

American Capital Agency Corp  
Form 10-Q  
October 31, 2008  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

- x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2008

OR

- .. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission file number 005-84030

**AMERICAN CAPITAL AGENCY CORP.**

(Exact name of registrant as specified in its charter)

Edgar Filing: American Capital Agency Corp - Form 10-Q

**Delaware**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**26-1701984**  
(I.R.S. Employer  
Identification No.)

**2 Bethesda Metro Center**

**14th Floor**

**Bethesda, Maryland 20814**

(Address of principal executive offices)

**(301) 968-9300**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports 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 earlier 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 is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of "accelerated filer," "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

Accelerated filer   
Smaller Reporting Company

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

The number of shares of the issuer's common stock, \$0.01 par value, outstanding as of October 15, 2008, was 15,004,600.

---

**Table of Contents**

**AMERICAN CAPITAL AGENCY CORP.**

**TABLE OF CONTENTS**

**PART I. FINANCIAL INFORMATION**

Item 1.	<u>Consolidated Financial Statements</u>	2
	<u>Consolidated Balance Sheets as of September 30, 2008 and June 30, 2008 (unaudited)</u>	2
	<u>Consolidated Statement of Operations for the three months ended September 30, 2008 and for the period from May 20, 2008 through September 30, 2008 (unaudited)</u>	3
	<u>Consolidated Statement of Stockholders' Equity for the period from May 20, 2008 through September 30, 2008 (unaudited)</u>	4
	<u>Consolidated Statement of Cash Flows for the period from May 20, 2008 through September 30, 2008 (unaudited)</u>	5
	<u>Notes to Consolidated Financial Statements (unaudited)</u>	6
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	19
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	33
Item 4.	<u>Controls and Procedures</u>	35

**PART II. OTHER INFORMATION**

Item 1.	<u>Legal Proceedings</u>	35
Item 1A.	<u>Risk Factors</u>	35
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	41
Item 3.	<u>Defaults Upon Senior Securities</u>	41
Item 4.	<u>Submission of Matters to a Vote of Security Holders</u>	41
Item 5.	<u>Other Information</u>	41
Item 6.	<u>Exhibits</u>	42
	<u>Signatures</u>	43

**Table of Contents****ITEM 1. Consolidated Financial Statements****AMERICAN CAPITAL AGENCY CORP.****CONSOLIDATED BALANCE SHEETS****(unaudited)****(in thousands, except per share data)**

	<b>September 30, 2008</b>	<b>June 30, 2008</b>
<b>Assets:</b>		
Investment portfolio, at fair value (\$1,500,362 and \$2,311,563 pledged under repurchase and derivative agreements, respectively)	\$ 1,624,060	\$ 2,401,917
Cash and cash equivalents	17,031	7,842
Restricted cash	18,914	15,859
Derivative assets, at fair value	2,935	1,259
Interest receivable	8,375	12,059
Receivable for agency securities sold	53,531	
Other assets	613	831
<b>Total assets</b>	<b>\$ 1,725,459</b>	<b>\$ 2,439,767</b>
<b>Liabilities:</b>		
Repurchase agreements	\$ 1,434,363	\$ 2,166,616
Accrued interest payable	1,875	2,612
Derivative liabilities, at fair value	5,114	1,584
Dividend payable	15,005	4,651
Due to Manager	482	925
Accounts payable and other accrued liabilities	758	1,497
<b>Total liabilities</b>	<b>1,457,597</b>	<b>2,177,885</b>
<b>Stockholders' equity:</b>		
Preferred stock, \$0.01 par value; 10,000 shares authorized, 0 shares issued and outstanding, respectively		
Common stock, \$0.01 par value; 150,000 shares authorized, 15,005 shares issued and outstanding, respectively	150	150
Additional paid-in capital	285,910	285,903
Retained earnings	4,744	848
Accumulated other comprehensive loss	(22,942)	(25,019)
<b>Total stockholders' equity</b>	<b>267,862</b>	<b>261,882</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 1,725,459</b>	<b>\$ 2,439,767</b>

See accompanying notes to consolidated financial statements.



Table of Contents

**AMERICAN CAPITAL AGENCY CORP.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

(unaudited)

(in thousands, except per share data)

	Three months ended September 30, 2008	For the period from May 20, 2008 (date operations commenced) through June 30, 2008	For the period from May 20, 2008  (date operations commenced) through September 30, 2008
<b>Interest income:</b>			
Interest income	\$ 28,071	\$ 9,924	\$ 37,995
Interest expense	11,009	3,597	14,606
Net interest income	17,062	6,327	23,389
<b>Other income:</b>			
(Loss) gain on sale of agency securities	(162)	231	69
Gain on derivative instruments	4,340	217	4,557
Total other income	4,178	448	4,626
<b>Expenses:</b>			
Management fees	915	402	1,317
General and administrative expenses	1,424	874	2,298
Total expenses	2,339	1,276	3,615
<b>Net income</b>	<b>\$ 18,901</b>	<b>\$ 5,499</b>	<b>\$ 24,400</b>
<b>Net income per common share-basic and diluted</b>	<b>\$ 1.26</b>	<b>\$ 0.37</b>	<b>\$ 1.63</b>
<b>Weighted average number of common shares outstanding-basic and diluted</b>	<b>15,000</b>	<b>15,000</b>	<b>15,000</b>
<b>Dividends declared per common share</b>	<b>\$ 1.00</b>	<b>\$ 0.31</b>	<b>\$ 1.31</b>

See accompanying notes to consolidated financial statements.

Table of Contents

## AMERICAN CAPITAL AGENCY CORP.

## CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY

(unaudited)

(in thousands, except per share data)

	Preferred Stock		Common Stock		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
	Shares	Amount	Shares	Amount				
<b>Balance, May 20, 2008 (date operations commenced)</b>		\$		\$	\$	\$	\$	\$
Net income						5,499		5,499
Other comprehensive loss:								
Unrealized loss on available-for-sale securities							(24,586)	(24,586)
Unrealized loss on derivative instruments							(433)	(433)
Comprehensive income (loss)						5,499	(25,019)	(19,520)
Issuance of common stock			15,000	150	285,900			286,050
Issuance of restricted stock			5					
Stock-based compensation					3			3
Common dividends declared						(4,651)		(4,651)
<b>Balance, June 30, 2008</b>		\$	15,005	\$ 150	\$ 285,903	\$ 848	\$ (25,019)	\$ 261,882
Net income						18,901		18,901
Other comprehensive income:								
Unrealized gain on available-for-sale securities							1,995	1,995
Reclassification adjustment for net loss included in net income							4,556	4,556
Unrealized loss on derivative instruments							(4,474)	(4,474)
Comprehensive income						18,901	2,077	20,978
Stock-based compensation					7			7
Common dividends declared						(15,005)		(15,005)
<b>Balance, September 30, 2008</b>		\$	15,005	\$ 150	\$ 285,910	\$ 4,744	\$ (22,942)	\$ 267,862

See accompanying notes to consolidated financial statements.

**Table of Contents****AMERICAN CAPITAL AGENCY CORP.****CONSOLIDATED STATEMENT OF CASH FLOWS****FOR THE PERIOD FROM MAY 20, 2008 (date operations commenced) THROUGH SEPTEMBER 30, 2008****(unaudited)****(in thousands)****Operating activities:**

Net income	\$ 24,400
Adjustments to reconcile net income to net cash used in operating activities:	
Amortization of agency securities premiums and discounts, net	3,143
Stock-based compensation	10
Gain on sale of agency securities	(69)
Gain on derivative instruments	(4,557)
Increase in interest receivable	(7,947)
Increase in other assets	(613)
Increase in accrued interest payable	1,875
Increase in due to Manager	482
Increase in accounts payable and other accrued liabilities	758
<b>Net cash used in operating activities</b>	<b>17,482</b>

**Investing activities:**

Purchases of agency securities	(2,654,243)
Proceeds from sale of agency securities	906,133
Proceeds from derivative instruments	1,829
Principal collections on agency securities	48,982
<b>Net cash used in investing activities</b>	<b>(1,697,299)</b>

**Financing activities:**

Net proceeds from common stock offerings	286,050
Cash dividends paid	(4,651)
Increase in restricted cash	(18,914)
Proceeds from repurchase arrangements	7,310,900
Repayments on repurchase arrangements	(5,876,537)
<b>Net cash provided by financing activities</b>	<b>1,696,848</b>
<b>Net change in cash and cash equivalents</b>	<b>17,031</b>
Cash and cash equivalents at beginning of period	
<b>Cash and cash equivalents at end of period</b>	<b>\$ 17,031</b>

See accompanying notes to consolidated financial statements.





**Table of Contents**

**AMERICAN CAPITAL AGENCY CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**Note 1. Unaudited Interim Consolidated Financial Statements**

The interim consolidated financial statements of American Capital Agency Corp. (which is referred throughout this report as the Company, we, us and our) are prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and pursuant to the requirements for reporting on Form 10-Q and Article 10 of Regulation S-X. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates.

Our unaudited consolidated financial statements include the accounts of our wholly-owned subsidiary, American Capital Agency TRS, LLC. Significant intercompany accounts and transactions have been eliminated. In the opinion of management, all adjustments, consisting solely of normal recurring accruals, necessary for the fair presentation of financial statements for the interim periods have been included. The current period's results of operations are not necessarily indicative of results that ultimately may be achieved for the year.

**Note 2. Organization**

We were organized in Delaware on January 7, 2008 and commenced operations on May 20, 2008 when we completed our initial public offering, or IPO, of ten million common shares. Concurrent with our IPO, American Capital, Ltd., or American Capital, purchased five million shares of our common shares in a private offering. We will elect to be taxed as a real estate investment trust, or REIT, under the Internal Revenue Code of 1986, as amended (the Code), commencing with our tax year ending December 31, 2008. As such, we are required to distribute annually 90% of our taxable net income. As long as we qualify as a REIT, we will generally not be subject to U.S. federal or state corporate taxes on our taxable net income to the extent that we distribute all of our annual taxable net income to our shareholders. We are managed by American Capital Agency Management, LLC, or our Manager, a subsidiary of a wholly-owned portfolio company of American Capital.

We earn income from primarily investing in single-family residential mortgage pass-through securities and collateralized mortgage obligations on a leveraged basis. These investments consist of securities for which the principal and interest payments are guaranteed by government-sponsored entities such as the Federal National Mortgage Association, or Fannie Mae, and the Federal Home Loan Mortgage Corporation, or Freddie Mac, or by a U.S. Government agency such as the Government National Mortgage Association, or Ginnie Mae. We refer to these types of securities as agency securities and the specific agency securities in which we invest as our investment portfolio.

**Note 3. Significant Accounting Policies**

***Cash and Cash Equivalents***

Cash and cash equivalents consist of unrestricted demand deposits and highly liquid investments with original maturities of three months or less. Cash and cash equivalents are carried at cost which approximates fair value.

***Restricted Cash***

Restricted cash includes cash pledged as collateral for clearing and executing trades, repurchase agreements and interest rate swaps. Restricted cash is carried at cost which approximates fair value.

**Table of Contents**

**AMERICAN CAPITAL AGENCY CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(unaudited)**

***Investments***

Statement of Financial Accounting Standards ( SFAS ) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, or SFAS No. 115, requires that at the time of purchase, we designate a security as held-to-maturity, available-for-sale or trading depending on our ability and intent to hold such security to maturity. Securities classified as trading and available-for-sale are reported at fair value, while securities classified as held-to-maturity are reported at amortized cost. Although we generally intend to hold most of our agency securities until maturity, we may, from time to time, sell any of our agency securities as part of our overall management of our investment portfolio. Accordingly, we are required to classify all of our agency securities as available-for-sale. All securities classified as available-for-sale are reported at fair value, based on market prices from third-party sources, with unrealized gains and losses excluded from earnings and reported in other comprehensive income (loss), a component of stockholders' equity.

We evaluate securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market conditions warrant such evaluation. The determination of whether a security is other-than-temporarily impaired involves judgments and assumptions based on subjective and objective factors. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of recovery in the fair value of the agency security, and (3) our intent and ability to retain our investment in the agency security for a period of time sufficient to allow for any anticipated recovery in fair value. Investments with unrealized losses are not considered other-than-temporarily impaired if we have the ability and intent to hold the investments for a period of time, to maturity if necessary, sufficient for a forecasted market price recovery up to or beyond the cost of the investments. Unrealized losses on securities that are considered other-than-temporary, as measured by the amount of the decline in fair value attributable to other-than-temporary factors, are recognized as an impairment charge in earnings as an unrealized loss and the cost basis of the securities are adjusted.

Upon a decision to sell an impaired available-for-sale investment security on which we do not expect the fair value of the investment to fully recover prior to the expected time of sale, the investment shall be deemed other-than-temporarily impaired in the period in which the decision to sell is made. We recognize an impairment loss when the impairment is deemed other-than-temporary even if a decision to sell has not been made. We did not recognize any other-than-temporary impairment on any of our agency securities for the period from May 20, 2008 through September 30, 2008.

***Interest Income***

Interest income is accrued based on the outstanding principal amount of the agency securities and their contractual terms. Premiums and discounts associated with the purchase of the agency securities are amortized or accreted into interest income over the projected lives of the securities, including contractual payments and estimated prepayments using the interest method in accordance with SFAS No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.

## Edgar Filing: American Capital Agency Corp - Form 10-Q

We estimate long-term prepayment speeds using third-party services, market data and internal models. These third-party services estimate prepayment speeds using models that incorporate the current yield curve, current mortgage rates, current mortgage rates of the outstanding loans, loan age, volatility and other factors. Management reviews the prepayment speeds estimated by the third-party services and compares the results to market consensus prepayment speeds, if available, and internal prepayment models. Management also considers historical prepayment speeds and current market conditions to validate reasonableness. Actual and anticipated

**Table of Contents**

**AMERICAN CAPITAL AGENCY CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(unaudited)**

prepayment experience is reviewed quarterly and effective yields are recalculated when differences arise between the previously estimated future prepayment and the amounts actually received plus current anticipated future prepayments. If the actual and anticipated future prepayment experience differs from our prior estimate of prepayments, we are required to make an adjustment to the amortization or accretion of premiums and discounts that would have an impact on future income.

***Repurchase Agreements***

We finance the acquisition of agency securities for our investment portfolio through repurchase transactions under master repurchase agreements. Repurchase transactions are treated as collateralized financing transactions and are carried at their contractual amounts, including accrued interest, as specified in the respective transactions. We have entered into master repurchase agreements with 15 financial institutions.

In instances where we acquire agency securities through repurchase agreements with the same counterparty from whom the agency securities were purchased, we account for the purchase commitment and repurchase agreement on a net basis and record a forward commitment to purchase agency securities as a derivative instrument if the transaction does not comply with the criteria in Financial Accounting Standards Board ( FASB ) Staff Position FAS 140-3, *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions*, or FSP FAS 140-3, for gross presentation. If the transaction does not comply with the criteria for gross presentation in FSP FAS 140-3, such forward commitments are recorded at fair value with subsequent changes in fair value recognized in income. If the transaction complies with the criteria for gross presentation in FSP FAS 140-3, we record both the assets and the related financing on a gross basis in our consolidated balance sheet and the corresponding interest income and interest expense in our consolidated statements of operations. During the period from May 20, 2008 through September 30, 2008, we did not have any seller-financed acquisitions of agency securities that did not qualify for gross presentation.

***Manager Compensation***

The management agreement provides for the payment to our Manager of a management fee and reimbursement of certain operating expenses, which are accrued and expensed during the period for which they are earned or incurred. Refer to Note 9 for disclosure on the terms of the management agreement and administrative services agreement.

***Derivatives Instruments***

The principal derivatives that we use are interest rate swaps, to-be-announced ( TBA ) securities and put and call options on TBA securities. We account for derivatives in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities, as amended*, or SFAS

## Edgar Filing: American Capital Agency Corp - Form 10-Q

No. 133. SFAS No. 133 requires an entity to recognize all derivatives as either assets or liabilities in the balance sheet and to measure those instruments at fair value.

The accounting for changes in the fair value of derivatives depends on the intended use of the derivative and the resulting designation. Derivatives that are intended to hedge exposure to variability in expected future cash flows are considered cash flow hedges. For derivatives designated in qualifying cash flow hedging relationships, the effective portion of the fair value adjustments are initially recorded in other comprehensive income (a component of stockholders' equity) and reclassified to income at the time that the hedged transactions affect

**Table of Contents**

**AMERICAN CAPITAL AGENCY CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(unaudited)**

earnings. The ineffective portion of the fair value adjustments is recognized in gain (loss) on derivative instruments in net income immediately. For derivatives not designated in hedging relationships under SFAS No. 133, the fair value adjustments are recorded in gain (loss) on derivative instruments in net income. Derivatives in a gain position are reported as derivative assets, at fair value and derivatives in a loss position are reported as derivative liabilities, at fair value in our consolidated balance sheets. When the underlying hedged transaction ceases to exist, all changes in the fair value of the instrument are marked-to-market with changes in value included in gain (loss) on derivative instruments in net income for each period until the derivative instrument matures or is settled. Any amounts that have been previously deferred in accumulated other comprehensive income may need to be reclassified to net income. We generally enter into interest rate swaps with the intention of qualifying for hedge accounting.

We may write put and call options on TBA securities. Under a put option, the counterparty has the right to sell us a specified TBA security at a predetermined price on the option exercise date in exchange for a premium at execution. Under a call option, the counterparty has the right to purchase from us a specified TBA security at a predetermined price on the option exercise date in exchange for a premium at execution. The premium received from writing a put or call option is reported as a liability in our consolidated balance sheets. The premium is valued at an amount equal to the fair value of the option that would have the effect of closing the position. The difference between the premium and the fair value of the option is reported in gain (loss) on derivative instruments in our consolidated statement of operations. When a written put or call option expires unexercised, a realized gain is reported in our consolidated statement of operations equal to the premium received. When we terminate a written put or call option, a realized gain or loss is reported in our consolidated statement of operations equal to the difference between the termination payment and the premium received. When a written put or call option is exercised, a realized gain or loss is reported in our consolidated statement of operations equal to the difference between the premium received and the fair value of the exercised put or call option. In addition, a derivative asset or liability is recorded in our consolidated balance sheet for the TBA security resulting from the put or call option exercise.

A TBA security is a futures contract for the purchase or sale of agency securities at a predetermined price, face amount, issuer, coupon and stated maturity on an agreed-upon future date. The specific agency securities delivered into the contract upon the settlement date, published each month by the Securities Industry and Financial Markets Association, are not known at the time of the transaction. TBA securities are exempt from SFAS No. 133 if there is no other way to purchase or sell that security, delivery of that security and settlement will occur within the shortest period possible for that type of security and it is probable at inception and throughout the term of the individual contract that physical delivery of the security will occur. Since we have not asserted that physical settlement is probable, we have accounted for all such commitments as derivatives and accordingly all realized and unrealized gains and losses are recognized in our consolidated statement of operations.

We estimate the fair value of interest rate swaps based on the estimated net present value of the future cash flows using a forward interest rate yield curve in effect as of the measurement period, adjusted for non-performance risk based on our credit risk and our counterparty's credit risk and we consider the impact of any collateral requirements, credit enhancements or netting arrangements on credit risk. TBA securities are valued using third-party pricing services. These third-party pricing services use pricing models that incorporate such factors as coupons, prepayment speeds, spread to the Treasury and swap curves, convexity, duration, periodic and life caps and credit enhancement.

The use of derivatives creates exposure to credit risk relating to potential losses that could be recognized in the event that the counterparties to these instruments fail to perform their obligations under the contracts. We





**Table of Contents**

**AMERICAN CAPITAL AGENCY CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(unaudited)**

minimize this risk by limiting our counterparties to major financial institutions with acceptable credit ratings and monitoring positions with individual counterparties.

***Income Taxes***

We will elect to be taxed as a REIT under the provisions of the Code and the corresponding provisions of state law, commencing with the tax year ending December 31, 2008. A REIT is not subject to tax on its earnings to the extent that it distributes its annual taxable income to its stockholders and as long as certain asset, income and stock ownership tests are met. We operate in a manner that will allow us to be taxed as a REIT and, as a result, we do not expect to pay substantial corporate-level income taxes. If we fail to qualify as a REIT and do not qualify for certain statutory relief provisions, we would be subject to federal, state and local income taxes and may be precluded from qualifying as a REIT for the subsequent four fiscal years following the year in which the REIT qualification was lost. Our domestic taxable REIT subsidiary, American Capital Agency TRS, LLC, will be subject to federal, state and, if applicable, local income tax. For the period from May 20, 2008 through September 30, 2008, we had no activity in American Capital Agency TRS, LLC.

***Recent Accounting Pronouncements***

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities*, or SFAS No. 161. The objective of SFAS No. 161 is to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity's financial position, financial performance, and cash flows. SFAS No. 161 improves transparency about the location and amounts of derivative instruments in an entity's financial statements; how derivative instruments and related hedged items are accounted for under SFAS No. 133; and how derivative instruments and related hedged items affect its financial position, financial performance, and cash flows. SFAS No. 161 achieves these improvements by requiring disclosure of the fair values of derivative instruments and their gains and losses in a tabular format. It also provides more information about an entity's liquidity by requiring disclosure of derivative features that are credit risk related. Finally, it requires cross-referencing within footnotes to enable financial statement users to locate important information about derivative instruments. SFAS No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. We did not early adopt SFAS No. 161. Management is currently evaluating the enhanced disclosure requirements and the impact on our consolidated financial statements of adopting SFAS No. 161.

In June 2008, the FASB issued FASB Staff Position (FSP) No. EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*, or FSP EITF 03-6-1. The objective of this FSP is to address questions that arose regarding whether unvested share-based payment awards with rights to receive dividends or dividend equivalents should be considered participating securities for the purposes of applying the two-class method of calculating earnings per share (EPS) pursuant to FASB Statement No. 128, *Earnings per Share*. In FSP EITF 03-6-1, the FASB staff concluded that unvested share-based payment awards that contain rights to receive non-forfeitable dividends or dividend equivalents (whether paid or unpaid) are participating securities, and thus, should be included in the two-class method of computing EPS. It is effective for fiscal years beginning after December 15, 2008, and interim periods within those years with early application prohibited. This FSP requires that all prior-period EPS data be adjusted retrospectively. Management is currently

Edgar Filing: American Capital Agency Corp - Form 10-Q

evaluating the impact on our consolidated financial statements of adopting FSP EITF 03-6-1.

**Table of Contents****AMERICAN CAPITAL AGENCY CORP.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)****Note 4. Agency Securities**

The following tables summarize our available-for-sale agency securities as of September 30, 2008 and June 30, 2008 (dollars in thousands):

	As of September 30, 2008			Total
	Fannie Mae	Freddie Mac	Ginnie Mae	
Agency securities, par	\$ 766,500	\$ 246,598	\$ 590,862	\$ 1,603,960
Unamortized discount	(48)			(48)
Unamortized premium	13,963	4,519	19,701	38,183
Amortized cost	780,415	251,117	610,563	1,642,095
Gross unrealized gains	256	8		264
Gross unrealized losses	(6,354)	(2,269)	(9,676)	(18,299)
Estimated fair value	\$ 774,317	\$ 248,856	\$ 600,887	\$ 1,624,060
Weighted average coupon	6.07%	6.10%	6.18%	6.12%
Weighted average yield(1)	5.60%	5.60%	5.36%	5.50%

	As of June 30, 2008			Total
	Fannie Mae	Freddie Mac	Ginnie Mae	
Agency securities, par	\$ 1,284,336	\$ 259,983	\$ 829,787	\$ 2,374,106
Unamortized discount	(48)			(48)
Unamortized premium	20,609	5,018	26,818	52,445
Amortized cost	1,304,897	265,001	856,605	2,426,503
Gross unrealized gains	78			78
Gross unrealized losses	(11,542)	(3,044)	(10,078)	(24,664)
Estimated fair value	\$ 1,293,433	\$ 261,957	\$ 846,527	\$ 2,401,917
Weighted average coupon	6.06%	6.12%	6.15%	6.10%
Weighted average yield(2)	5.58%	5.56%	5.36%	5.50%

(1) Weighted average yield for the quarter ended September 30, 2008 and incorporates future prepayment assumptions.

(2) Weighted average yield for the period from May 20, 2008 to June 30, 2008 and incorporates future prepayment assumptions.

**Table of Contents****AMERICAN CAPITAL AGENCY CORP.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

Actual maturities of agency securities are generally shorter than the stated contractual maturities. Actual maturities of the agency securities are affected by the contractual lives of the underlying mortgages, periodic principal payments and principal prepayments. The following table summarizes our agency securities as of September 30, 2008 and June 30, 2008, according to their estimated weighted average life classifications (dollars in thousands):

Weighted Average Life	As of September 30, 2008			As of June 30, 2008		
	Fair Value	Amortized Cost	Weighted Average Coupon	Fair Value	Amortized Cost	Weighted Average Coupon
Less than one year	\$	\$		\$	\$	
Greater than one year and less than five years	619,947	625,635	6.25%	213,931	215,569	6.35%
Greater than or equal to five years	1,004,113	1,016,460	6.03%	2,187,986	2,210,934	6.07%
Total	\$ 1,624,060	\$ 1,642,095	6.12%	\$ 2,401,917	\$ 2,426,503	6.10%

The weighted average lives of the agency securities as of September 30, 2008 and June 30, 2008 in the table above incorporates anticipated future prepayment assumptions. We estimate long-term prepayment assumptions using third-party services, market data and internal models. These third-party services estimate prepayment speeds using models that incorporate the current yield curve, current mortgage rates, current mortgage rates of the outstanding loans, loan age, volatility and other factors.

The following table presents the gross unrealized losses and estimated fair values of the Company's agency securities by length of time that such securities have been in a continuous unrealized loss position as of September 30, 2008 and June 30, 2008 (dollars in thousands):

	Unrealized Loss Position For					
	Less than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
September 30, 2008	\$ 1,479,741	\$ (18,299)	\$	\$	\$ 1,479,741	\$ (18,299)
June 30, 2008	\$ 2,345,966	\$ (24,664)	\$	\$	\$ 2,345,966	\$ (24,664)

During the quarter ended September 30, 2008, we sold agency securities with a cost basis of \$898.7 million for proceeds of \$898.5 million realizing a loss of \$0.2 million. During the period from May 20, 2008 through June 30, 2008, we sold agency securities with a carrying value of \$60.9 million for proceeds of \$61.1 million realizing a gain of \$0.2 million.

## Edgar Filing: American Capital Agency Corp - Form 10-Q

The decline in value of these securities is likely due to recent market volatility resulting from decreased market liquidity and increased uncertainty amongst participants facing material structural changes in the market place. All of the agency securities are AAA rated or carry an implied AAA rating. The investments are not considered other-than-temporarily impaired because we currently have the ability and intent to hold the investments to maturity or for a period of time sufficient for a forecasted market price recovery up to or beyond the cost of the investments. Also, the timely delivery of principal and interest payments is guaranteed by the issuing government agency or government sponsored entity.

**Table of Contents****AMERICAN CAPITAL AGENCY CORP.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

The following tables summarize our agency securities pledged as collateral under repurchase agreements and swaps by type as of September 30, 2008 and June 30, 2008 (dollars in thousands):

Type	As of September 30, 2008							Total Fair Value of Agency Securities Pledged and Accrued Interest
	Agency Securities Pledged Under Repurchase Agreements			Agency Securities Pledged Under Derivative Agreements				
	Fair Value/ Carrying Value	Amortized Cost	Accrued Interest on Pledged Agency Securities	Fair Value/ Carrying Value	Amortized Cost	Accrued Interest on Pledged Swaps		
Fannie Mae	\$ 670,443	\$ 676,062	\$ 3,357	\$ 18,942	\$ 19,005	\$ 96	\$ 692,838	
Freddie Mac	219,052	221,002	1,165	3,076	3,118	15	223,308	
Ginnie Mae	588,849	598,456	3,056				591,905	
Total	\$ 1,478,344	\$ 1,495,520	\$ 7,578	\$ 22,018	\$ 22,123	\$ 111	\$ 1,508,051	

Type	As of June 30, 2008							Total Fair Value of Agency Securities Pledged and Accrued Interest
	Agency Securities Pledged Under Repurchase Agreements			Agency Securities Pledged Under Derivative Agreements				
	Fair Value/ Carrying Value	Amortized Cost	Accrued Interest on Pledged Agency Securities	Fair Value/ Carrying Value	Amortized Cost	Accrued Interest on Pledged Swaps		
Fannie Mae	\$ 1,236,817	\$ 1,247,833	\$ 6,197	\$ 2,531	\$ 2,573	\$ 13	\$ 1,245,558	
Freddie Mac	225,688	228,326	1,144				226,832	
Ginnie Mae	846,527	856,605	4,250				850,777	
Total	\$ 2,309,032	\$ 2,332,764	\$ 11,591	\$ 2,531	\$ 2,573	\$ 13	\$ 2,323,167	

The following table summarizes our agency securities pledged as collateral under repurchase agreements by maturity as of September 30, 2008 and June 30, 2008 (dollars in thousands):

Maturity	As of September 30, 2008			As of June 30, 2008		
	Fair Value/ Carrying Value	Amortized Cost	Accrued Interest on Pledged Agency Securities	Fair Value/ Carrying Value	Amortized Cost	Accrued Interest on Pledged Agency Securities

Edgar Filing: American Capital Agency Corp - Form 10-Q

30 days or less	\$ 1,329,258	\$ 1,344,537	\$ 6,838	\$ 1,833,739	\$ 1,851,107	\$ 9,206
31 - 59 days	99,417	100,634	494	427,316	432,982	2,148
60 - 90 days	49,669	50,349	246	47,977	48,675	237
Greater than 90 days						
Total / Weighted Average	\$ 1,478,344	\$ 1,495,520	\$ 7,578	\$ 2,309,032	\$ 2,332,764	\$ 11,591



**Table of Contents****AMERICAN CAPITAL AGENCY CORP.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)****Note 5. Repurchase Agreements**

We pledge certain of our agency securities as collateral under repurchase arrangements with financial institutions, the terms and conditions of which are negotiated on a transaction-by-transaction basis. Interest rates on these borrowings are generally based on LIBOR plus or minus a margin and amounts available to be borrowed are dependent upon the fair value of the agency securities pledged as collateral, which fluctuates with changes in interest rates, credit quality and liquidity conditions within the banking, mortgage finance and real estate industries. In response to declines in fair value of pledged agency securities, lenders may require us to post additional collateral or pay down borrowings to re-establish agreed upon collateral requirements, referred to as margin calls. As of September 30, 2008, we have met all margin requirements.

The following table summarizes our borrowings under repurchase arrangements and weighted average interest rates classified by scheduled maturities as of September 30, 2008 and June 30, 2008 (dollars in thousands):

Maturity	As of September 30, 2008			As of June 30, 2008		
	Borrowings Outstanding	Average Interest Rate	Weighted Average Days to Maturity	Borrowings Outstanding	Average Interest Rate	Weighted Average Days to Maturity
30 days or less	\$ 1,298,895	2.78%	15 days	\$ 1,719,207	2.42%	16 days
31 - 59 days	92,349	2.69%	56 days	403,890	2.29%	55 days
60 - 90 days	43,119	2.45%	63 days	43,519	2.32%	65 days
Greater than 90 days						
Total /Weighted Average	\$ 1,434,363	2.77%	19 days	\$ 2,166,616	2.39%	24 days

As of September 30, 2008, we did not have an amount at risk with any counterparty greater than 10% of our stockholders' equity. We do not anticipate any defaults by our counterparties.

**Note 6. Derivative Instruments**

In connection with our risk management strategy, we hedge a portion of our interest rate risk by entering into derivative financial instrument contracts. We may enter into interest rate caps, collars, floors, forward contracts, put and call options on securities or securities underlying futures contracts, futures, options or swap agreements to attempt to mitigate the risk of the cost of our short-term variable rate liabilities increasing at a faster rate than the earnings of our long-term assets during a period of rising interest rates. As of September 30, 2008, our derivatives were primarily comprised of forward starting interest rate swaps, which will have the effect of modifying the repricing characteristics

## Edgar Filing: American Capital Agency Corp - Form 10-Q

of our repurchase agreements and cash flows on such liabilities, TBA securities and put and call options on TBA securities. Our interest rate swaps are used to manage the interest rate risk created by our floating rate short-term repurchase agreements. Under our interest rate swaps, we pay a fixed rate and receive a floating rate based on LIBOR. Collectively, our interest rate swaps, put and call options and TBA securities are incorporated to manage the overall interest rate risk of the portfolio, reduce fluctuations in book value and generate additional income distributable to shareholders.

The use of derivatives creates exposure to credit risk relating to potential losses that could be recognized in the event that the counterparties to these instruments fail to perform their obligations under the contracts. We minimize this risk by limiting our counterparties to major financial institutions with acceptable credit ratings and monitoring positions with individual counterparties. In addition, we are required to pledge assets as collateral for some of our derivatives, whose amounts vary over time based on the market value, notional amount and

**Table of Contents****AMERICAN CAPITAL AGENCY CORP.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

remaining term of the derivative. We had agency securities with a fair value of \$9.0 million and cash of \$2.2 million pledged as collateral against our interest rate swaps as of September 30, 2008. As of September 30, 2008, we had agency securities with a fair value of \$13.0 million pledged as collateral against our TBA securities. In the event of a default by a counterparty we may not receive payments provided for under the terms of our derivatives, and may have difficulty obtaining our assets pledged as collateral for our derivatives. We do not anticipate any defaults by our counterparties.

The table below summarizes information about our outstanding interest rate swaps as of September 30, 2008 and June 30, 2008 (dollars in thousands):

Swap Term	As of September 30, 2008			As of June 30, 2008		
	Notional Amount	Weighted Average Fixed Pay Rate	Net Estimated Fair Value	Notional Amount	Weighted Average Fixed Pay Rate	Net Estimated Fair Value
1 - 2 Years	\$ 550,000	3.42%	\$ (2,348)	\$ 550,000	3.42%	\$ 322
3 - 4 Years	50,000	4.37%	(1,148)	50,000	4.37%	(530)
4 - 5 Years	100,000	4.22%	(1,618)	100,000	4.22%	(225)
Greater than 5 Years						
Total / Weighted Average	\$ 700,000	3.60%	\$ (5,114)	\$ 700,000	3.60%	\$ (433)

Our interest rate swaps had no effect on interest expense during the periods ended September 30, 2008 and June 30, 2008 as all swaps were forward starting with effective dates starting in the fourth quarter of 2008. During the quarter ended September 30, 2008, we recorded a loss of \$0.2 million in gain on derivative instruments in our consolidated statement of operations for hedge ineffectiveness on our outstanding interest rate swaps.

The table below summarizes information about our outstanding TBA securities as of September 30, 2008 and June 30, 2008 (dollars in thousands):

TBA Security	As of September 30, 2008			As of June 30, 2008				
	Net Notional Long/(Short)	Settlement	Weighted Average Coupon	Estimated Fair Value	Net Notional Long/(Short)	Settlement	Weighted Average Coupon	Estimated Fair Value
Fannie Mae	\$ (175,000)	10/08	5.8%	\$ 927	\$			\$
Ginnie Mae	(250,000)	10/08	6.0%	2,008	25,000	8/08	6.0%	107
Freddie Mac								

## Edgar Filing: American Capital Agency Corp - Form 10-Q

Total	\$ (425,000)	\$ 2,935	\$ 25,000	\$ 107
-------	--------------	----------	-----------	--------

During the quarter ended September 30, 2008, we recorded a gain of \$4.5 million in gain on derivative instruments in our consolidated statement of operations related to our settled and unsettled put and call options and TBA securities. There were no outstanding put or call options as of September 30, 2008 and June 30, 2008.

**Table of Contents**

**AMERICAN CAPITAL AGENCY CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(unaudited)**

**Note 7. Fair Value Measurements**

SFAS No. 157, *Fair Value Measurements*, or SFAS No. 157, defines fair value, establishes a framework for measuring fair value and establishes a three-level valuation hierarchy for disclosure of fair value measurement. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. A financial instrument's categorization within the hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The three levels of hierarchy established by SFAS No. 157 are defined as follows:

Level 1 Inputs Quoted prices (unadjusted) for identical unrestricted assets and liabilities in active markets that are accessible at the measurement date.

Level 2 Inputs Quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.

Level 3 Inputs Instruments with primarily unobservable market data that cannot be corroborated.

***Agency Securities***

Agency securities are valued using third-party pricing services. If third-party pricing services are not available, the values are based on dealer quotes. The third-party pricing services use pricing models that incorporate such factors as coupons, prepayment speeds, spread to the Treasury and swap curves, convexity, duration, periodic and life caps and credit enhancement. Management reviews the fair values determined by the third-party pricing models and compares the results, if available, to dealer quotes, values from the repurchase agreement counterparties and internal pricing models on each investment to validate reasonableness. The dealer quotes incorporate common market pricing methods, including a spread measurement to the Treasury curve or interest rate swap curve as well as underlying characteristics of the particular security including coupon, periodic and life caps, rate reset period, issuer, additional credit support and expected life of the security.

***Derivative Instruments***

Interest rate swaps are valued using a third-party pricing model. The third-party pricing model incorporates such factors as the Treasury curve, LIBOR rates and the pay rate on the interest rate swaps. Credit valuation adjustments for nonperformance risk, if any, include a quantitative and/or qualitative evaluation of both our and our counterparty's credit risk.

TBA securities are valued using third-party pricing services. These third-party pricing services use pricing models that incorporate such factors as coupons, prepayment speeds, spread to the Treasury and swap curves, convexity, duration, periodic and life caps and credit enhancement.

**Table of Contents****AMERICAN CAPITAL AGENCY CORP.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

Our financial assets and liabilities carried at fair value on a recurring basis are valued as follows (in thousands):

	Level 1	Level 2	Level 3	Total
Agency securities:				
Fannie Mae	\$	\$ 774,317	\$	\$ 774,317
Ginnie Mae		600,887		600,887
Freddie Mac		248,856		248,856
Total agency securities	\$	\$ 1,624,060	\$	\$ 1,624,060
Derivative instruments:				
Assets	\$	\$ 2,935	\$	\$ 2,935
Liabilities			(5,114)	(5,114)
Total derivative instruments, net	\$	\$ 2,935	\$ (5,114)	\$ (2,179)
Total	\$	\$ 1,626,995	\$ (5,114)	\$ 1,621,881

During the quarter ended September 30, 2008, we recognized a loss of \$0.2 million in our consolidated statement of operations and an unrealized loss of \$4.5 million recorded in other comprehensive income (a component of stockholders' equity) related to our level 3 assets and liabilities. The following table sets forth a summary of changes in the fair value of financial assets and liabilities measured using Level 3 inputs for the quarter ended September 30, 2008 (in thousands):

	Balances, July 1, 2008	Realized Gains/ (Losses)	Reversal of Prior Period Appreciation/ (Depreciation) on Realization	Appreciation/ (Depreciation)(1)	Purchases, Sales, Issuances & Settlements, Net	Transfers In & Out of Level 3	Balances, September 30, 2008
Derivatives, net	\$ (433)	\$	\$	\$ (4,681)	\$	\$	\$ (5,114)

- (1) \$4.5 million recorded as an unrealized loss on derivative instruments in other comprehensive income (a component of stockholders' equity) and \$0.2 million recorded as a loss in gain on derivative instruments in our consolidated statement of operations as a result of hedge ineffectiveness on our outstanding interest rate swaps for the quarter ended September 30, 2008.

**Note 8. Long-term Incentive Plan**

## Edgar Filing: American Capital Agency Corp - Form 10-Q

We sponsor an equity incentive plan to provide for the issuance of equity-based awards, including stock options, restricted stock, restricted stock units and unrestricted stock awards to our independent directors. An aggregate of 100,000 shares of our common stock has been reserved for issuance under this plan. Simultaneous with the completion of our IPO, 4,500 shares of restricted common stock were granted to our independent directors pursuant to this plan (grant date fair value of \$19.35 per share) that vest annually over three years. As of September 30, 2008, the plan had 95,500 common shares remaining available for future issuance. As of September 30, 2008, we had unrecognized compensation expense of \$76,419 related to unvested shares of restricted stock. We recorded compensation expense of \$7,316 related to restricted stock awards during the quarter ended September 30, 2008. For the period from May 20, 2008 through June 30, 2008, we recorded compensation expense of \$3,340 related to restricted stock awards.



**Table of Contents**

**AMERICAN CAPITAL AGENCY CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(unaudited)**

**Note 9. Management Agreement and Related Party Transactions**

We entered into a management agreement with our Manager, which provides for an initial term through May 20, 2011 with automatic one-year extension options and subject to certain termination rights. We pay our Manager a monthly management fee equal to 1.25% per annum of our stockholders' equity (as defined in the management agreement). For the period from May 20, 2008 through June 30, 2008 and the quarter ended September 30, 2008, management fees of \$0.4 million and \$0.9 million, respectively, were expensed.

We are obligated to reimburse our Manager for its expenses incurred directly related to our operations, excluding employment-related expenses of our Manager's officers and any American Capital employees who provide services to us pursuant to the management agreement. Our Manager has entered into an administrative services agreement with American Capital, pursuant to which American Capital will provide personnel, services and resources necessary for our Manager to perform its obligations under the management agreement. For the period from May 20, 2008 through June 30, 2008 and for the quarter ended September 30, 2008, expense reimbursements of \$0.3 million and \$0.5 million, respectively, were expensed. In addition, we are required to reimburse our Manager, or American Capital, for all one-time costs that our Manager, or American Capital, paid on behalf of us that were incurred in connection with our formation, organization and IPO. These costs amounted to \$0.3 million for the period from May 20, 2008 through September 30, 2008.

As of June 30, 2008 and September 30, 2008, \$0.9 million and \$0.5 million, respectively, were payable to our Manager.

We will be required to pay our Manager a termination fee for non-renewal of the management agreement without cause. The termination fee will be equal to three times the average annual management fee earned by the Manager during the prior 24-month period immediately preceding the most recently completed month prior to the effective date of the termination.

**Note 10. Dividends**

On September 19, 2008, our Board of Directors declared a dividend of \$1.00 per share for the third quarter of 2008. The dividend was paid on October 10, 2008 to common shareholders of record as of September 29, 2008.

**Table of Contents**

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

Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) is designed to provide a reader of American Capital Agency Corp. financial statements with a narrative from the perspective of management. Our MD&A is presented in five sections:

Executive Overview

Financial Condition

Results of Operations

Liquidity and Capital Resources

Forward-Looking Statements

**EXECUTIVE OVERVIEW**

American Capital Agency Corp. (together with its consolidated subsidiary, is referred throughout this report as the Company, we, us and our) is a real estate investment trust, or REIT, that invests exclusively in single-family residential mortgage pass-through securities and collateralized mortgage obligations on a leveraged basis. These investments consist of securities for which principal and interest are guaranteed by government-sponsored entities such as the Federal National Mortgage Association, or Fannie Mae, and the Federal Home Loan Mortgage Corporation, or Freddie Mac, or by a U.S. Government agency such as the Government National Mortgage Association, or Ginnie Mae. We refer to these types of securities as agency securities and the specific agency securities in which we invest as our investment portfolio.

We were organized on January 7, 2008, and commenced operations on May 20, 2008 following the completion of our initial public offering, or IPO. In connection with the IPO, we sold ten million shares of our common stock at \$20.00 per share for net proceeds of \$186 million, net of the underwriters' commission and other offering expenses. Concurrently with our IPO, in a private offering we sold five million shares of our common stock at \$20.00 per share for aggregate proceeds of \$100 million to American Capital, Ltd., or American Capital. Our common stock is traded on the NASDAQ Global Market under the symbol AGNC.

We are externally managed by American Capital Agency Management, LLC, or our Manager. Our Manager is a wholly-owned subsidiary of American Capital, LLC, which is a wholly-owned portfolio company of American Capital. We do not have any employees.

Our principal goal is to generate net income for distribution to our stockholders through regular quarterly dividends from our net interest income, which is the spread between the interest income earned on our investment portfolio and the interest costs of our borrowings and hedging activities. We fund our investments through short-term borrowings structured as repurchase agreements.

## Edgar Filing: American Capital Agency Corp - Form 10-Q

We intend to qualify as a REIT for federal income tax purposes and will elect to be taxed as a REIT under the Internal Revenue Code of 1986, as amended, or the Code, commencing with our taxable year ending December 31, 2008. We generally will not be subject to federal income taxes on our taxable income to the extent that we annually distribute all of our taxable income to stockholders and maintain our intended qualification as a REIT.

As of September 30, 2008, we had total assets of \$1.7 billion. Our \$1.6 billion investment portfolio consisted entirely of fixed-rate agency securities. Our repurchase agreements outstanding were \$1.4 billion and our stockholders' equity was \$0.3 billion, or \$17.85 per share, for a leverage ratio of 5.4 times our stockholders' equity. During the quarter ended September 30, 2008, we reported net income of \$18.9 million, or \$1.26 per basic and diluted share. For the period from May 20, 2008 through September 30, 2008, we reported net income of \$24.4 million, or \$1.63 per basic and diluted share. We have declared dividends of \$1.31 per share through September 30, 2008, which represents a 80% dividend payout ratio of our net income per share.

---

## **Table of Contents**

### ***Recent Developments***

Our business is affected by general U.S. residential real estate fundamentals and the overall U.S. economic environment. In particular, our strategy and performance is influenced by the specific characteristics of these markets, including prepayment rates, interest rates and the interest rate yield curve. Our results of operations primarily depend on, among other things, the level of our interest income and the amount and cost of borrowings we may obtain by pledging our investment portfolio as collateral for the borrowings. Our interest income, which includes the amortization of purchase premiums and accretion of discounts, varies primarily as a result of changes in prepayment speeds of the agency securities. Our borrowing cost varies based on changes in interest rates and changes in the amount we can borrow which is generally based on the fair value of the portfolio and the advance rate the lenders are willing to lend against the collateral provided.

Since the middle of 2007, commercial banks, investment banks and insurance companies have announced extensive losses from exposure to the U.S. mortgage market. These losses have reduced financial industry capital leading to reduced liquidity for mortgage assets, more volatile valuations of mortgage assets and in some cases forced selling of mortgage assets. As a result, less financing on attractive terms is available for mortgage assets.

The payment of principal and interest on the agency securities that we invest in is guaranteed by Ginnie Mae, Freddie Mac or Fannie Mae. The payment of principal and interest on agency securities issued by Ginnie Mae is guaranteed by the full faith and credit of the U.S. government, while payment of principal and interest on agency securities issued by Freddie Mac or Fannie Mae is not guaranteed by the U.S. government. Any failure to honor its guarantee of agency securities by Freddie Mac or Fannie Mae or any downgrade of securities issued by Freddie Mac or Fannie Mae by the rating agencies could cause a significant decline in the value of and cash flow from, any agency securities we own that are guaranteed by such entity.

Due to increased market concerns about Freddie Mac and Fannie Mae's ability to withstand future credit losses associated with securities held in their investment portfolios, and on which they provide guarantees, without the direct support of the federal government, the government passed the Housing and Economic Recovery Act of 2008 on July 30, 2008. As a result of this legislation, Fannie Mae and Freddie Mac have been placed into the conservatorship of the Federal Housing Finance Agency, or FHFA, their federal regulator, pursuant to its powers under The Federal Housing Finance Regulatory Reform Act of 2008, a part of the Housing and Economic Recovery Act of 2008. As the conservator of Fannie Mae and Freddie Mac, the FHFA now controls and directs the operations of Fannie Mae and Freddie Mac and may (i) take over the assets of and operate Fannie Mae and Freddie Mac with all the powers of the shareholders, the directors, and the officers of Fannie Mae and Freddie Mac and conduct all business of Fannie Mae and Freddie Mac; (ii) collect all obligations and money due to Fannie Mae and Freddie Mac; (iii) perform all functions of Fannie Mae and Freddie Mac which are consistent with the conservator's appointment; (iv) preserve and conserve the assets and property of Fannie Mae and Freddie Mac; and (v) contract for assistance in fulfilling any function, activity, action or duty of the conservator.

In addition to FHFA becoming the conservator of Fannie Mae and Freddie Mac, (i) the U.S. Department of Treasury ( U.S. Treasury ) and FHFA have entered into separate preferred stock purchase agreements with Fannie Mae and Freddie Mac pursuant to which the U.S. Treasury will ensure that each of Fannie Mae and Freddie Mac maintains a positive net worth; (ii) the U.S. Treasury has established a new secured lending credit facility available until December 2009 to Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, which is intended to serve as a liquidity backstop; and (iii) the U.S. Treasury has initiated a temporary program to purchase RMBS issued by Fannie Mae and Freddie Mac. Given the highly fluid and evolving nature of these events, it is unclear how our business will be impacted. Based upon the further activity of the U.S. government or market response to developments at Fannie Mae or Freddie Mac, our business could be adversely impacted.

The Emergency Economic Stabilization Act of 2008, or EESA, was enacted on October 3, 2008. The EESA provides the U.S. Secretary of the Treasury with the authority to establish a Troubled Asset Relief Program, or



## **Table of Contents**

TARP, to purchase from financial institutions up to \$700 billion of residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008. In addition, it may purchase other financial instruments that the U.S. Secretary of the Treasury, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability. The EESA also provides for a program that would allow companies to insure their troubled assets.

On October 14, 2008, the U.S. Treasury announced the voluntary Capital Purchase Program ( CPP ), which was implemented under authority provided in the EESA. Under the CPP, the U.S. Treasury will purchase up to \$250 billion of senior preferred shares in qualifying U.S. controlled banks, savings associations, and certain bank and savings and loan holding companies engaged only in financial activities, that elect to participate by November 14, 2008. Nine of the largest banks in the United States, as well as other financial institutions, have accepted investments under the CPP. The U.S. Treasury has also taken under consideration the expansion of the CPP to non-financial institutions, including life or other insurance companies.

There can be no assurance that the EESA will have a beneficial impact on the financial markets, including current extreme levels of volatility. To the extent the market does not respond favorably to the TARP or CPP initiatives or the TARP or CPP initiatives do not function as intended, our business may not receive the anticipated positive impact from the legislation. In addition, the U.S. Government, Federal Reserve and other governmental and regulatory bodies have taken or are considering taking other actions to address the financial crisis. We cannot predict whether or when such actions may occur or what impact, if any, such actions could have on our business, results of operations and financial condition.

The challenges of the first two quarters of 2008 continued into the third quarter, as financing difficulties severely pressured liquidity and asset values across most asset classes, including residential MBS. In September 2008, Lehman Brothers Holdings, Inc., a global investment bank, experienced a major liquidity crisis and filed for bankruptcy; and American International Group, a large insurance company, was forced to accept a loan from the Federal Reserve Bank of New York to avoid failure. As a result of these events and others, securities trading was limited and mortgage securities financing markets were challenged as the industry continued to report negative news. This dislocation in the non-agency mortgage sector made it more difficult for us to obtain short-term repurchase financing on favorable terms in the agency MBS sector.

In anticipation of a tightening repurchase financing market, we prudently and opportunistically sold securities during the third quarter which allowed us to reduce our leverage from 8.3 times our stockholders' equity as of June 30, 2008 to 5.4 times as of September 30, 2008. If these circumstances continue, we expect to take additional actions intended to protect our liquidity, which may include further reducing borrowings and disposing of assets as well as raising capital.

### ***Our Manager***

We are externally managed and advised by our Manager pursuant to the terms of a management agreement. Our Manager is responsible for administering our business activities and day-to-day operations, subject to the supervision and oversight of our Board of Directors. Members of American Capital's senior management and its residential mortgage-backed securities, or RMBS, investment team serve as our Manager's officers. Because neither we nor our Manager have any employees, our Manager has entered into an administrative services agreement with American Capital, pursuant to which our Manager has access to American Capital's employees, infrastructure, business relationships, management expertise and capital raising capabilities. This access to American Capital's infrastructure allows our Manager to dedicate its time to managing our investment portfolio on our behalf so that we may fully take advantage of opportunities in the agency securities market. American Capital had \$20 billion of capital resources under management as of June 30, 2008 and 590 employees as of September 30, 2008.



## **Table of Contents**

### ***Our Investment Strategy***

Our investment strategy is to build an investment portfolio consisting exclusively of agency securities that seeks to generate risk-adjusted returns. Agency securities carry an actual or implied AAA rating. Our Manager has established an investment committee comprised of its officers. The investment committee has established investment guidelines that have been approved by our Board of Directors. The investment committee can change our investment guidelines at any time with the approval of our Board of Directors. The following are our investment guidelines:

no investment shall be made in any non-agency securities;

our leverage may not exceed 10 times our stockholders' equity (as computed in accordance with GAAP), which we refer to as our leverage threshold. In the event that our leverage inadvertently exceeds the leverage threshold, we may not utilize additional leverage without prior approval from our Board of Directors or until we are once again in compliance with the leverage threshold;

no investment shall be made that would cause us to fail to qualify as a REIT for federal income tax purposes;

no investment shall be made that would cause us to be regulated as an investment company under the Investment Company Act; and

prior to entering into any proposed investment transaction with American Capital or any of its affiliates, a majority of our independent directors must approve the terms of the transaction.

Agency securities consist of single-family residential pass-through certificates and CMOs for which the principal and interest are guaranteed by a U.S. Government agency or a U.S. Government sponsored entity.

***Single-Family Residential Pass-Through Certificates.*** Single-family residential pass-through certificates are securities representing interests in pools of mortgage loans secured by residential real property where payments of both interest and principal, plus pre-paid principal, on the securities are made monthly to holders of the security, 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 and servicers of the securities.

***Collateralized Mortgage Obligations (CMOs).*** CMOs are structured instruments comprised of agency securities. Interest and principal, if applicable, plus pre-paid principal, on a CMO are paid on a monthly basis. CMOs consist of multiple classes of securities, with each class bearing different stated maturity dates. Monthly payments of principal, including prepayments, are first returned to investors holding the shortest maturity class; investors holding the longer maturity classes receive principal only after the first class has been retired.

These securities are collateralized by either fixed-rate mortgage loans, or FRMs, adjustable-rate mortgage loans, or ARMs, or hybrid ARMs. Hybrid ARMs are mortgage loans that have interest rates that are fixed for an initial period (typically three, five, seven or 10 years) and thereafter reset at regular intervals subject to interest rate caps. Our allocation between securities collateralized by FRMs, ARMs or hybrid ARMs will depend on various factors including, but not limited to, relative value, expected future prepayment trends, supply 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. We take these factors into account when we make these types of investments.



## Edgar Filing: American Capital Agency Corp - Form 10-Q

As of September 30, 2008, our investment portfolio totaled \$1.6 billion financed at a leverage ratio of approximately 5.4 times our stockholders equity, which is below the leverage approved by our Board of Directors and permitted under our master repurchase agreements of 10 times our stockholders equity. Financing spreads (the difference between yields on our investments and rates on related borrowings) averaged 305 basis points during the quarter ended September 30, 2008.

## **Table of Contents**

The size and composition of our investment portfolio depends on investment strategies being implemented by management, the availability of investment capital and overall market conditions, including the availability of attractively priced investments and suitable financing to appropriately leverage our investment capital. Market conditions are influenced by, among other things, current levels of, and expectations for future levels of, short-term interest rates, mortgage prepayments and market liquidity.

### ***Our Financing Strategy***

As part of our investment strategy, we borrow against our investment portfolio pursuant to master repurchase agreements with financial institutions. We expect that our borrowings pursuant to repurchase transactions under such master repurchase agreements generally will have maturities that range from 30 to 90 days, but may have maturities of less than 30 days or up to 364 days. Per our investment guidelines approved by our Board of Directors, we would need Board of Director approval for our leverage to exceed 10 times the amount of our stockholders' equity.

### ***Our Hedging Strategy***

As part of our risk management strategy, we may hedge our exposure to interest rate and prepayment risk as our Manager determines is in our best interest given our investment strategy, the cost of the hedging transactions and our intention to qualify as a REIT. As a result, we may elect to bear a level of interest rate or prepayment risk that could otherwise be hedged when management believes, based on all relevant facts, that bearing the risk enhances our risk/return profile. We may enter into interest rate caps, collars, floors, forward contracts, futures, options or swap agreements to attempt to mitigate the risk of the cost of our variable rate liabilities increasing at a faster rate than the earnings on our assets during a period of rising interest rates.

### ***Our Option Strategy***

As part of our risk management strategy, we may write put or call options on TBA securities as a method of insulating our stockholders' equity and enhancing our risk/return profile. Our Manager implements this strategy based upon overall market conditions, the level of volatility in the mortgage market, size of our agency securities portfolio, notional value of our swap positions outstanding and our intention to qualify as a REIT. As a result, the notional value of our options contracts outstanding at any one time is less than the size of our agency securities portfolio.

### **Summary of Critical Accounting Policies**

Our critical accounting policies relate to investment accounting, revenue recognition, securities valuation, derivative accounting and income taxes. Each of these items involves estimates that will require management to make judgments that are subjective in nature. We will rely on our Manager's experience and analysis of historical and current market data in order to arrive at what we believe to be reasonable estimates. Under different conditions, we could report materially different amounts using these critical accounting policies.

### ***Investments***

Statement of Financial Accounting Standards ( SFAS ) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, or SFAS No. 115, requires that at the time of purchase, we designate a security as held-to-maturity, available-for-sale or trading depending on our ability and intent to hold such security to maturity. Securities classified as available-for-sale are reported at fair value, while securities classified as held-to-maturity are reported at amortized cost. Although we generally intend to hold most of our agency securities until maturity, we may, from time to time, sell any of our agency securities as part of our overall management of our investment portfolio. Accordingly, we are required to classify all of our securities as available-for-sale. All securities classified as available-for-sale are reported at fair value, based on market prices

---

## **Table of Contents**

from third-party sources, with unrealized gains and losses excluded from earnings and reported in other comprehensive income (loss), a component of stockholders' equity. Upon the sale of an investment security, any unrealized gain or loss is reclassified out of accumulated other comprehensive income to earnings as a realized gain or loss using the specific identification method.

We evaluate securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market conditions warrant such evaluation. The determination of whether a security is other-than-temporarily impaired involves judgments and assumptions based on subjective and objective factors. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of recovery in fair value of the agency security, and (3) our intent and ability to retain our investment in the agency security for a period of time sufficient to allow for any anticipated recovery in fair value. Investments with unrealized losses are not considered other-than-temporarily impaired if we have the ability and intent to hold the investments for a period of time, to maturity if necessary, sufficient for a forecasted market price recovery up to or beyond the cost of the investments. Unrealized losses on securities that are considered other-than-temporary, as measured by the amount of the difference between the securities' cost basis and its fair value are recognized as an impairment charge in earnings as an unrealized loss and the cost basis of the securities is adjusted.

### ***Interest Income***

Interest income is accrued based on the outstanding principal amount of the agency securities and their contractual terms. Premiums and discounts associated with the purchase of the agency securities are amortized or accreted into interest income over the projected lives of the securities, including contractual payments and estimated prepayments using the interest method in accordance with SFAS No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.

We estimate long-term prepayment speeds using third-party services, market data and internal models. These third-party services estimate prepayment speeds using models that incorporate the current yield curve, current mortgage rates, current mortgage rates of the outstanding loans, loan age, volatility and other factors. Management reviews the prepayment speeds estimated by the third-party services and compares the results to market consensus prepayment speeds, if available, and internal prepayment models. Management also considers historical prepayment speeds and current market conditions to validate reasonableness. Actual and anticipated prepayment experience is reviewed quarterly and effective yields are recalculated when differences arise between the previously estimated future prepayment and the amounts actually received plus current anticipated future prepayments. If the actual and anticipated future prepayment experience differs from our prior estimate of prepayments, we are required to make an adjustment to the amortization or accretion of premiums and discounts that would have an impact on future income.

### ***Repurchase Agreements***

We finance the acquisition of agency securities for our investment portfolio through repurchase transactions under master repurchase agreements. Repurchase transactions are treated as collateralized financing transactions and are carried at their contractual amounts, including accrued interest, as specified in the respective transactions. We have entered into master repurchase agreements with 15 financial institutions.

In instances where we acquire agency securities through repurchase agreements with the same counterparty from whom the agency securities were purchased, we account for the purchase commitment and repurchase agreement on a net basis and record a forward commitment to purchase agency securities as a derivative instrument if the transaction does not comply with the criteria in Financial Accounting Standards Board (FASB) Staff Position FAS 140-3, *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions*, or FSP FAS 140-3, for gross presentation. If the transaction does not comply with the criteria for



---

## **Table of Contents**

gross presentation in FSP FAS 140-3, such forward commitments are recorded at fair value with subsequent changes in fair value recognized in income. Additionally, we record the cash portion of our investment in agency securities as a mortgage related receivable from the counterparty on our balance sheet. If the transaction complies with the criteria for gross presentation in FSP FAS 140-3, we record both the assets and the related financing on a gross basis in our consolidated balance sheet and the corresponding interest income and interest expense in our consolidated statements of operations. During the quarter ended September 30, 2008, we did not have any seller-financed acquisitions of agency securities that did not qualify for gross presentation.

### ***Derivatives Instruments***

The principal derivatives that we use are interest rate swaps, to-be-announced ( TBA ) securities and put and call options on TBA securities. We account for derivatives in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities, as amended*, or SFAS No. 133. SFAS No. 133 requires an entity to recognize all derivatives as either assets or liabilities in the balance sheet and to measure those instruments at fair value.

The accounting for changes in the fair value of derivatives depends on the intended use of the derivative and the resulting designation. Derivatives that are intended to hedge exposure to variability in expected future cash flows are considered cash flow hedges. For derivatives designated in qualifying cash flow hedging relationships, the effective portion of the fair value adjustments are initially recorded in other comprehensive income (a component of stockholders' equity) and reclassified to income at the time that the hedged transactions affect earnings. The ineffective portion of the fair value adjustments is recognized in gain (loss) on derivative instruments in net income immediately. For derivatives not designated in hedging relationships under SFAS No. 133, the fair value adjustments are recorded in gain (loss) on derivative instruments in net income. Derivatives in a gain position are reported as derivative assets, at fair value and derivatives in a loss position are reported as derivative liabilities, at fair value in our consolidated balance sheets. When the underlying hedged transaction ceases to exist, all changes in the fair value of the instrument are marked-to-market with changes in value included in gain (loss) on derivative instruments in net income for each period until the derivative instrument matures or is settled as well as any amounts that have been previously deferred in accumulated other comprehensive income may need to be reclassified to net income. We generally enter into interest rate swaps with the intention of qualifying for hedge accounting.

We may write put and call options on TBA securities. Under a put option, the counterparty has the right to sell us a specified TBA security at a predetermined price on the option exercise date in exchange for a premium at execution. Under a call option, the counterparty has the right to purchase from us a specified TBA security at a predetermined price on the option exercise date in exchange for a premium at execution. The premium received from writing a put or call option is reported as a liability in our consolidated balance sheets. The premium is valued at an amount equal to the fair value of the option that would have the effect of closing the position. The difference between the premium and the fair value of the option is reported in gain (loss) on derivative instruments in net income. When a written put or call option expires, a realized gain is reported in our consolidated statement of operations equal to the premium received. When we terminate a written put or call option, a realized gain or loss is reported in our consolidated statement of operations equal to the difference between the termination payment and the premium received. When a written put or call option is exercised, a realized gain or loss is reported in our consolidated statement of operations equal to the difference between the premium received and the fair value of the exercised put or call option. In addition, a derivative asset or liability is recorded in our consolidated balance sheet for the TBA security resulting from the put or call option exercise.

A TBA security is a futures contract for the purchase or sale of agency securities at a predetermined price, face amount, issuer, coupon and stated maturity on an agreed-upon future date. The specific agency securities delivered into the contract upon the settlement date is published each month by the Securities Industry and Financial Markets Association and are not known at the time of the transaction. TBA securities are exempt from SFAS No. 133 if there is no other way to purchase or sell that security, delivery of that security and settlement



**Table of Contents**

will occur within the shortest period possible for that type of security and it is probable at inception and throughout the term of the individual contract that physical delivery of the security will occur. Since we have not asserted that physical settlement is probable, we have accounted for all such commitments as derivatives and accordingly all realized and unrealized gains and losses are recognized in the statement of operations.

We estimate the fair value of interest rate swaps based on the estimated net present value of the future cash flows using a forward interest rate yield curve in effect as of the measurement period, adjusted for non-performance risk based on our credit risk and our counterparty's credit risk and we consider the impact of any collateral requirements, credit enhancements or netting arrangements on credit risk. TBA securities are valued using third-party pricing services. These third-party pricing services use pricing models that incorporate such factors as coupons, prepayment speeds, spread to the Treasury and swap curves, convexity, duration, periodic and life caps and credit enhancement.

The use of derivatives creates exposure to credit risk relating to potential losses that could be recognized in the event that the counterparties to these instruments fail to perform their obligations under the contracts. We minimize this risk by limiting our counterparties to major financial institutions with acceptable credit ratings and monitoring positions with individual counterparties.

**Income Taxes**

We will elect to be taxed as a REIT in our tax return for the year ending December 31, 2008, under the provisions of the Code and the corresponding provisions of state law. A REIT is not subject to tax on its earnings to the extent that it distributes its annual taxable income to its stockholders and as long as certain asset, income and stock ownership tests are met. We operate in a manner that we believe allows us to be taxed as a REIT and, as a result, we do not expect to pay substantial corporate-level income taxes. If we failed to qualify as a REIT and did not qualify for certain statutory relief provisions, we would be subject to federal, state and local income taxes and may be precluded from qualifying as a REIT for the subsequent four fiscal years following the year in which the REIT qualification was lost. Our domestic taxable REIT subsidiary, American Capital Agency TRS, LLC, will be subject to federal, state and, if applicable, local income tax.

**FINANCIAL CONDITION**

As of September 30, 2008, our investment portfolio consisted of \$1.6 billion of agency securities. The following tables summarize certain characteristics of our investment portfolio as of September 30, 2008 and June 30, 2008 (dollars in thousands):

	September 30, 2008					
	Par Value	Amortized Cost	Purchase Price	Fair Value	Weighted Average Coupon	Weighted Average Yield(1)
Fannie Mae	\$ 766,500	\$ 780,415	101.8%	\$ 774,317	6.07%	5.60%
Freddie Mac	246,598	251,117	101.8%	248,856	6.10%	5.60%
Ginnie Mae	590,862	610,563	103.3%	600,887	6.18%	5.36%
Total / Weighted Average	\$ 1,603,960	\$ 1,642,095	102.4%	\$ 1,624,060	6.12%	5.50%



**Table of Contents**

	June 30, 2008					
	Par Value	Amortized Cost	Purchase Price	Fair Value	Weighted Average Coupon	Weighted Average Yield(2)
Fannie Mae	\$ 1,284,336	\$ 1,304,897	101.6%	\$ 1,293,433	6.06%	5.58%
Freddie Mac	259,983	265,001	101.9%	261,957	6.12%	5.56%
Ginnie Mae	829,787	856,605	103.2%	846,527	6.15%	5.36%
Total / Weighted Average	\$ 2,374,106	\$ 2,426,503	102.2%	\$ 2,401,917	6.10%	5.50%

- (1) Weighted average yield for the quarter ended September 30, 2008 and incorporates future prepayment assumptions.  
 (2) Weighted average yield for the period from May 20, 2008 to June 30, 2008 and incorporates future prepayment assumptions.

Actual maturities of agency securities are generally shorter than stated contractual maturities primarily as a result of prepayments of principal of the underlying mortgages. The stated contractual final maturity of the mortgage loans underlying our portfolio of agency securities ranges up to 40 years, but the expected maturity is subject to change based on the actual and expected future prepayments of the underlying loans. As of September 30, 2008 and June 30, 2008, the average final contractual maturity of the agency securities in our investment portfolio was 31 years. The estimated weighted average months to maturity of the agency securities in the tables below are based upon our prepayment expectations, which are estimated using third-party services, market data and internal models. These third-party services estimate prepayment speeds using models that incorporate the current yield curve, current mortgage rates, current mortgage rates of the outstanding loans, loan age, volatility and other factors.

The following table summarizes our agency securities, at fair value, according to their estimated weighted average life classifications as of September 30, 2008 and June 30, 2008 (dollars in thousands):

	September 30, 2008	June 30, 2008
Less than one year	\$	\$
Greater than one year and less than five years	619,947	213,931
Greater than or equal to five years	1,004,113	2,187,986
Total	\$ 1,624,060	\$ 2,401,917

The constant prepayment rate, or CPR, reflects the percentage of principal that is prepaid over a period of time on an annualized basis. As interest rates rise, the rate of refinancings typically declines, which we expect may result in lower rates of prepayment and, as a result, a lower portfolio CPR. Conversely, as interest rates fall, the rate of refinancings typically increases, which we expect may result in higher rates of prepayment and, as a result, a higher portfolio CPR. As of September 30, 2008, our portfolio was purchased at a net premium because in part, we believe that we are in an environment that will result in relatively slow CPRs. The actual CPR was approximately 5% for the quarter ended September 30, 2008 and approximately 4% for the period from May 20, 2008 through June 30, 2008. We expect that prepayments will continue to be slow in the near term due to higher mortgage rates, tighter underwriting standards and negative home price appreciation before returning to a higher normalized historical rate in the long term. In determining the yield on our agency securities, we have assumed that the CPR over the remaining projected life of the agency securities will be 16% as of September 30, 2008.

**Table of Contents****RESULTS OF OPERATIONS**

The table below presents our condensed statement of operations and key portfolio statistics (in thousands, except per share amounts):

	Three Months ended September 30, 2008	For the period from May 20, 2008 (date operations commenced) through June 30, 2008	For the period from May 20, 2008 (date operations commenced) through September 30, 2008
<b>Statement of Operations Data:</b>			
Interest income	\$ 28,071	\$ 9,924	\$ 37,995
Interest expense	11,009	3,597	14,606
Net interest income	17,062	6,327	23,389
Other income	4,178	448	4,626
Expenses	(2,339)	(1,276)	(3,615)
Net income	\$ 18,901	\$ 5,499	\$ 24,400
Net income per common share basic and diluted	\$ 1.26	\$ 0.37	\$ 1.63
Weighted average number of common shares outstanding basic and diluted	15,000	15,000	15,000
<b>Key Portfolio Statistics*:</b>			
Average agency securities	\$ 2,028,771	\$ 1,579,421	\$ 1,888,135
Average total assets	\$ 2,073,893	\$ 1,643,480	\$ 1,938,623
Average repurchase agreements	\$ 1,795,218	\$ 1,331,825	\$ 1,649,826
Average equity	\$ 264,985	\$ 273,966	\$ 267,800
Average asset yield(1)	5.50%	5.50%	5.50%
Average cost of funds(2)	2.45%	2.35%	2.41%
Net interest rate spread(3)	3.05%	3.15%	3.09%
Net return on average equity(4)	28.30%	17.44%	24.82%
Leverage (average during the period)(5)	6.8:1	4.9:1	6.2:1
Leverage (at period end)(6)	5.4:1	8.3:1	5.4:1
Expenses % of average assets(7)	0.45%	0.67%	0.51%
Expenses % of average equity(8)	3.50%	4.05%	3.68%
Book value per common share as of period end(9)	\$ 17.85	\$ 17.45	\$ 17.85

\* Average numbers for each period are weighted based on days on the Company's books and records. All percentages are annualized.

- (1) Weighted average asset yield for the period was calculated by dividing our average interest income on agency securities, including average amortization of premiums and discounts, by our average agency securities.
- (2) Weighted average cost of funds for the period was calculated by dividing our total interest expense by our weighted average repurchase agreements.
- (3) Net interest rate spread for the period was calculated by subtracting our weighted average cost of funds from our weighted average asset yield.
- (4) Net return on average equity for the period was calculated by dividing our net income by our average shareholders' equity.
- (5) Leverage during the period was calculated by dividing our average repurchase agreements outstanding by our average shareholders' equity.
- (6) Leverage at period end was calculated by dividing the amount outstanding under our repurchase agreements by our total shareholders' equity at period end.
- (7) Expenses as a % of average assets was calculated by dividing our total expenses by our average total assets.
- (8) Expenses as a % of average equity was calculated by dividing our total expenses by our average shareholders' equity.
- (9) Book value per common share was calculated by dividing our total shareholders' equity by our number of common shares outstanding.



## **Table of Contents**

### ***Interest Income and Asset Yield***

Interest income was \$28.1 million during the quarter ended September 30, 2008 and \$38.0 million for the period from May 20, 2008 through September 30, 2008. Interest income was \$9.9 million for the period ended June 30, 2008. The average yield on our investment portfolio was 5.50% during both the quarter ended September 30, 2008 and for the period from May 20, 2008 through September 30, 2008. The average yield on our investment portfolio was 5.50% for the period ended June 30, 2008. Net amortization of premiums and discounts on our investment portfolio of \$2.3 million and \$3.1 million, respectively, were included in interest income during the quarter ended September 30, 2008 and for the period from May 20, 2008 through September 30, 2008. Net amortization of premiums and discounts on our investment portfolio of \$0.8 million was included in interest income for the period ended June 30, 2008. As of September 30, 2008, the unamortized net premium was \$38.1 million. The asset yield on our investment portfolio as of September 30, 2008 was 5.52%.

### ***Leverage***

Our weighted average leverage during the quarter ended September 30, 2008 was 6.8 times our average stockholders' equity. Our weighted average leverage during the period from May 20, 2008 through September 30, 2008 was 6.2 times our average stockholders' equity, respectively. As of September 30, 2008, our leverage was 5.4 times our stockholders' equity. Our actual leverage will vary from time to time based on various factors, including our management's opinion of the level of risk of our assets and liabilities, our liquidity position, our level of unused borrowing capacity, over-collateralization levels required by lenders when we pledge agency securities to secure our borrowings and the current market value of our investment portfolio. Per our investment guidelines approved by our Board of Directors, we would need Board of Director approval for our leverage to exceed 10 times the amount of our stockholders' equity. Certain of our master repurchase agreements contain a restriction that prohibits our leverage from exceeding 10 times the amount of our stockholders' equity.

### ***Interest Expense and Cost of Funds***

Interest expense was \$11.0 million and \$14.6 million, respectively, during the quarter ended September 30, 2008 and for the period from May 20, 2008 through September 30, 2008. Interest expense was \$3.6 million for the period ended June 30, 2008. Our average cost of funds was 2.45% and 2.41% during the quarter ended September 30, 2008 and for the period from May 20, 2008 through September 30, 2008, respectively, compared to the average one-month LIBOR of 2.62% and 2.57% during the same periods. Our average cost of funds was 2.35% for the period ended June 30, 2008 compared to the average one-month LIBOR of 2.37% during the same period. As of September 30, 2008, our average cost of funds was 2.77%.

As of September 30, 2008, we had entered into forward starting interest rate swap agreements for a total notional amount of \$0.7 billion, or 49% of the outstanding balance under our repurchase agreements. There was no effect on interest expense during the quarter ended September 30, 2008 and period ended June 30, 2008 as all swaps were forward starting as of September 30, 2008 with effective dates in November and December 2008.

### ***Net Interest Income and Net Interest Rate Spread***

Net interest income, which equals interest income less interest expense, was \$17.1 million and \$23.4 million during the quarter ended September 30, 2008 and for the period from May 20, 2008 through September 30, 2008, respectively. Net interest income was \$6.3 million for

## Edgar Filing: American Capital Agency Corp - Form 10-Q

the period ended June 30, 2008. The net interest rate spread, which equals the yield on our average assets for the period less the average cost of funds for the period, was 3.05% and 3.09% during the quarter ended September 30, 2008 and for the period from May 20, 2008 through September 30, 2008, respectively. The net interest rate spread was 3.15% for the period ended June 30, 2008. As of September 30, 2008, the net interest rate spread was 2.75%.

## **Table of Contents**

### ***(Loss) Gain from Sale of Agency Securities***

During the quarter ended September 30, 2008, we sold assets with a carrying value of \$898.7 million for an aggregate loss of \$0.2 million. For the period from May 20, 2008 through September 30, 2008 and May 20, 2008 through June 30, 2008, we sold assets with a carrying value of \$959.6 million and \$60.9 million, respectively, for an aggregate gain of \$0.1 million and \$0.2 million, respectively.

### ***Gain on Derivative Instruments***

During the quarter ended September 30, 2008, we realized a gain of \$4.3 million on our derivative instruments. For the period from May 20, 2008 through September 30, 2008 and May 20, 2008 through June 30, 2008, we realized a gain of \$4.6 million and \$0.2 million, respectively, on our derivative instruments.

The principal derivative instruments that we use are interest rate swaps, TBA securities and put and call options on TBA securities. During the quarter ended September 30, 2008, we recorded a loss of \$0.2 million in gain on derivative instruments in our consolidated statement of operations as a result of hedge ineffectiveness on our outstanding interest rate swaps. We did not record any hedge ineffectiveness during the period ended June 30, 2008 related to our interest rate swaps.

During the quarter ended September 30, 2008, we recorded a gain of \$4.5 million in gain on derivative instruments in our consolidated statement of operations related to our settled and unsettled put and call options and TBA securities. As of September 30, 2008, we had outstanding short TBA securities with a notional amount of \$425 million and a fair value of \$2.9 million. There were no outstanding put or call options as of September 30, 2008 and June 30, 2008.

### ***Management Fee and General and Administrative Expenses***

We accrued a management fee of \$0.9 million and \$1.3 million during the quarter ended September 30, 2008 and for the period from May 20, 2008 through September 30, 2008, respectively. We accrued a management fee of \$0.4 million for the period ended June 30, 2008. We pay our Manager a monthly management fee equal to 1.25% per annum of our stockholders' equity (as defined in the management agreement).

General and administrative expenses were \$1.4 million and \$2.3 million during the quarter ended September 30, 2008 and for the period from May 20, 2008 through September 30, 2008, respectively. General and administrative expenses were \$0.9 million for the period ended June 30, 2008. The general and administrative expenses during these periods included non-recurring expenses of \$0.3 million related to our initial organization and formation costs.

### ***Net Income and Net Return on Equity***

## Edgar Filing: American Capital Agency Corp - Form 10-Q

Net income was \$18.9 million and \$24.4 million or \$1.26 and \$1.63 per basic and diluted share during the quarter ended September 30, 2008 and for the period from May 20, 2008 through September 30, 2008, respectively. For the period ended June 30, 2008, net income was \$5.5 million or \$0.37 per basic and diluted share. The net return on average equity was 28.30% and 24.82% during the quarter ended September 30, 2008 and for the period from May 20, 2008 through September 30, 2008, respectively. For the period ended June 30, 2008, the net return on average equity was 17.44%.

**Table of Contents****LIQUIDITY AND CAPITAL RESOURCES**

Our primary sources of funds are borrowings under master repurchase agreements and monthly principal and interest payments on our investment portfolio. Other sources of funds may include proceeds from debt and equity offerings and asset sales. We generally use our liquidity to pay down borrowings under repurchase arrangements to reduce borrowing costs and otherwise efficiently manage our long-term investment capital. Because the level of these borrowings can be adjusted on a daily basis, the level of cash and cash equivalents carried on the balance sheet is significantly less important than the potential liquidity available under our borrowing arrangements. We currently believe that we have sufficient liquidity and capital resources available for the acquisition of additional investments, repayments on borrowings and the payment of cash dividends as required for our continued qualification as a REIT.

As part of our investment strategy, we borrow against our investment portfolio pursuant to master repurchase agreements. We expect that our borrowings pursuant to repurchase transactions under such master repurchase agreements generally will have maturities that range from 30 to 90 days, but may have maturities of less than 30 days or up to 364 days. Per our investment guidelines approved by our Board of Directors, we would need Board of Director approval for our leverage to exceed 10 times the amount of our stockholders' equity. As of September 30, 2008, our leverage was 5.4 times the amount of our stockholders' equity. Our cost of borrowings under master repurchase agreements generally corresponds to LIBOR plus or minus a margin. We have master repurchase agreements with 15 financial institutions, subject to certain conditions, and have borrowings outstanding with 12 of these financial institutions as of September 30, 2008. Borrowings under repurchase arrangements secured by agency securities totaled \$1.4 billion as of September 30, 2008. As of September 30, 2008, we did not have an amount at risk with any counterparty greater than 10% of our stockholders' equity.

Amounts available to be borrowed under these arrangements are dependent upon lender collateral requirements and the lender's determination of the fair value of the securities pledged as collateral, which fluctuates with changes in interest rates, credit quality and liquidity conditions within the investment banking, mortgage finance and real estate industries. Under the repurchase agreements, we may be required to pledge additional assets to the repurchase agreement counterparties (i.e., lenders) in the event the estimated fair value of the existing pledged collateral under such agreements declines and such lenders demand additional collateral (a margin call), which may take the form of additional securities or cash. Similarly, if the estimated fair value of investment securities increases due to changes in the market interest rates, lenders may release collateral back to us. Specifically, margin calls would result from a decline in the value of the agency securities securing our repurchase agreements and prepayments on the mortgages securing such agency securities. As of September 30, 2008, we have met all margin requirements. We had unrestricted cash of \$17 million and unpledged securities of \$124 million available to meet margin calls on our repurchase agreements and derivative instruments as of September 30, 2008.

The following table summarizes our borrowings under repurchase arrangements and weighted average interest rates classified by scheduled maturities as of September 30, 2008 and June 30, 2008 (dollars in thousands):

Maturity	As of September 30, 2008			As of June 30, 2008		
	Borrowings Outstanding	Average Interest Rate	Weighted Average Days to Maturity	Borrowings Outstanding	Average Interest Rate	Weighted Average Days to Maturity
30 days or less	\$ 1,298,895	2.78%	15 days	\$ 1,719,207	2.42%	16 days
31 - 59 days	92,349	2.69%	56 days	403,890	2.29%	55 days
60 - 90 days	43,119	2.45%	63 days	43,519	2.32%	65 days
Greater than 90 days						
<b>Total / Weighted Average</b>	<b>\$ 1,434,363</b>	<b>2.77%</b>	<b>19 days</b>	<b>\$ 2,166,616</b>	<b>2.39%</b>	<b>24 days</b>





**Table of Contents**

Although we believe that we will have adequate sources of liquidity available to us through repurchase agreement financing to execute our business strategy, there can be no assurances that repurchase financing will be available to us upon the maturity of our current repurchase agreements to allow us to renew or replace our repurchase agreement financing on favorable terms or at all. The recent disruptions in the financial markets have resulted in greater price volatility of collateral, including agency securities, and reduced liquidity of repurchase agreement lenders. Many financial institutions, including repurchase agreement lenders, have experienced a reduction in their capacity to provide financing and have tightened their lending standards. In addition, if our repurchase agreement lenders default on their obligations to resell the underlying agency security back to us at the end of the term, we could incur a loss equal to the difference between the value of the agency security and the cash we originally received. As a result of these circumstances, we prudently and opportunistically sold securities during the third quarter of 2008 which allowed us to reduce our leverage from 8.3 times our stockholders' equity as of June 30, 2008 to 5.4 times as of September 30, 2008. If these circumstances continue, we expect to take additional actions intended to protect our liquidity, which may include further reducing borrowings and disposing of assets as well as raising capital.

We use interest rate swap agreements to effectively lock in fixed rates on a portion of our short-term borrowings because longer-term committed borrowings are not available at attractive terms. We have entered into interest rate swap agreements to attempt to mitigate the risk of the cost of our short-term variable rate liabilities thereby compressing the net spreads that we earn on our long-term fixed rate assets during a period of rising interest rates. As of September 30, 2008, our swap agreements had notional amounts totaling \$0.7 billion and were designated as cash flow hedges for accounting purposes of a like amount of our short-term borrowings. We may be limited on the types of hedging strategies we can deploy as a REIT under the Code; therefore, we may implement part of our hedging strategy through American Capital Agency TRS, LLC, our domestic taxable REIT subsidiary, which will be subject to federal, state and, if applicable, local income tax. As of September 30, 2008, our derivatives were primarily comprised of forward starting interest rate swaps with effective dates in November and December 2008, which will have the effect of modifying the repricing characteristics of our repurchase agreements and cash flows on such liabilities.

The table below summarizes information about our outstanding swaps as of September 30, 2008 and June 30, 2008 (dollars in thousands):

Swap Term	As of September 30, 2008			As of June 30, 2008		
	Notional Amount	Weighted Average Fixed Pay Rate	Net Estimated Fair Value	Notional Amount	Weighted Average Fixed Pay Rate	Net Estimated Fair Value
1 - 2 Years	\$ 550,000	3.42%	\$ (2,348)	\$ 550,000	3.42%	\$ 322
3 - 4 Years	50,000	4.37%	(1,148)	50,000	4.37%	(530)
4 - 5 Years	100,000	4.22%	(1,618)	100,000	4.22%	(225)
Greater than 5 Years						
Total / Weighted Average	\$ 700,000	3.60%	\$ (5,114)	\$ 700,000	3.60%	\$ (433)

To qualify as a REIT, we must distribute annually at least 90% of our taxable income. To the extent that we annually distribute all of our taxable income in a timely manner, we will generally not be subject to federal and state income taxes. We currently expect to distribute all of our taxable income. This distribution requirement limits our ability to retain earnings and thereby replenish or increase capital for operations.

**Off-Balance Sheet Arrangements**

As of September 30, 2008, we did not maintain any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance, or special purpose or variable interest entities, established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Further, as of September 30, 2008, we had not guaranteed any obligations of unconsolidated entities or entered into any commitment or intent to provide funding to any such entities.



## **Table of Contents**

### **FORWARD LOOKING STATEMENTS**

This document contains forward-looking statements (within the meaning of the Private Securities Litigation Reform Act of 1995) that inherently involve risks and uncertainties. Our actual results and liquidity can differ materially from those anticipated in these forward-looking statements because of changes in the level and composition of our investments and other factors. These factors may include, but are not limited to, changes in general economic conditions, the availability of suitable investments from both an investment return and regulatory perspective, the availability of new investment capital, fluctuations in interest rates and levels of mortgage prepayments, deterioration in credit quality and ratings, the effectiveness of risk management strategies, the impact of leverage, liquidity of secondary markets and credit markets, increases in costs and other general competitive factors.

### **Item 3. *Quantitative and Qualitative Disclosures About Market Risk***

#### **MARKET RISK**

Market risk is the exposure to loss resulting from changes in interest rates, foreign currency exchange rates, commodity prices and equity prices. The primary market risks that we will be exposed to are interest rate risk, prepayment risk, liquidity risk, extension risk and inflation risk

#### ***Interest Rate Risk***

Interest rate risk is highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond our control.

Changes in the general level of interest rates can affect our net interest income, which is the difference between the interest income earned on interest-earning assets and the interest expense incurred in connection with our interest-bearing liabilities, by affecting the spread between our interest-earning assets and interest-bearing liabilities. Changes in the level of interest rates also can affect the value of the agency securities that constitute our investment portfolio and our ability to realize gains from the sale of these assets.

We may utilize a variety of financial instruments, including interest rate caps, collars, floors, forward contracts, futures, options or swap agreements, in order to limit the effects of changes in interest rates on our operations. When we use these types of derivatives to hedge the risk of interest-earning assets or interest-bearing liabilities, we may be subject to certain risks, including the risk that losses on a hedge position will reduce the funds available for payments to holders of our common stock and that the losses may exceed the amount we invested in the instruments.

Our profitability and the value of our investment portfolio (including derivatives used for hedging purposes) may be adversely affected during any period as a result of changing interest rates including resulting changes in forward yield curves. The following table quantifies the estimated changes in net interest income and investment portfolio value should interest rates go up or down by 50 and 100 basis points, assuming the yield curves of the rate shocks will be parallel to each other and the current yield curve. These estimates were compiled using third-party services, market data and internal models. All changes in income and value are measured as percentage changes from the projected net interest income and investment portfolio value at the base interest rate scenario. The base interest rate scenario assumes interest rates at September 30, 2008 and

## Edgar Filing: American Capital Agency Corp - Form 10-Q

various estimates regarding prepayment and all activities are made at each level of rate shock.

Actual results could differ materially from estimates, especially in the current market environment. The accuracy of the projected agency securities prices relies on assumptions that define specific agency securities spreads at projected interest rate levels. To the extent that these estimates do not hold true, which is likely in a period of high price volatility, actual results will likely differ materially from projections.

**Table of Contents**

<b>Change in Interest Rate</b>	<b>Percentage Change in Projected Net Interest Income(1)</b>	<b>Percentage Change in Projected Portfolio Value, with Effect of Derivatives</b>
+100 Basis Points	-20%	-2%
+50 Basis Points	-9%	-1%
-50 Basis Points	7%	1%
-100 Basis Points	13%	1%

(1) Does not include the effect of our forward starting interest rate swaps.

**Prepayment Risk**

Premiums and discounts associated with the purchase of agency securities are amortized or accreted into interest income over the projected lives of the securities, including contractual payments and estimated prepayments using the interest method. Our policy for estimating prepayment speeds for calculating the effective yield is to evaluate published prepayment data for similar agency securities, market consensus and current market conditions. If the actual prepayment experienced differs from our estimate of prepayments, we will be required to make an adjustment to the amortization or accretion of premiums and discounts that would have an impact on future income.

**Liquidity Risk**

The primary liquidity risk for us arises from financing long-term assets with shorter-term borrowings in the form of repurchase agreements. Our assets which are pledged to secure repurchase agreements are high-quality agency securities and cash. As of September 30, 2008, we had unrestricted cash and cash equivalents of \$17 million and unpledged agency securities of \$124 million available to meet margin calls on our repurchase agreements, derivative instruments and for other corporate purposes. However, should the value of our investment securities pledged as collateral suddenly decrease, margin calls relating to our repurchase agreements could increase, causing an adverse change in our liquidity position. As such, we cannot assure that we will always be able to roll over our repurchase agreements.

**Extension Risk**

The projected weighted-average life of our investments is based on our assumptions regarding the rate at which the borrowers will prepay the underlying mortgage loans. In general, when we acquire a FRM or hybrid ARM security, we may, but are not required to, enter into an interest rate swap agreement or other hedging instrument that effectively fixes our borrowing costs for a period close to the anticipated average life of the fixed-rate portion of the related assets. This strategy is designed to protect us from rising interest rates because the borrowing costs are fixed for the duration of the fixed-rate portion of the related agency security.

However, if prepayment rates decrease in a rising interest rate environment, the life of the fixed-rate portion of the related assets could extend beyond the term of the swap agreement or other hedging instrument. This could have a negative impact on our results from operations, as borrowing costs would no longer be fixed after the end of the hedging instrument while the income earned on the FRM or hybrid ARM security would remain fixed. This situation may also cause the market value of our FRM or hybrid ARM security to decline, with little or no offsetting gain from the related hedging transactions. In extreme situations, we may be forced to sell assets to maintain adequate liquidity, which could

cause us to incur losses.

## **Table of Contents**

### **Inflation Risk**

Virtually all of our assets and liabilities are interest rate sensitive in nature. As a result, interest rates and other factors influence our performance more so than does inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. Further, our financial statements are prepared in accordance with GAAP and our distributions are determined by our Board of Directors based primarily by our net income as calculated for tax purposes. In each case, our activities and balance sheet are measured with reference to historical cost and/or fair market value without considering inflation.

### **Item 4.      *Controls and Procedures***

#### **Evaluation of Disclosure Controls and Procedures**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure based on the definition of "disclosure controls and procedures" as promulgated under the SEC Act of 1934, as amended. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

We, including our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of September 30, 2008. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective.

## **PART II. OTHER INFORMATION**

### **Item 1.      *Legal Proceedings***

From time to time, we may be involved in various claims and legal actions arising in the ordinary course of business. As of September 30, 2008, we have no legal proceedings.

### **Item 1A.     *Risk Factors***

There have been no material changes to the risk factors previously disclosed in the prospectus filed pursuant to rule 424(b) on May 16, 2008 with the Securities and Exchange Commission in connection with our initial public offering, except as described below.



## Edgar Filing: American Capital Agency Corp - Form 10-Q

You should carefully consider the risks described below and all other information contained in this interim report on Form 10-Q, including our interim consolidated financial statements and the related notes thereto before making a decision to purchase our securities. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties not presently known to us, or not presently deemed material by us, may also impair our operations and performance.

If any of the following risks actually occur, our business, financial condition or results of operations could be materially adversely affected. If that happens, the trading price of our securities could decline, and you may lose all or part of your investment.

---

**Table of Contents**

**Risks Related to Our Investing and Financing Strategy**

*The conservatorship of Fannie Mae and Freddie Mac and related efforts, along with any changes in laws and regulations affecting the relationship between Fannie Mae and Freddie Mac and the federal government, may adversely affect our business.*

Since June 30, 2008, there have been increased market concerns about Freddie Mac and Fannie Mae's ability to withstand future credit losses associated with securities held in their investment portfolios, and on which they provide guarantees, without the direct support of the federal government. On July 30, 2008, the government passed the Housing and Economic Recovery Act of 2008. On September 7, 2008, the Federal Housing Finance Agency, or FHFA, placed Fannie Mae and Freddie Mac into conservatorship and, together with the U.S. Treasury, established a program designed to boost investor confidence in Fannie Mae's and Freddie Mac's debt and mortgage-backed securities. As the conservator of Fannie Mae and Freddie Mac, the FHFA controls and directs the operations of Fannie Mae and Freddie Mac and may (1) take over the assets of and operate Fannie Mae and Freddie Mac with all the powers of the shareholders, the directors, and the officers of Fannie Mae and Freddie Mac and conduct all business of Fannie Mae and Freddie Mac; (2) collect all obligations and money due to Fannie Mae and Freddie Mac; (3) perform all functions of Fannie Mae and Freddie Mac which are consistent with the conservator's appointment; (4) preserve and conserve the assets and property of Fannie Mae and Freddie Mac; and (5) contract for assistance in fulfilling any function, activity, action or duty of the conservator.

In addition to FHFA becoming the conservator of Fannie Mae and Freddie Mac, (i) the U.S. Treasury and FHFA have entered into preferred stock purchase agreements between the U.S. Department of Treasury and Fannie Mae and Freddie Mac pursuant to which the U.S. Department of Treasury will ensure that each of Fannie Mae and Freddie Mac maintains a positive net worth; (ii) the U.S. Department of Treasury has established a new secured lending credit facility which will be available to Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, which is intended to serve as a liquidity backstop, which will be available until December 2009; and (iii) the U.S. Department of Treasury has initiated a temporary program to purchase agency securities issued by Fannie Mae and Freddie Mac. Given the highly fluid and evolving nature of these events, it is unclear how our business will be impacted.

Although the federal government has committed capital to Fannie Mae and Freddie Mac, there can be no assurance that these credit facilities and other capital infusions will be adequate for their needs. If the financial support is inadequate, these companies could continue to suffer losses and could fail to honor their guarantees and other obligations. The future roles of Fannie Mae and Freddie Mac could be significantly reduced and the nature of their guarantees could be considerably limited relative to historical measurements. Any changes to the nature of the guarantees provided by Fannie Mae and Freddie Mac could redefine what constitutes an agency security and could have broad adverse market implications.

The size and timing of the federal government's agency security purchase program is subject to the discretion of the Secretary of the Treasury, who has indicated that the scale of the program will be based on developments in the capital markets and housing markets. Purchases under this program have already begun, but there is no certainty that the U.S. Treasury will continue to purchase additional agency securities in the future. The U.S. Treasury can hold its portfolio of agency securities to maturity, and, based on mortgage market conditions, may make adjustments to the portfolio. This flexibility may adversely affect the pricing and availability for our target assets. It is also possible that the U.S. Treasury's commitment to purchase agency securities in the future could create additional demand that would negatively affect the pricing of agency securities that we seek to acquire.

The U.S. Treasury could also stop providing credit support to Fannie Mae and Freddie Mac in the future. The U.S. Treasury's authority to purchase agency securities and to provide financial support to Fannie Mae and Freddie Mac under the Housing and Economic Recovery Act of 2008 expires on December 31, 2009. The problems faced by Fannie Mae and Freddie Mac resulting in their being placed into conservatorship have stirred



## Table of Contents

debate among some federal policy makers regarding the continued role of the federal government in providing liquidity for mortgage loans. Following expiration of the current authorization, each of Fannie Mae and Freddie Mac could be dissolved and the federal government could determine to stop providing liquidity support of any kind to the mortgage market. If Fannie Mae or Freddie Mac were eliminated, or their structures were to change radically, we would not be able to acquire agency securities from these companies, which would eliminate the major component of our business model.

Our income could be negatively affected in a number of ways depending on the manner in which related events unfold. For example, the current credit support provided by the U.S. Treasury to Fannie Mae and Freddie Mac, and any additional credit support it may provide in the future, could have the effect of lowering the interest rate we expect to receive from agency securities that we seek to acquire, thereby tightening the spread between the interest we earn on our portfolio of targeted assets and our cost of financing that portfolio. A reduction in the supply of agency securities could also negatively affect the pricing of agency securities we seek to acquire by reducing the spread between the interest we earn on our portfolio of targeted assets and our cost of financing that portfolio.

As indicated above, recent legislation has changed the relationship between Fannie Mae and Freddie Mac and the federal government and requires Fannie Mae and Freddie Mac to reduce the amount of mortgage loans they own or for which they provide guarantees on agency securities. Future legislation could further change the relationship between Fannie Mae and Freddie Mac and the federal government, and could also nationalize or eliminate such entities entirely. Any law affecting these government-sponsored enterprises may create market uncertainty and have the effect of reducing the actual or perceived credit quality of securities issued or guaranteed by Fannie Mae or Freddie Mac. As a result, such laws could increase the risk of loss on investments in Fannie Mae and/or Freddie Mac agency security. It also is possible that such laws could adversely impact the market for such securities and spreads at which they trade. All of the foregoing could materially adversely affect our business, operations and financial condition.

***There can be no assurance that the actions of the U.S. government, Federal Reserve and other governmental and regulatory bodies for the purpose of stabilizing the financial markets, or market response to those actions, will achieve the intended effect, our business may not benefit from these actions and further government or market developments could adversely impact us.***

In response to the financial issues affecting the banking system and financial markets and going concern threats to investment banks and other financial institutions, the Emergency Economic Stabilization Act of 2008, or EESA, was enacted on October 3, 2008. The EESA provides the U.S. Secretary of the Treasury with the authority to establish a Troubled Asset Relief Program, or TARP, to purchase from financial institutions up to \$700 billion of residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008, as well as any other financial instrument that the U.S. Secretary of the Treasury, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability, upon transmittal of such determination, in writing, to the appropriate committees of the U.S. Congress. The EESA also provides for a program that would allow companies to insure their troubled assets.

On October 14, 2008, the U.S. Treasury announced the voluntary Capital Purchase Program ( CPP ), which was implemented under authority provided in the EESA. Under the CPP, the U.S. Treasury will purchase up to \$250 billion of senior preferred shares in qualifying U.S. controlled banks, savings associations, and certain bank and savings and loan holding companies engaged only in financial activities, that elect to participate by November 14, 2008. Nine of the largest banks in the United States, as well as other financial institutions, have accepted investments under the CPP. The U.S. Treasury has also taken under consideration the expansion of the CPP to non-financial institutions, including life or other insurance companies.

## **Table of Contents**

There can be no assurance that the EESA will have a beneficial impact on the financial markets, including current extreme levels of volatility. To the extent the market does not respond favorably to the TARP or CPP initiatives or the TARP or CPP initiatives do not function as intended, our business may not receive the anticipated positive impact from the legislation. In addition, the U.S. Government, Federal Reserve and other governmental and regulatory bodies have taken or are considering taking other actions to address the financial crisis. We cannot predict whether or when such actions may occur or what impact, if any, such actions could have on our business, results of operations and financial condition.

***Recent market conditions may upset the historical relationship between interest rate changes and prepayment trends, which would make it more difficult for us to analyze our investment portfolio.***

Our success depends on our ability to analyze the relationship of changing interest rates on prepayments of the mortgage loans that underlie our agency securities. Changes in interest rates and prepayments affect the market price of the agency securities that we intend to purchase and any agency securities that we hold at a given time. As part of our overall portfolio risk management, we will analyze interest rate changes and prepayment trends separately and collectively to assess their effects on our investment portfolio. In conducting our analysis, we will depend on certain assumptions based upon historical trends with respect to the relationship between interest rates and prepayments under normal market conditions. If the recent dislocations in the residential mortgage market or other developments change the way that prepayment trends have historically responded to interest rate changes, our ability to (i) assess the market value of our investment portfolio, (ii) implement our hedging strategies and (iii) implement techniques to reduce our prepayment rate volatility would be significantly affected, which could materially adversely affect our financial position and results of operations.

***Continued adverse developments in the broader residential mortgage market may adversely affect the value of the agency securities in which we invest.***

In 2008, the residential mortgage market in the United States has experienced a variety of difficulties and changed economic conditions, including defaults, credit losses and liquidity concerns. Recently, some commercial banks, investment banks and insurance companies have announced extensive losses from exposure to the residential mortgage market. These losses have reduced financial industry capital, leading to reduced liquidity for some institutions. These factors have impacted investor perception of the risk associated with real estate related assets, including agency securities and other high-quality RMBS assets. As a result, values for RMBS assets, including some agency securities and other AAA-rated RMBS assets, have experienced significant volatility. Further increased volatility and deterioration in the broader residential mortgage and RMBS markets may adversely affect the performance and market value of our agency securities.

We invest exclusively in agency securities and rely on our agency securities as collateral for our financings. Any decline in their value, or perceived market uncertainty about their value, would likely make it difficult for us to obtain financing on favorable terms or at all, or maintain our compliance with terms of any financing arrangements already in place. The agency securities we invest in are classified for accounting purposes as available-for-sale. All assets classified as available-for-sale are reported at fair value, based on market prices from third-party sources, with unrealized gains and losses excluded from earnings and reported as a separate component of stockholders' equity. As a result, a decline in fair values may reduce the book value of our assets. Moreover, if the decline in fair value of an available-for-sale security is other-than-temporarily impaired, such decline will reduce earnings. If market conditions result in a decline in the value of our agency securities, our financial position and results of operations could be adversely affected.

---

**Table of Contents**

***Continued adverse developments in the residential mortgage market, including recent mergers, acquisitions or bankruptcies of potential repurchase agreement counterparties, as well as defaults, credit losses and liquidity concerns, could make it difficult for us to borrow money to acquire agency securities on a leveraged basis, on favorable terms or at all, which could adversely affect our profitability.***

We rely on the availability of financing to acquire agency securities on a leveraged basis. Since June 30, 2008, there have been several announcements of proposed mergers, acquisitions or bankruptcies of investment banks and commercial banks that have historically acted as repurchase agreement counterparties. This has resulted in a fewer number of potential repurchase agreement counterparties operating in the market. In addition, many commercial banks, investment banks and insurance companies have announced extensive losses from exposure to the residential mortgage market. These losses have reduced financial industry capital, leading to reduced liquidity for some institutions. Institutions from which we seek to obtain financing may have owned or financed RMBS which have declined in value and caused them to suffer losses as a result of the recent downturn in the residential mortgage market. If these conditions persist, these institutions may be forced to exit the repurchase market, become insolvent or further tighten their lending standards or increase the amount of equity capital or haircut required to obtain financing, and in such event, could make it more difficult for us to obtain financing on favorable terms or at all. Our profitability will be adversely affected if we were unable to obtain cost-effective financing for our investments.

***Failure to procure adequate repurchase agreement financing, or to renew (roll) or replace existing repurchase agreement financing as it matures, would adversely affect our results of operations and may, in turn, negatively affect the market value of our common stock and our ability to make distributions to our stockholders.***

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

our lenders do not make repurchase agreement financing available to us at acceptable rates;

certain of our lenders exit the repurchase market;

our lenders require that we pledge additional collateral to cover our borrowings, which we may be unable to do; or

we determine that the leverage would expose us to excessive risk.

We cannot assure you that any, or sufficient, repurchase agreement financing will be available to us in the future on terms that are acceptable to us. Over the last few months, investors and financial institutions that lend in the securities repurchase market, have tightened lending standards in response to the difficulties and changed economic conditions that have materially adversely affected the RMBS market. While the market disruptions have been most pronounced in the non-agency RMBS market, recently, the impact has extended to agency RMBS and the value of these assets have declined and become relatively illiquid compared to prior periods. Any decline in their value, or perceived market uncertainty about their value, would make it more difficult for us to obtain financing on favorable terms or at all, or maintain our compliance with terms of any financing arrangements already in place. Additionally, the lenders from which we have obtained repurchase financing may have owned or financed RMBS that have declined in value and caused the lender to suffer losses as a result of the recent downturn in the residential mortgage market. If these conditions persist, these institutions may be forced to exit the repurchase market, become insolvent or further tighten lending standards or increase the amount of equity capital or haircut required to obtain financing, and in such event, could make it more difficult for us to obtain financing on favorable terms or at all. In the event that we cannot obtain sufficient funding on acceptable terms, there may be a negative impact on the value of our common stock and our ability to make distributions, and you may lose part or all of your investment.



## **Table of Contents**

Furthermore, because we rely primarily on short-term borrowings, our ability to achieve our investment objective depends not only on our ability to borrow money in sufficient amounts and on favorable terms, but also on our ability to renew or replace on a continuous basis our maturing short-term borrowings. If we are not able to renew or replace maturing borrowings, we may have to sell some or all of our assets, possibly under adverse market conditions.

***Pursuant to the terms of borrowings under our master repurchase agreements, we are subject to margin calls that could result in defaults or force us to sell assets under adverse market conditions or through foreclosure.***

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

Our borrowings, which are generally made under our master repurchase agreements, may qualify for special treatment under the Bankruptcy Code. This special treatment would allow the lenders under these agreements to avoid the automatic stay provisions of the Bankruptcy Code and to liquidate the collateral under these agreements without delay.

***If our lenders pursuant to our repurchase transactions default on their obligations to resell the underlying agency security back to us at the end of the transaction term, or if the value of the underlying agency security has declined by the end of the term or if we default on our obligations under the transaction, we will lose money on these transactions.***

When we engage in a repurchase transaction, we initially sell securities to the financial institution under one of our master repurchase agreements in exchange for cash and our counterparty is obligated to resell the securities to us at the end of the term of the transaction, which is typically from 30 to 90 days, but which may have terms from one day to 364 days. The cash we receive when we initially sell the securities is less than the value of those securities, which is referred to as the haircut. Recently, there has been an increase in the haircut on pass-through securities required from some financial institutions from which we may obtain repurchase agreement financing. As a result, we are able to borrow against a smaller portion of the agency securities we initially sell in these transactions. These increased haircuts will require us to post additional cash collateral for our agency securities. The haircut rates under our master repurchase agreements we have entered into will not be set until we engage in a specific repurchase transaction under these agreements. If our counterparty defaults on its obligation to resell the securities to us we would incur a loss on the transaction equal to the amount of the haircut (assuming there was no change in the value of the securities). We would also lose money on a repurchase transaction if the value of the underlying securities has declined as of the end of the transaction term, as we would have to repurchase the securities for their initial value but would receive securities worth less than that amount. Any losses we incur on our repurchase transactions could adversely affect our earnings, and thus our cash available for distribution to our stockholders.

If we default on one of our obligations under a repurchase transaction, the counterparty can terminate the transaction and cease entering into any other repurchase transactions with us. In that case, we would likely need





## **Table of Contents**

to establish a replacement repurchase facility with another financial institution in order to continue to leverage our portfolio and carry out our investment strategy. There is no assurance we would be able to establish a suitable replacement facility on acceptable terms or at all.

### **Risks Related to Our Management Agreement Structure**

*The fee structure of our management agreement may limit our Manager's ability to retain access to key personnel of American Capital.*

We rely on our Manager to administer our business activities and day-to-day operations. Because neither we nor our Manager has any employees, our Manager has entered into an administrative services agreement with American Capital pursuant to which our Manager is provided personnel, services and resources necessary for our Manager to perform its obligations and responsibilities under the management agreement. Thus, we are dependent upon certain personnel of American Capital, including members of the American Capital RMBS investment team.

Under the terms of our management agreement, our Manager is paid a base management fee of 1.25% of our shareholders' equity (as defined in the management agreement). Our Manager uses the proceeds from the management fee in part to pay American Capital for services provided to us by its employees, including members of its senior management and its RMBS investment team, pursuant to the terms of the administrative services agreement. Our management agreement does not provide our Manager with an incentive management fee that would pay our Manager additional compensation as a result of meeting performance targets. However, many of our externally managed competitors pay for an incentive management fee which would enable the manager to provide additional compensation to its key personnel. Additionally, many of our internally managed competitors provide their employees with stock compensation to award strong performance. Thus, the lack of an incentive fee in our management agreement may limit the ability of our Manager, and ultimately American Capital to provide key personnel of American Capital, including members of its RMBS investment team, with additional compensation for strong performance, which could adversely affect American Capital's ability to retain these key personnel. If American Capital were not able to retain any of the key personnel that are currently providing services to our Manager and us, it would have to find replacement personnel to provide those services. However, those replacement key personnel may not be able to produce the same operating results as the current key personnel.

#### **Item 2. *Unregistered Sales of Equity Securities and Use of Proceeds***

None

#### **Item 3. *Defaults Upon Senior Securities***

None.

#### **Item 4. *Submission of Matters to a Vote of Security Holders***

None.

**Item 5. *Other Information***

None.

**Table of Contents**

**Item 6. Exhibits**

(a) **Exhibits:**

- \*3.1 American Capital Agency Corp. Amended and Restated Certificate of Incorporation, incorporated herein by reference to Exhibit 3.1 of Form 10-Q for the quarter ended June 30, 2008 (File No. 001-34057), filed August 14, 2008.
- \*3.2 American Capital Agency Corp. Amended and Restated Bylaws, incorporated herein by reference to Exhibit 3.2 of Form 10-Q for the quarter ended June 30, 2008 (File No. 001-34057), filed August 14, 2008.
- \*4.1 Instruments defining the rights of holders of securities: See Article IV of our Amended and Restated Certificate of Incorporation, incorporated herein by reference to Exhibit 4.1 of Form 10-Q for the quarter ended June 30, 2008 (File No. 001-34057), filed August 14, 2008.
- \*4.2 Instruments defining the rights of holders of securities: See Article VI of our Amended and Restated Bylaws, incorporated herein by reference to Exhibit 4.2 of Form 10-Q for the quarter ended June 30, 2008 (File No. 001-34057), filed August 14, 2008.
- 31.1 Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
- 32 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\* Previously filed in whole or in part.

**Table of Contents**

**SIGNATURES**

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

AMERICAN CAPITAL AGENCY CORP.

Date: October 31, 2008

By:

/s/ MALON WILKUS  
**Malon Wilkus**  
**Chairman of the Board of Directors,**  
**President and Chief Executive Officer**

43

**Table of Contents**

**INDEX TO EXHIBITS**

<b>Exhibit No.</b>	<b>Description</b>
31.1	Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
31.2	Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
32	Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.