(578 )
Foreign currency swaps	—	—	—	3,311	795	4,106
TBAs	1,524	—	—	(2,726 )	—	(1,202 )
Total	\$18,418	\$ —	\$(16,015 )	\$ (73,599 )	\$ 2,301	\$(68,895)

(1) Contractual interest income (expense), net on derivative instruments includes interest settlement paid or received.



At December 31, 2017 and December 31, 2016, the Company had cash pledged as collateral for its derivatives of approximately \$63.3 million and approximately \$206.6 million respectively, which is reported in "Due from counterparties" in the Consolidated Balance Sheets. Effective in January 2017, variation margin of CME cleared derivatives are treated as settlements of the derivative contract as opposed to cash collateral. The December 31, 2017 cash collateral balance of \$63.3 million represents upfront cash collateral upon the Company entering into the derivative transaction and cash collateral for derivatives not cleared through the CME. As a result of the change in the CME rules, the \$157.9 million of previously posted cash collateral is now recorded as a reduction in the derivative liability. The Company also held cash collateral against derivatives of \$0 and approximately \$470 thousand at December 31, 2017 and December 31, 2016, respectively, which is reported in "Due to counterparties" in the Consolidated Balance Sheets.

#### Interest rate swaps and interest rate swaptions

The Company enters into interest rate swaps and interest rate swaptions to mitigate its exposure to higher short-term interest rates in connection with its repurchase agreements. Interest rate swaps generally involve the receipt of variable-rate amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the interest rate swap without exchange of the underlying notional amount. Notwithstanding the foregoing, in order to manage its hedge position with regard to its liabilities, the Company on occasion will enter into interest rate swaps which involve the receipt of fixed-rate amounts from a counterparty in exchange for the Company making variable-rate payments over the life of the interest rate swap without exchange of the underlying notional amount. The Company also enters into forward starting swaps and interest rate swaptions to help mitigate the effects of changes in interest rates on a portion of its borrowings under repurchase agreements. Interest rate swaptions provide the Company 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. On occasion the Company may enter into a MAC interest rate swap in which it may receive or make a payment at the time of entering such interest rate swap to compensate for the out of the market nature of such interest rate swap. Similar to all other interest rate swaps, these interest rate swaps are also subject to margin requirements as previously described.

The Company has not elected to account for its interest rate swaps as "hedges" under GAAP, accordingly the change in fair value of the interest rate swaps not designated in hedging relationships are recorded together with periodic net interest settlement amounts in "Gain (loss) on derivatives instruments, net" in the Consolidated Statements of Operations.

#### Interest Rate Swaps

In April 2017, we restructured our hedge positions, effectively terminating fix-pay interest rate swaps with a notional value of approximately \$3.2 billion and variable-pay interest rate swaps with a notional value of approximately \$2.0 billion to effectively hedge our debt and reduce swap related interest expense.

The following tables summarize the average fixed pay rate, average floating receive rate and average maturity for the Company's interest rate swaps as of December 31, 2017 and December 31, 2016 (dollars in thousands):

Remaining Interest Rate Swap Term	Notional Amount	December 31, 2017				Forward Starting (1)
		Average Pay Rate	Average Floating Receive Rate	Average Maturity (Years)	Forward Starting (1)	
Greater than 1 year and less than 3 years	\$600,000	1.6 %	1.5 %	1.8	— %	
Greater than 3 years and less than 5 years	960,000	2.0 %	1.4 %	4.3	— %	
Greater than 5 years	1,692,200	2.5 %	1.4 %	10.5	90.2 %	
Total	\$3,252,200	2.2 %	1.4 %	7.1	46.9 %	

(1) Represents the percentage of notional that is forward starting



Remaining Interest Rate Swap Term	December 31, 2016						
	Notional Amount	Average Pay Rate	Average Floating Receive Rate	Average Maturity (Years)	Forward Starting <sup>(1)</sup>		
1 year or less	\$105,900	0.8 %	0.8 %	0.8	—	%	
Greater than 1 year and less than 3 years	993,000	1.2 %	0.9 %	1.4	88.1	%	
Greater than 3 years and less than 5 years	1,861,700	1.9 %	0.9 %	3.9	36.5	%	
Greater than 5 years	1,701,600	3.1 %	0.9 %	10.5	6.5	%	
Total	\$4,662,200	2.1 %	0.9 %	5.7	35.7	%	

(1) Represents the percentage of notional that is forward starting

As of December 31, 2017 and December 31, 2016, the Company has entered into fixed pay forward starting swaps of approximately \$1.5 billion and \$1.7 billion respectively, which have weighted average forward starting dates of 4 months and 4.5 months, respectively.

There were no variable pay-rate interest rate swaps as of December 31, 2017. The following table summarizes the average variable pay rate, average fixed pay receive rate and average maturity for the Company's interest rate swaps as of December 31, 2016 (dollars in thousands):

Remaining Interest Rate interest rate swap Term	December 31, 2016						
	Notional Amount	Fair Value—(Liability), net	Average Variable Pay Rate	Average Fixed Received Rate	Average Maturity (Years)	Forward Starting	
Greater than 3 years and less than 5 years	\$1,811,400	\$(24,112)	0.9 %	1.4 %	3.7	%	
Greater than 5 years	871,000	(18,749)	0.9 %	2.2 %	12.3	—	
Total	\$2,682,400	\$(42,861)	0.9 %	1.7 %	6.5	%	

#### Options

The Company may enter into options on U.S. Treasuries. As of December 31, 2017, the Company had long position options on U.S. Treasuries with a notional amount of \$320.0 million and a fair value in an asset position of \$100 thousand and short position options on U.S. Treasuries with a notional amount of \$320.0 million and a fair value in a liability position of \$50 thousand. As of December 31, 2016, the Company had no option contracts on U.S. Treasuries.

#### Futures Contracts

The Company may enter into Eurodollar, Volatility Index and U.S. Treasury futures. As of December 31, 2017, the Company had entered into contracts to sell or short positions for U.S. Treasuries with a notional amount of \$480.0 million, a fair value in an asset position of \$628 thousand and an expiration date of March 2018. As of December 31, 2016, the Company had entered into contracts to buy or long positions for U.S. Treasuries with a notional amount of \$56.9 million, a fair value in an asset position of \$71 thousand and an expiration date of March 2017. In addition, as of December 31, 2016, the Company had sale contracts or short positions for U.S. Treasuries with a notional amount of \$176.3 million, a fair value in an liability position of \$2.5 million and an expiration date of March 2017.

#### Currency Swaps and Forwards

The Company has invested in and, in the future, may invest in additional securities which are denominated in a currency or currencies other than U.S. dollars. Similarly, it has and may in the future, finance such assets in a currency or currencies other than U.S. dollars. In order to mitigate the impact to the Company, the Company may enter into derivative financial instruments, including foreign currency swaps and foreign currency forwards, to manage fluctuations in the valuation between U.S. dollars and such foreign currencies. Foreign currency swaps involve the payment of a foreign currency at fixed interest rate on a fixed notional amount and the receipt of U.S. dollars at a fixed interest rate on a fixed notional amount. Foreign currency forwards provide for



the payment of a fixed amount of a foreign currency in exchange for a fixed amount of U.S. dollars at a date certain in the future. The carrying value of foreign currency swaps and forwards is included in "Derivative assets, at fair value" and "Derivative liability, at fair value" in the Consolidated Balance Sheets with changes in valuation included in "Gain (loss) on derivative instruments, net" in the Consolidated Statements of Operations. The Company had no foreign currency swaps at December 31, 2017. The following is a summary of the Company's foreign currency forwards at December 31, 2016 (dollars and euros in thousands):

Derivative Type	December 31, 2016		Maturity	Fair Value
	Notional Amount	Notional (USD Equivalent)		
Buy USD/Sell EUR currency forward	€10	\$ 784	January 2017	\$ 34
Currency forwards, assets	€10	\$ 784	n/a	\$ 34
Buy EUR/Sell USD currency forward	€73	\$ 735	February 2017	\$(23)
Buy EUR/Sell USD currency forward	€10	\$ 797	January 2017	\$(46)
Currency forwards, liabilities	€1,383	\$ 1,532	n/a	\$(69)
Total currency forwards	€2,093	\$ 2,316	n/a	\$(35)

#### To-be-announced securities

The Company purchased or sold TBAs during the years ended December 31, 2017 and 2016. As of December 31, 2016, the Company had no contracts to purchase ("long position") and sell ("short position") TBAs on a forward basis. The following is a summary of the Company's long and short TBA positions reported, as of December 31, 2017, reported in "Derivative assets, at fair value" and "Derivative liability, at fair value" in the Consolidated Balance Sheets (dollars in thousands):

	December 31, 2017	
	Notional Amount	Fair Value
Purchase contracts, liability	\$125,000	\$(10)
TBA securities, liability	125,000	(10)
TBA securities, net	\$125,000	\$(10)

The following table presents additional information about the Company's contracts to purchase and sell TBAs for the year ended December 31, 2017 (dollars in thousands):

	Notional Amount	Settlement, Termination, Expiration or Exercise	Notional Amount
	December 31, 2016		December 31, 2017
Purchase of TBAs \$	—\$5,843,200	\$ (5,718,200)	\$ 125,000
Sale of TBAs \$	—\$5,718,200	\$ (5,718,200)	\$ —

#### Interest-Only Strips

The Company also invests in Interest-Only Strips. In determining the classification of its holdings of Interest-Only Strips, the Company evaluates the securities to determine if the nature of the cash flows has been altered from that of the underlying mortgage collateral. Generally, Interest-Only Strips for which the security represents a strip off of a mortgage pass through security will be considered a hybrid instrument classified as a MBS investment in the Consolidated Balance Sheets utilizing the fair value option. Alternatively, those Interest-Only Strips, for which the underlying mortgage collateral has been included into a structured security that alters the cash flows from the underlying mortgage collateral, are accounted for as derivatives at fair value with changes recognized in "Gain (loss) on derivative instruments, net" in the Consolidated Statements of Operations, along with any interest received. The carrying value of these Interest-Only Strips is included in "Mortgage-backed securities and other securities, at fair value" in the Consolidated Balance Sheets.





## Total Return Swap

In 2016, the Company entered into a total return swap and in the future, may continue to enter into these types of credit derivatives. This swap transfers the total return of the referenced asset, including interim cash flows and capital appreciation or depreciation from a specified price to the Company. The total return swap has a referenced asset which is a security collateralized by residential loans with a notional amount of €51.0 million. The Company receives interest from the referenced asset equal to EURIBOR plus 2.75% and is required to pay the counterparty EURIBOR plus 0.50% through June 23, 2019, with the spread decreasing to 0.25% through December 2019, with the spread further decreasing to 0% through the maturity date of the referenced asset in December 2020. In 2017, the Company terminated its position realizing a loss of approximately \$569 thousand, which is reported in "Gain (loss) on derivative instruments, net" for the year ended December 31, 2017. The Company had no total return swaps at December 31, 2017.

## Credit Default Swaps

In 2017, the Company entered into credit default swaps and, in the future, may continue to enter into these type of credit derivatives. As of December 31, 2017, the Company had entered into credit default swaps with a notional amount of approximately \$14.8 million, a fair value in a liability position of \$95 thousand and a maturity date of May 2063. Under these instruments, the Company makes a monthly premium payment over the term of the contract in exchange for the counterparty making a payment to the Company for losses of the reference securities, upon the occurrence of a specified credit event.

## Note 8—Offsetting Assets and Liabilities

The following tables present information about certain assets and liabilities that are subject to master netting agreements (or similar agreements) and can potentially be offset in the Company's Consolidated Balance Sheets at December 31, 2017 and December 31, 2016 (dollars in thousands):

Description	December 31, 2017						
	Gross Amounts	Gross Amounts Offset in the Consolidated Balance Sheets	Net Amounts of Assets presented in the Consolidated Balance Sheets	Gross Amounts Not Offset in the Consolidated Balance Sheets	Financial Instruments <sup>(1)</sup>	Cash Collateral <sup>(1)</sup>	Net Amount
<b>Derivative Assets</b>							
Interest-Only Strips, accounted for as derivatives included in MBS	\$ 16,176	\$ —	—\$ 16,176	\$(11,633 )	\$ —		\$ 4,543
Derivative asset, at fair value <sup>(2)</sup>	728	—	728	(50 )	—		678
Total derivative assets	\$ 16,904	\$ —	—\$ 16,904	\$(11,683 )	\$ —		\$ 5,221
<b>Derivative Liabilities and Repurchase Agreements</b>							
Derivative liability, at fair value <sup>(2)(3)</sup>	\$ 4,346	\$ —	—\$ 4,346	\$(50 )	\$(4,270 )		\$ 26
Repurchase Agreements <sup>(4)</sup>	3,251,686	—	3,251,686	(3,251,686 )	—		—
Total derivative liability	\$ 3,256,032	\$ —	—\$ 3,256,032	\$(3,251,736 )	\$(4,270 )		\$ 26

(1) Amounts disclosed in the Financial Instruments column of the tables above represent securities, Whole-Loans and securitized commercial loan collateral pledged and derivative assets that are available to be offset against liability balances associated with repurchase agreement and derivative liabilities. Amounts disclosed in the Cash Collateral

column of the tables above represents amounts pledged or received as collateral against derivative transactions.

- (2) Derivative asset, at fair value and Derivative liability, at fair value includes interest rate swaps, interest rate swaptions, mortgage put options, currency forwards, futures contracts, total return swaps and TBAs.
- (3) Cash collateral pledged against the Company's derivative counterparties was approximately \$63.3 million as of December 31, 2017.
- (4) The carrying value of investments pledged against the Company's repurchase agreements was approximately \$3.5 billion as of December 31, 2017.

Description	December 31, 2016					
	Gross Amounts	Gross Amounts Offset in the Consolidated Balance Sheets	Net Amounts of Assets presented in the Consolidated Balance Sheets	Gross Amounts Not Offset in the Consolidated Balance Sheets		
				Financial Instruments <sup>(1)</sup>	Cash Collateral <sup>(1)</sup>	Net Amount
<b>Derivative Assets</b>						
Interest-Only Strips, accounted for as derivatives included in MBS	\$27,317	\$	—\$27,317	\$(23,338)	\$—	\$3,979
Derivative asset, at fair value <sup>(2)</sup>	20,571	—	20,571	(20,500)	—	71
Total derivative assets	\$47,888	\$	—\$47,888	\$(43,838)	\$—	\$4,050
<b>Derivative Liabilities and Repurchase Agreements</b>						
Derivative liability, at fair value <sup>(2)(3)</sup>	\$182,158	\$	—\$182,158	\$(20,500)	\$(161,588)	\$70
Repurchase Agreements <sup>(4)</sup>	2,155,644	—	2,155,644	(2,155,644)	—	—
Total derivative liability	\$2,337,802	\$	—\$2,337,802	\$(2,176,144)	\$(161,588)	\$70

Amounts disclosed in the Financial Instruments column of the tables above represent securities, Whole-Loans and securitized commercial loan collateral pledged and derivative assets that are available to be offset against liability (1) balances associated with repurchase agreement and derivative liabilities. Amounts disclosed in the Cash Collateral column of the tables above represents amounts pledged or received as collateral against derivative transactions.

(2) Derivative asset, at fair value and Derivative liability, at fair value includes interest rate swaps, interest rate swaptions, mortgage put options, currency forwards, futures contracts and TBAs.

(3) Cash collateral pledged against the Company's derivative counterparties was approximately \$206.6 million as of December 31, 2016.

(4) The fair value of investments pledged against the Company's repurchase agreements was approximately \$2.5 billion as of December 31, 2016.

Certain of the Company's repurchase agreement and derivative transactions are governed by underlying agreements that generally provide for a right of set-off in the event of default or in the event of a bankruptcy of either party to the transaction.

#### Note 9—Related Party Transactions

##### Management Agreement

In connection with the Company's IPO in May 2012, the Company entered into a management agreement (the "Management Agreement") with the Manager, which describes the services to be provided by the Manager and compensation for such services. The Manager is responsible for managing the Company's operations, including: (i) performing all of its day-to-day functions; (ii) determining investment criteria in conjunction with the Board of Directors; (iii) sourcing, analyzing and executing investments, asset sales and financings; (iv) performing asset management duties; and (v) performing financial and accounting management, subject to the direction and oversight of the Company's Board of Directors. Pursuant to the terms of the Management Agreement, the Manager is paid a management fee equal to 1.50% per annum of the Company's stockholders' equity (as defined in the Management Agreement), calculated and payable (in cash) quarterly in arrears. For purposes of calculating the management fee, "stockholders' equity" means the sum of the net proceeds from any issuances of the Company's equity securities since inception (allocated on a pro rata daily basis for such issuances during the fiscal quarter of any such issuance), plus retained earnings, calculated in accordance with GAAP, at the end of the most recently completed fiscal quarter (without taking into account any non-cash equity compensation expense incurred in current or prior periods), less any amount paid for repurchases of the Company's shares of common stock, excluding any unrealized gains or losses on

our investments and derivatives and other non-cash items, (including OTTI charges prior to January 1, 2016) that have impacted stockholder's equity as reported in the Company's consolidated financial statements prepared in accordance with GAAP, regardless of whether such items are included in other comprehensive income or loss, or in net income, and excluding one-time events pursuant to changes in GAAP and certain other non-cash charges after discussions between the Manager and the Company's independent directors and after approval by a majority of the Company's independent directors. However, if the Company's stockholders' equity for any given quarter is negative based on the calculation described above, the Manager will not be entitled to receive any management fee for that quarter.

On August 3, 2016, the Company and the Manager entered into an amendment to the Management Agreement that amended the definition of "Equity" in the Management Agreement. Under the new definition, for all periods beginning on January 1, 2016, OTTI will reduce the Company's "Equity" for any completed fiscal quarter that OTTI was recognized, which in turn will reduce the Company's management fee from what would have been payable before the amendment.

In addition, the Company may be required to reimburse the Manager for certain expenses as described below, and shall reimburse the Manager for the compensation paid to the Company's CFO, controller and their staff. Expense reimbursements to the Manager are made in cash on a regular basis. The Company's reimbursement obligation is not subject to any dollar limitation. Because the Manager's personnel perform certain legal, accounting, due diligence tasks and other services that outside professionals or outside consultants otherwise would perform, the Manager may be paid or reimbursed for the documented cost of performing such tasks, provided that such costs and reimbursements are in amounts which are no greater than those which would be payable to outside professionals or consultants engaged to perform such services pursuant to agreements negotiated on an arm's-length basis.

The Management Agreement may be amended, supplemented or modified by agreement between the Company and the Manager. The Management Agreement expires on May 16, 2019. It is automatically renewed for one year terms on each May 15th unless previously terminated as described below. The Company's independent directors review the Manager's performance and any fees payable to the Manager annually and, the Management Agreement may be terminated annually upon the affirmative vote of at least two-thirds (2/3) of the Company's independent directors, based upon: (i) the Manager's unsatisfactory performance that is materially detrimental to the Company; or (ii) the Company's determination that any fees payable to the Manager are not fair, subject to the Manager's right to prevent such termination due to unfair fees by accepting a reduction of management fees agreed to by at least two-thirds (2/3) of the Company's independent directors. The Company will provide the Manager 180 days prior notice of any such termination. Unless terminated for cause, the Company will pay the Manager a termination fee equal to three times the average annual management fee earned by the Manager during the prior 24-month period immediately preceding the date of termination, calculated as of the end of the most recently completed fiscal quarter prior to the date of termination.

The Company may also terminate the Management Agreement at any time, without the payment of any termination fee, with 30 days prior written notice from the Company's Board of Directors for cause, which will be determined by at least two-thirds (2/3) of the Company's independent directors, which is defined as: (i) the Manager's continued material breach of any provision of the Management Agreement (including the Manager's failure to comply with the Company's investment guidelines); (ii) the Manager's fraud, misappropriation of funds, or embezzlement against the Company; (iii) the Manager's gross negligence in the performance of its duties under the Management Agreement; (iv) the occurrence of certain events with respect to the bankruptcy or insolvency of the Manager, including an order for relief in an involuntary bankruptcy case or the Manager authorizing or filing a voluntary bankruptcy petition; (v) the Manager is convicted (including a plea of nolo contendere) of a felony; or (vi) the dissolution of the Manager. For the years ended December 31, 2017, December 31, 2016 and December 31, 2015 the Company incurred \$8.1 million, \$10.4 million and \$10.9 million in management fees, respectively.

In addition to the management fee, the Company is also responsible for reimbursing the Manager for certain expenses paid by the Manager on behalf of the Company, as defined in the Management Agreement. For the years ended December 31, 2017, December 31, 2016 and December 31, 2015, the Company recorded expenses included in general and administrative expense totaling approximately \$1.4 million, \$740 thousand and \$1.2 million, respectively, related to reimbursable employee costs. Any such expenses incurred by the Manager and reimbursed by the Company, including the employee compensation expense, are typically included in the Company's general and administrative expense in the Consolidated Statements of Operations. At December 31, 2017 and December 31, 2016, approximately \$1.9 million and approximately \$2.5 million, respectively, for management fees incurred but not yet paid was included in "Payable to affiliates" in the Consolidated Balance Sheets. In addition, at December 31, 2017 and December 31, 2016, approximately \$99 thousand and \$83 thousand, respectively of reimbursable costs incurred but not yet paid was included in "Payable to affiliates" in the consolidated balance sheets.

Securitized debt

At December 31, 2017 and December 31, 2016, the Company had securitized debt related to the consolidated VIEs, with a principal balance of \$10.9 million and \$11.0 million, respectively (and a fair value of \$10.9 million and \$10.7 million, respectively) which was held by an affiliate. The securitized debt of the VIEs can only be settled with the commercial loans that serve as collateral of the VIE and is non-recourse to the Company.

#### Note 10—Share-Based Payments

In conjunction with the Company's IPO and concurrent private placement, the Company's Board of Directors approved the Western Asset Mortgage Capital Corporation Equity Plan (the "Equity Plan") and the Western Asset Manager Equity Plan (the "Manager Equity Plan" and collectively the "Equity Incentive Plans"). The Equity Incentive Plans include provisions for grants of restricted common stock and other equity-based awards to the Manager, its employees and employees of its affiliates and to the Company's directors, officers and employees. The Company can issue up to 3.0% of the total number of issued and outstanding shares of its common stock (on a fully diluted basis) at the time of each award (other than any shares previously issued or subject to awards made pursuant to one of the Company's Equity Incentive Plans) under these Equity Incentive Plans. At May 15, 2012, there were 308,335 shares of common stock initially reserved for issuance under the Equity Incentive Plans. Upon the completion of the follow-on offerings, the number of shares of common stock available for issuance under the Equity Incentive Plans increased to 1,237,711. Approximately 725,449 of shares have been issued under the Equity Plans with 512,262 shares available for issuance as of December 31, 2017.

Under the Equity Plan, the Company made the following grants during the years ended December 31, 2017 and December 31, 2016:

On June 1, 2017, the Company granted a total of 15,536 (3,884 each) of restricted common stock under the Equity Plan to the Company's four independent directors. These restricted shares will vest in full on June 1, 2018, the first anniversary of the grant date. Each of the independent directors has elected to defer the shares granted to him under the Company's Director Deferred Fee Plan (the "Director Deferred Fee Plan"). The Director Deferred Fee Plan permits eligible members of the Company's board of directors to defer certain stock awards made under its director compensation programs. The Director Deferred Fee Plan allows directors to defer issuance of their stock awards and therefore defer payment of any tax liability until the deferral is terminated, pursuant to the election form executed each year by each eligible director.

On June 2, 2016, the Company granted a total of 17,132 (4,283 each) of restricted common stock under the Equity Plan to the Company's four independent directors. These restricted shares vested in full on June 2, 2017, the first anniversary of the grant date. Each of the independent directors has elected to defer the shares granted to him under the Director Deferred Fee Plan. The Director Deferred Fee Plan permits eligible members of the Company's board of directors to defer certain stock awards made under its director compensation programs. The Director Deferred Fee Plan allows directors to defer issuance of their stock awards and therefore defer payment of any tax liability until the deferral is terminated, pursuant to the election form executed each year by each eligible director.

During the years ended December 31, 2017, December 31, 2016 and December 31, 2015, 152,630, 200,983 and 175,824 restricted common shares vested, respectively, including shares whose issuance has been deferred under the Director Deferred Fee Plan. The Company recognized stock-based compensation expense of approximately \$981 thousand, approximately \$1.7 million and approximately \$2.3 million for the years ended December 31, 2017, December 31, 2016 and December 31, 2015, respectively. In addition, the Company had unamortized compensation expense of \$66 thousand for equity awards and approximately \$111 thousand for liability awards and \$67 thousand for equity awards and approximately \$895 thousand for liability awards at December 31, 2017 and December 31, 2016, respectively.

All restricted common shares granted, other than those whose issuance has been deferred pursuant to the Director Deferred Fee Plan, possess all incidents of ownership, including the right to receive dividends and distributions currently, and the right to vote. Dividend equivalent payments otherwise allocable to restricted common shares under the Deferred Compensation Plan are deemed to purchase additional phantom shares of the Company's common stock that are credited to each participant's deferral account. The award agreements include restrictions whereby the restricted shares cannot be sold, assigned, transferred, pledged, hypothecated or otherwise disposed of prior to the lapse of restrictions under the respective award agreement. The restrictions lapse on the unvested restricted shares awarded when vested, subject to the grantee's continuing to provide services to the Company as of the vesting date. Unvested restricted shares and rights to dividends thereon are forfeited upon termination of the grantee.

The following is a summary of restricted common stock vesting dates as of December 31, 2017 and December 31, 2016, including shares whose issuance has been deferred under the Director Deferred Fee Plan:





	December 31, 2017	December 31, 2016
Vesting Date	Shares Vesting	Shares Vesting
March 2017	—	133,334
June 2017	—	18,196
March 2018	66,667	66,667
June 2018	16,488	—
	83,155	218,197

The following table presents information with respect to the Company's restricted stock for the years ended December 31, 2017 and December 31, 2016, including shares whose issuance has been deferred under the Director Deferred Fee Plan:

	December 31, 2017		December 31, 2016	
	Shares of Restricted Stock	Weighted Average Grant Date Fair Value <sup>(1)</sup>	Shares of Restricted Stock	Weighted Average Grant Date Fair Value <sup>(1)</sup>
Outstanding at beginning of period	707,861	\$ 17.17	688,394	\$ 17.39
Granted <sup>(2)</sup>	17,588	10.30	19,467	9.40
Outstanding at end of period	725,449	\$ 17.00	707,861	\$ 17.17
Unvested at end of period	83,155	\$ 14.07	218,197	\$ 14.98

(1) The grant date fair value of restricted stock awards is based on the closing market price of the Company's common stock at the grant date.

(2) Included 2,052 shares and 2,335 shares of restricted stock attributed to dividends on restricted stock under the Director Deferred Fee Plan for the years ended December 31, 2017 and December 31, 2016, respectively.

#### Note 11—Stockholders' Equity Warrants

On May 9, 2012, the Company entered into agreements with certain institutional investors to sell 2,231,787 warrant units. Each warrant unit consists of one share of the Company's common stock and a warrant to purchase 0.5 of a share of the Company's common stock, subject to adjustment. As of December 31, 2017, the adjusted exercise price of the warrants was \$16.70 and there were a total of 1,232,916 warrant shares purchasable. The warrants expire on May 15, 2019.

#### At-The-Market Program

In April 2017, the Company entered into an equity distribution agreement with JMP Securities LLC under which the Company may offer and sell up to \$100.0 million of common stock in an At-The-Market equity offering. We did not sell any shares under this agreement during 2017.

#### Stock Repurchase Program

On December 21, 2017, the Board of Directors of the Company reauthorized its repurchase program of up to 2,100,000 shares of its common stock through December 31, 2019. The previous reauthorization announced on February 25, 2016 of the Company's repurchase program of up to 2,050,000 shares of its common stock expired on December 31, 2017. The original authorization expired on December 31, 2015. Purchases made pursuant to the program will be made in the open market, in privately negotiated transactions, or pursuant to any trading plan that may be adopted in accordance with Rules 10b5-1 and 10b-18 of the Securities and Exchange Commission. The authorization does not obligate the Company to acquire any particular amount of common shares and the program may be suspended or discontinued at the Company's discretion without prior notice. The timing, manner, price and

amount of any repurchases will be determined by the Company in its discretion and will be subject to economic and market conditions, stock price, applicable legal requirements and other factors. The Company has repurchased 125,722 shares

128

---

of common stock pursuant to the authorization as of December 31, 2017. The repurchased stock was not retired and will be accounted for as treasury stock.

#### Dividends

The following table presents cash dividends declared and paid by the Company on its common stock:

Declaration Date	Record Date	Payment Date	Amount per Share	Tax Characterization
<b>2017</b>				
December 21, 2017	January 2, 2018	January 26, 2018	\$ 0.31	Return of capital
September 21, 2017	October 2, 2017	October 26, 2017	\$ 0.31	Return of capital
June 20, 2017	June 30, 2017	July 26, 2017	\$ 0.31	Return of capital
March 23, 2017	April 3, 2017	April 26, 2017	\$ 0.31	Ordinary income
<b>2016</b>				
December 22, 2016	January 3, 2017	January 26, 2017	\$ 0.31	Ordinary income
September 22, 2016	October 4, 2016	October 25, 2016	\$ 0.31	Ordinary income
June 23, 2016	July 5, 2016	July 26, 2016	\$ 0.31	Ordinary income
March 24, 2016	April 4, 2016	April 26, 2016	\$ 0.45	Ordinary income
<b>2015</b>				
December 17, 2015	December 28, 2015	January 26, 2016	\$ 0.58	Ordinary income
September 24, 2015	October 5, 2015	October 27, 2015	\$ 0.60	Ordinary income
June 18, 2015	June 29, 2015	July 28, 2015	\$ 0.64	Ordinary income
March 26, 2015	April 6, 2015	April 28, 2015	\$ 0.67	Ordinary income

#### Note 12—Net Income (Loss) per Common Share

The table below presents basic and diluted net income (loss) per share of common stock using the two-class method for the years ended December 31, 2017, December 31, 2016 and December 31, 2015 (dollars, other than shares and per share amounts, in thousands):

	For the year ended December 31, 2017	For the year ended December 31, 2016	For the year ended December 31, 2015
Numerator:			
Net income (loss) attributable to common stockholders and participating securities for basic and diluted earnings per share	\$ 85,097	\$(25,015 )	\$(9,484 )
Less:			
Dividends and undistributed earnings allocated to participating securities	312	377	1,045
Net income (loss) allocable to common stockholders—basic and diluted	\$ 84,785	\$(25,392 )	\$(10,529 )
Denominator:			
Weighted average common shares outstanding for basic earnings per share	41,817,455	41,688,950	41,490,556
Weighted average common shares outstanding for diluted earnings per share	41,817,455	41,688,950	41,490,556
Basic earnings per common share	\$ 2.03	\$(0.61 )	\$(0.25 )
Diluted earnings per common share	\$ 2.03	\$(0.61 )	\$(0.25 )

For the years ended December 31, 2017, December 31, 2016 and December 31, 2015, the Company excluded the effects of the warrants and the convertible senior unsecured notes from the computation of diluted earnings per share since the average market value per share of the Company's common stock was below the exercise price of the warrants and the convertible senior unsecured notes.

#### Note 13—Income Taxes

As a REIT, the Company is not subject to federal income tax to the extent that it makes qualifying distributions to its stockholders and satisfies on a continuing basis, through actual investment and operating results, the REIT requirements including certain asset, income and stock ownership tests.

Based on the Company's analysis of any potential uncertain income tax positions, the Company concluded that it does not have any uncertain tax positions that meet the recognition or measurement criteria as of December 31, 2017. The Company files U.S. federal and state income tax returns. As of December 31, 2017, U.S. federal tax returns filed by the Company for 2016, 2015 and 2014 and state tax returns filed for 2016, 2015, 2014 and 2013 are open for examination pursuant to relevant statutes of limitation. In the event that the Company incurs income tax related interest and penalties, the Company's policy is to classify them as a component of its provision for income taxes.

#### Income Tax Provision

Subject to the limitation under the REIT asset test rules, the Company is permitted to own up to 100% of the stock of one or more TRS. Currently, the Company owns one TRS that is taxable as a corporation and is subject to federal, state and local income tax on its net income at the applicable corporate rates. The TRS, which was formed in Delaware on July 28, 2014, is a limited liability company and a wholly-owned subsidiary of the Company. For the years ended December 31, 2017 and December 31, 2016, the Company recorded a federal and state tax provision of approximately \$3.5 million and approximately \$3.2 million, respectively. In addition, on completion and filing of its 2015 federal and state tax returns in September 2016 for the TRS, the Company incurred an additional tax liability of approximately \$2.0 million due to changes in the estimated taxable income from certain investments, which is recorded in "Income tax provision (benefit)" in the Consolidated Statements of Operations for the year ended December 31, 2016.

The following table summarizes the Company's income tax provision for the years ended December 31, 2017 and December 31, 2016 (dollars in thousands):

	For the year ended December 31, 2017	For the year ended December 31, 2016
Current tax provision (benefit)		
Federal	\$ 4,076	\$ 2,365
State	(267 )	672
Interest and Penalties	—	119
Total Current Provision for Income taxes, net	3,809	3,156
Deferred Provision (Benefit) for Income Taxes		
Federal	85	—
State	(407 )	—
Total Deferred Benefit for Income Taxes, net	(322 )	—
Total Income Tax Provision, net	\$ 3,487	\$ 3,156

#### Deferred Tax Asset and Deferred Tax Liability

As of December 31, 2017, the Company recorded a deferred tax asset of approximately \$6.1 million relating to capital loss carryforward and temporary differences as a result of the timing of income recognition of certain investments held in the TRS. The capital loss carryforwards and temporary differences may only be recognized to the extent of capital gains. There is uncertainty as to the TRS ability to recognize capital gains in the future. As a result, the Company has concluded it is more likely than not the deferred tax asset will not be realized and has recorded a full valuation allowance.

In addition, the REIT generated net operating losses related to its swap terminations and for the California return a portion of the NOL's is apportioned to the TRS. The Company recorded a deferred state tax asset of \$8.8 million in the REIT and \$765 thousand in the TRS. The TRS can carryback the NOL's to each of the two preceding years and receive a refund for taxes paid. As a result, the Company has concluded it is more likely than not the deferred tax asset will not be realized with the exception of the TRS carryback to 2015 and has recorded a combined valuation allowance of \$9.2 million. The Company also recorded a deferred federal tax liability of \$85 thousand in anticipation of the receipt of the state tax refund as a result of the carryback of the California NOL.

The following tables disclose the components of the Company's deferred tax asset and deferred tax liability at December 31, 2017 and 2016 (dollars in thousands):

	December 31, 2017	December 31, 2016
Deferred Tax Asset		
Net operating loss available for carry-back and carry-forward	\$ 9,604	\$ —
Net capital loss carry-forward	4,158	1,981
Investments	1,948	4,504
Deferred tax asset	15,710	6,485
Allowance	(15,303 )	(6,485 )
Net deferred tax asset	\$ 407	\$ —

	December 31, 2017	December 31, 2016
Deferred Tax Liability		

Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-K

Net operating loss available for carry-back and carry-forward	\$ 85	\$	—
Net deferred tax liability	\$ 85	\$	—

131

---

## Reconciliation of Tax Rate to Effective Tax Rate

The Company's effective tax rate differs from its combined federal and state income tax rate primarily due to the deduction of dividends distributions to be paid under Code Section 857(a). The reconciliation of these rates are as follows:

	For the		For the	
	year ended		year ended	
	December		December	
	31, 2017		31, 2016	
Federal statutory rate	34.3	%	34.0	%
State statutory rate, net of federal benefit	(1.3)	)%	3.0	%
Other	(1.0)	)%	(9.5)	)%
Change in valuation allowance	0.8	%	(15.4)	)%
Effect of statutory rate changes	2.9	%	—	%
REIT earnings not subject to corporate taxes	(31.8)	)%	(26.5)	)%
Effective Tax Rate	3.9	%	(14.4)	)%

## Excise Tax

For the years ended December 31, 2017 and December 31, 2016, the Company recorded excise tax expense of \$0 and \$339 thousand, respectively. Excise tax represents a four percent tax on the required amount of the Company's ordinary income and net capital gains not distributed during the year. The expense is calculated in accordance with applicable tax regulations.

## Tax Cuts and Jobs Act

On December 15, 2017, a House of Representatives and Senate Conference Committee released a unified version of the Tax Cuts and Jobs Act (the "TCJA"). This followed passage of the Tax Cuts and Jobs Act by the House of Representatives on November 16, 2017, and by the Senate on December 2, 2017. The Tax Cuts and Jobs Act would reform the individual income tax code by lowering tax rates on wages, investment, and business income; broadening the tax base; and simplifying the tax code. The plan would lower the corporate income tax rate to 21 percent. In addition, the alternative minimum tax was repealed net operating loss are limited to 80% of taxable income and a real estate business is not subject to the interest expense limitation upon making an irrevocable exemption election. The Company has made its best estimate on how TCJA will impact its existing deferred tax balances.

## Note 14—Contingencies

From time to time, the Company may become involved in various claims and legal actions arising in the ordinary course of business. Management is not aware of any material contingencies at December 31, 2017.

## Note 15—Summarized Quarterly Results (unaudited)

The following is a presentation of selected unaudited results of operations:

	Quarter Ended			
	March 31, 2017	June 30, 2017	September 30, 2017	December 31, 2017
Net Interest Income				
Interest income	\$28,430	\$30,055	\$ 30,928	\$ 34,878
Interest expense	8,737	10,407	12,363	16,866
Net Interest Income	19,693	19,648	18,565	18,012
Other Income (Loss)				
Realized gain (loss) on sale of investments, net	21,258	(2,488 )	1,830	(2 )
Other than temporary impairment	(6,097 )	(6,579 )	(7,225 )	(2,972 )
Unrealized gain (loss), net	(5,140 )	35,017	5,249	(6,730 )
Gain (loss) on derivative instruments, net	(4,697 )	(18,555 )	7,217	19,327
Other, net	403	222	216	190
Other Income (Loss)	5,727	7,617	7,287	9,813
Expenses				
Management fee to affiliate	2,476	1,830	1,853	1,941
Other operating expenses	417	736	702	564
General and administrative expenses:				
Compensation expense	740	664	660	628
Professional fees	888	832	781	741
Other general and administrative expenses	345	404	244	332
Total general and administrative expenses	1,973	1,900	1,685	1,701
Total Expenses	4,866	4,466	4,240	4,206
Income (loss) before income taxes	20,554	22,799	21,612	23,619
Income tax provision (benefit)	312	2,115	(1,155 )	2,215
Net income (loss)	\$20,242	\$20,684	\$ 22,767	\$ 21,404
Net income (loss) per Common Share—Basic	\$0.48	\$0.49	\$ 0.54	\$ 0.51
Net income (loss) per Common Share—Diluted	\$0.48	\$0.49	\$ 0.54	\$ 0.51



	Quarter Ended			
	March 31, 2016	June 30, 2016	September 30, 2016	December 31, 2016
Net Interest Income:				
Interest income	\$29,618	\$29,220	\$ 29,154	\$ 35,764
Interest expense	7,979	7,727	7,685	9,039
Net Interest Income	21,639	21,493	21,469	26,725
Other Income (Loss):				
Realized gain (loss) on sale of investments, net	(6,055 )	(352 )	1,439	(17,023 )
Other than temporary impairment	(10,797 )	(6,356 )	(4,978 )	(10,155 )
Unrealized gain (loss), net	10,769	21,510	15,292	(64,678 )
Gain (loss) on derivative instruments, net	(45,170 )	(14,165 )	6,121	32,479
Other, net	(332 )	234	(60 )	338
Other Income (Loss)	(51,585 )	871	17,814	(59,039 )
Expenses:				
Management fee to affiliate	2,753	2,588	2,604	2,503
Other operating expenses	438	183	188	236
General and administrative expenses:				
Compensation expense	737	649	868	768
Professional fees	2,002	1,222	723	867
Other general and administrative expenses	428	419	379	691
Total general and administrative expenses	3,167	2,290	1,970	2,326
Total Expenses	6,358	5,061	4,762	5,065
Income (loss) before income taxes	(36,304 )	17,303	34,521	(37,379 )
Income tax provision (benefit)	—	—	2,239	917
Net income (loss)	\$(36,304)	\$17,303	\$ 32,282	\$( 38,296 )
Net income (loss) per Common Share—Basic	\$(0.88 )	\$0.41	\$ 0.77	\$( 0.92 )
Net income (loss) per Common Share—Diluted	\$(0.88 )	\$0.41	\$ 0.77	\$( 0.92 )

Western Asset Mortgage Capital Corporation and Subsidiary

Schedule IV

Mortgage Loans on Real Estate

As of December 31, 2017

\$ in thousands Asset Type	Description	Number of Loans	Interest Rate	Maturity Date	Periodic Payment Terms <sup>(1)</sup>	Face Prior Liens of Mortgages	Carrying Amount of Mortgages	Principal Amount of Loans Subject to Delinquent Principal or Interest
Adjustable Rate Residential Mortgage Loan Held in Securitization Trusts	Original Loan Balance \$0 - \$249,999	152	Hybrid ARM 3.9% to 5.8%	11/1/2041 to 12/1/2047	P&I	\$ — \$ 22,929	\$ 23,457	\$ —
Adjustable Rate Residential Mortgage Loan Held in Securitization Trusts	Original Loan Balance \$250,000 - \$499,999	303	Hybrid ARM 3.9% to 5.9%	1/1/2042 to 12/1/2047	P&I	— 98,802	100,973	—
Adjustable Rate Residential Mortgage Loan Held in Securitization Trusts	Original Loan Balance \$500,000 - \$749,999	76	Hybrid ARM 3.9% to 5.6%	2/1/2042 to 12/1/2047	P&I	— 42,406	43,278	579
Adjustable Rate Residential Mortgage Loan Held in Securitization Trusts	Original Loan Balance \$750,000 - \$999,999	29	Hybrid ARM 3.9% to 5.5%	9/1/2042 to 11/1/2047	P&I	— 23,342	22,697	—
Adjustable Rate Residential Mortgage Loan Held in Securitization Trusts	Original Loan Balance \$1,000,000 - \$1,249,999	11	Hybrid ARM 4.4% to 5.9%	5/1/2043 to 11/1/2047	P&I	— 11,125	12,457	—
Adjustable Rate Residential Mortgage Loan Held in Securitization Trusts	Original Loan Balance \$1,250,000 - \$1,499,999	5	Hybrid ARM 4.0% to 4.9%	12/1/2041 to 8/1/2043	P&I	— 6,534	6,669	—
Adjustable Rate Residential Mortgage Loan Held in Securitization Trusts	Original Loan Balance \$1,500,000 and above	8	Hybrid ARM 4.3% to 5.3%	2/1/2042 to 12/1/2047	P&I	— 13,987	14,355	—
Variable Rate Residential Mortgage Loan	Original Loan Balance \$0 - \$249,999	7	Variable 4.5% to 4.7%	2/1/2044 to 6/1/2044	P&I	— 1,198	1,229	—

Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-K

Held in Securitization Trusts									
Variable Rate Residential Mortgage Loan Held in Securitization Trusts	Original Loan Balance \$250,000 - \$499,999	6	Variable 4.4% to 4.7%	4/1/2044 to 6/1/2044	P&I	—	2,124	2,185	—
Variable Rate Residential Mortgage Loan Held in Securitization Trusts	Original Loan Balance \$500,000 - \$749,999	2	Variable 4.4% to 4.7%	4/1/2044 to 5/1/2044	P&I	—	993	1,022	—
Variable Rate Residential Mortgage Loan Held in Securitization Trusts	Original Loan Balance \$1,250,000 - \$1,499,999	3	Variable 4.5% to 4.7%	2/1/2044 to 5/1/2044	P&I	—	2,634	2,700	—
Variable Rate Residential Mortgage Loan Held in Securitization Trusts	Original Loan Balance \$1,500,000 and above	1	Variable 4.4%	4/1/2044	P&I	—	1,400	1,432	—
Fixed Rate Residential Mortgage Loan Held in Securitization Trusts	Original Loan Balance \$0 - \$249,999	5	Fixed 4.9% to 6.8%	9/1/2026 to 12/1/2047	P&I	—	624	647	—

\$ in thousands Asset Type	Description	Number of Loans	Interest Rate	Maturity Date	Periodic Payment Terms <sup>(1)</sup>	Face Prior Amount Lien of Mortgages	Carrying Amount of Mortgages	Principal Amount of Loans Subject to Delinquent Principal or Interest
Fixed Rate Residential Mortgage Loan Held in Securitization Trusts	Original Loan Balance \$250,000 - \$499,999	3	Fixed 5.0% to 5.9%	9/1/2026 to 11/1/2041	P&I	— 659	683	—
Fixed Rate Residential Mortgage Loan Held in Securitization Trusts	Original Loan Balance \$500,000 - \$749,999	3	Fixed 5.4% to 5.5%	8/1/2034 to 12/1/2047	P&I	— 1,529	1,577	—
Fixed Rate Residential Mortgage Loan Held in Securitization Trusts	Original Loan Balance \$1,000,000 - \$1,249,999	1	Fixed 6.3%	4/1/2040	P&I	— 970	1,007	—
Fixed Rate Residential Mortgage Loan Held in Securitization Trusts	Original Loan Balance \$1,250,000 - \$1,499,999	1	Fixed 6.3%	2/1/2036	P&I	— 1,014	1,055	—
Fixed Rate Residential Bridge Loans Held in Securitization Trusts	Original Loan Balance \$0 - \$249,999	200	Fixed 5.8% to 18.0%	December 1, 2017	Interest Only <sup>(3)</sup>	— 30,624	30,960	1,042
Fixed Rate Residential Bridge Loans Held in Securitization Trusts	Original Loan Balance \$250,000 - \$499,999	76	Fixed 5.8% to 18.0%	September 1, 2017	Interest Only <sup>(3)</sup>	— 26,024	26,275	728
Fixed Rate Residential Bridge Loans Held in Securitization	Original Loan Balance \$500,000 - \$749,999	35	Fixed 6.0% to 11.0%	January 1, 2018	Interest Only <sup>(3)</sup>	— 20,714	20,819	—

Edgar Filing: Western Asset Mortgage Capital Corp - Form 10-K

Trusts									
Fixed Rate Residential Bridge Loans Held in Securitization Trusts	Original Loan Balance		Fixed	January 1, 2018	Interest Only <sup>(3)</sup>	—	18,351	18,431	—
	\$750,000 - \$999,999	21	5.8% to 11.3%						
Fixed Rate Residential Bridge Loans Held in Securitization Trusts	Original Loan Balance		Fixed	June 1, 2018	Interest Only <sup>(3)</sup>	—	4,875	4,882	—
	\$1,000,000 - \$1,249,999	6	9.0% to 11.0%						
Fixed Rate Residential Bridge Loans Held in Securitization Trusts	Original Loan Balance		Fixed	January 1, 2018	Interest Only <sup>(3)</sup>	—	5,280	5,306	—
	\$1,500,000 and above	2	8.0% to 10.0%						
Commercial Mezzanine Loan Held in Securitization Trust	Original Loan Balance		Fixed	7/6/2020	P&I <sup>(2)</sup>	—	24,846	24,876	—
	\$25,000,000	1	9.0%						
						\$	-\$362,984	\$368,972	\$2,349

(1) Principal and interest ("P&I")

(2) Interest only payments for initial 2 years. After 2 years, monthly P&I payments are based on a 30 years amortization schedule and a balloon payment is due on the maturity date.

(3) Residential Bridge Loans are mainly interest only loans with a balloon payment at maturity.

Reconciliation of Carrying Value of Mortgage Loans on Real Estate:

	2017	2016	2015
Beginning balance	\$216,361	\$243,538	\$7,220
Additions during period:			
New mortgage loans	232,545	29,399	262,949
Unrealized gains	3,167	1,187	3,631
Deductions during period:			
Collections of principal	80,550	53,714	29,105
Amortization of premium and (discounts)	1,470	2,044	1,074
Unrealized losses	1,081	2,005	83
Balance at end of period	\$368,972	\$216,361	\$243,538

137

---

ITEM 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None.

ITEM 9A. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) that are designed to provide reasonable assurance that information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our Chief Executive Officer and Chief Financial Officer as appropriate to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, we recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and therefore we are required to apply judgment in evaluating the cost-benefit relationship of possible controls and procedures.

The Company's Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level as of December 31, 2017.

(b) Management's Report on Internal Control over Financial Reporting

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rules 13a-15(f) and 15d-15(f) promulgated under the Exchange Act as a process designed by, or under the supervision of, the Company's Chief Executive Officer and Chief Financial Officer and effected by the Company's Board of Directors, management and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles, and includes those policies and procedures that:

pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company;

provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and

provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risks that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

Management of the Company has assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2017. In making its assessment of internal control over financial reporting, management used the criteria described in "Internal Control—Integrated Framework" (2013 framework) issued by the Committee of Sponsoring Organizations of the Treadway Commission, ("COSO"). Based on this evaluation, management concluded that the Company's internal control over financial reporting was effective as of December 31, 2017 based on criteria in "Internal Control—Integrated Framework" (2013 framework) issued by the COSO.

The effectiveness of the Company's internal control over financial reporting as of December 31, 2017 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which appears herein.

(c) Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting during the three months ended December 31, 2017, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

138

---



ITEM 9B. Other Information

None.

PART III

ITEM 10. Directors, Executive Officers and Corporate Governance

The information regarding the Company's directors, executive officers and certain other matters required by Item 401 of Regulation S-K is incorporated herein by reference to the Company's proxy statement relating to its annual meeting of stockholders to be held on or about June 1, 2017 (the "Proxy Statement"), to be filed with the SEC within 120 days after December 31, 2017.

The information regarding compliance with Section 16(a) of the Exchange Act required by Item 405 of Regulation S-K is incorporated herein by reference to the Proxy Statement to be filed with the SEC within 120 days after December 31, 2017.

The information regarding the Company's Code of Business Conduct and Ethics required by Item 406 of Regulation S-K is incorporated herein by reference to the Proxy Statement to be filed with the SEC within 120 days after December 31, 2017.

The information regarding certain matters pertaining to the Company's corporate governance required by Item 407(c)(3), (d)(4) and (d)(5) of Regulation S-K is incorporated by reference to the Proxy Statement to be filed with the SEC within 120 days after December 31, 2017.

ITEM 11. Executive Compensation.

The information regarding executive compensation and other compensation related matters required by Items 402 and 407(e)(4) and (e)(5) of Regulation S-K is incorporated herein by reference to the Proxy Statement to be filed with the SEC within 120 days after December 31, 2017.

ITEM 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder

The tables on equity compensation plan information and beneficial ownership of the Company required by Items 201(d) and 403 of Regulation S-K are incorporated herein by reference to the Proxy Statement to be filed with the SEC within 120 days after December 31, 2017.

ITEM 13. Certain Relationships and Related Transactions and Director Independence

The information regarding transactions with related persons, promoters and certain control persons and director independence required by Items 404 and 407(a) of Regulation S-K is incorporated herein by reference to the Proxy Statement to be filed with the SEC within 120 days after December 31, 2017.

ITEM 14. Principal Accounting Fees and Services

The information concerning principal accounting fees and services and the Audit Committee's pre-approval policies and procedures required by Item 9(e) of Schedule 14A is incorporated herein by reference to the Proxy Statement to be filed with the SEC within 120 days after December 31, 2017.

ITEM 15. Exhibits

Documents filed as part of this report:

- 1) Financial Statements

WESTERN ASSET MORTGAGE CAPITAL CORPORATION	
<u>Consolidated Balance Sheets as of December 31, 2017 and 2016</u>	<u>81</u>
<u>Consolidated Statements of Operations for the years ended December 31, 2017, December 31, 2016 and December 31, 2015</u>	<u>83</u>
<u>Consolidated Statements of Changes in Stockholders' Equity for the years ended December 31, 2017, December 31, 2016 and December 31, 2015</u>	<u>84</u>
<u>Consolidated Statements of Cash Flow for the years ended December 31, 2017, December 31, 2016 and December 31, 2015</u>	<u>85</u>
<u>Notes to Consolidated Financial Statements</u>	<u>88</u>
<u>Schedule IV—Mortgage Loans on Real Estate</u>	<u>134</u>

Financial Statements Schedules other than the one listed above are omitted because the required information is not applicable or deemed not material, or the required information is presented in the financial statements and/or in the notes to financial statements.

2) Exhibits

The following exhibits are filed as part of this report.

Exhibit No.	Description
3.1*	<u>Amended and restated certificate of incorporation of Western Asset Mortgage Capital Corporation, incorporated by reference to Exhibit 3.1 to Amendment No. 10 Form S-11 (Registration Statement No. 333-159962), filed May 8, 2012</u>
3.2*	<u>Amendment to the Amended and restated certificate of incorporation of Western Asset Mortgage Capital Corporation, dated June 3, 2016, incorporated by reference to Exhibit 3.3 to the Annual report on Form 10-K, filed March 7, 2017.</u>
3.3*	<u>Amended and restated bylaws of Western Asset Mortgage Capital Corporation, incorporated by reference to Exhibit 3.2 to Amendment No. 10 Form S-11 (Registration Statement No. 333-159962), filed May 8, 2012.</u>
4.1*	<u>Specimen Common Stock Certificate of Western Asset Mortgage Capital Corporation, incorporated by reference to Exhibit 4.1 to Amendment No. 10 Form S-11 (Registration Statement No. 333-159962), filed May 8, 2012</u>
4.2*	<u>Indenture, dated as of October 2, 2017, between Western Asset Mortgage Capital Corporation and Wells Fargo Bank, National Association, incorporated by reference to Exhibit 4.1 to the Current Report on Form 8-K, filed on October 3, 2017.</u>
4.3*	<u>First Supplemental Indenture, dated as of October 2, 2017, between Western Asset Mortgage Capital Corporation and Wells Fargo Bank, National Association, incorporated by reference to Exhibit 4.2 to the Current Report on Form 8-K, filed on October 3, 2017.</u>
4.4*	<u>Form of 6.75% Convertible Senior Notes due 2022 (attached as Exhibit A to the First Supplemental Indenture filed as Exhibit 4.3 hereto), incorporated by reference to Exhibit 4.3 to the Current Report on Form 8-K, filed on October 3, 2017.</u>
10.1*	<u>Amendment to the Management Agreement between Western Asset Mortgage Capital Corporation and Western Asset Management Company, dated August 3, 2016, incorporated by reference to Exhibit 10.1 to the Quarterly Report on Form 10-Q, filed August 5, 2016.</u>
10.2*	<u>Form of Warrant, incorporated by reference to Exhibit 10.2 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.</u>
10.3*	<u>Management Agreement, dated May 9, 2012, between Western Asset Mortgage Capital Corporation and Western Asset Management Company, incorporated by reference to Exhibit 10.4 to the Quarterly Report on Form 10-Q, filed August 14, 2012.</u>
10.4*	<u>Registration Rights Agreement, dated May 15, 2012, among Western Asset Mortgage Capital Corporation, Western Asset Management Company and certain individual holders named therein, incorporated by reference</u>

to Exhibit 10.5 to the Quarterly Report on Form 10-Q, filed August 14, 2012.

10.5\* Western Asset Mortgage Capital Corporation Equity Plan, incorporated by reference to Exhibit 10.5 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.

10.6\* Western Asset Mortgage Capital Corporation Manager Equity Plan, incorporated by reference to Exhibit 10.6 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.

140

---

Exhibit No.	Description
10.7*	<u>Form of Indemnification Agreement between Western Asset Mortgage Capital Corporation and a director, incorporated by reference to Exhibit 10.7 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.</u>
10.8*	<u>Restricted Stock Award Agreement, dated May 15, 2012, for Western Asset Management Company, incorporated by reference to Exhibit 10.9 to the Quarterly Report on Form 10-Q, filed August 14, 2012.</u>
10.9*	<u>Form of Restricted Stock Award Agreement for independent directors, incorporated by reference to Exhibit 10.2 to the Form S-8 dated May 15, 2012 (File No. 1-35543).</u>
10.10*	<u>Equity Distribution Agreement, dated March 6, 2017, among Western Asset Mortgage Capital Corporation, Western Asset Management Company and JMP Securities LLC, incorporated by reference to Exhibit 1.1 to the Current Report on Form 8-K, filed March 9, 2017.</u>
23.1	<u>Consent of Independent Registered Public Accounting Firm</u>
31.1	<u>Rule 13a-14(a) / 15d-14(a) Certification of Chief Executive Officer.</u>
31.2	<u>Rule 13a-14(a) / 15d-14(a) Certification of Chief Financial Officer.</u>
32.1	<u>Section 1350 Certifications of Chief Executive Officer and Chief Financial Officer</u>
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

\* Fully or partly previously filed.

ITEM 16. Form 10-K Summary

None.

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.

WESTERN ASSET MORTGAGE CAPITAL  
CORPORATION

/s/ Jennifer W. Murphy

By: Jennifer W. Murphy

President, Chief Executive Officer and Director

March 29, 2018

---

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

/s/ Jennifer W. Murphy

By: Jennifer W. Murphy

President, Chief Executive Officer and Director (Principal Executive Officer)

March 29, 2018

/s/ LISA MEYER

By: Lisa Meyer

Chief Financial Officer & Treasurer (Principal Financial and Accounting Officer)

March 29, 2018

/s/ JAMES W. HIRSCHMANN III

By: James W. Hirschmann III

Director

March 29, 2018

/s/ EDWARD D. FOX JR.

By: Edward D. Fox Jr.

Director

March 29, 2018

/s/ RICHARD ROLL

By: Richard Roll

Director

March 29, 2018

/s/ M. CHRISTIAN MITCHELL

By: M. Christian Mitchell

Director

March 29, 2018

/s/ RANJIT M. KRIPALANI

By: Ranjit M. Kripalani

Director

March 29, 2018

