

Western Asset Mortgage Capital Corp  
Form 10-Q  
August 07, 2018  
Table of Contents

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q  
(Mark One)

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended June 30, 2018

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 (IRS Employer  
incorporation or organization) Identification Number)

Western Asset Mortgage Capital Corporation  
385 East Colorado Boulevard  
Pasadena, California 91101  
(Address of Registrant's principal executive offices)

(626) 844-9400  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  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   
(Do not check if a smaller reporting company)

Emerging growth company

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

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 under the Securities Exchange Act of 1934). Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date.

As of August 3, 2018, there were 41,616,379 shares, par value \$0.01, of the registrant's common stock outstanding.

---

Table of Contents

TABLE OF CONTENTS

	Page
<u>Part I — FINANCIAL INFORMATION</u>	
<u>ITEM 1. Financial Statements</u>	<u>2</u>
<u>ITEM 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>49</u>
<u>ITEM 3. Quantitative and Qualitative Disclosures about Market Risk</u>	<u>91</u>
<u>ITEM 4. Controls and Procedures</u>	<u>97</u>
<u>Part II — OTHER INFORMATION</u>	
<u>ITEM 1. Legal Proceedings</u>	<u>98</u>
<u>ITEM 1A. Risk Factors</u>	<u>98</u>
<u>ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>98</u>
<u>ITEM 3. Defaults Upon Senior Securities</u>	<u>98</u>
<u>ITEM 4. Mine Safety Disclosures</u>	<u>98</u>
<u>ITEM 5. Other Information</u>	<u>98</u>
<u>ITEM 6. Exhibits</u>	<u>99</u>
<u>Signatures</u>	<u>101</u>

---

Table of Contents

## Part I

## ITEM I. Financial Statements

## Western Asset Mortgage Capital Corporation and Subsidiaries

## Consolidated Balance Sheets

(in thousands—except share and per share data)

(Unaudited)

	June 30, 2018	December 31, 2017
Assets:		
Cash and cash equivalents	\$ 16,295	\$ 48,024
Restricted cash	58,747	—
Agency mortgage-backed securities, at fair value (\$2,440,683 and \$2,833,595 pledged as collateral, at fair value, respectively)	2,495,161	2,858,600
Non-Agency mortgage-backed securities, at fair value (\$432,352 and \$266,189 pledged as collateral, at fair value, respectively)	432,596	378,158
Other securities, at fair value (\$107,864 and \$89,823 pledged as collateral, at fair value, respectively)	108,001	122,065
Residential Whole-Loans, at fair value (\$335,149 and \$237,423 pledged as collateral, at fair value, respectively)	335,149	237,423
Residential Bridge Loans (\$236,359 and \$64,526 at fair value and \$259,339 and \$106,673 pledged as collateral, respectively)	259,339	106,673
Securitized commercial loans, at fair value	1,309,195	24,876
Commercial Loans, at fair value (\$20,515 and \$0 pledged as collateral, at fair value, respectively)	70,717	—
Investment related receivable	37,286	7,665
Interest receivable	19,487	13,603
Due from counterparties	64,791	86,930
Derivative assets, at fair value	6,998	728
Other assets	3,571	2,161
Total Assets <sup>(1)</sup>	\$5,217,333	\$ 3,886,906
Liabilities and Stockholders' Equity:		
Liabilities:		
Repurchase agreements, net	\$3,267,369	\$ 3,251,686
Convertible senior unsecured notes, net	109,401	108,743
Securitized debt, at fair value (includes \$348,799 and \$10,945 held by affiliates, respectively)	1,231,300	10,945
Interest payable (includes \$976 and \$70 on securitized debt held by affiliates, respectively)	10,309	8,322
Investment related payables	52,530	17,217
Due to counterparties	5,208	1,490
Derivative liability, at fair value	1,623	4,346
Accounts payable and accrued expenses	2,531	3,118
Payable to affiliate	3,062	2,041
Dividend payable	12,901	12,960
Other liabilities	59,308	—
Total Liabilities <sup>(2)</sup>	4,755,542	3,420,868
Commitments and contingencies		

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

Stockholders' Equity:

Common stock: \$0.01 par value, 500,000,000 shares authorized, 41,616,379 and 41,794,079 outstanding, respectively	419	419
Preferred stock, \$0.01 par value, 100,000,000 shares authorized and no shares outstanding	—	—
Treasury stock, at cost, 303,422 and 125,722 shares held, respectively	(2,965 )	(1,232 )
Additional paid-in capital	768,945	768,763
Retained earnings (accumulated deficit)	(304,608 )	(301,912 )
Total Stockholders' Equity	461,791	466,038
Total Liabilities and Stockholders' Equity	\$5,217,333	\$ 3,886,906

See notes to unaudited consolidated financial statements.

Western Asset Mortgage Capital Corporation and Subsidiaries

Consolidated Balance Sheets (Continued)

(in thousands—except share and per share data)

(Unaudited)

	June 30, 2018	December 31, 2017
(1) Assets of consolidated VIEs included in the total assets above:		
Cash and cash equivalents	\$364	\$ —
Restricted cash	58,747	—
Residential Whole-Loans, at fair value (\$335,149 and \$237,423 pledged as collateral, at fair value, respectively)	335,149	237,423
Residential Bridge Loans (\$236,359 and \$64,526 at fair value and \$259,339 and \$106,673 pledged as collateral, respectively)	259,339	106,673
Securitized commercial loans, at fair value	1,309,195	24,876
Commercial Loans, at fair value (\$20,515 and \$0 pledged as collateral, at fair value, respectively)	20,515	—
Investment related receivable	37,286	7,665
Interest receivable	9,794	3,358
Other assets	548	—
Total assets of consolidated VIEs	\$2,030,937	\$ 379,995

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

Securitized debt, at fair value (includes \$348,799 and \$10,945 held by affiliates, respectively)	\$1,231,300	\$ 10,945
Interest payable (includes \$976 and \$70 on securitized debt held by affiliates, respectively)	2,687	70
Accounts payable and accrued expenses	678	189
Other liabilities	59,309	—
Total liabilities of consolidated VIEs	\$1,293,974	\$ 11,204

See notes to unaudited consolidated financial statements.

Table of Contents

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

	For the three months ended June 30, 2018	For the three months ended June 30, 2017	Six Months Ended June 30, 2018	Six Months Ended June 30, 2017
Net Interest Income				
Interest income	\$57,154	\$30,055	\$96,881	\$58,485
Interest expense (includes \$4,719, \$248, \$5,207 and \$494 on securitized debt held by affiliates, respectively)	38,134	10,407	58,831	19,144
Net Interest Income	19,020	19,648	38,050	39,341
Other Income (Loss)				
Realized gain (loss) on sale of investments, net	(5,608 )	(2,488 )	(5,033 )	18,770
Other than temporary impairment	(2,974 )	(6,579 )	(5,890 )	(12,676 )
Unrealized gain (loss), net	(31,693 )	35,017	(100,654)	29,877
Gain (loss) on derivative instruments, net	28,490	(18,555 )	108,072	(23,252 )
Other, net	(145 )	222	(98 )	625
Other Income (Loss)	(11,930 )	7,617	(3,603 )	13,344
Expenses				
Management fee to affiliate	2,259	1,830	4,439	4,306
Other operating expenses	1,555	736	2,524	1,153
General and administrative expenses:				
Compensation expense	572	664	1,082	1,404
Professional fees	818	832	2,113	1,720
Other general and administrative expenses	397	404	758	749
Total general and administrative expenses	1,787	1,900	3,953	3,873
Total Expenses	5,601	4,466	10,916	9,332
Income before income taxes	1,489	22,799	23,531	43,353
Income tax provision	36	2,115	349	2,427
Net income	\$1,453	\$20,684	\$23,182	\$40,926
Net income per Common Share — Basic	\$0.03	\$0.49	\$0.55	\$0.97
Net income per Common Share — Diluted	\$0.03	\$0.49	\$0.55	\$0.97
Dividends Declared per Share of Common Stock	\$0.31	\$0.31	\$0.62	\$0.62

See notes to unaudited consolidated financial statements.

Table of Contents

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

	Common Stock		Additional Paid-In Capital	Retained	Treasury	Total
	Outstanding Shares	Par		Earnings (Accumulated Deficit)	Stock	
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	—	—	—	85,097	—	85,097
Dividends declared 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
Vesting of restricted stock	—	—	125	—	—	125
Treasury stock	(177,700 )	—	—	—	(1,733 )	(1,733 )
Net income	—	—	—	23,182	—	23,182
Dividends declared on common stock	—	—	57	(25,878 )	—	(25,821 )
Balance at June 30, 2018	41,616,379	\$419	\$ 768,945	\$ (304,608 )	\$(2,965)	\$461,791

See notes to unaudited consolidated financial statements.

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

	For the six months ended June 30, 2018	For the six months ended June 30, 2017
Cash flows from operating activities:		
Net income	\$ 23,182	\$ 40,926
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Premium amortization and (discount accretion), net	277	(2,044 )
Interest income earned added to principal of securities	—	(46 )
Amortization of deferred financing costs	384	—
Amortization of discount on convertible senior notes	275	—
Restricted stock amortization	125	577
Interest payments and basis recovered on MAC interest rate swaps	293	258
Premium on purchase of Residential Whole-Loans	(2,677 )	(354 )
Premium on purchase of Residential Bridge Loans	(2,196 )	(425 )
Premium on purchase of securitized commercial loans	(3,019 )	—
Unrealized (gain) loss, net	100,654	(29,877 )
Unrealized (gain) loss on derivative instruments, net	(5,576 )	(156,696 )
Other than temporary impairment	5,890	12,676
Realized (gain) loss on sale of securities, net	5,033	(18,770 )
(Gain) loss on derivatives, net	(7,769 )	156,245
Loss on foreign currency transactions, net	—	2
Changes in operating assets and liabilities:		
(Increase) decrease in interest receivable	(5,884 )	7,006
Increase in other assets	(1,267 )	(695 )
Increase (decrease) in interest payable	1,987	(10,596 )
Decrease in accounts payable and accrued expenses	(587 )	(447 )
Increase (decrease) in payable to affiliate	1,021	(671 )
Net cash provided by (used in) operating activities	110,146	(2,931 )
Cash flows from investing activities:		
Purchase of securities	(235,043 )	(1,656,239 )
Proceeds from sale of securities	416,869	962,404
Principal repayments and basis recovered on securities	67,259	140,813
Purchase of Residential Whole-Loans	(124,225 )	(35,317 )
Principal repayments on Residential Whole-Loans	23,871	24,000
Purchase of Commercial Loans	(70,257 )	—
Purchase of securitized commercial loans	(1,350,000 )	—
Principal repayments on securitized commercial loans	78,907	—
Purchase of Residential Bridge Loans	(276,173 )	(73,565 )
Principal repayments on Residential Bridge Loans	98,528	8,160
Payment of premium for option derivatives	(467 )	(4,786 )
Premium received from option derivatives	298	3,750
Premium received from credit default swaps	(174 )	—
Net settlements of TBAs	134	2,558



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

Proceeds from (Payments on) termination of futures, net	4,591	(9,153 )
Interest payments and basis recovered on MAC interest rate swaps	(293 )	(258 )
Due from counterparties	—	4,124
Payments on total return swaps, net	—	(500 )
Premium for interest rate swaptions, net	—	(115 )
Net cash used in investing activities	(1,366,175	(634,124 )

Cash flows from financing activities:

5

---

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

	For the six months ended June 30, 2018	For the six months ended June 30, 2017
Repurchase of common stock	(1,733 )	—
Proceeds from repurchase agreement borrowings	9,929,408	7,464,705
Repayments of repurchase agreement borrowings	(9,913,725)	(6,818,742)
Proceeds from securitized debt	1,285,219	—
Repayments of securitized debt	(74,845 )	—
Proceeds from forward contracts	—	5,407
Repayments of forward contracts	—	(5,427 )
Due from counterparties, net	22,139	10,647
Due to counterparties, net	3,718	1,445
Increase in other liabilities	58,746	—
Dividends paid on common stock	(25,880 )	(25,991 )
Net cash provided by financing activities	1,283,047	632,044
Effect of exchange rate changes on cash and cash equivalents	—	(2 )
Net increase (decrease) in cash, cash equivalents and restricted cash	27,018	(5,013 )
Cash, cash equivalents and restricted cash, beginning of period	48,024	46,172
Cash, cash equivalents and restricted cash, end of period	\$75,042	\$41,159
Supplemental disclosure of operating cash flow information:		
Interest paid	\$56,935	\$16,902
Income taxes paid	\$1,635	\$2,380
Supplemental disclosure of non-cash financing/investing activities:		
Principal payments of securities, not settled	\$—	\$16
Securities sold, not settled	\$—	\$209,310
Securities purchased, not settled	\$(52,530 )	\$—
Dividends and distributions declared, not paid	\$12,901	\$12,995
Principal payments of Residential Whole-Loans, not settled	\$5,845	\$1,598
Principal payments of Residential Bridge Loans, not settled	\$31,441	\$809
Derivative collateral offset against derivatives	\$—	\$(157,913)
Other assets	\$143	\$—
See notes to unaudited consolidated financial statements.		

## Table of Contents

Western Asset Mortgage Capital Corporation and Subsidiaries  
Notes to Consolidated Financial Statements (Unaudited)  
(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; and references to “Residential Whole-Loans”, “Residential Bridge Loans” and “Commercial Loans” (collectively “Whole-Loans”) refer to individual mortgage loans secured by single family, multifamily and commercial properties.

### Note 1 — Organization

Western Asset Mortgage Capital Corporation, a Delaware corporation, and its subsidiaries (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, Residential Whole Loans, Residential Bridge Loans and Commercial 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 accompanying unaudited financial statements and related notes have been prepared in conformity with generally accepted accounting principles in the United States of America (“GAAP”) for interim financial reporting in accordance with Article 10 of Regulation S-X and the instructions to Form 10-Q. Certain prior period amounts have been reclassified to conform to the current period’s presentation. In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary have been made to state fairly the Company’s financial position, results of operations and cash flows. The results of operations for the period ended June 30, 2018, are not necessarily

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

indicative of the results to be expected for the full year or any future period. These consolidated financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2017, filed with the SEC on March 29, 2018.

The consolidated financial statements include the accounts of the Company, its wholly-owned subsidiary and variable interest entities ("VIEs") in which it is considered the primary beneficiary. All intercompany amounts between the Company and its subsidiary and consolidated VIEs have been eliminated in consolidation.

## Table of Contents

### 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 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 where the Company and its related parties have variable interests in a VIE, 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 as a whole meets these two criteria, the determination of primary beneficiary within the related party group requires significant judgment. The analysis is based upon qualitative as well as quantitative factors, such as the relationship of the VIE to each of the members of the related-party group, as well as the significance of the VIE's activities to those members, with the objective of determining which party is most closely associated with the VIE.

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.

### Significant Accounting Policies

There have been no changes to our accounting policies included in Note 2 to the consolidated financial statements of our Annual Report on Form 10-K for the year ended December 31, 2017, other than the significant accounting policies disclosed below.

Restricted Cash

Restricted cash represents cash held by the trustee or servicer for mortgage escrows in connection with the Company's securitized loan and commercial loan investments held in two consolidated VIEs. These escrows consist of principal and interest escrows, capital improvement reserves, repair reserves, real estate tax and insurance reserves and tenant reserves. The corresponding liability is recorded in "Other liabilities" in the Consolidated Balance Sheets. The restricted cash is not available for general corporate use.

## Table of Contents

### Securitized Commercial Loans

Securitized commercial loans are comprised of commercial loans of consolidated variable interest entities which were sponsored by third parties. These 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. Accordingly, these loans are recorded at fair value with periodic changes in fair value being recorded in earnings as a component of "Unrealized gain (loss), net".

The securitized commercial loans are typically collateralized by commercial real estate. As a result, the Company regularly evaluates the extent and impact of any credit migration associated with the performance and/or value of the underlying collateral property as well as the financial and operating capability of the borrower on a loan by loan basis. On a quarterly basis, the Company evaluates 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 the Company 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 the Company has 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. Interest income accrual is resumed when the loan becomes contractually current and performance is demonstrated. A loan is written off when it is no longer realizable and/or legally discharged.

### Commercial Loans

Investments in Commercial Loans, which are comprised of commercial mortgage loans and commercial mezzanine 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 its Commercial Loan portfolio. Accordingly, these loans are recorded at fair value with periodic changes in fair value being recorded in earnings as a component of "Unrealized gain (loss), net". All other costs incurred in connection with acquiring the Commercial Loans or committing to purchase these loans are charged to expense as incurred.

The Company's loans are typically collateralized by commercial real estate. As a result, the Company regularly evaluates the extent and impact of any credit migration associated with the performance and or value of the underlying collateral property as well as the financial and operating capability of the borrower on a loan by loan basis. On a quarterly basis, the Company evaluates 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 the Company 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 the Company has 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. Interest income accrual is resumed when the loan becomes contractually current and performance is demonstrated. A loan is written off when it is no longer realizable and/or legally discharged.

Interest Income Recognition

Loan Portfolio

Interest income on the Company's residential loan portfolio and commercial loan portfolio is recorded 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.



Table of Contents

## Recently adopted accounting pronouncements

Description	Adoption Date	Effect on Financial Statements
<p>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).</p>	First quarter 2018.	<p>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 did not have a material impact on the Company's consolidated financial statements.</p>
<p>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. In February 2018, the FASB issued a separate Update for technical corrections and improvements related to the ASU 2016-01 to increase stakeholders' awareness of the amendments and to expedite the improvements (ASU 2018-3).</p>	First quarter 2018.	<p>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 did not have a material impact on the Company's consolidated financial statements.</p>
<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>	First quarter 2018 and requires retrospective adoption.	<p>The adoption of this standard did not have a material impact on its Consolidated Statements 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</p>	First quarter 2018 and requires retrospective adoption.	<p>The adoption of this standard did not have a material impact on its Consolidated Statements of Cash Flows.</p>

nature of the restrictions on its cash and cash equivalents.

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.

First quarter 2018. The guidance should be applied prospectively on or after the effective date.

The adoption of this standard did not have a material impact on its Consolidated Statements of Cash Flows.

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 share-based payment award require an entity to apply modification accounting in Topic 718.

First quarter 2018.

There are no changes to the terms and conditions of the Company's share-based compensation. The adoption of this standard did not have a material impact on the Company's consolidated financial statements.

Table of Contents

## Recently issued accounting pronouncements

Description	Effective Date	Effect on Financial Statements
<p>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.</p>	First quarter 2020.	<p>The Company is currently evaluating the impact the standard may have on its consolidated financial statements when adopted.</p>
<p>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.</p>	First quarter 2019.	<p>The Company is evaluating the impact this standard may have on its consolidated financial statements.</p>
<p>In June 2018, the FASB issued ASU 2018-07, "Compensation-Stock Compensation (Topic 718), Improvements to Nonemployee Share-Based Payment Accounting." The amendments in this update expand the scope of Topic 718 to include share-based payment transactions for acquiring goods and services from nonemployees.</p>	First quarter 2019.	<p>The Company is evaluating the impact this standard may have on its consolidated financial statements.</p>
<p>In July 2018, the FASB issued ASU 2018-09, "Codification Improvements." The amendments in this update affect a wide variety of Topics in the Codification including derivatives and hedging, stock compensation-income taxes, distinguishing liabilities from equity, debt modification and extinguishment, reporting comprehensive income, business combinations-income taxes, financial services and Plan accounting.</p>	First quarter 2019.	<p>The Company is evaluating the impact this standard may have on its consolidated</p>

financial  
statements.

Table of Contents

## Note 3 — Fair Value of Financial Instruments

The following tables present the Company's financial instruments carried at fair value as of June 30, 2018 and December 31, 2017, based upon the valuation hierarchy (dollars in thousands):

	June 30, 2018			Total
	Fair Value			
	Level I	Level II	Level III	
<b>Assets</b>				
Agency RMBS	\$—	\$402,853	\$—	\$402,853
Agency RMBS Interest-Only Strips	—	—	13,559	13,559
Agency RMBS Interest-Only Strips accounted for as derivatives, included in MBS	—	—	9,247	9,247
Agency CMBS	—	2,012,342	52,237	2,064,579
Agency CMBS Interest-Only Strips accounted for as derivatives, included in MBS	—	4,923	—	4,923
Subtotal Agency MBS	—	2,420,118	75,043	2,495,161
<b>Non-Agency RMBS</b>				
Non-Agency RMBS	—	84,896	13	84,909
Non-Agency RMBS Interest-Only Strips	—	—	16,294	16,294
Non-Agency CMBS	—	331,393	—	331,393
Subtotal Non-Agency MBS	—	416,289	16,307	432,596
<b>Other securities</b>				
Total mortgage-backed securities and other securities	—	99,046	8,955	108,001
	—	2,935,453	100,305	3,035,758
<b>Residential Whole-Loans</b>				
Residential Whole-Loans	—	—	335,149	335,149
Residential Bridge Loans	—	—	236,359	236,359
Securitized commercial loans	—	—	1,309,195	1,309,195
Commercial Loans	—	—	70,717	70,717
Derivative assets	3,723	3,275	—	6,998
Total Assets	\$3,723	\$2,938,728	\$2,051,725	\$4,994,176
<b>Liabilities</b>				
Derivative liabilities	\$26	\$1,597	\$—	\$1,623
Securitized debt	—	1,228,430	2,870	1,231,300
Total Liabilities	\$26	\$1,230,027	\$2,870	\$1,232,923

Table of Contents

	December 31, 2017			
	Fair Value			Total
	Level I	Level II	Level III	
<b>Assets</b>				
Agency RMBS	\$—	\$672,177	\$—	\$672,177
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
<b>Liabilities</b>				
Derivative liabilities	\$50	\$4,296	\$—	\$4,346
Securitized debt	—	—	10,945	10,945
Total Liabilities	\$50	\$4,296	\$10,945	\$15,291

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.

In instances when the Company is required to consolidate a VIE that is determined to be a qualifying collateralized financing entity ("CFE"), 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.

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

13

---

## Table of Contents

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 loan valuation, utilizing a valuation model that is calibrated to recent loan trade execution. 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.

### Commercial Loans

Values for the Company's Commercial Loans are based upon either prices obtained from an independent third party pricing service that specializes in loan valuation, utilizing a valuation model that is calibrated to recent loan trade execution or a broker quote. The third party pricing service uses a 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, lien position and times late. Due to the inherent uncertainty of such valuation, the fair values established for commercial 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 commercial loans are classified as a Level III.

### Securitized commercial loans

Values for the Company's securitized commercial loans are based on the CFE valuation methodology. Since there is an extremely limited market for the securitized commercial loans, the Company determined the securitized debt is more actively traded and therefore was more observable. Due to the inherent uncertainty of such valuation, the Company classifies its securitized commercial loans as Level III.

### Securitized debt

In determining the proper fair value hierarchy or level, the Company considers the amount of available observable market data for each security. Since the securitized debt represents traded debt securities, the Manager's pricing team reviews the trade activity during the quarter for each security to determine the appropriate level within the fair value hierarchy. If there is sufficient trade data above a predetermined threshold, the Manager determines it has sufficient observable market data and the debt security will be categorized as a Level II. If there is not sufficient observable



market data the debt security will be categorized as a 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, 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 periods ended June 30, 2018 and December 31, 2017.

Table of Contents

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.

Table of Contents

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	Three months ended June 30, 2018							
	Agency MBS	Non-Agency MBS	Other Securities	Residential Whole-Loans	Residential Bridge Loans	Commercial Loans	Securitized commercial loans	Securitized debt
Beginning balance	\$44,802	\$ 17,000	\$ 9,113	\$ 296,719	\$ 129,469	\$ 40,455	\$ 1,383,044	\$ 12
Transfers into Level III from Level II	—	—	—	—	—	—	—	—
Transfers from Level III into Level II	(19,461 )	—	—	—	—	—	—	—
Purchases	52,530	—	—	54,019	156,730	29,851	—	—
Principal repayments	—	—	(177 )	(14,902 )	(49,402 )	—	(78,807 )	—
Total net gains / losses included in net income								
Other than temporary impairment	(207 )	(19 )	—	—	—	—	—	—
Unrealized gains/(losses), net on assets <sup>(1)</sup>	(1,181 )	(53 )	(25 )	(475 )	(108 )	374	5,621	—
Unrealized (gains)/losses, net on liabilities <sup>(2)</sup>	—	—	—	—	—	—	—	2,834
Premium and discount amortization, net	(1,440 )	(621 )	44	(212 )	(330 )	37	(663 )	24
Ending balance	\$75,043	\$ 16,307	\$ 8,955	\$ 335,149	\$ 236,359	\$ 70,717	\$ 1,309,195	\$ 2,870
Unrealized gains/(losses), net on assets held at the end of the period <sup>(1)</sup>	\$ (798 )	\$ (53 )	\$ (25 )	\$ (274 )	\$ 140	\$ 374	\$ 5,621	\$ —
Unrealized gains/(losses), net on liabilities held at the end of the period <sup>(2)</sup>	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ (2,834 )

\$ in thousands	Three months ended June 30, 2017							
	Agency MBS	Non-Agency MBS	Other Securities	Residential Whole-Loans	Securitized commercial loan	Securitized debt	Derivative liability	
Beginning balance	\$50,273	\$ 15,622	\$ 21,432	\$ 215,800	\$ 24,500	\$ 10,780	\$ 459	
Transfers into Level III from Level II	—	—	—	—	—	—	—	
Transfers from Level III into Level II	(50,999 )	—	—	—	—	—	—	
Purchases	131	—	—	—	—	—	—	
Sales and settlements	—	—	—	—	—	—	(14,711)	
Principal repayments	(15 )	(1,698 )	—	(12,220 )	—	—	—	
Total net gains / losses included in net income			0					

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

Realized (gains)/losses, net on liabilities	—	—	—	—	—	—	14,711
Other than temporary impairment	—	—	(438	) —	—	—	—
Unrealized gains/(losses), net on assets <sup>(1)</sup>	614	392	603	260	375	—	—
Unrealized (gains)/losses, net on liabilities <sup>(2)</sup>	—	—	—	—	—	165	(130 )
Premium and discount amortization, net	(4	) 10	808	(300	) —	—	—
Ending balance	\$—	\$ 14,326	\$ 22,405	\$ 203,540	\$ 24,875	\$ 10,945	\$ 329
Unrealized gains/(losses), net on assets held at the end of the period <sup>(1)</sup>	\$—	\$ 392	\$ 603	\$ 478	\$ 375	\$—	\$ —
Unrealized gains/(losses), net on liabilities held at the end of the period <sup>(2)</sup>	\$—	\$—	\$—	\$—	\$—	\$(165 )	\$ 130

Table of Contents

Six months ended June 30, 2018								
\$ in thousands	Agency MBS	Non-Agency MBS	Other Securities	Residential Whole-Loans	Residential Bridge Loans	Commercial Loans	Securitized commercial loans	Securitized debt
Beginning balance	\$17,217	\$8,735	\$9,239	\$237,423	\$64,526	\$—	\$24,876	\$10,945
Transfers into Level III from Level II	22,794	—	—	—	—	—	—	—
Transfers from Level III into Level II	(16,805)	—	—	—	—	—	—	(10,899)
Purchases	54,623	8,602	—	122,014	214,843	70,257	1,353,019	—
Sales and settlements	—	—	—	—	—	—	—	12
Principal repayments	(53)	—	(317)	(22,679)	(42,544)	—	(78,907)	(44)
Total net gains / losses included in net income								
Other than temporary impairment	(207)	(48)	—	—	—	—	—	—
Unrealized gains/(losses), net on assets <sup>(1)</sup>	(1,070)	(56)	(54)	(1,273)	(130)	416	10,870	—
Unrealized (gains)/losses, net on liabilities <sup>(2)</sup>	—	—	—	—	—	—	—	2,832
Premium and discount amortization, net	(1,456)	(926)	87	(336)	(336)	44	(663)	24
Ending balance	\$75,043	\$16,307	\$8,955	\$335,149	\$236,359	\$70,717	\$1,309,195	\$2,870
Unrealized gains/(losses), net on assets held at the end of the period <sup>(1)</sup>	\$ (712)	\$ (56)	\$ (54)	\$ (888)	\$ 151	\$ 416	\$ 10,870	\$ —
Unrealized gains/(losses), net on liabilities held at the end of the period <sup>(2)</sup>	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ (2,834)

Six months ended June 30, 2017								
\$ in thousands	Agency MBS	Non-Agency MBS	Other Securities	Residential Whole-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	—	—	15,610	—	—	—	—	—
Transfers from Level III into Level II	(73,715)	(7,434)	(9,227)	—	—	—	—	—
Purchases	—	—	—	35,671	—	—	—	—
Sales and settlements	—	—	(60,132)	—	—	—	—	(14,197)
Principal repayments	—	—	(2,075)	(172)	(24,357)	—	—	—
Total net gains / losses included in net income								

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

Realized gains/(losses), net on assets—	2,623	—	—	—	—	—	—
Realized (gains)/losses, net on liabilities	—	—	—	—	—	—	14,197
Other than temporary impairment	—	—	(1,702 )	—	—	—	—
Unrealized gains/(losses), net on assets <sup>(1)</sup>	636	(9,007 )	456	638	650	—	—
Unrealized (gains)/losses, net on liabilities <sup>(2)</sup>	—	—	—	—	—	286	(1,344 )
Premium and discount amortization, net	20	(835 )	1,694	(548 )	—	—	—
Ending balance	\$—	\$ 14,326	\$ 22,405	\$ 203,540	\$ 24,875	\$ 10,945	\$ 329
Unrealized gains/(losses), net on assets held at the end of the period <sup>(1)</sup>	\$—	\$ 392	\$ 385	\$ 792	\$ 650	\$—	\$—
Unrealized gains/(losses), net on liabilities held at the end of the period <sup>(2)</sup>	\$—	\$—	\$—	\$—	\$—	\$(286 )	\$ 1,344

(1) Gains and losses are included in "Unrealized gain (loss), net" in the Consolidated Statements of Operations.

(2) Gains and losses on securitized debt and derivative liability are included in "Unrealized gain (loss), net" and "Gain (loss) on derivative instruments, net" in the Consolidated Statements of Operations, respectively.

Table of Contents

Transfers between hierarchy levels during operations for the three and six months ended June 30, 2018 and June 30, 2017 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 three and six months ended June 30, 2018 and June 30, 2017.

## 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 June 30, 2018 and December 31, 2017 in the consolidated financial statements (dollars in thousands):

	June 30, 2018		December 31, 2017	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
<b>Assets</b>				
Residential Bridge Loans	\$22,980	\$22,805	\$42,147	\$42,881
Total	\$22,980	\$22,805	\$42,147	\$42,881
<b>Liabilities</b>				
Borrowings under repurchase agreements	\$3,267,369	\$3,265,879	\$3,251,686	\$3,257,956
Convertible senior unsecured notes	109,401	116,512	108,743	114,819
Total	\$3,376,770	\$3,382,391	\$3,360,429	\$3,372,775

"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 loan valuation, utilizing a valuation model that is calibrated to recent loan trade execution. Their valuation methodology uses a discount cash flow model and 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 is 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 June 30, 2018 and December 31, 2017 (dollars in thousands):



Table of Contents

	June 30, 2018							
	Principal Balance	Unamortized Premium (Discount), net	Discount Designated as Credit Reserv and OTTI	Amortized Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value	Net Weighted Average Coupon
Agency RMBS	\$403,154	\$ 13,467	\$ —	\$416,621	\$ —	\$(13,768 )	\$402,853	3.6 %
Agency RMBS Interest-Only Strips (2)	N/A	N/A	N/A	13,501	835	(777 )	13,559	2.3 % (1)
Agency RMBS Interest-Only Strips, accounted for as derivatives (1) (2)	N/A	N/A	N/A	N/A	N/A	N/A	9,247	2.7 % (1)
Subtotal Agency RMBS	403,154	13,467	—	430,122	835	(14,545 )	425,659	3.1 %
Agency CMBS	2,141,182	3,338	—	2,144,520	—	(79,941 )	2,064,579	3.0 %
Agency CMBS Interest-Only Strips accounted for as derivatives (1) (2)	N/A	N/A	N/A	N/A	N/A	N/A	4,923	0.5 % (1)
Subtotal Agency CMBS	2,141,182	3,338	—	2,144,520	—	(79,941 )	2,069,502	2.8 %
Total Agency MBS	2,544,336	16,805	—	2,574,642	835	(94,486 )	2,495,161	2.9 %
Non-Agency RMBS	115,776	5,783	(40,333 )	81,226	3,867	(184 )	84,909	4.4 %
Non-Agency RMBS Interest-Only Strips (1)	N/A	N/A	N/A	16,365	—	(71 )	16,294	0.5 % (1)
Subtotal Non-Agency RMBS	115,776	5,783	(40,333 )	97,591	3,867	(255 )	101,203	1.0 %
Non-Agency CMBS	421,642	(55,426 )	(28,292 )	337,924	4,435	(10,966 )	331,393	5.2 %
Total Non-Agency MBS	537,418	(49,643 )	(68,625 )	435,515	8,302	(11,221 )	432,596	2.3 %
Other securities (3)	83,717	2,689	(10,212 )	96,296	11,759	(54 )	108,001	8.6 %
Total	\$3,165,471	\$(30,149 )	\$(78,837 )	\$3,106,453	\$20,896	\$(105,761)	\$3,035,758	2.8 %

Table of Contents

	December 31, 2017							
	Principal	Unamortized	Discount		Unrealized	Unrealized	Estimated	Net
	Balance	Premium	Designated	as Amortized	Gain	Loss	Fair Value	Weighted
		(Discount),	Credit Reserv	Cost				Average
		net	and OTTI					Coupon
Agency RMBS	\$641,044	\$28,876	\$—	\$669,920	\$4,571	\$(2,314)	\$672,177	3.9 %
Agency RMBS Interest-Only Strips <sup>(1)</sup>	N/A	N/A	N/A	14,750	878	(191)	15,437	2.9 % (1)
Agency RMBS Interest-Only Strips, accounted for as derivatives <sup>(1)(2)</sup>	N/A	N/A	N/A	N/A	N/A	N/A	10,419	2.9 % (1)
Subtotal Agency RMBS	641,044	28,876	—	684,670	5,449	(2,505)	698,033	3.6 %
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>(1)</sup>	N/A	N/A	N/A	—	10	—	10	3.2 % (1)
Agency CMBS Interest-Only Strips accounted for as derivatives <sup>(1)(2)</sup>	N/A	N/A	N/A	N/A	N/A	N/A	5,757	0.5 % (1)
Subtotal Agency CMBS	2,145,139	2,142	—	2,147,281	16,923	(9,394)	2,160,567	2.7 %
Total 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>(1)</sup>	N/A	N/A	N/A	8,738	—	(16)	8,722	0.9 % (1)
Subtotal Non-Agency RMBS	119,748	5,263	(39,491)	94,258	5,473	(177)	99,554	1.8 %
Non-Agency CMBS	379,183	(59,129)	(28,020)	292,034	1,702	(15,132)	278,604	4.8 %
Total Non-Agency MBS	498,931	(53,866)	(67,511)	386,292	7,175	(15,309)	378,158	3.3 %
Other securities <sup>(3)</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 %

(1) 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 interest-only class of securities. At June 30, 2018, the notional balance for Agency RMBS IOs and IIOs, Non-Agency RMBS IOs and IIOs, Agency RMBS IOs and IIOs, accounted for as derivatives and Agency CMBS IOs and IIOs, accounted for as derivatives was \$176.8 million, \$843.0 million, \$105.0 million and \$181.1 million, respectively. 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.

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

(3) Other securities include residual interests in asset-backed securities which have no principal balance and an amortized cost of approximately \$20.1 million and \$22.9 million, as of June 30, 2018 and December 31, 2017, respectively.

Table of Contents

As of June 30, 2018 and December 31, 2017 the weighted average expected remaining term of the MBS and other securities investment portfolio was 8.5 years and 8.6 years, respectively.

The following tables present 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 three and six months ended June 30, 2018 and June 30, 2017 (dollars in thousands):

	Three months ended June 30, 2018			Three months ended June 30, 2017		
	Discount Credit Reserve and OTTI	Designated as Accretable Discount <sup>(1)</sup>	Amortizable Premium <sup>(1)</sup>	Discount Credit Reserve and OTTI	Designated as Accretable Discount <sup>(1)</sup>	Amortizable Premium <sup>(1)</sup>
Balance at beginning of period	\$(79,474)	\$(72,868 )	\$ 21,494	\$(47,517)	\$(78,573 )	\$ 16,330
Accretion of discount	—	2,786	—	—	2,722	—
Amortization of premium	—	—	(223 )	—	—	(47 )
Realized credit losses	2,095	—	—	48	—	—
Purchases	—	—	—	—	—	—
Sales	765	2,941	(554 )	1,700	465	(571 )
Net impairment losses recognized in earnings	(2,753 )	—	—	(5,979 )	—	—
Transfers/release of credit reserve <sup>(2)</sup>	530	(1,536 )	1,006	1,918	(1,392 )	(526 )
Balance at end of period	\$(78,837)	\$(68,677 )	\$ 21,723	\$(49,830)	\$(76,778 )	\$ 15,186
	Six months ended June 30, 2018			Six months ended June 30, 2017		
	Discount Credit Reserve and OTTI	Designated as Accretable Discount <sup>(1)</sup>	Amortizable Premium <sup>(1)</sup>	Discount Credit Reserve and OTTI	Designated as Accretable Discount <sup>(1)</sup>	Amortizable Premium <sup>(1)</sup>
Balance at beginning of period	\$(72,915)	\$(68,438 )	\$ 20,872	\$(130,484)	\$(109,822 )	\$ 44,527
Accretion of discount	—	5,169	—	—	5,954	—
Amortization of premium	—	—	(364 )	—	—	(689 )
Realized credit losses	2,221	—	—	1,829	—	—
Purchases	(7,182 )	(6,473 )	435	(1,724 )	(668 )	1,522
Sales	3,339	3,728	(684 )	89,441	30,085	(31,042 )
Net impairment losses recognized in earnings	(5,499 )	—	—	(10,351 )	—	—
Transfers/release of credit reserve <sup>(2)</sup>	1,199	(2,663 )	1,464	1,459	(2,327 )	868
Balance at end of period	\$(78,837)	\$(68,677 )	\$ 21,723	\$(49,830 )	\$(76,778 )	\$ 15,186

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

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

Table of Contents

The following tables present the fair value and contractual maturities of the Company's investment securities at June 30, 2018 and December 31, 2017 (dollars in thousands):

	June 30, 2018				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	\$—	\$ —	\$ 60,217	\$ 342,636	\$ 402,853
Agency RMBS Interest-Only Strips	3,352	3,658	6,549	—	13,559
Agency RMBS Interest-Only Strips, accounted for as derivatives	1,377	4,828	3,042	—	9,247
Agency CMBS	1,499,873	564,706	—	—	2,064,579
Agency CMBS Interest-Only Strips accounted for as derivatives	—	—	—	4,923	4,923
Subtotal Agency	1,504,602	573,192	69,808	347,559	2,495,161
Non-Agency RMBS	13	24,944	17,113	42,839	84,909
Non-Agency RMBS Interest- Only Strips	—	—	8,263	8,031	16,294
Non-Agency CMBS	—	85,116	148,471	97,806	331,393
Subtotal Non-Agency	13	110,060	173,847	148,676	432,596
Other securities	—	77,417	—	30,584	108,001
Total	\$ 1,504,615	\$ 760,669	\$ 243,655	\$ 526,819	\$ 3,035,758
	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	\$—	\$ 56,228	\$ 239,197	\$ 376,752	\$ 672,177
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

Table of Contents

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 June 30, 2018 and December 31, 2017 (dollars in thousands):

	June 30, 2018								
	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	\$402,854	\$(13,768)	10	\$—	\$—	—	\$402,854	\$(13,768)	10
Agency RMBS Interest-Only Strips	4,906	(614)	11	2,130	(163)	4	7,036	(777)	15
Agency CMBS	2,064,579	(79,941)	132	—	—	—	2,064,579	(79,941)	132
Subtotal Agency	2,472,339	(94,323)	153	2,130	(163)	4	2,474,469	(94,486)	157
Non-Agency RMBS	14,751	(184)	2	—	—	—	14,751	(184)	2
Non-Agency RMBS Interest-Only Strips	16,188	(71)	3	—	—	—	16,188	(71)	3
Non-Agency CMBS	88,673	(1,610)	15	101,644	(9,356)	27	190,317	(10,966)	42
Subtotal Non-Agency	119,612	(1,865)	20	101,644	(9,356)	27	221,256	(11,221)	47
Other securities	8,955	(54)	1	—	—	—	8,955	(54)	1
Total	\$2,600,906	\$(96,242)	174	\$103,774	\$(9,519)	31	\$2,704,680	\$(105,761)	205
	December 31, 2017								
	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	\$330,259	\$(2,179)	11	\$1,632	\$(135)	5	\$331,891	\$(2,314)	16
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

At June 30, 2018, 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 Other Than Temporary Impairment ("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, 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."

Table of Contents

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

	Three months ended June 30, 2018	Three months ended June 30, 2017	Six months ended June 30, 2018	Six months ended June 30, 2017
Agency RMBS	\$ 201	\$ 161	\$ 343	\$ 660
Non-Agency RMBS	19	—	110	—
Non-Agency CMBS	2,754	5,980	5,437	10,314
Other securities	—	438	—	1,702
Total	\$ 2,974	\$ 6,579	\$ 5,890	\$ 12,676

The following tables present components of interest income on the Company's MBS and other securities for the three and six months ended June 30, 2018 and June 30, 2017, respectively (dollars in thousands):

	For the three months ended June 30, 2018				For the three months ended June 30, 2017			
	Coupon Interest	Net (Premium Amortization/Amortization Basis) Discount Amortization	Interest Income		Coupon Interest	Net (Premium Amortization/Amortization Basis) Discount Amortization	Interest Income	
Agency RMBS	\$5,796	\$ (1,705 )	\$ 4,091		\$10,305	\$ (3,639 )	\$ 6,666	
Agency CMBS	15,943	(88 )	15,855		8,432	338	8,770	
Non-Agency RMBS	2,057	(281 )	1,776		558	392	950	
Non-Agency CMBS	5,170	2,508	7,678		4,913	2,264	7,177	
Other securities	4,180	(1,803 )	2,377		1,733	827	2,560	
Total	\$33,146	\$ (1,369 )	\$ 31,777		\$25,941	\$ 182	\$ 26,123	

	Six months ended June 30, 2018				Six months ended June 30, 2017			
	Coupon Interest	Net (Premium Amortization/Amortization Basis) Discount Amortization	Interest Income		Coupon Interest	Net (Premium Amortization/Amortization Basis) Discount Amortization	Interest Income	
Agency RMBS	\$12,920	\$ (2,974 )	\$ 9,946		\$21,627	\$ (7,667 )	\$ 13,960	
Agency CMBS	31,941	32	31,973		13,337	607	13,944	
Non-Agency RMBS	3,477	(149 )	3,328		3,911	(69 )	3,842	
Non-Agency CMBS	9,983	4,404	14,387		10,433	4,433	14,866	
Other securities	7,936	(3,165 )	4,771		3,140	1,648	4,788	
Total	\$66,257	\$ (1,852 )	\$ 64,405		\$52,448	\$ (1,048 )	\$ 51,400	

The following tables present the sales and realized gain (loss) of the Company's MBS and other securities for the three and six months ended June 30, 2018 and June 30, 2017, respectively (dollars in thousands):

	For the three months ended June 30, 2018				For the three months ended June 30, 2017			
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS <sup>(1)</sup>	\$208,331	\$ —	\$ (4,531 )	\$ (4,531 )	\$314,800	\$ 848	\$ (3,725 )	\$ (2,877 )



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

Agency CMBS	126,867	—	(5,016	)	(5,016	)	—	—	—	—
Non-Agency RMBS	47,758	2,220	—		2,220		—	—	—	—
Non-Agency CMBS	385	—	(38	)	(38	)	15,220	730	(341	) 389
Other securities	21,757	1,757	—		1,757		—	—	—	—
Total	\$405,098	\$ 3,977	\$ (9,585	)	\$(5,608	)	\$330,020	\$ 1,578	\$ (4,066	) \$(2,488)

24

---

Table of Contents

(1) For the three months ended June 30, 2017, excludes proceeds for Agency RMBS Interest-Only Strips, accounted for as derivatives, of approximately \$2.6 million and gross realized gains of \$432 thousand, respectively.

	Six months ended June 30, 2018				Six months ended June 30, 2017			
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS <sup>(1)</sup>	\$209,581	\$ 18	\$ (4,531 )	\$(4,513 )	\$865,151	\$ 4,379	\$ (7,365 )	\$(2,986 )
Agency CMBS	126,867	—	(5,016 )	(5,016 )	—	—	—	—
Non-Agency RMBS <sup>(2)</sup>	51,958	3,114	—	3,114	243,811	24,389	(2,242 )	22,147
Non-Agency CMBS	6,706	61	(436 )	(375 )	35,037	736	(1,073 )	(337 )
Other securities	21,757	1,757	—	1,757	22,946	—	(54 )	(54 )
Total	\$416,869	\$ 4,950	\$ (9,983 )	\$(5,033 )	\$1,166,945	\$ 29,504	\$ (10,734 )	\$18,770

(1) For the six months ended June 30, 2017, excludes proceeds for Agency RMBS Interest-Only Strips, accounted for as derivatives, of approximately \$2.6 million and gross realized gains of \$432 thousand, respectively.

(2) For the six months ended June 30, 2017, 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, respectively.

## Unconsolidated CMBS VIEs

The Company's economic interests held in unconsolidated CMBS VIEs are limited in nature to those of a passive holder of 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. The Company evaluates the CMBS VIEs for consolidation in which it owns the most subordinate tranche or a portion of the controlling class. As of June 30, 2018, the Company held five variable interest in CMBS VIEs and had three variable interests in CMBS VIE's as of December 31, 2017, in which it either owned the most subordinate class or a portion of the controlling class. The Company determined it was not the primary beneficiary and accordingly, the CMBS VIEs were not consolidated in the Company's consolidated financial statements. As of June 30, 2018 and December 31, 2017, the Company's maximum exposure to loss from these variable interests did not exceed the carrying value of these investments of \$87.6 million and \$62.1 million. These investments are classified in "Non-Agency mortgage-backed securities, at fair value" in the Company's Consolidated Balance Sheets. Further, as of June 30, 2018 and December 31, 2017, 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 5 — Residential Whole-Loans and Bridge Loans

## Residential Whole-Loan Trust

The consolidated financial statements include the consolidation of a residential whole-loan trust that met 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 such trust. The Company determined that it was the primary beneficiary of the Residential Whole-Loan trust 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 trust has issued a trust certificate that is wholly owned by the Company and represents the entire beneficial interest in pools of Residential Whole-Loans held by the trust. As of June 30, 2018, the Company financed the trust certificate with \$265.6 million 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 and certain Residential Whole-Loans held by the trust. Residential Bridge Loans are mortgage loans secured by 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 June 30, 2018, the Company financed the trust certificate with \$259.0 million of

Table of Contents

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" and the Residential Whole-Loans in "Residential Whole-Loans" in the Consolidated Balance Sheets. The Company has eliminated the intercompany trust certificate in consolidation.

## Consolidated Residential Whole-Loan and Residential Bridge 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 consolidated Residential Whole-Loan Trust holds 819 Residential Whole-Loans and the consolidated Bridge Loan Trust holds 813 Residential Bridge Loans and 13 Residential Whole-Loans as of June 30, 2018.

The following table presents a summary of the assets and liabilities of the consolidated Residential Whole-Loan and Residential Bridge Loan trusts included in the Consolidated Balance Sheets as of June 30, 2018 and December 31, 2017 (dollars in thousands):

	June 30, 2018	December 31, 2017
Cash and cash equivalents	\$364	\$ —
Residential Whole-Loans, at fair value (\$335,149 and \$237,423 pledged as collateral, at fair value, respectively)	335,149	237,423
Residential Bridge Loans (\$236,359 and \$64,526 at fair value and \$259,339 and \$106,673 pledged as collateral, respectively)	259,339	106,673
Investment related receivable	37,286	7,665
Interest receivable	6,572	3,197
Other assets	548	—
Total assets	\$639,258	\$ 354,958
Accounts payable and accrued expenses	669	188
Other liabilities	562	—
Total liabilities	\$1,231	\$ 188

The Company's risk with respect to its investment in each residential loan trust is limited to its direct ownership in the trust. The Residential Whole-Loans and Residential Bridge Loans 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. The Company is not contractually required and has not provided any additional financial support to the trusts for the three and six months ended June 30, 2018 and June 30, 2017.

The following table presents the components of the carrying value of Residential Whole-Loans and Residential Bridge Loans as of June 30, 2018 and December 31, 2017 (dollars in thousands):

Table of Contents

	Residential Whole-Loans, at Fair Value		Residential Bridge Loans, at Fair Value <sup>(1)</sup>		Residential Bridge Loans, at Amortized Cost <sup>(1)</sup>	
	June 30, 2018	December 31, 2017	June 30, 2018	December 31, 2017	June 30, 2018	December 31, 2017
Principal balance	\$329,153	\$ 232,270	\$234,881	\$ 63,802	\$22,954	\$42,066
Unamortized premium	4,541	2,021	1,536	293	51	122
Unamortized discount	(1,625 )	(1,190 )	(387 )	(128 )	(25 )	(41 )
Amortized cost	332,069	233,101	236,030	63,967	22,980	42,147
Gross unrealized gains	4,309	4,463	1,153	655	N/A	N/A
Gross unrealized losses	(1,229 )	(141 )	(824 )	(96 )	N/A	N/A
Fair value	\$335,149	\$ 237,423	\$236,359	\$ 64,526	N/A	N/A

(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”). The following tables present certain information about the Company’s Residential Whole-Loan investment portfolio at June 30, 2018 and December 31, 2017 (dollars in thousands):

June 30, 2018

Current Coupon Rate	Number of Loans	Principal Balance	Weighted Average		Expected Life (years)	Contractual Maturity (years)	Coupon Rate
			Original LTV	Original FICO Score <sup>(1)</sup>			
3.01 – 4.00%	3	\$1,772	64.1%	734	4.0	29.2	4.0 %
4.01– 5.00%	545	219,954	58.7%	743	1.8	28.0	4.7 %
5.01 – 6.00%	276	103,968	57.4%	735	1.7	27.1	5.3 %
6.01 – 7.00%	6	3,008	68.4%	740	1.5	22.5	6.2 %
7.01 - 8.00%	1	357	70.0%	777	2.0	29.6	7.2 %
8.01 - 9.00%	1	94	70.0%	689	2.0	29.6	8.4 %
Total	832	\$329,153	58.5%	741	1.8	27.7	4.9 %

(1) The original FICO score is not available for 143 loans with a principal balance of approximately \$55.6 million at June 30, 2018. The Company has excluded these loans from the weighted average computations.

December 31, 2017

Current Coupon Rate	Number of Loans	Principal Balance	Weighted Average		Expected Life (years)	Contractual Maturity (years)	Coupon Rate
			Original LTV	Original FICO Score <sup>(1)</sup>			
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.

Table of Contents

The following table presents the various states across the United States in which the collateral securing the Company's Residential Whole-Loans at June 30, 2018 and December 31, 2017, based on principal balance, is located (dollars in thousands):

June 30, 2018			December 31, 2017			
State	State Concentration	Principal Balance	State	State Concentration	Principal Balance	
California	65.4 %	\$ 215,242	California	62.2 %	\$ 144,321	
New York	21.7 %	71,412	New York	24.4 %	56,631	
Georgia	3.8 %	12,512	Georgia	4.3 %	10,061	
Washington	2.9 %	9,633	Washington	4.0 %	9,244	
Massachusetts	2.6 %	8,564	Massachusetts	3.9 %	9,114	
Other	3.6 %	11,790	Other	1.2 %	2,899	
Total	100.0 %	\$ 329,153	Total	100.0 %	\$ 232,270	

## 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 tables present certain information about the Company's Residential Bridge Loan investment portfolio at June 30, 2018 and December 31, 2017 (dollars in thousands):

June 30, 2018

Current Coupon Rate	Number of Loans	Principal Balance	Weighted Average		Coupon Rate
			Original Maturity (months)	Contractual Maturity	
6.01 - 7.00%	35	\$9,772	62.6%	5.9	6.8 %
7.01 - 8.00%	175	59,378	69.3%	7.0	7.7 %
8.01 - 9.00%	256	95,689	68.3%	7.1	8.7 %
9.01 - 10.00%	214	62,888	70.8%	6.8	9.7 %
10.01 - 11.00%	86	19,043	69.0%	6.2	10.6 %
11.01 - 12.00%	29	7,407	71.6%	6.0	11.4 %
12.01 - 13.00%	9	1,261	66.9%	8.8	12.6 %
17.01 - 18.00%	9	2,397	74.8%	7.6	18.0 %
Total	813	\$257,835	69.1%	6.9	9.0 %

Table of Contents

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 U.S. states in which the collateral securing the Company's Residential Bridge Loans at June 30, 2018 and December 31, 2017, based on principal balance, is located (dollars in thousands):

June 30, 2018			December 31, 2017		
State	Concentration	Principal Balance	State	Concentration	Principal Balance
California	45.0 %	\$ 115,885	California	48.2 %	\$ 51,080
Florida	9.3 %	23,865	Florida	13.4 %	14,199
New York	8.3 %	21,472	Washington	6.3 %	6,645
New Jersey	6.2 %	16,015	New York	4.4 %	4,703
Texas	5.0 %	12,894	Texas	4.4 %	4,660
Other	26.2 %	67,704	Other	23.3 %	24,581
Total	100.0 %	\$ 257,835	Total	100.0 %	\$ 105,868

## Non-performing Loans

## Residential Whole-Loans

As of June 30, 2018, there were two Residential Whole-Loans in non-accrual status with a current unpaid principal balance of \$1.4 million and a fair value of \$1.4 million. These nonperforming loans represent approximately 0.4% of the total outstanding principal balance. No allowance and provision for credit losses was recorded for these loans as of and for the three and six months ended June 30, 2018 and June 30, 2017 since the Company elected the fair value option. The Company stopped accruing interest income for these loans when they became contractually 90 days delinquent.

## Residential Bridge Loans

As of June 30, 2018, there were 10 Residential Bridge Loans carried at amortized cost in non-accrual status with an unpaid principal balance of approximately \$3.8 million and 3 Residential Bridge Loans carried at fair value in non-accrual status with an unpaid principal balance of approximately \$1.3 million. These nonperforming loans represent approximately 2.0% of the total outstanding principal balance. These loans are collateral dependent with a weighted average original LTV of 73%. No allowance and provision for credit losses was recorded for these loans carried at amortized costs as of and for the three and six months ended June 30, 2018 and June 30, 2017 since the fair value of the collateral balance less the cost to sell was in excess of the outstanding principal and interest balances.



Note 6 — Commercial Real Estate Investments

29

---

## Table of Contents

### Securitized Commercial Loans

Securitized commercial loans is comprised of commercial loans from consolidated third party sponsored CMBS VIE's. At June 30, 2018, the Company had variable interests in two CMBS VIEs, CMSC Trust 2015 - Longhouse MZ and RETL 2018- RVP, that it determined it was the primary beneficiary and was required to consolidate. The commercial loans that serve as collateral for the securitized debt issued by these VIE's and can only be used to settle the securitized debt. Refer to Note 7 - "Financings" for details on the associated securitized debt. 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.

#### CMSC Trust 2015 - Longhouse MZ

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 an outstanding balance of \$13.8 million and a fair value of \$13.9 million at June 30, 2018. 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 the Company believes could potentially be significant to the trust. As the primary beneficiary the Company was required to consolidate CMSC Trust and accordingly its \$13.9 million investment in CMSC Trust was eliminated in consolidation. The CMSC Trust holds a \$24.7 million mezzanine loan collateralized by interests in commercial real estate. The mezzanine loan serves as collateral for the \$24.7 million of trust certificates issued. Refer to Note 7 - "Financings" for details on the associated securitized debt.

#### RETL 2018-RVP

In March 2018, the Company acquired a \$67.8 million interest in the trust certificate issued by RETL 2018-RVP ("RETL Trust"), which represents the 5% eligible horizontal residual interest under the Credit Risk Retention Rules of Section 15G of the Exchange Act. Under the credit risk retention rules the Company must retain its investment for five years and is limited in its ability to finance and hedge its investment. The trust certificate's pass-through rate is one month LIBOR plus 9.5%. The outstanding balance and the fair value of the Company's interest in the trust are \$63.8 million and \$64.0 million, respectively, at June 30, 2018. The Company determined that RETL Trust was a VIE and itself the primary beneficiary because its Manager was involved in certain aspects of the design of the trust and the Company together with other related party entities own more than 50% of the controlling class. The owner of 50% or more of the controlling class 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 from the trust that the Company believes could potentially be significant to the trust. As the primary beneficiary, the Company was required to consolidate RETL and accordingly its investment in RETL was eliminated in consolidation. The RETL Trust holds a commercial loan collateralized by first mortgages, deeds of trusts and interests in commercial real estate. The outstanding principal balance on this commercial loan is \$1.27 billion as of June 30, 2018. The loan's stated maturity date is February 9, 2021 (subject to the borrower's option to extend the initial stated maturity date for two successive one-year terms) and bears an interest rate of one month LIBOR plus 3.15%. The commercial loan serves as collateral for the \$1.27 billion of securitized debt issued. Refer to Note 7 - "Financings" for details on the associated securitized debt.

### Commercial Loans

#### Revolving Small Balance Commercial Trust 2018-1

In March 2018, the Company formed the Revolving Small Balance Commercial Trust 2018-1 ("RSBC Trust") to acquire a \$20.6 million first lien commercial mortgage loan collateralized by three senior care living facilities. The loan matures on March 6, 2019 and bears an interest rate of one month LIBOR plus 4.75%. The Company determined that the wholly owned RSBC Trust was a VIE and itself the primary beneficiary because it was involved in the design of the trust and holds 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 June 30, 2018, the Company financed the trust certificate with \$12.3 million of repurchase borrowings, which is a liability held outside the trust.

#### Commercial Loans

30

---

Table of Contents

In March 2018, the Company acquired a \$20.0 million mezzanine loan secured by a partnership interest in an entity that owns a hotel. The mezzanine loan has a maturity date of December 9, 2019 with three one year extension options and bears an interest rate of one month LIBOR plus 6.5%.

In June 2018, the Company acquired a \$30.0 million commercial loan secured by a hotel. The loan has a maturity date of June 9, 2020 with a one year extension option and bears an interest rate of one month LIBOR plus 4.5% .

## Consolidated Commercial 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 commercial loan trusts, CMSC Trust, RETL Trust and RSBC Trust collectively hold three commercial loans as of June 30, 2018.

The following table presents a summary of the assets and liabilities of the three consolidated commercial loan trusts included in the Consolidated Balance Sheets as of June 30, 2018 and December 31, 2017 (dollars in thousands).

	June 30, 2018	December 31, 2017
Restricted cash	\$58,747	\$ —
Securitized commercial loans, at fair value	1,309,195	24,876
Commercial Loans, at fair value	20,515	—
Interest receivable	3,222	161
Total assets	\$1,391,679	\$ 25,037
Securitized debt, at fair value	\$1,231,300	\$ 10,945
Interest payable	2,687	70
Accounts payable and accrued expenses	9	1
Other liabilities	58,747	—
Total liabilities	\$1,292,743	\$ 11,016

The Company's risk with respect to its investment in each commercial loan trust is limited to its direct ownership in the trust. The commercial loans 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. 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 three and six months ended June 30, 2018 and June 30, 2017.

The following table presents the components of the carrying value of the commercial real estate loans as of June 30, 2018 and December 31, 2017 (dollars in thousands):

Table of Contents

	CMSC Trust Securitized Commercial Loan, at Fair Value		RETL Trust Securitized Commercial Loan, at Fair Value		RSBC Trust Commercial Loan, at Fair Value		Commercial Loans, at Fair Value		
	June 30, 2018	December 31, 2017	June 30, 2018	December 31, 2017	June 30, 2018	December 31, 2017	June 30, 2018	December 31, 2017	
Principal balance	\$24,652	\$ 24,846	\$1,271,288	\$	—\$20,638	\$	—\$50,000	\$	—
Unamortized premium	—	—	2,355	—	—	—	—	—	—
Unamortized discount	—	—	—	—	(81	) —	(257	) —	—
Amortized cost	24,652	24,846	1,273,643	—	20,557	—	49,743	—	—
Gross unrealized gains	89	30	10,811	—	—	—	459	—	—
Gross unrealized losses	—	—	—	—	(42	) —	—	—	—
Fair value	\$24,741	\$ 24,876	\$1,284,454	\$	—\$20,515	\$	—\$50,202	\$	—

## Note 7— Financings

## 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.

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 June 30, 2018.

As of June 30, 2018, the Company had master repurchase agreements with 28 counterparties. As of June 30, 2018, the Company had borrowings under repurchase agreements with 17 counterparties. The following table summarizes certain characteristics of the Company's repurchase agreements at June 30, 2018 and December 31, 2017 (dollars in thousands):

Table of Contents

Securities Pledged	June 30, 2018			December 31, 2017		
	Repurchase Agreement Borrowings	Weighted Average Interest Rate on Borrowings Outstanding end of period	Weighted Average Remaining Maturity (days)	Repurchase Agreement Borrowings	Weighted Average Interest Rate on Borrowings Outstanding of period	Weighted Average Remaining Maturity (days)
Agency RMBS	\$404,498	2.18 %	56	\$665,919	1.62 %	61
Agency CMBS	1,923,906	2.21 %	93	2,035,222	1.53 %	53
Non-Agency RMBS	73,152	3.71 %	34	46,530	2.76 %	41
Non-Agency CMBS	249,055	3.77 %	52	154,325	2.98 %	40
Residential Whole-Loans (1)	268,100	3.86 %	27	189,270	3.66 %	8
Residential Bridge Loans (1)	256,488	4.32 %	62	100,183	4.05 %	59
Commercial loans (1)	12,321	4.83 %	74	—	— %	—
Securitized commercial loans (1)	7,620	3.94 %	20	—	— %	—
Other securities	72,229	3.97 %	29	60,237	2.94 %	23
Borrowings under repurchase agreements	\$3,267,369	2.71 %	74	\$3,251,686	1.86 %	51

(1) Repurchase agreement borrowings on loans owned are through trust certificates. The trust certificates are eliminated upon consolidation.

For the six months ended June 30, 2018 and the year ended December 31, 2017, the Company had average borrowings under its repurchase agreements of approximately \$3.4 billion and \$2.7 billion, respectively, and had a maximum month-end balance during the periods of approximately \$3.6 billion and \$3.3 billion, respectively. The Company had interest payable at June 30, 2018 and December 31, 2017 of approximately \$5.7 million and \$6.3 million, respectively.

At June 30, 2018 and December 31, 2017, repurchase agreements collateralized by investments had the following remaining maturities:

(dollars in thousands)	June 30, 2018	December 31, 2017
Overnight	\$—	\$—
1 to 29 days	1,125,808	1,387,599
30 to 59 days	196,826	665,656
60 to 89 days	1,112,450	871,819
90 to 119 days	80,919	—
Greater than or equal to 120 days	751,366	326,612
Total	\$3,267,369	\$3,251,686

At June 30, 2018, 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	June 30, 2018

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

	Amount of Collateral at Risk, at fair value	Weighted Average Remaining Maturity (days)	Percentage of Stockholders' Equity	
UBS AG, London Branch	\$ 73,008	32	15.8	%
Credit Suisse AG, Cayman Islands Branch	68,884	27	14.9	%

Collateral for Borrowings under Repurchase Agreements

The following table summarizes the Company's collateral positions, with respect to its borrowings under repurchase agreements at June 30, 2018 and December 31, 2017 (dollars in thousands):

33

---

Table of Contents

	June 30, 2018			December 31, 2017		
	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	\$423,418	\$1,678	\$ 425,096	\$690,255	\$2,601	\$ 692,856
Agency CMBS, at fair value	2,017,265	5,203	2,022,468	2,143,340	5,454	2,148,794
Non-Agency RMBS, at fair value	101,190	729	101,919	58,127	160	58,287
Non-Agency CMBS, at fair value	331,162	1,661	332,823	208,062	1,100	209,162
Residential Whole-Loans, at fair value <sup>(1)</sup>	335,149	2,617	337,766	237,423	1,754	239,177
Residential Bridge Loans <sup>(1)</sup>	259,339	3,955	263,294	106,673	1,443	108,116
Commercial Loans, at fair value <sup>(1)</sup>	20,515	116	20,631	—	—	—
Securitized commercial loans, at fair value <sup>(1)</sup>	13,855	86	13,941	—	—	—
Other securities, at fair value	107,864	191	108,055	89,823	105	89,928
Cash <sup>(2)</sup>	9,663	—	9,663	23,591	—	23,591
Total	\$3,619,420	\$16,236	\$ 3,635,656	\$3,557,294	\$12,617	\$ 3,569,911

<sup>(1)</sup> Loans owned through trust certificates are pledged as collateral. The trust certificates are eliminated upon consolidation.

<sup>(2)</sup> 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 June 30, 2018 and December 31, 2017, investments held by counterparties as security for repurchase agreements totaled approximately \$3.6 billion and approximately \$3.5 billion, respectively. Cash collateral held by counterparties at June 30, 2018 and December 31, 2017 was approximately \$9.7 million and approximately \$23.6 million, respectively. Cash posted by repurchase agreement counterparties at June 30, 2018 and December 31, 2017, was \$2.3 million and approximately \$1.5 million, respectively. In addition, at June 30, 2018 and December 31, 2017, the Company held securities with a fair value of \$0 and \$306 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.



Securitized Debt

CMSC Trust 2015 - Longhouse MZ

CMSC Trust issued \$25.0 million in commercial pass-through certificates. The outstanding balance of the trust certificates was \$24.7 million at June 30, 2018, with a fair value of \$24.7 million. The trust certificates bear a fixed interest rate of 8.9% and

34

---

Table of Contents

mature on July 6, 2020. The Company owns \$13.8 million of the trust certificates which was eliminated in consolidation and the remaining \$10.8 million is held by related parties and is carried at a fair value of \$10.9 million.

## RETL 2018-RVP

The following table summarizes RETL Trust's commercial mortgage pass-through certificates at June 30, 2018 (dollars in thousands):

Classes	Principal Balance	Coupon	Fair Value	Contractual Maturity
Class A	493,448	3.2%	495,560	2/15/2021
Class B	149,918	3.8%	150,700	2/15/2021
Class C	129,860	4.1%	130,726	2/15/2021
Class D	114,793	4.8%	115,703	2/15/2021
Class E	155,851	6.6%	157,481	2/15/2021
Class F	150,954	8.1%	152,537	2/15/2021
Class G	12,619	9.6%	12,768	2/15/2021
Class HRR	63,847	11.6%	64,040	2/15/2021
Class X-CP <sup>(1)</sup>	N/A	2.6%	2,069	3/11/2019
Class X-EXT <sup>(1)</sup>	N/A	—%	2,870	2/15/2021
	\$1,271,290		\$1,284,454	

(1) Class X-CP and Class X-EXT are interest only classes with a notional balance of \$114.8 million each.

The Company owns the HRR certificates which are eliminated in consolidation. Of the remaining outstanding principal balance of \$1.2 billion, excluding the interest only securities, of trust certificates, \$333.4 million is owned by related parties and \$874.0 million owned by third parties. The securitized debt of the RETL Trust can only be settled with the commercial loan that serves as collateral for the securitized debt and is non-recourse to the Company.

## Note 8 — Derivative Instruments

The Company's derivatives may include interest rate swaps, options, futures contracts, TBAs, Agency and Non-Agency Interest-Only Strips that are classified as derivatives, credit default swaps and total return swaps.

Table of Contents

The following table summarizes the Company's derivative instruments at June 30, 2018 and December 31, 2017 (dollars in thousands):

Derivative Instrument	Accounting Designation	Consolidated Balance Sheets Location	June 30, 2018		December 31, 2017
			Notional Amount	Fair Value	Notional Amount
Interest rate swaps, asset	Non-Hedge	Derivative assets, at fair value	\$3,154,600	\$1,617	\$—
Options, asset	Non-Hedge	Derivative assets, at fair value	—	—	320,000
Futures contracts, asset	Non-Hedge	Derivative assets, at fair value	595,800	3,723	480,280
Credit default swaps, asset	Non-Hedge	Derivative assets, at fair value	50,000	226	—
TBA securities, asset	Non-Hedge	Derivative assets, at fair value	200,000	1,432	—
Total derivative instruments, assets				6,998	728
Interest rate swaps, liability	Non-Hedge	Derivative liability, at fair value	—	—	3,232,900 )
Options, liability	Non-Hedge	Derivative liability, at fair value	—	—	320,000 )
Futures contracts, liability	Non-Hedge	Derivative liability, at fair value	3,900	(26 )	—
Credit default swaps, liability	Non-Hedge	Derivative liability, at fair value	14,782	(96 )	14,955 )
TBA securities, liability	Non-Hedge	Derivative liability, at fair value	500,000	(1,501 )	125,000 )
Total derivative instruments, liabilities				(1,623 )	(4,346 )
Total derivative instruments, net				\$5,375	\$(3,618)

The following tables summarize the effects 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 three and six months ended June 30, 2018 and June 30, 2017 (dollars in thousands):

Table of Contents

Description	Realized Gain (Loss), net					Contractual interest income (expense), net <sup>(1)</sup>	Total
	Other Settlements / Expirations	Variation Margin Settlement	Return (Recovery) Basis	of Mark-to-Market			
Three months ended June 30, 2018							
Interest rate swaps	\$24	\$21,634	\$ 211	\$ 2,177	\$ 833	\$24,879	
Interest-Only Strips— accounted for as derivatives	—	—	(783	) (96	) 1,011	132	
Options	(100	) —	—	88	—	(12	)
Futures contracts	614	—	—	2,567	—	3,181	
Credit default swaps	(23	) —	—	66	—	43	
TBAs	801	—	—	(534	) —	267	
Total	\$1,316	\$21,634	\$ (572	) \$ 4,268	\$ 1,844	\$28,490	
Three months ended June 30, 2017							
Interest rate swaps	\$(154,304)	\$(21,504	) \$ 117	\$ 160,596	\$ (3,673	) \$(18,768)	
Interest-Only Strips— accounted for as derivatives	432	—	(2,004	) 164	2,372	964	
Options	237	—	—	(413	) —	(176	)
Futures contracts	(2,515	) —	—	545	—	(1,970	)
Foreign currency forwards	3	—	—	29	—	32	
Total return swaps	14	—	—	130	143	287	
TBAs	2,125	—	—	(1,049	) —	1,076	
Total	\$(154,008)	\$(21,504	) \$ (1,887	) \$ 160,002	\$ (1,158	) \$(18,555)	

Table of Contents

Description	Realized Gain (Loss), net					
	Other Settlements / Expirations	Variation Margin Settlement	Return (Recovery) Basis	of Mark-to-Market	Contractual interest income (expense), net <sup>(1)</sup>	Total
Six months ended June 30, 2018						
Interest rate swaps	\$ 19	\$ 97,864	\$ 292	\$ 2,245	\$ (304)	\$ 100,116
Interest-Only Strips— accounted for as derivatives	—	—	(1,974)	(30)	2,433	429
Options	(518)	—	—	300	—	(218)
Futures contracts	4,592	—	—	3,069	—	7,661
Credit default swaps	(42)	—	—	51	—	9
TBA's	134	—	—	(59)	—	75
Total	\$ 4,185	\$ 97,864	\$ (1,682)	\$ 5,576	\$ 2,129	\$ 108,072
Six months ended June 30, 2017						
Interest rate swaps	\$(150,555)	\$(17,530)	\$ 286	\$ 158,130	\$ (10,898)	\$(20,567)
Interest rate swaptions	(115)	—	—	—	—	(115)
Interest-Only Strips— accounted for as derivatives	526	—	(3,569)	(1,134)	4,413	236
Options	65	—	—	(611)	—	(546)
Futures contracts	(9,153)	—	—	2,416	—	(6,737)
Foreign currency forwards	(20)	—	—	58	—	38
Foreign currency swaps	—	—	—	—	—	—
Total return swaps	(500)	—	—	1,344	374	1,218
TBA's	2,571	—	—	650	—	3,221
Total	\$(157,181)	\$(17,530)	\$ (3,283)	\$ 160,853	\$ (6,111)	\$(23,252)

At June 30, 2018 and December 31, 2017, the Company had cash pledged as collateral for derivatives which represents upfront cash collateral upon the Company entering into the derivative transaction and cash collateral for derivatives not cleared through the Chicago Mercantile Exchange ("CME"), of approximately \$54.8 million and approximately \$63.3 million, respectively, which is reported in "Due from counterparties" in the Consolidated Balance Sheets. The Company also held cash collateral against derivatives of \$2.9 million and \$0 at June 30, 2018 and December 31, 2017, 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 (Market Agreed Coupon) interest rate swaps in which it may receive or make a payment at the time of entering such interest rate swap to compensate

38

---

Table of Contents

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 “hedged” 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

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 June 30, 2018 and December 31, 2017 (dollars in thousands):

Remaining Interest Rate Swap Term	June 30, 2018			Average		Average Maturity (Years)	Forward Starting (1)	
	Notional Amount	Average Fixed Pay Rate	Floating Receive Rate	Floating Receive Rate				
1 year or less	\$400,000	1.5 %	2.3 %	1.0	—	%		
Greater than 1 year and less than 3 years	200,000	1.8 %	2.4 %	1.9	—	%		
Greater than 3 years and less than 5 years	738,000	2.0 %	2.4 %	3.8	—	%		
Greater than 5 years	1,816,600	2.5 %	2.4 %	10.3	10.9	%		
Total	\$3,154,600	2.2 %	2.4 %	7.1	6.3	%		

  

Remaining Interest Rate Swap Term	December 31, 2017			Average		Average Maturity (Years)	Forward Starting (1)	
	Notional Amount	Average Fixed Pay Rate	Floating Receive 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.

As of June 30, 2018 and December 31, 2017, the Company has entered into fixed-pay forward starting interest rate swaps of approximately \$198.1 million and \$1.5 billion, respectively, which have weighted average forward starting dates of 1.9 months and 4.0 months, respectively.

## Options

The Company may enter into options on U.S. Treasuries and Eurodollar. 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.

## Futures Contracts

The Company may enter into Eurodollar, Volatility Index, and U.S. Treasury futures. As of June 30, 2018, the Company had entered into contracts to buy or long positions for U.S. Treasuries with a notional amount of \$119.7 million, a fair value in an asset position of \$1.8 million and an expiration date of September 2018. As of June 30, 2018, the Company 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 \$1.9 million and an expiration date of September 2018. As of December 31, 2017, the Company had entered into contracts to buy or



Table of Contents

long 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.

## To-Be-Announced Securities

The Company purchased or sold TBAs during the six months ended June 30, 2018 and the year ended December 31, 2017. The following is a summary of the Company's long and short TBA positions as of June 30, 2018 and December 31, 2017 reported in "Derivative assets, at fair value" and "Derivative liability, at fair value" in the Consolidated Balance Sheets (dollars in thousands):

	June 30, 2018		December 31, 2017	
	Notional Amount	Fair Value	Notional Amount	Fair Value
Purchase contracts, asset	\$200,000	\$1,432	\$—	\$—
TBA securities, asset	200,000	1,432	—	—
Purchase contracts, liability	300,000	(62 )	125,000	(10 )
Sale contracts, liability	(200,000 )	(1,439 )	—	—
TBA securities, liability	100,000	(1,501 )	125,000	(10 )
TBA securities, net	\$300,000	\$(69 )	\$125,000	\$(10)

The following tables present additional information about the Company's contracts to purchase and sell TBAs for the six months ended June 30, 2018 and the year ended December 31, 2017 (dollars in thousands):

	Notional Amount December 31, 2017	Additions	Settlement, Termination, Expiration or Exercise	Notional Amount June 30, 2018
Purchase of TBAs	\$125,000	\$3,425,000	\$ (3,050,000 )	\$500,000
Sale of TBAs	\$—	\$3,250,000	\$ (3,050,000 )	\$200,000

	Notional Amount December 31, 2016	Additions	Settlement, Termination, Expiration or Exercise	Notional Amount 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 "Agency mortgage-backed securities, at fair value" in the

Consolidated Balance Sheets.

Credit Default Swaps

As of June 30, 2018, the Company had entered into credit default swaps with a notional amount of \$64.8 million and a fair value in net asset position of \$130 thousand. As of December 31, 2017, the Company had entered into credit default swaps with a notional amount of \$14.8 million and a fair value in a liability position of \$95 thousand. Under these instruments, the

40

---

Table of Contents

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 9 — 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 June 30, 2018 and December 31, 2017 (dollars in thousands):

Description	June 30, 2018		Gross Amounts Not		Net Amount	
	Gross Amounts	Net Amounts	Offset in the Consolidated Balance Sheets	Offset in the Consolidated Balance Sheets		
Derivative Assets						
Agency and Non-Agency Interest-Only Strips, accounted for as derivatives included in MBS	\$ 14,170	\$ —	—\$ 14,170	\$(11,929 )	\$ —	\$ 2,241
Derivative asset, at fair value <sup>(2)</sup>	6,998	—	6,998	(122 )	(2,820 )	4,056
Total derivative assets	\$ 21,168	\$ —	—\$ 21,168	\$(12,051 )	\$(2,820 )	\$ 6,297
Derivative Liabilities and Repurchase Agreements						
Derivative liability, at fair value <sup>(2)(3)</sup>	\$ 1,623	\$ —	—\$ 1,623	\$(122 )	\$ —	\$ 1,501
Repurchase Agreements <sup>(4)</sup>	3,267,369	—	3,267,369	(3,267,369 )	—	—
Total derivative liability	\$ 3,268,992	\$ —	—\$ 3,268,992	\$(3,267,491 )	\$ —	\$ 1,501

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.

(1) 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, foreign currency swaps and TBAs.

(2) Cash collateral pledged against the Company's derivative counterparties was approximately \$54.8 million as of June 30, 2018.

(3) The carrying value of investments pledged against the Company's repurchase agreements was approximately \$3.6 billion as of June 30, 2018.

Table of Contents

	December 31, 2017		Gross Amounts Not			
	Gross	Net	Gross	Offset in	Net	
	Amounts	Amounts	Amounts	the Consolidated	Amount	
		of Assets	Offset in the	Balance		
		presented in	Consolidated	Financial	Cash	
		the Consolidated	Sheets	Instruments <sup>(1)</sup>	Collateral	
		Balance	Balance		<sup>(1)</sup>	
		Sheets	Sheets			
<b>Derivative Assets</b>						
Agency and Non-Agency 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

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 Pledged column of the tables above represents amounts pledged as collateral against derivative transactions.

(1) 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.

(2) Cash collateral pledged against the Company's derivative counterparties was approximately \$63.3 million as of December 31, 2017.

(3) The carrying value of investments pledged against the Company's repurchase agreements was approximately \$3.5 billion as of December 31, 2017.

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 10 — Related Party Transactions

##### Management Agreement

In connection with the Company's initial public offering ("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 (excluding OTTI ) 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.

Table of Contents

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 three months ended June 30, 2018 and June 30, 2017, the Company incurred approximately \$2.3 million and approximately \$1.8 million in management fees, respectively. For the six months ended June 30, 2018 and June 30, 2017, the Company incurred approximately \$4.4 million and approximately \$4.3 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 three months ended June 30, 2018 and June 30, 2017, the Company recorded expenses included in general and administrative expenses totaling approximately \$872 thousand and approximately \$704 thousand, respectively, related to reimbursable employee costs. For the six months ended June 30, 2018 and June 30, 2017, the Company recorded expenses included in general and administrative expenses totaling approximately \$1.1 million and approximately \$920 thousand, 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 expenses in the Consolidated Statements of Operations. At June 30, 2018 and December 31, 2017, approximately \$2.3 million and approximately \$1.9 million, respectively, for management fees incurred but not yet paid was included in "Payable to affiliate" in the Consolidated Balance Sheets. In addition, at

June 30, 2018 and December 31, 2017, approximately \$803 thousand and approximately \$99 thousand, respectively, of reimbursable costs incurred but not yet paid was included in "Payable to affiliate" in the Consolidated Balance Sheets.

Note 11 — 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

Table of Contents

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. Approximately 752,401 shares have been issued under the Equity Plans with 485,310 shares available for issuance, as of June 30, 2018.

Under the Equity Plan, the Company did not make any grants during the six months ended June 30, 2018 and it made the following grants during the year ended December 31, 2017:

On June 1, 2017, the Company granted a total of 15,536 shares (3,884 each) of restricted common stock under the Equity Plan to the Company's four independent directors. These restricted shares vested 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 7, 2018, the Company granted a total of 25,904 shares (6,476 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, 2019, 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.

During the six months ended June 30, 2018 and June 30, 2017, 84,203 and 152,630 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 \$50 thousand and approximately \$215 thousand for the three months ended June 30, 2018 and June 30, 2017, respectively. The Company recognized stock-based compensation expense of approximately \$125 thousand and approximately \$577 thousand for the six months ended June 30, 2018 and June 30, 2017, respectively. In addition, the Company had unamortized compensation expense of \$257 thousand for equity awards and \$0 for liability awards and \$66 thousand for equity awards and approximately \$111 thousand for liability awards at June 30, 2018 and December 31, 2017, 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 Company's 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 June 30, 2018 and December 31, 2017, including shares whose issuance has been deferred under the Director Deferred Fee Plan:

June 30, 2018



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

		December 31, 2017		
Vesting Date	Shares Vesting		Shares Vesting	
March 2018	—		66,667	
June 2018	—		16,488	
June 2019	25,904		—	
	25,904		83,155	

Table of Contents

The following table presents information with respect to the Company's restricted stock for the six months ended June 30, 2018, including shares whose issuance has been deferred under the Director Deferred Fee Plan:

	Shares of Restricted Stock	Weighted Average Grant Date Fair Value <sup>(1)</sup>
Outstanding at beginning of period	725,449	\$ 17.00
Granted <sup>(2)</sup>	26,952	10.77
Cancelled/forfeited	—	—
Outstanding at end of period	752,401	\$ 16.78
Unvested at end of period	25,904	\$ 10.81

(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 1,048 shares of restricted stock attributed to dividends on restricted stock under the Director Deferred Fee Plan.

## Note 12 — 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 June 30, 2018, the adjusted exercise price of the warrants was \$16.70 per share 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. The Company has not sold any shares under this agreement.

## 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. 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 Act of 1934, as amended. 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 303,422 shares of common stock pursuant to the authorization as of June 30, 2018. The repurchased stock was not retired and is accounted for as treasury stock.

Table of Contents

## 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
2018				
June 21, 2018	July 2, 2018	July 26, 2018	\$ 0.31	Not yet determined
March 22, 2018	April 2, 2018	April 26, 2018	\$ 0.31	Not yet determined
2017				
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

## Note 13 — Net Income per Common Share

The table below presents basic and diluted net income per share of common stock using the two-class method for the three and six months ended June 30, 2018 and June 30, 2017 (dollars, other than shares and per share amounts, in thousands):

	For the three months ended June 30, 2018	For the three months ended June 30, 2017	Six months ended June 30, 2018	Six months ended June 30, 2017
Numerator:				
Net income attributable to common stockholders and participating securities for basic and diluted earnings per share	\$ 1,453	\$ 20,684	\$ 23,182	\$ 40,926
Less:				
Dividends and undistributed earnings allocated to participating securities	27	62	65	163
Net income allocable to common stockholders — basic and diluted	\$ 1,426	\$ 20,622	\$ 23,117	\$ 40,763
Denominator:				
Weighted average common shares outstanding for basic earnings per share	41,619,198	41,853,134	41,671,278	41,809,672
Weighted average common shares outstanding for diluted earnings per share	41,619,198	41,853,134	41,671,278	41,809,672
Basic earnings per common share	\$ 0.03	\$ 0.49	\$ 0.55	\$ 0.97
Diluted earnings per common share	\$ 0.03	\$ 0.49	\$ 0.55	\$ 0.97

For the three and six months ended June 30, 2018 and June 30, 2017, 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 14 — 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.

## Table of Contents

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 June 30, 2018. The Company files U.S. federal and state income tax returns. As of June 30, 2018, 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 taxable REIT subsidiaries ("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. During the three months ended June 30, 2018 and June 30, 2017, the Company recorded a federal and state tax provision of approximately \$36 thousand and \$2.1 million, respectively, which is recorded in "Income tax provision" in the Consolidated Statements of Operations. During the six months ended June 30, 2018 and June 30, 2017, the Company recorded a federal and state tax provision of approximately \$349 thousand and \$3.2 million, respectively.

### Deferred Tax Asset

As of June 30, 2018 and December 31, 2017, the Company recorded a deferred tax asset of approximately \$3.5 million and \$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 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 valuation allowance of \$3.5 million and \$6.1 million.

In addition, the REIT generated net operating losses ("NOLs") during the year ended December 31, 2017, related to its interest rate swap terminations, and for its California return a portion of the NOL's is apportioned to the TRS. The TRS can carryback these NOLs to each of the two preceding years and receive a refund for taxes paid. The Company recorded a deferred state tax asset relating to the NOLs of \$8.7 million and \$8.8 million in the REIT and \$752 thousand and \$765 thousand in the TRS as of June 30, 2018 and December 31, 2017, respectively. As a result, the Company has concluded it is more likely than not the deferred tax asset relating to the NOLs will not be realized with the exception of the TRS carryback to 2015 and has recorded a combined valuation allowance of \$9.0 million and \$9.2 million as of June 30, 2018 and December 31, 2017, respectively. The Company also recorded a deferred federal tax liability of \$85 thousand and \$85 thousand as of June 30, 2018 and December 31, 2017, respectively, in anticipation of the receipt of the state tax refund as a result of the carryback of the California NOL.

### Effective Tax Rate

The Company's effective tax rate differs from its combined federal and state income tax rate primarily due to its valuation allowance and the deduction of dividends distributions to be paid under Code Section 857(a).

### Tax Cuts and Jobs Act

On December 22, 2017, the President of the United States signed and enacted comprehensive tax legislation into law H.R. 1, commonly referred to as the Tax Cuts and Jobs Act (the "Tax Act"). The Tax Act significantly revises the U.S. corporate income tax by, among other things, lowering the corporate income tax rate from 35% to 21%. Shortly after the enactment of the Tax Act, the SEC issued guidance under Staff Accounting Bulletin No. 118, Income Tax

Accounting Implications of the Tax Cuts and Jobs Act (“SAB 118”), which allows a Company to record provisional amounts during a measurement period not to extend beyond one year of the enactment date. The ultimate impact of the Tax Act may differ from these provisional amounts due to, among other things, additional analysis, changes in interpretations and assumptions the Company has made, additional regulatory guidance that may be issued, and actions the Company may take as a result of the Act. We expect to complete our analysis within the measurement period in accordance with SAB 118.

Table of Contents

Note 15 — 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 June 30, 2018.

Table of Contents

ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

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" herein and in the Company's Annual Report on Form 10-K for the year ended December 31, 2017, filed with the SEC on March 29, 2018. 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.

## Table of Contents

### Overview

Western Asset Mortgage Capital Corporation, a Delaware corporation, and its subsidiaries (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 one subsidiary as a 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, supported 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.

### 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 caption “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2017, which is available on the SEC's website at [www.sec.gov](http://www.sec.gov) for additional factors that may impact our operating results.

### Recent Market Conditions

Our business is affected by general U.S. residential and 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 interest rate levels and credit spreads. We expect the results of our operations to be affected by various factors, many of which are beyond our control.

Our Manager expects growth and inflation to improve from subdued levels, U.S. growth and inflation to be aided by fiscal stimulus, based in part on central banks signaling their path to normalization, and spread sectors to outperform in 2018 though margins are thin and emerging markets are expected to perform strongly. The first quarter of 2018 experienced volatility, with steadily increasing short-term interest rates. We saw wider credit spreads and spreads on Agency MBS widened. We were prepared for the move in interest rates by actively limiting our duration gap. Our hedge portfolio helped to minimize the impact of the movement in interest rates on our book value and economic return.

## Table of Contents

After a volatile first quarter, the financial markets returned to more normal levels in the second quarter of 2018. During the second quarter, the 10-year U.S. Treasury rate increased to 2.85% as of June 30, 2018, and the yield curve continued its flattening trend. Agency CMBS and credit spreads widened during the second quarter but by quarter end credit spreads on the Agency CMBS began to tighten. We earned a positive economic return for the second quarter of 0.4%, experiencing a modest decline in our book value of 2.4% as a result of the credit spread widening in particular on our Agency CMBS portfolio.

With our view that interest rates will continue to increase, we continue to operate with interest rate risk protection with our interest rate hedge positions approximately 96% of our repurchase agreements as of June 30, 2018. We believe this interest rate protection will minimize the impact of the increase in long-term rates on our portfolio and mitigate interest rate risk to further rate increases. Our net "duration gap," which is a measure of the risk due to mismatches that can occur between the interest rate sensitivity of our assets and liabilities, inclusive of hedges, was negative 0.19 years as of June 30, 2018.

We still believe the Agency RMBS sector is at risk for spread widening in the longer term. In response, we continued to reduce our Agency RMBS portfolio and redeploy the proceeds into credit sensitive investments such as Residential Whole and Bridge Loans Non Agency CMBS subordinate securities and Commercial Loans.

As anticipated the Federal Reserve increased the federal funds rate by 50 basis point during the first half of 2018. The combination of higher interest rates coupled with higher costs associated with financing our credit sensitive investments our average effective borrowing costs excluding the consolidated VIEs increased by 24 basis points, to 2.51% as of June 30, 2018 from 2.27% as of December 31, 2017. Our average effective borrowing costs, includes the cost of our repurchase agreements and the net interest paid or received on our interest rate swap hedges.

Against this backdrop, the fundamentals in the U.S. housing market remain strong and spreads for most mortgages remained supported during the first half of 2018. Credit sensitive mortgage sectors have performed relatively well and are expected to continue to offer attractive returns.

## 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

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

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

51

---

Table of Contents

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

## Table of Contents

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.** — Commercial Whole-Loans are generally small balance loans ranging from, \$2.5 million to \$25.0 million, secured by commercial real estate typically short-term, held by us or through a trust with us owning the beneficial interest in the trust.

**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.

Table of Contents

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 June 30, 2018.

In March 2018, the Company acquired a \$67.8 million Non-Agency CMBS security which resulted in the consolidation of a VIE and the initial recording of a \$1.3 billion securitized commercial loan and \$1.3 billion non-recourse securitized debt. Refer to Note 6 - "Commercial Real Estate Investments" for details. The following table reflects the portfolio including the fair market value of the Non-Agency CMBS security as of June 30, 2018 of \$64.0 million and excludes the \$1.3 billion securitized commercial loan.

Table of Contents

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, excluding securitized debt, 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 June 30, 2018, our aggregate debt-to-equity ratio was approximately 7.3 to 1 when we exclude our securitized debt and 10.0 to 1 when we include our securitized debt. 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 June 30, 2018, 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 25.0% 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 15.0% to a high of 50.0% and for Non-Agency CMBS, haircuts range from a low of 12.5% to a high of 35.0%. Haircuts for Whole-Loans range from a low of 20.0% to a high of 45.0% and other securities range from a low of 25.0% to a high of 50.0%.

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

## Table of Contents

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 June 30, 2018, we had repurchase agreements with 28 counterparties and outstanding borrowings with 17 of such counterparties. Our total outstanding borrowings under our repurchase agreements was \$3.3 billion, with a maximum net exposure to any single repurchase agreement counterparty of \$73.0 million or 15.8% 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 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.

## Critical Accounting Policies

The consolidated financial statements include our accounts, those of our 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, see Note 2 of our "Notes to Consolidated Financial Statements (Unaudited)".

There have been no significant changes to our critical accounting policies that are disclosed in our most recent Annual Report on Form 10-K for the year ended December 31, 2017, other than the critical accounting policies disclosed below.

### Securitized Commercial Loans

Securitized commercial loans are comprised of commercial loans of consolidated variable interest entities which were sponsored by third parties. These 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. Accordingly, these loans are recorded at fair value with periodic changes in fair value being recorded in earnings as a component of "Unrealized gain (loss), net".

The securitized commercial loans are typically collateralized by commercial real estate. As a result, we regularly evaluate the extent and impact of any credit migration associated with the performance and or value of the underlying collateral property as well as the financial and operating capability of the borrower on a loan by loan basis. On a quarterly basis, we evaluate the

## Table of Contents

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. Interest income accrual is resumed when the loan becomes contractually current and performance is demonstrated. A loan is written off when it is no longer realizable and/or legally discharged.

### Commercial Loans

Investments in Commercial Loans, which are comprised of commercial mortgage loans and commercial mezzanine 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 Commercial Loan portfolio. Accordingly, these loans are recorded at fair value with periodic changes in fair value being recorded in earnings as a component of "Unrealized gain (loss), net". All other costs incurred in connection with acquiring the Commercial Loans or committing to purchase these loans are charged to expense as incurred.

Our loans are typically collateralized by commercial real estate. As a result, we regularly evaluate the extent and impact of any credit migration associated with the performance and or value of the underlying collateral property as well as the financial and operating capability of the borrower on a loan by loan basis. 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. Interest income 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.

### Interest Income Recognition

#### Loan Portfolio

Interest income on our residential loan portfolio and commercial 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.

#### 2018 Activity



Table of Contents

## Investment Activity

We continually evaluate our investment portfolio, 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 expect to gradually reduced our exposure to Agency MBS and deployed capital to acquire, Non-Agency CMBS, Residential Whole and Bridge Loans, Commercial Loans and Non-Agency RMBS collateralized by prime jumbo loan pools.

The following table presents our investing activity for the six months ended June 30, 2018 (dollars in thousands):

Investment Type	Balance at December 31, 2017	Purchases	Principal Payments and Basis Reductions	Proceeds from Sales	Realized Gain/(Loss)	Unrealized Gain/(loss)	Premium and discount amortization, net	OTTI	Balance at June 30, 2018
Agency RMBS and Agency RMBS IOs	\$698,033	\$2,094	\$(42,231)	\$(209,581)	\$(4,513)	\$(16,588)	\$(1,206)	\$(349)	\$425,659
Non-Agency RMBS	99,554	55,022	(3,512)	(51,958)	3,114	(1,684)	777	(110)	101,203
Agency CMBS and Agency CMBS IOs	2,160,567	132,073	(3,724)	(126,867)	(5,016)	(87,457)	32	(106)	2,069,502
Non-Agency CMBS	278,604	71,481	(17,475)	(6,706)	(376)	6,897	4,405	(5,437)	331,393
Other securities <sup>(1)</sup>	122,065	9,686	(317)	(21,757)	1,758	(269)	(3,165)	—	108,001
Total MBS and other securities	3,358,823	270,356	(67,259)	(416,869)	(5,033)	(99,101)	843	(6,002)	3,035,758
Residential Whole-Loans	237,423	126,902	(27,430)	—	—	(1,241)	(505)	—	335,149
Residential Bridge Loans	106,673	278,369	(124,731)	—	—	(229)	(743)	—	259,339
Commercial Loans	—	70,257	—	—	—	416	44	—	70,717
Securitized commercial loan	24,876	1,353,019	(78,907)	—	—	10,870	(663)	—	1,309,195
Total Investments	\$3,727,795	\$2,098,903	\$(298,327)	\$(416,869)	\$(5,033)	\$(89,285)	\$(1,024)	\$(6,002)	\$5,010,158

(1) Other securities include \$78.2 million of GSE CRTs and \$29.8 million of ABS at June 30, 2018.

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 loans, including junior tranches of CMBS transactions. We intend to continue to deploy capital into credit sensitive investments. At June 30, 2018, we



held \$2.5 billion in credit sensitive investments, primarily consisting of 52.1% of Securitized commercial loans, 13.2% Non-Agency CMBS, 13.3% Residential Whole-Loans, 10.3% Residential Bridge Loans, 4.0% Non-Agency RMBS and 3.1% 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.

Table of Contents

## Portfolio Characteristics

## Our Agency Portfolio

The following table summarizes our Agency portfolio by investment category as of June 30, 2018 (dollars in thousands):

	Principal Balance	Amortized Cost	Fair Value	Net Weighted Average Coupon	
Agency RMBS	\$ 403,154	\$ 416,621	\$402,853	3.6	%
Agency RMBS IOs and IIOs <sup>(1)</sup>	N/A	13,501	13,559	2.3	%
Agency RMBS IOs and IIOs accounted for as derivatives <sup>(1)</sup>	N/A	N/A	9,247	2.7	%
Total Agency RMBS	403,154	430,122	425,659	3.1	%
Agency CMBS	2,141,182	2,144,520	2,064,579	3.0	%
Agency CMBS IOs and IIOs accounted for as derivatives <sup>(1)</sup>	N/A	N/A	4,923	0.5	%
Total Agency CMBS	2,141,182	2,144,520	2,069,502	2.8	%
Total	\$ 2,544,336	\$ 2,574,642	\$2,495,161	2.9	%

<sup>(1)</sup> 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 June 30, 2018:

Credit Sensitive Securities	Pre 2006	2006	2007	2011	2012	2013	2014	2015	2016	2017	2018	Total
Non-Agency RMBS	0.4 %	0.9 %	0.3 %	— %	— %	— %	— %	— %	— %	1.1 %	0.7 %	3.4 %
Non-Agency RMBS IOs	— %	— %	— %	— %	— %	— %	— %	— %	— %	0.3 %	0.3 %	0.6 %
Non-Agency CMBS	0.2 %	1.8 %	3.5 %	1.4 %	0.3 %	0.1 %	0.9 %	3.1 %	— %	1.0 %	0.9 %	13.2 %
Other securities	0.4 %	— %	— %	— %	— %	— %	0.3 %	0.5 %	1.5 %	1.2 %	0.4 %	4.3 %
Residential Whole-Loans	0.1 %	— %	— %	0.2 %	0.3 %	2.8 %	1.3 %	0.1 %	2.0 %	5.1 %	1.5 %	13.4 %
Residential Bridge Loans	— %	— %	— %	— %	— %	— %	— %	0.1 %	0.5 %	4.0 %	5.7 %	10.3 %
Securitized commercial loans	— %	— %	— %	— %	— %	— %	— %	1.0 %	— %	— %	51.0 %	52.0 %
Commercial Loans	— %	— %	— %	— %	— %	— %	— %	— %	— %	— %	2.8 %	2.8 %
Total	1.1 %	2.7 %	3.8 %	1.6 %	0.6 %	2.9 %	2.5 %	4.8 %	4.0 %	12.7 %	63.3 %	100 %

<sup>(1)</sup> 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 June 30, 2018 (fair value dollars in thousands):



Table of Contents

Category	Fair Value	Weighted Average		Original LTV	Original FICO	60+ Day Delinquent	6-Month CPR
		Purchase Price	Life (Years)				
Prime	\$ 25,376	\$58.03	12.0	68.9 %	769	— %	6.0 %
Alt-A	68,112	68.47	9.5	78.0 %	680	12.0 %	9.4 %
Subprime	7,715	58.57	22.4	77.4 %	598	18.0 %	3.5 %
Total	\$ 101,203	\$65.09	11.1	75.6 %	696	9.4 %	8.1 %

## Non-Agency CMBS

The following table presents certain characteristics of our Non-Agency CMBS portfolio as of June 30, 2018 (dollars in thousands):

Type	Vintage	Principal		Weighted Average		
		Balance	Fair Value	Life (Years)	Original LTV	
Conduit:						
	2006-2009	\$ 160,357	\$ 136,598	2.4	71.5 %	
	2010-2018	177,245	114,741	7.4	64.0 %	
		337,602	251,339	4.7	68.1 %	
Single Asset:						
	2010-2018	84,040	80,054	3.0	64.0 %	
Total		\$421,642	\$ 331,393	4.3	67.1 %	

## Residential Whole-Loans

The following table presents certain information about our Residential Whole-Loans investment portfolio at June 30, 2018 (dollars in thousands):

Current Coupon Rate	Number of Loans	Principal Balance	Weighted Average		Expected Life (years)	Contractual Maturity (years)	Coupon Rate
			Original LTV	Original FICO Score <sup>(1)</sup>			
3.01 – 4.00%	3	\$ 1,772	64.1 %	734	4.0	29.2	4.0 %
4.01 – 5.00%	545	219,954	58.7 %	743	1.8	28.0	4.7 %
5.01 – 6.00%	276	103,968	57.4 %	735	1.7	27.1	5.3 %
6.01 – 7.00%	6	3,008	68.4 %	740	1.5	22.5	6.2 %
7.01 - 8.00%	1	357	70.0 %	777	2.0	29.6	7.2 %
8.01 - 9.00%	1	94	70.0 %	689	2.0	29.6	8.4 %
Total	832	\$ 329,153	58.5 %	741	1.8	27.7	4.9 %

(1) The original FICO score is not available for 143 loans with a principal balance of approximately \$55.6 million at June 30, 2018. We have excluded those loans from the weighted average computation.

As of June 30, 2018, there were two Residential Whole-Loans over 90-days past due with a current unpaid principal balance of \$1.4 million and a fair value of \$1.4 million. These nonperforming loans represent approximately 0.4% of the total outstanding principal balance. No allowance and provision for credit losses was recorded for these loans as of and for the three months ended June 30, 2018 since we elected the fair value option for these loans. We stopped accruing interest income for these loans when they became contractually 90 days delinquent.

Residential Bridge Loans

60

---

Table of Contents

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 June 30, 2018 (dollars in thousands):

Current Coupon Rate	Number of Loans	Principal Balance	Weighted Average		Coupon Rate
			Original Maturity (months)	Contractual Maturity (months)	
6.01 - 7.00%	35	9,772	62.6%	5.9	6.8 %
7.01 - 8.00%	175	59,378	69.3%	7.0	7.7 %
8.01 - 9.00%	256	95,689	68.3%	7.1	8.7 %
9.01 - 10.00%	214	62,888	70.8%	6.8	9.7 %
10.01 - 11.00%	86	19,043	69.0%	6.2	10.6 %
11.01 - 12.00%	29	7,407	71.6%	6.0	11.4 %
12.01 - 13.00%	9	1,261	66.9%	8.8	12.6 %
17.01 - 18.00%	9	2,397	74.8%	7.6	18.0 %
Total	813	\$257,835	69.1%	6.9	9.0 %

As of June 30, 2018, there were 10 Residential Bridge Loans carried at amortized cost in non-accrual status with an unpaid principal balance of approximately \$3.8 million and 3 Residential Bridge Loans carried at fair value in non-accrual status with an unpaid principal balance of approximately \$1.3 million. These nonperforming Residential Bridge Loans represent approximately 2.0% of the total outstanding principal balance. We reviewed the estimated fair value of the collateral to determine if an allowance and provision of credit loss was required for loans carried at amortized costs. Based upon our evaluation, no allowance and provision for credit losses was recorded for these loans as of and for the three and six months ended June 30, 2018 since the fair value of the collateral balance less the cost to sell was in excess of the outstanding principal and interest balances. We stopped accruing interest income for these loans when they became contractually 90 days delinquent.

## Commercial Real Estate Investments

## Securitized Commercial Loans

In November 2015, we acquired a \$14.0 million variable interest in CMSC Trust, which is a VIE that we were required to consolidate. Please refer to Note 6 - "Commercial Real Estate Investments" for details. The CMSC Trust holds a \$24.7 million mezzanine loan collateralized by interests in commercial real estate. The mezzanine loan serves as collateral for the \$24.7 million of securitized debt issued. Refer to Note 7 - "Financings" for details on the associated securitized debt.

In March 2018, we acquired a \$67.8 million variable interest in RETL Trust, which is a VIE that we were required to consolidate. Please refer to Note 6 - "Commercial Real Estate Investments" for details. The RETL Trust holds a \$1.3 billion commercial loan collateralized by first mortgages, deeds of trusts and interests in commercial real estate located throughout the United States and Puerto Rico. The loan's stated maturity date is February 9, 2021 (subject to the borrower's option to extend the initial stated maturity date for two successive one-year terms) and bears an interest rate of one month LIBOR plus 3.15%. The commercial loan serves as collateral for the \$1.3 billion of securitized debt issued. Refer to Note 7 - "Financings" for details on the associated securitized debt.

## Commercial Loans

In March 2018, we acquired a \$20.6 million first lien commercial mortgage loan collateralized by three senior care living facilities located in North Carolina through RSBC Trust. The loan matures on March 6, 2019 and bears an

interest rate of one month LIBOR plus 4.75%.

In March 2018, we acquired a \$20.0 million mezzanine loan secured by a partnership interest in an entity that owns a hotel located in Boston, MA. The mezzanine loan has a maturity date of December 9, 2019 with three one year extension options and bears an interest rate of one month LIBOR plus 6.5%.

Table of Contents

In June 2018, we acquired a \$30.0 million commercial loan secured by a hotel. The loan has a maturity date of June 9, 2020 with a one year extension option and bears an interest rate of one month LIBOR plus 4.5% .

## 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 June 30, 2018, based on fair value (dollars in thousands):

	Non-Agency RMBS			Non-Agency CMBS		
	Concentration	Fair Value		Concentration	Fair Value	
California	30.6 %	\$ 31,019	New York	11.6 %	\$ 38,437	
Florida	9.9 %	10,028	California	8.1 %	26,842	
New York	8.8 %	8,861	Florida	7.1 %	23,543	
Virginia	6.6 %	6,663	Illinois	6.8 %	22,399	
New Jersey	3.8 %	3,798	North Carolina	6.1 %	20,370	

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 June 30, 2018, based on principal balance, is located (dollars in thousands):

	Residential Whole-Loans			Residential Bridge Loans		
	State	Principal Balance		State	Principal Balance	
California	65.4 %	\$ 215,242	California	45.0 %	\$ 115,885	
New York	21.7 %	71,412	Florida	9.3 %	23,865	
Georgia	3.8 %	12,512	New York	8.3 %	21,472	
Washington	2.9 %	9,633	New Jersey	6.2 %	16,015	
Massachusetts	2.6 %	8,564	Texas	5.0 %	12,894	
Other	3.6 %	11,790	Other	26.2 %	67,704	
Total	100.0 %	\$ 329,153	Total	100.0 %	\$ 257,835	

## Financing Activity

## Repurchase Agreements

At June 30, 2018, we had repurchase agreements with 28 counterparties and outstanding borrowings with 17 of such counterparties. The following table summarizes our 2018 financing activity under our repurchase agreements for the six months ended June 30, 2018 (dollars in thousands):



Table of Contents

Collateral	Balance at December 31, 2017	Proceeds	Repayments	Balance at June 30, 2018
Agency RMBS	\$665,919	\$1,259,253	\$(1,520,674)	\$404,498
Agency CMBS	2,035,222	5,146,606	(5,257,922)	1,923,906
Non-Agency RMBS	46,530	239,457	(212,835)	73,152
Non-Agency CMBS	154,325	495,903	(401,173)	249,055
Residential Whole-Loans <sup>(1)</sup>	189,270	2,026,847	(1,948,017)	268,100
Commercial loans	—	24,641	(12,320)	12,321
Securitized commercial loan <sup>(1)</sup>	—	30,527	(22,907)	7,620
Residential Bridge Loans <sup>(1)</sup>	100,183	505,250	(348,945)	256,488
Other securities	60,237	200,924	(188,932)	72,229
Borrowings under repurchase agreements	\$3,251,686	\$9,929,408	\$(9,913,725)	\$3,267,369

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

Table of Contents

At June 30, 2018, we had outstanding repurchase agreement borrowings with the following counterparties:

(dollars in thousands)	Amount Outstanding	Percent of Total Company		Counterparty Rating <sup>(1)</sup>	
		Amount Outstanding	Investments Held as Collateral		
Repurchase Agreement Counterparties					
Citigroup Global Markets Inc.	\$ 795,129	24.4	%	\$ 834,058	A+
Royal Bank of Canada	347,051	10.6	%	364,781	AA-
UBS Securities LLC	281,600	8.6	%	296,599	A+
Nomura Securities International, Inc.	271,328	8.3	%	283,043	Unrated <sup>(2)</sup>
Credit Suisse AG, Cayman Islands Branch	265,581	8.1	%	331,961	A
Mizuho Securities USA Inc.	262,399	8.0	%	275,302	A
Merrill Lynch Pierce Fenner & Smith Inc.	205,764	6.3	%	212,027	A+
Jefferies & Company, Inc.	185,490	5.7	%	193,549	BBB-
UBS AG, London Branch	167,693	5.1	%	240,246	A+
JP Morgan Securities LLC	139,151	4.3	%	158,323	A+
RBC (Barbados) Trading Bank Corporation	131,052	4.0	%	161,213	P-1
KGS-Alpha Capital Markets, L.P.	103,785	3.2	%	108,818	Unrated
TD Securities (USA) LLC	39,745	1.2	%	41,979	AA-
Credit Suisse Securities (USA) LLC	39,138	1.2	%	71,187	A
All other counterparties <sup>(3)</sup>	32,463	1.0	%	36,671	
Total	\$ 3,267,369	100.0	%	\$ 3,609,757	

The counterparty ratings presented above are the long-term issuer credit ratings as rated at June 30, 2018 by S&P, (1) except for RBC (Barbados) Trading Bank Corporation which is the short-term issuer credit rating by Moody's at June 30, 2018.

(2) Nomura Holdings, Inc., the parent company of Nomura Securities International, Inc., is rated A- by S&P at June 30, 2018.

(3) Represents amount outstanding with three counterparties, which each holds collateral valued less than 5% of our stockholders' equity as security for our obligations under the applicable repurchase agreements as of June 30, 2018.

#### Securitized Debt

We acquired a variable interest in CMSC Trust and RETL Trust and were required to consolidate the CMBS VIEs. Refer to Note 7 - "Financings" for details. At June 30, 2018, the consolidated CMSC Trust's commercial mortgage pass-through certificate, which bears a fixed interest rate of 8.9% and mature on July 6, 2020, had an outstanding balance of \$10.8 million and a fair value of \$10.9 million.

The following table summarizes the consolidated RETL Trust's commercial mortgage pass-through certificates at June 30, 2018 which is classified in "Securitized debt" in the Consolidated Balance Sheets (dollars in thousands):

Table of Contents

Classes	Principal Balance	Coupon	Fair Value	Contractual Maturity
Class A	493,448	3.2 %	495,560	2/15/2021
Class B	149,918	3.8 %	150,700	2/15/2021
Class C	129,860	4.1 %	130,726	2/15/2021
Class D	114,793	4.8 %	115,703	2/15/2021
Class E	155,851	6.6 %	157,481	2/15/2021
Class F	150,954	8.1 %	152,537	2/15/2021
Class G	12,619	9.6 %	12,768	2/15/2021
Class X-CP <sup>(1)</sup>	N/A	2.6 %	2,069	3/11/2019
Class X-EXT <sup>(1)</sup>	N/A	— %	2,870	2/15/2021
	\$1,207,443		\$1,220,414	

(1) Class X-CP and Class X-EXT are interest only classes with a notional balance of \$114.8 million each.

The following table presents our average repurchase agreement borrowings, excluding unamortized debt issuance costs, by type of collateral pledged for the three and six months ended June 30, 2018 (dollars in thousands):

Collateral	Three Months Ended June 30, 2018	Six months ended June 30, 2018
Agency RMBS	\$515,453	\$584,726
Agency CMBS	2,001,751	2,032,023
Non-Agency RMBS	84,279	66,173
Non-Agency CMBS	250,129	211,560
Residential Whole-Loans	258,069	239,432
Commercial loans	12,321	7,420
Securitized commercial loans	7,634	4,049
Residential Bridge Loans	211,308	160,708
Other securities	85,033	74,752
Total	\$3,425,977	\$3,380,843
Maximum borrowings during the period <sup>(1)</sup>	\$3,573,043	\$3,573,043

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

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.

The following tables summarize the hedging activity during the six months ended June 30, 2018 (dollars in thousands):



Table of Contents

Derivative Instrument	Notional Amount at December 31, 2017	Acquisitions	Settlements, Terminations or Expirations	Notional Amount at June 30, 2018
Fixed pay interest swaps	\$3,252,200	\$570,400	\$(668,000)	\$3,154,600
Options - long positions	320,000	642,000	(962,000)	—
Options - short positions	320,000	632,300	(952,300)	—
Futures contracts - long positions	—	360,300	(240,600)	119,700
Futures contracts - short positions	480,000	1,362,700	(1,362,700)	480,000
Credit default swaps	14,815	50,000	(33)	64,782
TBA securities - long positions	125,000	3,425,000	(3,050,000)	500,000
TBA securities - short positions	—	3,250,000	(3,050,000)	200,000
Total derivative instruments	\$4,512,015	\$10,292,700	\$(10,285,633)	\$4,519,082

Derivative Instrument	Fair Value at December 31, 2017	Acquisitions	Settlements, Terminations or Expirations	Realized Gains / Losses	Mark-to-market	Fair Value at June 30, 2018
Fixed pay interest swaps	\$(4,191)	\$16,842	\$(111,162)	\$97,883	\$2,245	\$1,617
Options - long positions	100	463	—	(1,163)	600	—
Options - short positions	(50)	(298)	3	645	(300)	—
Futures contracts - long positions	—	—	2,406	(2,406)	1,822	1,822
Futures contracts - short positions	628	—	(6,998)	6,998	1,247	1,875
Credit default swaps	(95)	174	—	—	51	130
TBA securities	(10)	—	(134)	134	(59)	(69)
Total derivative instruments	\$(3,618)	\$17,181	\$(115,885)	\$102,091	\$5,606	\$5,375

As of June 30, 2018, we had approximately \$3.0 billion of fixed pay rate interest rate swaps, excluding approximately \$198.1 million of forward starting fixed pay interest rate swap (forward starting date of 1.9 months). The following table provides additional information on our interest rate swaps (dollars in thousands):

Remaining Interest Rate Swap Term	June 30, 2018						Forward Starting <sup>(1)</sup>	
	Notional Amount	Average Fixed Pay Rate	Average Floating Receive Rate	Average Maturity (Years)				
1 year or less	\$400,000	1.5 %	2.3 %	1.0	—	%		
Greater than 1 year and less than 3 years	200,000	1.8 %	2.4 %	1.9	—	%		
Greater than 3 years and less than 5 years	738,000	2.0 %	2.4 %	3.8	—	%		
Greater than 5 years	1,816,600	2.5 %	2.4 %	10.3	10.9	%		
Total	\$3,154,600	2.2 %	2.4 %	7.1	6.3	%		

(1) Represents the percentage of notional that is forward starting.

#### Capital Markets Activity

The following is a summary of activity during the six months ended June 30, 2018:

Pursuant to the repurchase plan that was reauthorized in December 2017, we acquired approximately 177,700 shares of the Company stock with an average price, including commission, of \$9.75 per share, totaling approximately \$1.7 million; and

Our dividend remained stable at \$0.31 for each of the nine quarters ending on June 30, 2018. For the quarter ended June 30, 2018, we generated a dividend yield of approximately 11.9% based on the stock closing price of \$10.42 at June 29, 2018.

Table of Contents

Book Value

The following chart reflects our book value per common share basic and diluted over five consecutive quarters: Our book value per common share basic and diluted, net of our quarterly dividends was \$11.10 at June 30, 2018, a decrease of \$0.27 or 2.4% when compared to our March 31, 2018 book value of \$11.37. The decline in book value was mainly a result of spread widening in our Agency CMBS portfolio.

Results of Operations

Comparison of the three months ended June 30, 2018 to the three months ended June 30, 2017.

General

Our operating results mainly depend upon the difference between the yield on our investments, the cost of our borrowing, including our hedging activities, the composition and changes in market prices of our portfolio and our expenses. For the three months ended June 30, 2018, we generated net income of \$1.5 million, or \$0.03 per basic and diluted weighted common share, compared to net income of \$20.7 million, or \$0.49 per basic and diluted weighted common share, for the three months ended June 30, 2017. The decrease in net income was attributable to spread widening resulting in a decline in value of mainly our Agency portfolio. The decrease in net income was offset by the gain on our derivative instruments and lower OTTI and general administrative expenses. The key components of these changes are discussed in greater detail below.

Table of Contents

## Net Interest Income

The following tables set forth certain information regarding our net interest income on our investment portfolio for the three months ended June 30, 2018 and June 30, 2017 (dollars in thousands):

Three Months Ended June 30, 2018	Average Amortized Cost of Assets	Total Interest Income	Yield on Average Assets	
<b>Investments</b>				
Agency RMBS	\$537,544	\$4,091	3.05	%
Agency CMBS	2,155,858	15,855	2.95	%
Non-Agency RMBS	112,521	1,776	6.33	%
Non-Agency CMBS	339,034	7,678	9.08	%
Residential Whole-Loans	328,669	3,705	4.52	%
Residential Bridge Loans	229,453	4,190	7.32	%
Commercial loans	41,092	818	7.98	%
Securitized commercial loans	1,324,767	16,664	5.05	%
Other securities	112,916	2,377	8.44	%
Total investments	\$5,181,854	\$57,154	4.42	%
	Average Carrying Value	Total Interest Expense	Average Cost of Funds <sup>(1)</sup>	
<b>Borrowings</b>				
Repurchase agreements	\$3,425,977	\$21,523	2.52	%
Convertible senior unsecured notes, net	109,291	2,271	8.33	%
Securitized debt	1,245,722	14,340	4.62	%
Total borrowings	\$4,780,990	\$38,134	3.20	%
Net interest income and net interest margin		\$19,020	1.47	%

(1) Average cost of funds does not include the interest expense related to our derivatives. In accordance with GAAP, such costs are included in "Gain (loss) on derivative instruments, net" in the Consolidated Statements of Operations.



Table of Contents

Three Months Ended June 30, 2017	Average Amortized Cost of Assets	Total Interest Income	Yield on Average Assets	
<b>Investments</b>				
Agency RMBS	\$977,294	\$ 6,666	2.74	%
Agency CMBS	1,150,446	8,770	3.06	%
Non-Agency RMBS	60,227	950	6.33	%
Non-Agency CMBS	337,971	7,177	8.52	%
Residential Whole-Loans	206,764	2,063	4.00	%
Residential Bridge Loans	58,479	1,301	8.92	%
Securitized commercial loan	25,000	568	9.11	%
Other securities	124,104	2,560	8.27	%
Total investments	\$2,940,285	\$ 30,055	4.10	%
	Average Carrying Value	Total Interest Expense	Average Cost of Funds <sup>(1)</sup>	
<b>Borrowings</b>				
Repurchase agreements	\$2,571,946	\$ 10,159	1.58	%
Securitized debt	11,000	248	9.04	%
Total borrowings	\$2,582,946	\$ 10,407	1.62	%
Net interest income and net interest margin		\$ 19,648	2.68	%

(1) Average cost of funds does not include the interest expense related to our derivatives. In accordance with GAAP, such costs are included in "Gain (loss) on derivative instruments, net" in the Consolidated Statements of Operations.

**Interest Income**

For the three months ended June 30, 2018 and June 30, 2017, we earned interest income on our investments of approximately \$57.2 million and \$30.1 million, respectively. The increase in interest income for the three months ended June 30, 2018 as compared to the three months ended June 30, 2017 was primarily the result of an overall larger investment portfolio. The 1.3 billion securitized commercial loan as a result of the consolidation of RETL securitization loan increased interest income by approximately \$16.1 million. Interest income on our Agency CMBS, Residential Whole and Bridge Loans and Commercial Loans also increased by approximately \$12 million, due to larger portfolios, which was partially offset by reduction in interest income on Agency RMBS due to a smaller Agency RMBS portfolio.

**Interest Expense**

Interest expense increased from \$10.4 million for the three months ended June 30, 2017 to \$38.1 million for the three months ended June 30, 2018. The increase in our borrowing costs reflects: (i) increase in our average outstanding borrowings due to larger investment portfolio (our average outstanding borrowings on our repurchase agreement increased by \$854.0 million to \$3.4 billion for the three months ended June 30, 2018 from \$2.6 billion for the three months ended June 30, 2017); (ii) generally higher interest rates on our repurchase agreements in 2018 coupled with higher costs associated with financing our credit-sensitive investments, which generally have higher interest rates (our average cost of funds on our repurchase agreements increased from 1.58% for the three months ended June 30, 2017 to 2.52% for the three months ended June 30, 2018); (iii) the issuance of \$115.0 million aggregate principal amount of

6.75% convertible senior unsecured notes in October 2017; and the consolidation of RETL trust as of March 27, 2018, which added \$1.2 billion of securitized debt to our balance sheet with a weighted average interest rate of 4.62%, increasing interest expense by approximately \$14.1 million dollars.

Other income (loss), net

Realized gain (loss) on investments

Table of Contents

Realized gain (loss) on investments represents 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, we expect to continue to redeploy our capital out of Agency MBS and into credit sensitive investments in order to adjust the overall characteristics of our portfolio.

The following table presents the sales and realized gains (losses) of our investments for each of the three months ended June 30, 2018 and June 30, 2017 (dollars in thousands):

	For the three months ended June 30, 2018				For the three months ended June 30, 2017			
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS <sup>(1)</sup>	\$208,331	\$ —	\$ (4,531 )	\$(4,531 )	\$314,800	\$ 848	\$ (3,725 )	\$(2,877)
Agency CMBS	126,867	—	(5,016 )	(5,016 )	—	—	—	—
Non-Agency RMBS	47,758	2,220	—	2,220	—	—	—	—
Non-Agency CMBS	385	—	(38 )	(38 )	15,220	730	(341 )	389
Other securities	21,757	1,757	\$ —	1,757	—	—	—	—
Total	\$405,098	\$ 3,977	\$ (9,585 )	\$(5,608 )	\$330,020	\$ 1,578	\$ (4,066 )	\$(2,488)

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

	Three months ended June 30, 2018	Three months ended June 30, 2017
Agency RMBS <sup>(1)</sup>	\$ 201	\$ 161
Non-Agency RMBS	19	—
Non-Agency CMBS	2,754	5,980
Other securities	—	438
Total	\$ 2,974	\$ 6,579

(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. In the second quarter of 2018, the wider spreads resulted in a significant decrease in the value of our Agency portfolio, which accounts for the majority of the increase in unrealized loss for the period.

70

---

Table of Contents

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

	Three months ended June 30, 2018	Three months ended June 30, 2017
Agency RMBS	\$(457 )	\$7,622
Agency CMBS	(33,168 )	10,924
Non-Agency RMBS	(1,205 )	1,993
Non-Agency CMBS	4,924	7,706
Residential Whole-Loans	(452 )	628
Residential Bridge Loans	(76 )	—
Commercial loans	374	—
Securitized commercial loans	5,621	—
Other securities	(1,624 )	6,309
Securitized debt	(5,798 )	(165 )
Other liabilities	168	—
Total	\$(31,693)	\$35,017

## 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 the second quarter of 2018, swap rates also increased which resulted in favorable realized gains on our fix pay interest rate swap positions.

Table of Contents

The following table presents the components of gain (loss) on derivatives for the three months ended June 30, 2018 and June 30, 2017 (dollars in thousands):

Description	Realized Gain (Loss), net					Contractual interest income (expense), net <sup>(1)</sup>	Total
	Other Settlements / Expirations	Variation Margin Settlement	Return (Recovery) Basis	of Mark-to-Market			
Three months ended June 30, 2018							
Interest rate swaps	\$24	\$21,634	\$ 211	\$ 2,177	\$ 833		\$24,879
Agency and Non-Agency Interest-Only Strips— accounted for as— derivatives		—	(783 )	(96 )	1,011		132
Options	(100 )	—	—	88	—		(12 )
Futures contracts	614	—	—	2,567	—		3,181
Credit default swaps	(23 )	—	—	66	—		43
TBAs	801	—	—	(534 )	—		267
Total	\$1,316	\$21,634	\$ (572 )	\$ 4,268	\$ 1,844		\$28,490
Three months ended June 30, 2017							
Interest rate swaps	\$(154,304)	\$(21,504 )	\$ 117	\$ 160,596	\$ (3,673 )		\$(18,768)
Agency and Non-Agency Interest-Only Strips— accounted for as— derivatives	\$32	—	(2,004 )	164	2,372		964
Options	237	—	—	(413 )	—		(176 )
Futures contracts	(2,515 )	—	—	545	—		(1,970 )
Foreign currency forwards	3	—	—	29	—		32
Total return swaps	14	—	—	130	143		287
TBAs	2,125	—	—	(1,049 )	—		1,076
Total	\$(154,008)	\$(21,504 )	\$ (1,887 )	\$ 160,002	\$ (1,158 )		\$(18,555)

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

## Other, net

For the three months ended June 30, 2018 and June 30, 2017, "Other, net" was an expense of \$145 thousand and income of \$222 thousand, respectively. The balance is mainly comprised of miscellaneous net interest income (expense) on cash collateral for our repurchase agreements and derivatives.

## Expenses

## Management Fee Expense

We incurred management fee expense of approximately \$2.3 million and \$1.8 million for the three months ended June 30, 2018 and June 30, 2017, 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 increase was mainly attributable to the realized gain on our interest rate swaps increasing our stockholders equity utilized to calculate our management fee.

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

72

---

Table of Contents

Other Operating Expenses

We incurred other operating expenses of approximately \$1.6 million and \$736 thousand for the three months ended June 30, 2018 and June 30, 2017, respectively. Other operating cost is comprised of derivative transaction costs, custody, and asset management/loan servicing fees. The increase was primarily a result of the larger residential loan portfolio and the addition of commercial loans thereby increasing the associated third party asset management/loan servicing fees.

General and Administrative Expenses

We incurred general and administrative expenses of approximately \$1.8 million and \$1.9 million for the three months ended June 30, 2018 and June 30, 2017, respectively. The following describes the key components of general and administrative expenses.

Compensation Expense

Compensation expense decreased from approximately \$664 thousand for the three months ended June 30, 2017 to approximately \$572 thousand for the three months ended June 30, 2018. The decrease was a result lower stock based compensation from awards becoming fully vested in the first quarter of 2018. We did not issue any new stock based awards to our Manager or executive officers in 2017 or first quarter of 2018.

Professional Fees

Professional fees were basically flat quarter over quarter for the three months ended June 30, 2018 compared to the three months ended June 30, 2017.

Other general and administrative expenses

Other general and administrative expenses was flat quarter over quarter for the three months ended June 30, 2018 compared to the three months ended June 30, 2017.

Comparison of the six months ended June 30, 2018 to the six months ended June 30, 2017.

General

Our operating results mainly depend upon the difference between the yield on our investments, the cost of our borrowing, including our hedging activities, the composition and changes in market prices of our portfolio and our expenses. For the six months ended June 30, 2018, we generated net income of \$23.2 million, or \$0.55 per basic and diluted weighted common share, compared to net income of \$40.9 million, or \$0.97 per basic and diluted weighted common share, for the six months ended June 30, 2017. The decrease in net income was a attributable spread widening resulting in a decline in value of mainly our Agency portfolio. The decrease in net income was offset by the gain on our derivative instruments and lower OTTI. The key components of these changes are discussed in greater detail below.



Table of Contents

## Net Interest Income

The following tables set forth certain information regarding our net interest income on our investment portfolio for the six months ended June 30, 2018 and June 30, 2017 (dollars in thousands):

Six months ended June 30, 2018	Average Amortized Cost of Assets	Total Interest Income	Yield on Average Assets
<b>Investments</b>			
Agency RMBS	\$603,982	\$9,946	3.32 %
Agency CMBS	2,165,493	31,973	2.98 %
Non-Agency RMBS	102,967	3,328	6.52 %
Non-Agency CMBS	320,561	14,387	9.05 %
Residential Whole-Loans	301,786	6,745	4.51 %
Residential Bridge Loans	175,263	6,541	7.53 %
Commercial loans	26,435	1,044	7.96 %
Securitized commercial loans	715,742	18,146	5.11 %
Other securities	113,116	4,771	8.51 %
Total investments	\$4,525,345	\$96,881	4.32 %
	Average Carrying Value	Total Interest Expense	Average Cost of Funds <sup>(1)</sup>
<b>Borrowings</b>			
Repurchase agreements	\$3,380,843	\$38,912	2.32 %
Convertible senior unsecured notes, net	109,127	4,519	8.35 %
Securitized debt	842,516	15,400	3.69 %
Total borrowings	\$4,332,486	\$58,831	2.74 %
Net interest income and net interest margin		\$38,050	1.70 %

(1) Average cost of funds does not include the interest expense related to our derivatives. In accordance with GAAP, such costs are included in "Gain (loss) on derivative instruments, net" in the Consolidated Statements of Operations.

Table of Contents

Six months ended June 30, 2017	Average Amortized Cost of Assets	Total Interest Income	Yield on Average Assets	
<b>Investments</b>				
Agency RMBS	\$1,010,650	\$ 13,960	2.79	%
Agency CMBS	918,323	13,944	3.06	%
Non-Agency RMBS	107,501	3,842	7.21	%
Non-Agency CMBS	355,319	14,866	8.44	%
Residential Whole-Loans	212,526	4,334	4.11	%
Residential Bridge Loans	36,141	1,620	9.04	%
Securitized commercial loan	25,000	1,131	9.12	%
Other securities	116,263	4,788	8.30	%
Total investments	\$2,781,723	\$ 58,485	4.24	%
	Average Carrying Value	Total Interest Expense	Average Cost of Funds <sup>(1)</sup>	
<b>Borrowings</b>				
Repurchase agreements	\$2,421,323	\$ 18,650	1.55	%
Securitized debt	11,000	494	9.06	%
Total borrowings	\$2,432,323	\$ 19,144	1.59	%
Net interest income and net interest margin		\$ 39,341	2.85	%

(1) Average cost of funds does not include the interest expense related to our derivatives. In accordance with GAAP, such costs are included in "Gain (loss) on derivative instruments, net" in the Consolidated Statements of Operations.

**Interest Income**

For the six months ended June 30, 2018 and June 30, 2017, we earned interest income on our investments of approximately \$96.9 million and \$58.5 million, respectively. The increase in interest income for the six months ended June 30, 2018 as compared to the six months ended June 30, 2017 was primarily the result of an overall larger investment portfolio. The \$1.3 billion securitized commercial loan that was acquired in March 2018 increased interest income by approximately \$17.0 million. Interest income on our Agency CMBS, Residential Whole and Bridge Loans and Commercial Loans also increased by approximately \$26.4 million, due to larger portfolios, which was partially offset by reduction in interest income on Agency RMBS due to a smaller Agency RMBS portfolio. The repositioning of our portfolio from Agency securities to a more credit sensitive portfolio increased the overall yield on our assets to 4.32% for the six month ended June 30, 2018 compared to an overall portfolio yield of 4.24% for the six month ended June 30, 2017.

**Interest Expense**

Interest expense increased from \$19.1 million for the six months ended June 30, 2017 to \$58.8 million for the six months ended June 30, 2018. The increase in our borrowing costs reflects: (i) increase in our average outstanding borrowings due to larger investment portfolio (our average outstanding borrowings on our repurchase agreement increased by \$1.0 billion to \$3.4 billion for the six months ended June 30, 2018 from \$2.4 billion for the six months ended June 30, 2017); (ii) generally higher interest rates on our repurchase agreements in 2018 coupled with higher costs associated with financing our credit-sensitive investments, which generally have higher interest rates (our

average cost of funds on our repurchase agreements increased from 1.55% for the six months ended June 30, 2017 to 2.32% for the six months ended June 30, 2018); (iii) the issuance of \$115.0 million aggregate principal amount of 6.75% convertible senior unsecured notes in October 2017; and the consolidation of a securitized trust as of March 27, 2018, which added \$1.2 billion of securitized debt to our balance sheet with a weighted average cost of 3.69% increasing interest expense by approximately \$14.9 million dollars.

Other income (loss), net

75

---

Table of Contents

## Realized gain (loss) on investments

Realized gain (loss) on investments represents 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, we expect to continue to redeployed our capital out of Agency MBS and into credit sensitive investments in order to adjust the overall characteristics of our portfolio.

The following table presents the sales and realized gains (losses) of our investments for each of the six months ended June 30, 2018 and June 30, 2017 (dollars in thousands):

	For the six months ended June 30, 2018				For the six months ended June 30, 2017			
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS <sup>(1)</sup>	\$209,581	\$ 18	\$ (4,531 )	\$(4,513 )	\$865,151	\$ 4,379	\$ (7,365 )	\$(2,986 )
Agency CMBS	126,867	—	(5,016 )	(5,016 )	—	—	—	—
Non-Agency RMBS <sup>(1)</sup>	51,958	3,114	—	3,114	243,811	24,389	(2,242 )	22,147
Non-Agency CMBS	6,706	61	(436 )	(375 )	35,037	736	(1,073 )	(337 )
Other securities	21,757	1,757	\$ —	1,757	22,946	—	(54 )	(54 )
Total	\$416,869	\$ 4,950	\$ (9,983 )	\$(5,033 )	\$1,166,945	\$ 29,504	\$ (10,734 )	\$18,770

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

	Six months ended June 30, 2018	Six months ended June 30, 2017
Agency RMBS <sup>(1)</sup>	\$ 343	\$660
Non-Agency RMBS	110	—
Non-Agency CMBS	5,437	10,314
Other securities	—	1,702
Total	\$ 5,890	\$12,676

(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. In the first half of 2018, the wider spreads

76

---

Table of Contents

resulted in a significant decrease in the value of our Agency portfolio, which accounts for the majority of the increase in unrealized loss for the period.

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

	Six months ended June 30, 2018	Six months ended June 30, 2017
Agency RMBS	\$(16,654 )	\$6,397
Agency CMBS	(87,470 )	12,705
Non-Agency RMBS	(1,684 )	(13,193 )
Non-Agency CMBS	6,897	15,324
Residential Whole-Loans	(1,241 )	1,283
Residential Bridge Loans	(229 )	—
Commercial loans	416	—
Securitized commercial loans	10,870	—
Other securities	(269 )	7,647
Securitized debt	(10,728 )	(286 )
Other liabilities	(562 )	—
Total	\$(100,654)	\$29,877

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 the first half of 2018, swap rates also increased which resulted in favorable realized gains on our fix pay interest rate swap positions.

Table of Contents

The following table presents the components of gain (loss) on derivatives for the six months ended June 30, 2018 and June 30, 2017 (dollars in thousands):

Description	Realized Gain (Loss), net Other Settlements / Expirations	Variation Margin Settlement	Return (Recovery) of Basis	Mark-to-Market	Contractual interest income (expense), net <sup>(1)</sup>	Total
Six months ended June 30, 2018						
Interest rate swaps	\$ 19	\$ 97,864	\$ 292	\$ 2,245	\$ (304)	\$ 100,116
Agency and Non-Agency Interest-Only Strips— accounted for as derivatives	—	—	(1,974)	(30)	2,433	429
Options	(518)	—	—	300	—	(218)
Futures contracts	4,592	—	—	3,069	—	7,661
Credit default swaps	(42)	—	—	51	—	9
TBAs	134	—	—	(59)	—	75
Total	\$ 4,185	\$ 97,864	\$ (1,682)	\$ 5,576	\$ 2,129	\$ 108,072
Six months ended June 30, 2017						
Interest rate swaps	\$(150,555)	\$(17,530)	\$ 286	\$ 158,130	\$ (10,898)	\$(20,567)
Interest rate swaptions	(115)	—	—	—	—	(115)
Agency and Non-Agency Interest-Only Strips— accounted for as derivatives	526	—	(3,569)	(1,134)	4,413	236
Options	65	—	—	(611)	—	(546)
Futures contracts	(9,153)	—	—	2,416	—	(6,737)
Foreign currency forwards	(20)	—	—	58	—	38
Total return swaps	(500)	—	—	1,344	374	1,218
TBAs	2,571	—	—	650	—	3,221
Total	\$(157,181)	\$(17,530)	\$ (3,283)	\$ 160,853	\$ (6,111)	\$(23,252)

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

## Other, net

For the six months ended June 30, 2018 and June 30, 2017, "Other, net" was an expense of \$98 thousand and income of \$625 thousand, respectively. The balance is mainly comprised of miscellaneous net interest income (expense) on cash collateral for our repurchase agreements and derivatives.

## Expenses

## Management Fee Expense

We incurred management fee expense of approximately \$4.4 million and \$4.3 million for the six months ended June 30, 2018 and June 30, 2017, 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 increase was mainly attributable to the realized gain on our

interest rate swaps increasing our stockholders equity utilized to calculate our management fee.



## Table of Contents

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

### Other Operating Expenses

We incurred other operating expenses of approximately \$2.5 million and \$1.2 million for the six months ended June 30, 2018 and June 30, 2017, respectively. Other operating cost is comprised of derivative transaction costs, custody, and asset management/loan servicing fees. The increase was primarily a result of the larger Residential Whole and Bridge loan portfolio and the addition of commercial loans, thereby increasing the associated third party asset management/loan servicing fees.

### General and Administrative Expenses

We incurred general and administrative expenses of approximately \$4.0 million and \$3.9 million for the six months ended June 30, 2018 and June 30, 2017, respectively. The following describes the key components of general and administrative expenses.

#### Compensation Expense

Compensation expense decreased from approximately \$1.4 million for the six months ended June 30, 2017 to approximately \$1.1 million for the six months ended June 30, 2018. The decrease was a result lower stock based compensation from awards becoming fully vested in the first half of 2018. We did not issue any new stock based awards to our Manager or executive officers in 2017 or the first half of 2018.

#### Professional Fees

Professional fees increased to approximately \$2.1 million for the six months ended June 30, 2018 from approximately \$1.7 million for the six months ended June 30, 2017. The increase was a result of slightly higher audit fees incurred in connection with becoming Sarbanes Oxley 404(b) complaint.

#### Other general and administrative expenses

Other general and administrative expenses was flat quarter over quarter for the six months ended June 30, 2018 compared to the six months ended June 30, 2017.

### 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 three and six months ended June 30, 2018 and June 30, 2017 (dollars in thousands):



Table of Contents

Three Months Ended June 30, 2018	Average Amortized Cost of Assets <sup>(1)</sup>	Total Interest Income <sup>(2)</sup>	Yield on Average Assets
<b>Investments</b>			
Agency RMBS	\$545,745	\$4,266	3.14 %
Agency CMBS	2,161,268	15,908	2.95 %
Non-Agency RMBS	112,521	1,776	6.33 %
Non-Agency CMBS	339,034	7,678	9.08 %
Residential Whole-Loans	328,669	3,705	4.52 %
Residential Bridge Loans	229,453	4,190	7.32 %
Commercial loans	41,092	818	7.98 %
Securitized commercial loans	1,324,767	16,664	5.05 %
Other securities	112,916	2,377	8.44 %
Total investments	\$5,195,465	\$57,382	4.43 %
<b>Adjustments:</b>			
Securitized commercial loans from consolidated VIEs	(1,324,767 )	(16,664 )	5.05 %
Investments in consolidated VIEs eliminated in consolidation	79,584	2,210	11.14 %
Adjusted total investments	\$3,950,282	\$42,928	4.36 %
	Average Carrying Value	Total Interest Expense <sup>(3)</sup>	Average Effective Cost of Funds
<b>Borrowings</b>			
Repurchase agreements	\$3,425,977	\$21,523	2.52 %
Convertible senior unsecured notes, net	109,291	2,271	8.33 %
Securitized debt	1,245,722	14,340	4.62 %
Interest rate swaps	n/a	(1,044 )	(0.09 )%
Total borrowings	\$4,780,990	\$37,090	3.11 %
<b>Adjustments:</b>			
Securitized debt from consolidated VIEs	\$(1,245,722)	\$(14,340 )	4.62 %
Adjusted total borrowings	\$3,535,268	\$22,750	2.58 %
Adjusted net interest income and net interest margin		\$20,178	2.05 %

Table of Contents

Three Months Ended June 30, 2017	Average Amortized Cost of Assets <sup>(1)</sup>	Total Interest Income <sup>(2)</sup>	Yield on Average Assets
<b>Investments</b>			
Agency RMBS	\$989,793	\$ 6,971	2.82 %
Agency CMBS	1,158,561	8,833	3.06 %
Non-Agency RMBS	60,227	951	6.33 %
Non-Agency CMBS	337,971	7,177	8.52 %
Residential Whole-Loans	206,764	2,063	4.00 %
Residential Bridge Loans	58,479	1,301	8.92 %
Securitized commercial loan	25,000	568	9.11 %
Other securities	124,104	2,559	8.27 %
Total return swaps	4,326	143	13.26 %
Total investments	\$2,965,225	\$ 30,566	4.13 %
<b>Adjustments:</b>			
Securitized commercial loan from consolidated VIE	(25,000 )	(568 )	9.11 %
Investment in consolidated VIE eliminated in consolidation	14,000	316	9.05 %
Adjusted total investments	\$2,954,225	\$ 30,314	4.12 %
	Average Carrying Value	Total Interest Expense <sup>(3)</sup>	Average Effective Cost of Funds
<b>Borrowings</b>			
Repurchase agreements	\$2,571,946	\$ 10,159	1.58 %
Securitized debt	11,000	248	9.04 %
Interest rate swaps	n/a	3,556	0.55 %
Total borrowings	\$2,582,946	\$ 13,963	2.17 %
<b>Adjustments:</b>			
Securitized debt from consolidated VIE	\$(11,000 )	\$(248 )	9.04 %
Adjusted total borrowings	\$2,571,946	\$ 13,715	2.14 %
Adjusted net interest income and net interest margin		\$ 16,599	2.25 %

Table of Contents

Six months ended June 30, 2018	Average Amortized Cost of Assets <sup>(1)</sup>	Total Interest Income <sup>(2)</sup>	Yield on Average Assets	
<b>Investments</b>				
Agency RMBS	\$612,853	\$ 10,290	3.39	%
Agency CMBS	2,171,439	32,088	2.98	%
Non-Agency RMBS	102,967	3,328	6.52	%
Non-Agency CMBS	320,561	14,387	9.05	%
Residential Whole-Loans	301,786	6,745	4.51	%
Residential Bridge Loans	175,263	6,541	7.53	%
Commercial loans	26,435	1,044	7.96	%
Securitized commercial loans	715,742	18,146	5.11	%
Other securities	113,116	4,771	8.51	%
Total investments	\$4,540,162	\$ 97,340	4.32	%
<b>Adjustments:</b>				
Securitized commercial loans from consolidated VIEs	(715,742 )	(18,146 )	5.11	%
Investments in consolidated VIEs eliminated in consolidation	48,787	2,626	10.85	%
Adjusted total investments	\$3,873,207	\$ 81,820	4.26	%
	Average Carrying Value	Total Interest Expense <sup>(3)</sup>	Average Effective Cost of Funds	
<b>Borrowings</b>				
Repurchase agreements	\$3,380,843	\$ 38,912	2.32	%
Convertible senior unsecured notes, net	109,127	4,519	8.35	%
Securitized debt	842,516	15,400	3.69	%
Interest rate swaps	n/a	12	—	%
Total borrowings	\$4,332,486	\$ 58,843	2.74	%
<b>Adjustments:</b>				
Securitized debt from consolidated VIEs	\$(842,516 )	\$(15,400 )	3.69	%
Adjusted total borrowings	\$3,489,970	\$ 43,443	2.51	%
Adjusted net interest income and net interest margin		\$ 38,377	2.00	%

Table of Contents

Six months ended June 30, 2017	Average Amortized Cost of Assets <sup>(1)</sup>	Total Interest Income <sup>(2)</sup>	Yield on Average Assets	
<b>Investments</b>				
Agency RMBS	\$1,024,891	\$ 14,645	2.88	%
Agency CMBS	926,904	14,064	3.06	%
Non-Agency RMBS	107,986	3,881	7.25	%
Non-Agency CMBS	355,319	14,866	8.44	%
Residential Whole-Loans	212,526	4,334	4.11	%
Residential Bridge Loans	36,141	1,620	9.04	%
Securitized commercial loan	25,000	1,131	9.12	%
Other securities	116,263	4,788	8.30	%
Total return swaps	5,504	374	13.67	%
Total investments	\$2,810,534	\$ 59,703	4.28	%
<b>Adjustments:</b>				
Securitized commercial loan from consolidated VIE	(25,000 )	(1,131 )	9.12	%
Investment in consolidated VIE eliminated in consolidation	14,000	628	9.05	%
Adjusted total investments	\$2,799,534	\$ 59,200	4.26	%
	Average Carrying Value	Total Interest Expense <sup>(3)</sup>	Average Effective Cost of Funds	
<b>Borrowings</b>				
Repurchase agreements	\$2,421,323	\$ 18,650	1.55	%
Securitized debt	11,000	494	9.06	%
Interest rate swaps	n/a	10,612	0.88	%
Total borrowings	\$2,432,323	\$ 29,756	2.47	%
<b>Adjustments:</b>				
Securitized debt from consolidated VIE	\$(11,000 )	\$(494 )	9.06	%
Adjusted total borrowings	\$2,421,323	\$ 29,262	2.44	%
Adjusted net interest income and net interest margin		\$ 29,938	2.16	%

(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 adjusted interest income, which includes interest income on Agency and Non-Agency Interest-Only Strips classified as derivatives (Non-GAAP financial measure) for the three and six months ended June 30, 2018 and June 30, 2017:

Table of Contents

(dollars in thousands)	Three months ended June 30, 2018	Three months ended June 30, 2017	Six months ended June 30, 2018	Six months ended June 30, 2017
Coupon interest income:				
Agency RMBS	\$5,796	\$10,305	\$12,920	\$21,627
Agency CMBS	15,943	8,432	31,941	13,337
Non-Agency RMBS	2,057	558	3,477	3,911
Non-Agency CMBS	5,170	4,913	9,983	10,433
Residential Whole-Loans	3,990	2,356	7,250	4,877
Residential Bridge Loans	4,799	1,405	7,284	1,729
Commercial loans	781	—	1,000	—
Securitized commercial loans	17,327	568	18,809	1,131
Other Securities	4,180	1,733	7,936	3,140
Subtotal coupon interest	60,043	30,270	100,600	60,185
Premium accretion, discount amortization and amortization of basis, net:				
Agency RMBS	(1,705 )	(3,639 )	(2,974 )	(7,667 )
Agency CMBS	(88 )	338	32	607
Non-Agency RMBS	(281 )	392	(149 )	(69 )
Non-Agency CMBS	2,508	2,264	4,404	4,433
Residential Whole-Loans	(285 )	(293 )	(505 )	(543 )
Residential Bridge Loans	(609 )	(104 )	(743 )	(109 )
Commercial loans	37	—	44	—
Securitized commercial loans	(663 )	—	(663 )	—
Other Securities	(1,803 )	827	(3,165 )	1,648
Subtotal accretion and amortization	(2,889 )	(215 )	(3,719 )	(1,700 )
Interest income	\$57,154	\$30,055	\$96,881	\$58,485
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	\$1,011	\$2,372	\$2,433	\$4,413
Amortization of basis	(783 )	(2,004 )	(1,974 )	(3,569 )
Total return swaps	—	143	—	374
Subtotal	228	511	459	1,218
Total adjusted interest income	\$57,382	\$30,566	\$97,340	\$59,703

(1) Reported in "Gain (loss) on derivative instruments, net" in our 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.

Table of Contents

The following table reconciles the Effective Cost of Funds (Non-GAAP financial measure) with interest expense for the three and six months ended June 30, 2018 and June 30, 2017:

(dollars in thousands)	Three months ended June 30, 2018		Three months ended June 30, 2017		Six months ended June 30, 2018		Six months ended June 30, 2017	
	Reconciliation	Cost of Funds/ Effective Borrowing Costs	Reconciliation	Cost of Funds/ Effective Borrowing Costs	Reconciliation	Cost of Funds/ Effective Borrowing Costs	Reconciliation	Cost of Funds/ Effective Borrowing Costs
Interest expense	\$38,134	3.20 %	\$10,407	1.62 %	\$58,831	2.74 %	\$19,144	1.59 %
Net interest (received) paid - interest rate swaps	(1,044 )	(0.09 )%	3,556	0.55 %	12	— %	10,612	0.88 %
Effective Borrowing Costs	\$37,090	3.11 %	\$13,963	2.17 %	\$58,843	2.74 %	\$29,756	2.47 %
Weighted average borrowings	\$4,780,990		\$2,582,946		\$4,332,486		\$2,432,323	

## Core Earnings

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 unrealized gain (loss) resulting from mark-to-market adjustments on derivative contracts; (iv) other than temporary impairment; (v) provision for income 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.

The table below reconciles Net Income (Loss) to Core Earnings for the three and six months ended June 30, 2018 and June 30, 2017:



Table of Contents

(dollars in thousands)	Three months ended June 30, 2018	Three months ended June 30, 2017	Six months ended June 30, 2018	Six months ended June 30, 2017
Net Income (Loss)	\$ 1,453	\$ 20,684	\$ 23,182	\$ 40,926
Income tax provision (benefit)	36	2,115	349	2,427
Net Income (Loss) before income taxes	1,489	22,799	23,531	43,353
Adjustments:				
Investments:				
Unrealized (gain) loss on investments, securitized debt and other liabilities	31,693	(35,017 )	100,654	(29,877 )
Other than temporary impairment	2,974	6,579	5,890	12,676
Realized (gain) loss on sale of investments	5,608	2,488	5,033	(18,770 )
Realized (gain) loss on foreign currency transactions	—	1	—	2
Acquisition costs	163	—	204	—
Derivative Instruments:				
Net realized (gain) loss on derivatives	(22,973 )	175,512	(102,091)	174,711
Net unrealized (gain) loss on derivatives	(4,268 )	(160,002)	(5,576 )	(160,853)
Amortization of discount on convertible senior unsecured notes	138	—	275	—
Non-cash stock-based compensation expense	50	215	125	577
Total adjustments	13,385	(10,224 )	4,514	(21,534 )
Core Earnings	\$ 14,874	\$ 12,575	\$ 28,045	\$ 21,819

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 Acquisition costs, adding Amortization of discount on convertible senior notes and adding Interest income on cash balances and other income (loss), net:

(dollars in thousands)	Three months ended June 30, 2018	Three months ended June 30, 2017	Six months ended June 30, 2018	Six months ended June 30, 2017
Adjusted net interest income	\$ 20,292	\$ 16,603	\$ 38,497	\$ 29,947
Total expenses	(5,601 )	(4,466 )	(10,916 )	(9,332 )
Non-cash stock based compensation	50	215	125	577
Acquisition costs	163	—	204	—
Amortization of discount on convertible unsecured senior notes	138	—	275	—
Interest income on cash balances and other income (loss), net	(168 )	223	(140 )	627
Core Earnings	\$ 14,874	\$ 12,575	\$ 28,045	\$ 21,819

## 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

86

---

Table of Contents

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 June 30, 2018, our principal sources of cash consist of borrowings under repurchase agreements, 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 \$16.3 million and \$41.2 million at June 30, 2018 and June 30, 2017, 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 June 30, 2018, we had master repurchase agreements with 28 counterparties. We had borrowings under repurchase agreements with 17 counterparties of approximately \$3.3 billion at June 30, 2018. The following tables present our repurchase agreement borrowings by type of collateral pledged, as of June 30, 2018 and June 30, 2017, and the respective effective cost of funds (Non-GAAP financial measure) for the three and six months ended June 30, 2018 and June 30, 2017, respectively. See “Non-GAAP Financial Measures” (dollars in thousands):

Collateral	June 30, 2018				Three months ended June 30, 2018		Six months ended June 30, 2018			
	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 Cost of Funds	Weighted Average Effective Cost of Funds (Non-GAAP)	Weighted Average Haircut at period end		
Agency RMBS, at fair value	\$404,498	\$423,418	2.18 %	2.02 %	2.02 %	1.85 %	1.85 %	4.62 %		
Agency CMBS, at fair value	1,923,906	2,017,265	2.21 %	1.96 %	1.96 %	1.84 %	1.84 %	5.02 %		
Non-Agency RMBS, at fair value	73,152	101,190	3.71 %	3.59 %	3.59 %	3.38 %	3.38 %	28.01 %		
Non-Agency CMBS, at fair value	249,055	331,162	3.77 %	3.67 %	3.67 %	3.52 %	3.52 %	24.76 %		
Residential Whole-Loans, at fair value <sup>(3)</sup>	268,100	335,149	3.86 %	4.25 %	4.25 %	4.22 %	4.22 %	20.00 %		
Residential Bridge Loans <sup>(3)</sup>	256,488	259,339	4.32 %	4.48 %	4.48 %	4.58 %	4.58 %	20.00 %		

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

Commercial loans, at fair value	12,321	20,515	4.83	%	4.72%	4.72	%	4.70%	4.70	%	40.00	%
Securitized commercial loan, at fair value <sup>(3)</sup>	7,620	13,855	3.94	%	3.84%	3.84	%	3.83%	3.83	%	45.00	%
Other securities, at fair value	72,229	107,864	3.97	%	3.80%	3.80	%	3.57%	3.57	%	32.89	%
Interest rate swaps	n/a	n/a	n/a		n/a	(0.12)	)%	n/a	—	%	n/a	
Total	\$3,267,369	\$3,609,757	2.71	%	2.52%	2.40	%	2.32%	2.32	%	10.24	%

(1) Excludes approximately \$9.7 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 (2) MAC swaps, of approximately \$1.0 million received and \$12 thousand paid for the three and six months ended June 30,

Table of Contents

2018. 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, Bridge Loans and securitized commercial loan owned through trust certificates. The trust certificates are eliminated upon consolidation.

Collateral	June 30, 2017		Three months ended June 30, 2017				Six months ended June 30, 2017			
	Borrowings Outstanding	Fair 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 Cost of Funds (Non-GAAP) <sup>(2)</sup>	Weighted Average Effective Cost of Funds (Non-GAAP) <sup>(2)</sup>	Weighted Average Cost of Funds (Non-GAAP) <sup>(2)</sup>	Weighted Average Haircut end of period <sup>(2)</sup>	
Agency RMBS	\$1,030,440	\$1,062,672	1.23 %	1.14 %	1.14 %	1.07 %	1.07 %	4.66 %		
Agency CMBS	1,226,008	1,291,072	1.25 %	1.16 %	1.16 %	1.11 %	1.11 %	5.24 %		
Non-Agency RMBS	48,908	63,646	2.73 %	2.70 %	2.70 %	2.64 %	2.64 %	23.29 %		
Non-Agency CMBS	215,841	298,183	2.84 %	2.80 %	2.80 %	2.73 %	2.73 %	29.29 %		
Residential Whole-Loans <sup>(3)</sup>	165,554	203,540	3.33 %	3.30 %	3.30 %	3.28 %	3.28 %	20.00 %		
Residential Bridge Loans <sup>(3)</sup>	54,621	64,912	4.19 %	4.45 %	4.45 %	4.50 %	4.50 %	20.00 %		
Securitized commercial loan <sup>(3)</sup>	6,808	13,930	3.21 %	3.36 %	3.36 %	3.32 %	3.32 %	50.00 %		
Other securities	53,426	102,951	2.59 %	3.34 %	3.34 %	3.30 %	3.30 %	38.46 %		
Interest rate swaps	n/a	n/a	n/a	n/a	0.55 %	n/a	0.88 %	n/a		
Total	\$2,801,606	\$3,100,906	1.60 %	1.58 %	2.18 %	1.55 %	2.47 %	9.10 %		

(1) Excludes approximately \$22.6 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

(2) MAC swaps, of approximately \$3.6 million and \$10.6 million for the three and six months ended June 30, 2017, respectively. 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) Includes approximately \$202.9 million of repurchase agreement borrowings related to securities sold in June 2017 that was paid off when the sale settled in July 2017.

(4) Repurchase agreement borrowings collateralized by Whole-Loans, Bridge 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 or the six months ended June 30, 2018.

Table of Contents

## Cash Generated from Operations

For the six months ended June 30, 2018, net cash from operating activities was approximately \$110.1 million, this was primarily attributable to the net interest income we earned on our investments less operating expenses, general and administrative expenses and margin settlements of interest rate swaps. For the six months ended June 30, 2017, net cash used in operating activities was approximately \$2.9 million, which was primarily attributable to net interest income we earned on our investments less operating expenses, general and administrative expenses. The change period over period was mainly attributable to the settlement of interest rate swaps.

## Cash Provided by and Used in Investing Activities

For the six months ended June 30, 2018, net cash used in investing activities was approximately \$1.4 billion. This was primarily attributable to our investment acquisitions, including an investment from a consolidated CMBS VIE, which was partially offset by proceeds from sales and receipts of principal payments on our investments. For the six months ended June 30, 2017, net cash used in investing activities was approximately \$634.1 million. This was primarily attributable to our investment acquisitions, which was partially offset by proceeds from sales and receipts of principal payments on our investments.

## Cash Provided by and Used in Financing Activities

For the six months ended June 30, 2018, net cash provided by financing activities was approximately \$1.3 billion. This was primarily attributable to proceeds received from securitized debt related to a consolidated CMBS VIE. For the six months ended June 30, 2017, net cash provided by financing activities was approximately \$632.0 million. This was primarily attributable to the net repurchase agreement borrowings.

## Contractual Obligations and Commitments

Our contractual obligations as of June 30, 2018 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	\$3,267,369	—	—	—	\$3,267,369
Contractual interest on repurchase agreements	22,894	—	—	—	22,894
Convertible senior unsecured notes	—	—	115,000	—	115,000
Contractual interest on convertible senior unsecured notes	7,763	15,525	11,644	—	34,932
Securitized debt <sup>(2)</sup>	—	1,218,288	—	—	1,218,288
Contractual interest on securitized debt <sup>(3)</sup>	57,688	95,990	—	—	153,678
Investment related payables	52,530	—	—	—	52,530
Total: GAAP Basis - Excluding TBA - long positions	3,408,244	1,329,803	126,644	—	4,864,691
TBA - long positions	511,645	—	—	—	511,645
Total: Non-GAAP Basis	\$3,919,889	1,329,803	126,644	—	\$5,376,336

(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.

(2) The securitized debt is non-recourse to us and can only be settled with the assets held in the securitization.

(3) Assumes entire outstanding principal balance at June 30, 2018 is paid at maturity.

(3) For variable rate debt, the one month LIBOR rate as of June 30, 2018 of 2.1% was used to calculate the contractual interest.

Repurchase Agreements

At June 30, 2018, we had entered into repurchase agreement borrowings of approximately \$94.6 million, which settled by July 2, 2018, with a weighted average interest rate of 2.17%, a weighted average contractual maturity of 31 days and secured by collateral of approximately \$99.5 million.



## Table of Contents

### Securitized Debt

At June 30, 2018, we had securitized debt related to the consolidated VIEs, with a principal balance of \$1.2 billion (and a fair value of \$1.2 billion). The securitized debt and related interest payments of the VIEs can only be settled with the securitized commercial loans that serve as collateral of the VIEs 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.

### Off-Balance Sheet Arrangements

As of June 30, 2018, we held contracts to purchase (“long position”) and sell (“short position”) TBAs on a forward basis. If a counterparty to one of the TBAs that we enter into defaults on its obligations, we may not receive payments or securities due under the TBA agreement, and thus, we may lose any unrealized gain associated with that TBA transaction.

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 12 “Stockholders' Equity - Warrants” to the financial statements contained in this Quarterly Report on Form 10-Q, 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 that 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.



## Table of Contents

### ITEM 3. 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, 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 June 30, 2018, 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 may utilize derivative financial instruments to hedge the interest rate risk associated with our borrowings. These hedging activities may not be effective. 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

Table of Contents

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

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 June 30, 2018, 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 Net Interest Income		Percentage Change in Projected Portfolio Value	
		%		%
+1.00%	4.70	%	(0.51	)%
+0.50%	2.21	%	(0.24	)%
-0.50%	(2.61	)%	0.18	%
-1.00%	(6.69	)%	0.28	%

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 June 30, 2018. 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

92

---

## Table of Contents

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 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.

93

---



## Table of Contents

### 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 June 30, 2018, 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

## Table of Contents

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.

## Table of Contents

### 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, these investments are 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 Statements 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 4. Controls and Procedures

Disclosure Controls and Procedures: Our management is responsible for establishing and maintaining disclosure controls and procedures that are designed to ensure that information we are required to disclose 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. Disclosure controls and procedures include controls and procedures designed to ensure that the required information is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

We have evaluated, with the participation of our principal executive officer and principal financial officer, the effectiveness of our disclosure controls and procedures as of June 30, 2018. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives. Based upon our evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by us 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 applicable rules and forms, and that it is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

No change occurred in our internal control over financial reporting (as defined in Rule 13a-15(f) and Rule 15d-15(f) of the Exchange Act) during the three months ended June 30, 2018 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II — OTHER INFORMATION

ITEM 1. Legal Proceedings

From time to time, the Company may be involved in various claims and legal actions arising in the ordinary course of business. As of June 30, 2018, the Company was not involved in any legal proceedings.

ITEM 1A. Risk Factors

There were no material changes during the period covered by this report to the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2017, as filed with the SEC on March 29, 2018. Additional risks not presently known, or that we currently deem immaterial, also may have a material adverse effect on our business, financial condition and results of operations.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

ITEM 3. Defaults Upon Senior Securities

None.

ITEM 4. Mine Safety Disclosures

Not Applicable.

ITEM 5. Other Information

None.



Table of Contents

ITEM 6. Exhibits

The following exhibits are filed as part of this report.

Exhibit No. Description

- 3.1\* 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.
- 3.2\* 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.
- 3.3\* Amended and restated bylaws of Western Asset Mortgage Capital Corporation, incorporated by reference to Exhibit 3.2 to Amendment No. 10 to Form S-11 (Registration Statement No. 333-159962), filed May 8, 2012
- 4.1\* Specimen Common Stock Certificate of Western Asset Mortgage Capital Corporation, incorporated by reference to Exhibit 4.1 to Amendment No. 10 to Form S-11 (Registration Statement No. 333-159962), filed May 8, 2012.
- 4.2\* 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.
- 4.3\* 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.
- 4.4\* 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.
- 10.1\* 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 on August 5, 2016.
- 10.2\* Form of Warrant, incorporated by reference to Exhibit 10.2 to Amendment No. 9 to Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.
- 10.3\* 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.
- 10.4\* 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 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 to 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 to Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.
- 10.7\* 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.
- 10.8\* 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.
- 10.9\* 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).

Table of Contents

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>
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.

Table of Contents

SIGNATURES

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.

By: /s/ JENNIFER W. MURPHY

Jennifer W. Murphy  
President, Chief Executive  
Officer and Director (Principal  
Executive Officer)

August 7, 2018

By: /s/ LISA MEYER

Lisa Meyer  
Chief Financial Officer and  
Treasurer (Principal Financial  
and Accounting Officer)

August 7, 2018