

DYNEX CAPITAL INC  
Form 10-Q  
May 09, 2016

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549  
FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended March 31, 2016

or

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
Commission File Number: 1-9819

DYNEX CAPITAL, INC.

(Exact name of registrant as specified in its charter)

Virginia

52-1549373

(State or other jurisdiction of

(I.R.S. Employer

incorporation or organization)

Identification No.)

4991 Lake Brook Drive, Suite 100, Glen Allen, Virginia 23060-9245

(Address of principal executive offices)

(Zip Code)

(804) 217-5800

(Registrant's telephone number, including area code)

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

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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

Large accelerated filer

Accelerated filer

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

On April 30, 2016, the registrant had 49,098,058 shares outstanding of common stock, \$0.01 par value, which is the registrant's only class of common stock.

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FORM 10-Q  
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PART I. FINANCIAL INFORMATION  
ITEM 1. FINANCIAL STATEMENTS

DYNEX CAPITAL, INC.  
CONSOLIDATED BALANCE SHEETS  
(\$ in thousands except share data)

	March 31, 2016	December 31, 2015
	(unaudited)	
<b>ASSETS</b>		
Mortgage-backed securities (including pledged of \$3,264,828 and \$3,361,635, respectively)	\$3,328,752	\$ 3,493,701
Mortgage loans held for investment, net	23,271	24,145
Investment in limited partnership	98	10,835
Investment in FHLB stock	11,475	11,475
Cash and cash equivalents	82,940	33,935
Restricted cash	86,864	51,190
Derivative assets	14,845	7,835
Principal receivable on investments	6,382	6,193
Accrued interest receivable	22,151	22,764
Other assets, net	7,310	7,975
Total assets	\$3,584,088	\$ 3,670,048
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Liabilities:		
Repurchase agreements	\$2,722,019	\$ 2,589,420
FHLB advances	263,000	520,000
Non-recourse collateralized financing	8,140	8,442
Derivative liabilities	90,487	41,205
Accrued interest payable	2,243	1,743
Accrued dividends payable	12,247	13,709
Other liabilities	2,153	3,504
Total liabilities	3,100,289	3,178,023
Shareholders' equity:		
Preferred stock, par value \$.01 per share, 8.5% Series A Cumulative Redeemable; 8,000,000 shares authorized; 2,300,000 shares issued and outstanding (\$57,500 aggregate liquidation preference)	55,407	55,407
Preferred stock, par value \$.01 per share, 7.625% Series B Cumulative Redeemable; 7,000,000 shares authorized; 2,250,000 shares issued and outstanding (\$56,250 aggregate liquidation preference)	54,251	54,251
Common stock, par value \$.01 per share, 200,000,000 shares authorized; 49,095,797 and 49,047,335 shares issued and outstanding, respectively	491	490
Additional paid-in capital	725,438	725,358
Accumulated other comprehensive income (loss)	28,960	(12,768 )
Accumulated deficit	(380,748 )	(330,713 )
Total shareholders' equity	483,799	492,025
Total liabilities and shareholders' equity	\$3,584,088	\$ 3,670,048

See notes to the unaudited consolidated financial statements.

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DYNEX CAPITAL, INC.  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(UNAUDITED)

(amounts in thousands except per share data)

	Three Months Ended March 31,	
	2016	2015
Interest income	\$25,089	\$24,099
Interest expense	6,310	5,371
Net interest income	18,779	18,728
Loss on derivative instruments, net	(48,264 )	(25,323 )
(Loss) gain on sale of investments, net	(3,941 )	1,308
Fair value adjustments, net	24	39
Other income, net	63	34
General and administrative expenses:		
Compensation and benefits	(2,219 )	(2,117 )
Other general and administrative	(1,873 )	(2,141 )
Net loss	(37,431 )	(9,472 )
Preferred stock dividends	(2,294 )	(2,294 )
Net loss to common shareholders	\$(39,725)	\$(11,766)
Other comprehensive income:		
Change in net unrealized gain on available-for-sale investments	\$37,760	\$23,304
Reclassification adjustment for loss (gain) on sale of investments, net	3,941	(1,308 )
Reclassification adjustment for de-designated cash flow hedges	27	1,057
Total other comprehensive income	41,728	23,053
Comprehensive income to common shareholders	\$2,003	\$11,287
Net loss per common share-basic and diluted	\$(0.81 )	\$(0.21 )
Weighted average common shares-basic and diluted	49,041	54,800

See notes to the unaudited consolidated financial statements.

DYNEX CAPITAL, INC.  
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY  
(UNAUDITED)  
(\$ in thousands)

	Preferred Stock	Common Stock	Additional Paid-in Capital	Other Comprehensive (Loss) Income	Accumulated Deficit	Total Shareholders' Equity
Balance as of December 31, 2015	\$ 109,658	\$ 490	\$ 725,358	\$ (12,768 )	\$ (330,713 )	\$ 492,025
Stock issuance	—	—	56	—	—	56
Restricted stock granted, net of amortization	—	2	827	—	—	829
Adjustments for tax withholding on share-based compensation	—	(1 )	(484 )	—	—	(485 )
Stock issuance costs amortization	—	—	(9 )	—	—	(9 )
Common stock repurchased	—	—	(310 )	—	—	(310 )
Net loss	—	—	—	—	(37,431 )	(37,431 )
Dividends on preferred stock	—	—	—	—	(2,294 )	(2,294 )
Dividends on common stock	—	—	—	—	(10,310 )	(10,310 )
Other comprehensive income	—	—	—	41,728	—	41,728
Balance as of March 31, 2016	\$ 109,658	\$ 491	\$ 725,438	\$ 28,960	\$ (380,748 )	\$ 483,799

See notes to the unaudited consolidated financial statements.

DYNEX CAPITAL, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)  
(\$ in thousands)

	Three Months Ended March 31,	
	2016	2015
Operating activities:		
Net loss	\$(37,431)	\$(9,472 )
Adjustments to reconcile net loss to cash provided by operating activities:		
Decrease (increase) in accrued interest receivable	613	(1,699 )
Increase in accrued interest payable	500	313
Loss on derivative instruments, net	48,264	25,323
Loss (gain) on sale of investments, net	3,941	(1,308 )
Fair value adjustments, net	(24 )	(39 )
Amortization of investment premiums, net	37,547	36,640
Other amortization and depreciation, net	477	1,521
Stock-based compensation expense	829	693
Other operating activities	(1,103 )	(1,014 )
Net cash and cash equivalents provided by operating activities	53,613	50,958
Investing activities:		
Purchase of investments	(4,970 )	(386,660 )
Principal payments received on investments	92,420	102,033
Proceeds from sales of investments	77,530	102,923
Principal payments received on mortgage loans held for investment, net	899	6,984
Payment to acquire interest in limited partnership	—	(6,000 )
Distributions received from limited partnership	10,737	—
Net payments on derivatives, including terminations	(5,992 )	(6,405 )
Other investing activities	(38 )	(75 )
Net cash and cash equivalents provided by (used in) investing activities	170,586	(187,200 )
Financing activities:		
Borrowings under repurchase agreements and FHLB advances	5,403,089	4,219,094
Repayments of repurchase agreement borrowings and FHLB advances	(5,527,490)	(4,046,361)
Principal payments on non-recourse collateralized financing	(305 )	(603 )
Increase in restricted cash	(35,674 )	(24,704 )
Proceeds from issuance of common stock, net of issuance costs	47	30
Cash paid for repurchases of common stock	(310 )	(131 )
Payments related to tax withholding for stock-based compensation	(485 )	(545 )
Dividends paid	(14,066 )	(15,978 )
Net cash and cash equivalents (used in) provided by financing activities	(175,194)	130,802
Net increase (decrease) in cash and cash equivalents	49,005	(5,440 )
Cash and cash equivalents at beginning of period	33,935	43,944
Cash and cash equivalents at end of period	\$82,940	\$ 38,504
Supplemental Disclosure of Cash Activity:		
Cash paid for interest	\$5,781	\$ 3,989
See notes to the unaudited consolidated financial statements.		



NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

DYNEX CAPITAL, INC.

(\$ in thousands except per share data)

NOTE 1 –ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization

Dynex Capital, Inc., ("Company") was incorporated in the Commonwealth of Virginia on December 18, 1987 and commenced operations in February 1988. The Company primarily earns income from investing on a leveraged basis in mortgage-backed securities ("MBS") that are issued or guaranteed by the U.S. Government or U.S. Government sponsored agencies ("Agency MBS") and MBS issued by others ("non-Agency MBS").

Basis of Presentation

The accompanying unaudited consolidated financial statements of Dynex Capital, Inc. and its subsidiaries (together, "Dynex" or, as appropriate, the "Company") have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and with the instructions to the Quarterly Report on Form 10-Q and Article 10, Rule 10-01 of Regulation S-X promulgated by the Securities and Exchange Commission (the "SEC"). Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, all significant adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation of the consolidated financial statements have been included. Operating results for the three months ended March 31, 2016 are not necessarily indicative of the results that may be expected for any other interim periods or for the entire year ending December 31, 2016. The unaudited consolidated financial statements included herein should be read in conjunction with the audited financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015 filed with the SEC.

Reclassifications

Certain items in the prior periods' consolidated financial statements have been reclassified to conform to the current period's presentation. Because the Company's equity in income of limited partnership was immaterial for the three months ended March 31, 2016 and March 31, 2015, this amount is now included within "other income (expense), net" on the Company's consolidated statements of comprehensive income. This presentation change has no effect on reported total assets, total liabilities, results of operations, or cash flow activities.

Consolidation

The consolidated financial statements include the accounts of the Company and the accounts of its majority owned subsidiaries and variable interest entities ("VIE") for which it is the primary beneficiary. As a primary beneficiary, the Company has both the power to direct the activities that most significantly impact the economic performance of the VIE and a right to receive benefits or absorb losses of the entity that could be potentially significant to the VIE. The Company is required to reconsider its evaluation of whether to consolidate a VIE each reporting period, based upon changes in the facts and circumstances pertaining to the VIE. The Company consolidates certain trusts through which it has securitized mortgage loans as a result of not meeting the sale criteria under GAAP at the time the financial assets were transferred to the trust. All intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates

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 the disclosure of contingent assets and liabilities at the date of the financial statements as well as the reported amounts of revenue and expenses during the reported period. Actual results could differ from those estimates. The most significant estimates used by management include, but are not limited to, fair value measurements of its investments, other-than-temporary impairments, contingencies, and amortization of premiums and discounts. These items are discussed further below within this note to the consolidated financial statements.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

DYNEX CAPITAL, INC.

(\$ in thousands except per share data)

Income Taxes

The Company has elected to be taxed as a real estate investment trust ("REIT") under the Internal Revenue Code of 1986 and the corresponding provisions of state law. To qualify as a REIT, the Company must meet certain tests including investing in primarily real estate-related assets and the required distribution of at least 90% of its annual REIT taxable income to stockholders after consideration of its net operating loss ("NOL") carryforward and not including taxable income retained in its taxable subsidiaries. As a REIT, the Company generally will not be subject to federal income tax on the amount of its income or capital gains that is distributed as dividends to shareholders.

The Company assesses its tax positions for all open tax years and determines whether the Company has any material unrecognized liabilities in accordance with Accounting Standards Codification ("ASC") Topic 740. The Company records these liabilities, if any, to the extent they are deemed more likely than not to have been incurred.

Net Income (Loss) Per Common Share

The Company calculates basic net income (loss) per common share by dividing net income (loss) to common shareholders for the period by weighted-average shares of common stock outstanding for that period. The Company did not have any potentially dilutive securities outstanding during the three months ended March 31, 2016 or March 31, 2015.

Holders of unvested shares of the Company's issued and outstanding restricted common stock are eligible to receive non-forfeitable dividends. As such, these unvested shares are considered participating securities as per ASC Topic 260-10 and therefore are included in the computation of basic net income (loss) per common share using the two-class method. Upon vesting, restrictions on transfer expire on each share of restricted stock, and each such share of restricted stock is converted to one equal share of common stock.

Because the Company's 8.50% Series A Cumulative Redeemable Preferred Stock (the "Series A Preferred Stock") and 7.625% Series B Cumulative Redeemable Preferred Stock (the "Series B Preferred Stock") are redeemable at the Company's option for cash only and may convert into shares of common stock only upon a change of control of the Company, the effect of those shares and their related dividends is excluded from the calculation of diluted net income (loss) per common share.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand and highly liquid investments with original maturities of three months or less.

Restricted Cash

Restricted cash consists of cash the Company has pledged to cover initial and variation margin with its financing and derivative counterparties.

Mortgage-Backed Securities

The Company invests in Agency and non-Agency RMBS, CMBS and CMBS IO securities, all of which are designated as available-for-sale ("AFS"). All of the Company's MBS are recorded at fair value on the consolidated balance sheet. Changes in unrealized gain (loss) on the Company's MBS are reported in other comprehensive income ("OCI") until each security is collected, disposed of, or determined to be other than temporarily impaired. Although the Company generally intends to hold its AFS securities until maturity, it may sell any of these securities as part of the overall management of its business. Upon the sale of an AFS security, any unrealized gain or loss is reclassified out of accumulated other comprehensive income ("AOCI") into net income as a realized "gain (loss) on sale of investments, net" using the specific identification method.

The Company's MBS pledged as collateral against repurchase agreements and derivative instruments are included in MBS on the consolidated balance sheets with the fair value of the MBS pledged disclosed parenthetically.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

DYNEX CAPITAL, INC.

(\$ in thousands except per share data)

Interest Income, Premium Amortization, and Discount Accretion. Interest income on MBS is accrued based on the outstanding principal balance (or notional balance in the case of interest-only, or "IO", securities) and their contractual terms. Premiums and discounts on Agency MBS as well as any non-Agency MBS rated 'AA' and higher at the time of purchase are amortized into interest income over the expected life of such securities using the effective yield method and adjustments to premium amortization are made for actual cash payments as well as changes in projected future cash payments. The Company's projections of future cash payments are based on input and analysis received from external sources and internal models, and includes assumptions about the amount and timing of credit losses, loan prepayment rates, fluctuations in interest rates, and other factors. On at least a quarterly basis, the Company reviews and makes any necessary adjustments to its cash flow projections and updates the yield recognized on these assets.

The Company holds certain non-Agency MBS that had credit ratings of less than 'AA' at the time of purchase or were not rated by any of the nationally recognized credit rating agencies. A portion of these non-Agency MBS were purchased at discounts to their par value, which management does not believe to be substantial. The discount is accreted into income over the security's expected life, which reflects management's estimate of the security's projected cash flows. Future changes in the timing of projected cash flows or differences arising between projected cash flows and actual cash flows received may result in a prospective change in the effective yield on those securities.

Determination of MBS Fair Value. The Company estimates the fair value of the majority of its MBS based upon prices obtained from third-party pricing services and broker quotes. The remainder of the Company's MBS are valued by discounting the estimated future cash flows derived from cash flow models that utilize information such as the security's coupon rate, estimated prepayment speeds, expected weighted average life, collateral composition, estimated future interest rates, expected losses, and credit enhancements as well as certain other relevant information. Refer to Note 6 for further discussion of MBS fair value measurements.

Other-than-Temporary Impairment. MBS is considered impaired when its fair value is less than its amortized cost. The Company evaluates all of its impaired MBS for other-than-temporary impairments ("OTTI") on at least a quarterly basis. An impairment is considered other-than-temporary if: (1) the Company intends to sell the MBS; (2) it is more likely than not that the Company will be required to sell the MBS before its fair value recovers; or (3) the Company does not expect to recover the full amortized cost basis of the MBS. If either of the first two conditions is met, the entire amount of the impairment is recognized in earnings. If the impairment is solely due to the inability to fully recover the amortized cost basis, the security is further analyzed to quantify any credit loss, which is the difference between the present value of cash flows expected to be collected on the MBS and its amortized cost. The credit loss, if any, is then recognized in earnings, while the balance of impairment related to other factors is recognized in other comprehensive income.

Following the recognition of an OTTI through earnings, a new cost basis is established for the security. Any subsequent recoveries in fair value may be accreted back into the amortized cost basis of the MBS on a prospective basis through interest income. Please see Note 2 for additional information related to the Company's evaluation for OTTI.

#### Investment in Limited Partnership

The Company is a limited partner with a less than 50% interest in a limited partnership for which it does not have substantive participating or kick-out rights that overcome the general partner's presumption of control. The Company accounts for its investment in this limited partnership using the equity method of accounting, which requires initially

recording an investment in the equity of an investee at cost and subsequently adjusting the carrying amount of the investment to recognize the investor's share of the earnings or losses, capital contributions and distributions, and other changes in equity.

During the quarter, the Company received a \$10,737 distribution from the limited partnership, which reduced its investment in the limited partnership. The limited partnership is selling its remaining assets to make a final liquidating distribution.

#### Secured Borrowings

The Company's repurchase agreements and Federal Home Loan Bank (or "FHLB") advances, which are used to finance its purchases of MBS, are accounted for as secured borrowings under which the Company pledges its securities as collateral to secure a loan, which is equal in value to a specified percentage of the estimated fair value of the pledged collateral. The Company

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

### DYNEX CAPITAL, INC.

(\$ in thousands except per share data)

retains beneficial ownership of the pledged collateral. At the maturity of a repurchase agreement, the Company is required to repay the loan and concurrently receives back its pledged collateral from the lender or, with the consent of the lender, the Company may renew the agreement at the then prevailing financing rate. A repurchase agreement lender may require the Company to pledge additional collateral in the event of a decline in the fair value of the collateral pledged. Repurchase agreement financing is recourse to the Company and the assets pledged. Most of the Company's repurchase agreements are based on the September 1996 version of the Bond Market Association Master Repurchase Agreement, which generally provides that the lender, as buyer, is responsible for obtaining collateral valuations from a generally recognized source agreed to by both the Company and the lender, or, in an instance when such source is not available, the value determination is made by the lender.

As a result of a final rule issued by the Federal Housing Finance Administration ("FHFA") in January 2016 regarding the exclusion of captive insurance entities from membership in the FHLB, the Company's wholly owned subsidiary, Mackinaw Insurance Company, LLC ("Mackinaw"), must terminate its membership in the FHLB of Indianapolis by February 19, 2017 and will no longer be permitted new advances or renewals of existing advances. FHLB advances outstanding on the Company's consolidated balance sheet as of March 31, 2016 will be repaid before December 31, 2016.

#### Derivative Instruments

The Company's derivative instruments, which currently include interest rate swaps and Eurodollar futures, are accounted for at fair value and recognized accordingly as either derivative assets or derivative liabilities on the Company's consolidated balance sheet. All periodic interest costs and changes in fair value of derivative instruments, including gains and losses realized upon termination, are recorded in "gain (loss) on derivative instruments, net" on the Company's consolidated statement of comprehensive income. Please refer to [Note 4](#) for additional information regarding the Company's accounting for its derivative instruments.

Although MBS have characteristics that meet the definition of a derivative instrument, ASC Topic 815 specifically excludes these instruments from its scope because they are accounted for as debt securities under ASC Topic 320.

#### Share-Based Compensation

Pursuant to the Company's 2009 Stock and Incentive Plan, the Company may grant share-based compensation to eligible employees, directors or consultants or advisers to the Company, including stock awards, stock options, stock appreciation rights, dividend equivalent rights, performance shares, and restricted stock units. The Company's restricted stock currently issued and outstanding under this plan may be settled only in shares of its common stock, and therefore are treated as equity awards with their fair value measured at the grant date and recognized as compensation cost over the requisite service period with a corresponding credit to shareholders' equity. The requisite service period is the period during which an employee is required to provide service in exchange for an award, which is equivalent to the vesting period specified in the terms of the time-based restricted stock award. None of the Company's restricted stock awards have performance based conditions. The Company does not currently have any share-based compensation issued or outstanding other than restricted stock.

#### Contingencies

In the normal course of business, there may be various lawsuits, claims, and other contingencies pending against the Company. On a quarterly basis, the Company evaluates whether to establish provisions for estimated losses from those matters. The Company recognizes a liability for a contingent loss when: (a) the underlying causal event has occurred prior to the balance sheet date; (b) it is probable that a loss has been incurred; and (c) there is a reasonable basis for estimating that loss. A liability is not recognized for a contingent loss when it is only possible or remotely possible that a loss has been incurred, however, possible contingent losses shall be disclosed. If the contingent loss (or an additional loss in excess of any accrual) is at least a reasonable possibility and material, then the Company discloses a reasonable estimate of the possible loss or range of loss, if such reasonable estimate can be made. If the Company cannot make a reasonable estimate of the possible material loss, or range of loss, then that fact is disclosed.



NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

DYNEX CAPITAL, INC.

(\$ in thousands except per share data)

Recent Accounting Pronouncements

The Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-02, Leases, which includes the following amendments:

- for operating and finance leases, a lessee is required to recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments in its consolidated balance sheet;
- for finance leases, a lessee is required to recognize interest on the lease liability separately from amortization of the right-of-use asset in the statement of comprehensive income;
- for finance leases, a lessee is required to classify repayments of the principal portion of the lease liability within financing activities and payments of interest on the lease liability and variable lease payments within operating activities in the statement of cash flows;
- for operating leases, a lessee is required to recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term on a generally straight-line basis in the statement of comprehensive income; and
- for operating leases, a lessee is required to classify all cash payments within operating activities in the statement of cash flows.

Under the new guidance, lessor accounting is largely unchanged. ASU No. 2016-02 is effective for public companies for fiscal years beginning after December 15, 2018, and early adoption is permitted. The Company does not expect this ASU to have a material impact on the Company's consolidated financial statements.

The FASB also issued ASU No. 2016-09, Compensation - Stock Compensation, which simplifies several aspects of the accounting for share-based payment award transactions, including income tax consequences, classification of awards as either equity or liabilities, and classification on the statement cash flows. The amendments are effective for public companies for fiscal years beginning after December 15, 2016, and early adoption is permitted. The Company does not expect this ASU to have a material impact on the Company's consolidated financial statements.

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## DYNEX CAPITAL, INC.

(\$ in thousands except per share data)

## NOTE 2 – MORTGAGE-BACKED SECURITIES

The majority of the Company's MBS are pledged as collateral to cover initial and variation margins for the Company's secured borrowings and derivative instruments. The following tables present the Company's MBS by investment type as of the dates indicated:

	March 31, 2016						
	Par	Net Premium (Discount)	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value	WAC (1)
<b>RMBS:</b>							
Agency	\$1,423,270	\$70,256	\$1,493,526	\$ 5,464	\$(10,156 )	\$1,488,834	3.01 %
Non-Agency	61,344	(37 )	61,307	87	(637 )	60,757	3.56 %
	1,484,614	70,219	1,554,833	5,551	(10,793 )	1,549,591	
<b>CMBS:</b>							
Agency	861,905	11,709	873,614	24,577	(68 )	898,123	3.41 %
Non-Agency	118,564	(7,900 )	110,664	7,692	(3 )	118,353	4.98 %
	980,469	3,809	984,278	32,269	(71 )	1,016,476	
<b>CMBS IO (2):</b>							
Agency	—	404,380	404,380	6,809	(1,541 )	409,648	0.80 %
Non-Agency	—	355,665	355,665	2,055	(4,683 )	353,037	0.68 %
	—	760,045	760,045	8,864	(6,224 )	762,685	

Total AFS securities: \$2,465,083 \$834,073 \$3,299,156 \$ 46,684 \$(17,088 ) \$3,328,752

(1) The current weighted average coupon ("WAC") is the gross interest rate of the pool of mortgages underlying the security weighted by the outstanding principal balance (or by notional balance in the case of an IO security).

(2) The notional balance for Agency CMBS IO and non-Agency CMBS IO was \$12,125,860 and \$10,668,570, respectively, as of March 31, 2016.

	December 31, 2015						
	Par	Net Premium (Discount)	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value	WAC (1)
<b>RMBS:</b>							
Agency	\$1,536,733	\$77,617	\$1,614,350	\$ 4,362	\$(20,190 )	\$1,598,522	3.03 %
Non-Agency	66,003	(45 )	65,958	70	(818 )	65,210	3.25 %
	1,602,736	77,572	1,680,308	4,432	(21,008 )	1,663,732	
<b>CMBS:</b>							
Agency	876,751	13,252	890,003	10,542	(14,614 )	885,931	3.45 %
Non-Agency	156,218	(8,133 )	148,085	7,039	(941 )	154,183	4.29 %
	1,032,969	5,119	1,038,088	17,581	(15,555 )	1,040,114	
<b>CMBS IO (2):</b>							
Agency	—	421,857	421,857	5,922	(1,651 )	426,128	0.80 %
Non-Agency	—	365,554	365,554	1,992	(3,819 )	363,727	0.71 %
	—	787,411	787,411	7,914	(5,470 )	789,855	
Total AFS securities:	\$2,635,705	\$870,102	\$3,505,807	\$ 29,927	\$(42,033 )	\$3,493,701	



## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## DYNEX CAPITAL, INC.

(\$ in thousands except per share data)

- (1) The current weighted average coupon ("WAC") is the gross interest rate of the pool of mortgages underlying the security weighted by the outstanding principal balance (or by notional balance in the case of an IO security).
- (2) The notional balance for the Agency CMBS IO and non-Agency CMBS IO was \$12,180,291 and \$10,328,628, respectively, as of December 31, 2015.

The Company's sale proceeds for MBS were \$77,530 and \$102,923 for the three months ended March 31, 2016 and March 31, 2015, respectively. The following table presents the gross realized gains (losses) of those sales included in "(loss) gain on sale of investments, net" on the Company's consolidated statements of comprehensive income for the periods indicated:

	Three Months Ended March 31,	
	2016	2015
Gross realized gains on sales of MBS	\$—	\$1,773
Gross realized losses on sales of MBS	(3,941 )	(465 )
(Loss) gain on sale of investments, net	\$(3,941)	\$1,308

The following table presents certain information for those MBS in an unrealized loss position as of the dates indicated:

	March 31, 2016			December 31, 2015		
	Fair Value	Gross Unrealized Losses	# of Securities	Fair Value	Gross Unrealized Losses	# of Securities
Continuous unrealized loss position for less than 12 months:						
Agency MBS	\$369,222	\$(2,543 )	48	\$1,332,849	\$(19,062 )	109
Non-Agency MBS	313,467	(5,007 )	70	351,650	(5,347 )	72
Continuous unrealized loss position for 12 months or longer:						
Agency MBS	\$736,971	\$(9,222 )	64	\$775,484	\$(17,393 )	72
Non-Agency MBS	6,808	(316 )	7	8,306	(231 )	7

Because the principal related to Agency MBS is guaranteed by the government-sponsored entities Fannie Mae and Freddie Mac which have the implicit guarantee of the U.S. government, the Company does not consider any of the unrealized losses on its Agency MBS to be credit related. Although the unrealized losses are not credit related, the Company assesses its ability and intent to hold any Agency MBS with an unrealized loss until the recovery in its value. This assessment is based on the amount of the unrealized loss and significance of the related investment as well as the Company's current leverage and anticipated liquidity. Based on this analysis, the Company has determined that the unrealized losses on its Agency MBS as of March 31, 2016 and December 31, 2015 were temporary.

The Company reviews any non-Agency MBS in an unrealized loss position to evaluate whether any decline in fair value represents an OTTI. The evaluation includes a review of the credit ratings of these non-Agency MBS and the seasoning of the mortgage loans collateralizing these securities as well as the estimated future cash flows which include projected losses. The Company performed this evaluation for the non-Agency MBS in an unrealized loss

position and has determined that there have not been any adverse changes in the timing or amount of estimated future cash flows that necessitate a recognition of OTTI amounts as of March 31, 2016 or December 31, 2015.

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## DYNEX CAPITAL, INC.

(\$ in thousands except per share data)

## NOTE 3 – SECURED BORROWINGS

The Company's secured borrowings, which consist of repurchase agreements and FHLB advances, that were outstanding as of March 31, 2016 and December 31, 2015 are summarized in the table below:

March 31, 2016

Collateral Type	Balance	Weighted Average Rate	Fair Value of Collateral Pledged
Agency RMBS	\$1,410,153	0.68 %	\$1,460,930
Non-Agency RMBS	48,542	1.80 %	60,053
Agency CMBS	516,893	0.68 %	579,169
Non-Agency CMBS	101,358	1.36 %	118,154
Agency CMBS IO	344,238	1.28 %	406,464
Non-Agency CMBS IO	294,392	1.36 %	352,191
Securitization financing bond	6,443	1.79 %	7,410
Total repurchase agreements	\$2,722,019	0.88 %	\$2,984,371
FHLB advances <sup>(1)</sup>	263,000	0.51 %	282,938
Total secured borrowings	\$2,985,019	0.85 %	\$3,267,309

December 31, 2015

Collateral Type	Balance	Weighted Average Rate	Fair Value of Collateral Pledged
Agency RMBS	\$1,439,436	0.47 %	\$1,483,152
Non-Agency RMBS	52,128	1.77 %	64,286
Agency CMBS	301,427	0.49 %	345,728
Non-Agency CMBS	126,378	1.26 %	143,785
Agency CMBS IOs	360,245	1.24 %	421,285
Non-Agency CMBS IOs	302,771	1.33 %	359,351
Securitization financing bond	7,035	1.65 %	8,054
Total repurchase agreements	\$2,589,420	0.75 %	\$2,825,641
FHLB advances <sup>(1)</sup>	520,000	0.40 %	541,771
Total secured borrowings	\$3,109,420	0.69 %	\$3,367,412

(1) As of March 31, 2016 and December 31, 2015, FHLB advances were collateralized primarily with Agency CMBS.

As of March 31, 2016, the weighted average remaining term to maturity of our repurchase agreements was 23 days compared to 22 days as of December 31, 2015. The remaining balance of FHLB advances is due in October 2016. The following table provides a summary of the original term to maturity of our secured borrowings as of March 31, 2016 and December 31, 2015:

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## DYNEX CAPITAL, INC.

(\$ in thousands except per share data)

Original Term to Maturity	March 31, 2016	December 31, 2015
Less than 30 days	\$537,874	\$ 551,643
30 to 90 days	1,368,124	782,393
91 to 180 days	816,021	1,512,384
181 to 364 days	263,000	—
1 year or longer	—	263,000
	\$2,985,019	\$ 3,109,420

The following table lists the counterparties with whom the Company had over 10% of its shareholders' equity at risk (defined as the excess of collateral pledged over the borrowings outstanding):

Counterparty Name	March 31, 2016		
	Balance	Weighted Average Rate	Equity at Risk
Wells Fargo Bank, N. A. and affiliates	\$286,672	1.32 %	\$56,502
JP Morgan Securities, LLC	311,455	1.30 %	49,202

Of the amount outstanding with Wells Fargo Bank, N.A. and affiliates, \$272,987 is under a committed repurchase facility which had an aggregate maximum borrowing capacity of \$300,000 as of March 31, 2016 and was scheduled to mature on August 6, 2016, subject to early termination provisions contained in the master repurchase agreement. The facility is collateralized primarily by CMBS IO, and its weighted average borrowing rate as of March 31, 2016 was 1.31%. This facility has been amended as discussed in [Note 8](#).

As of March 31, 2016, the Company had repurchase agreement amounts outstanding with 18 of its 32 available repurchase agreement counterparties. The Company's counterparties, as set forth in the master repurchase agreement with the counterparty, require the Company to comply with various customary operating and financial covenants, including, but not limited to, minimum net worth, maximum declines in net worth in a given period, and maximum leverage requirements as well as maintaining the Company's REIT status. In addition, some of the agreements contain cross default features, whereby default under an agreement with one lender simultaneously causes default under agreements with other lenders. To the extent that the Company fails to comply with the covenants contained in these financing agreements or is otherwise found to be in default under the terms of such agreements, the counterparty has the right to accelerate amounts due under the master repurchase agreement. With respect to outstanding repurchase agreement and FHLB advance financings as of March 31, 2016, the Company was in compliance with all covenants.

Please see [Note 5](#) for the Company's disclosures related to offsetting assets and liabilities.

## NOTE 4 – DERIVATIVES

The Company utilizes derivative instruments to economically hedge a portion of its exposure to interest rate risk. The Company primarily uses pay-fixed interest rate swaps and Eurodollar contracts to hedge its exposure to changes in interest rates and uses receive-fixed interest rate swaps to offset a portion of its pay-fixed interest rate swaps in order to manage its overall hedge position. The objective of the Company's risk management strategy is to mitigate declines in book value resulting from fluctuations in the fair value of the Company's assets from changing interest rates and to protect some portion of the Company's earnings from rising interest rates. Please refer to [Note 1](#) for

information related to the Company's accounting policy for its derivative instruments.

The table below summarizes information about the Company's derivative instruments treated as trading instruments on its consolidated balance sheet as of the dates indicated:

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NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS  
DYNEX CAPITAL, INC.

(\$ in thousands except per share data)

Trading Instruments	March 31, 2016			
	Derivative Assets		Derivative Liabilities	
	Fair Value	Notional	Fair Value	Notional
Interest rate swaps	\$14,845	\$425,000	\$(49,204)	\$1,705,000
Eurodollar futures <sup>(1)</sup>	—	—	(41,283 )	6,300,000
Total	\$14,845	\$425,000	\$(90,487)	\$8,005,000

Trading Instruments	December 31, 2015			
	Derivative Assets		Derivative Liabilities	
	Fair Value	Notional	Fair Value	Notional
Interest rate swaps	\$7,835	\$460,000	\$(12,108)	\$2,920,000
Eurodollar futures <sup>(1)</sup>	—	—	(29,097 )	6,300,000
Total	\$7,835	\$460,000	\$(41,205)	\$9,220,000

The Eurodollar futures aggregate notional amount represents the total notional of the 3-month contracts with (1) expiration dates from 2017 to 2020. The maximum notional outstanding for any future 3-month period did not exceed \$725,000 as of March 31, 2016 or as of December 31, 2015.

The following table summarizes the contractual maturities remaining for the Company's outstanding interest rate swap agreements as of March 31, 2016:

Remaining Maturity	Pay-Fixed	Pay-Fixed Weighted-Average Rate		Receive-Fixed	Receive-Fixed Weighted-Average Rate	
	Interest Rate Swaps			Interest Rate Swaps		
13-24 months	\$185,000	0.92	%	\$	—	%
25-36 months	125,000	1.40	%	—	—	%
37-48 months	470,000	1.74	%	250,000	1.91	%
49-60 months	250,000	1.58	%	150,000	1.71	%
61-72 months	75,000	1.77	%	—	—	%
73-84 months	125,000	1.98	%	—	—	%
85-96 months	—	—	%	—	—	%
97-108 months	—	—	%	25,000	2.71	%
109-120 months	475,000	2.86	%	—	—	%

The following table summarizes the volume of activity related to derivative instruments for the period indicated:

For the three months ended March 31, 2016:	Beginning	Additions	Settlement,	End of
	of Period Notional Amount		Termination, Expiration or Exercise	Period Notional Amount
Receive-fixed interest rate swaps	\$425,000	\$—	\$—	\$425,000
Pay-fixed interest rate swaps	2,955,000	1,000,000	(2,250,000 )	1,705,000
Eurodollar futures	6,300,000	—	—	6,300,000
	\$9,680,000	\$1,000,000	\$(2,250,000)	\$8,430,000

The table below provides detail of the Company's "loss on derivative instruments, net" by type of interest rate derivative for the periods indicated:

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## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## DYNEX CAPITAL, INC.

(\$ in thousands except per share data)

Type of Derivative Instrument	Three Months Ended March 31,	
	2016	2015
Receive-fixed interest rate swaps	\$10,534	\$4,528
Pay-fixed interest rate swaps	(46,612 )	(13,363 )
Eurodollar futures	(12,186 )	(16,488 )
Loss on derivative instruments, net	\$(48,264)	\$(25,323)

There is a net unrealized gain of \$948 remaining in AOCI on the Company's consolidated balance sheet as of March 31, 2016 which represents the activity related to interest rate swap agreements while they were previously designated as cash flow hedges, and this amount will be recognized in the Company's net income as a portion of "interest expense" over the remaining contractual life of the agreements. The Company estimates a credit of \$377 will be reclassified to net income as a reduction of "interest expense" within the next 12 months.

A portion of the Company's interest rate swaps were entered into under bilateral agreements which contain cross-default provisions with other agreements between the parties. In addition, these bilateral agreements contain financial and operational covenants similar to those contained in our repurchase agreements, as described in [Note 3](#). With respect to interest rate agreements under which interest rate swaps were entered into as of March 31, 2016, the Company was in compliance with all covenants.

Please see [Note 5](#) for the Company's disclosures related to offsetting assets and liabilities.

## NOTE 5 – OFFSETTING ASSETS AND LIABILITIES

The Company's derivatives, repurchase agreements, and FHLB advances are subject to underlying agreements with master netting or similar arrangements, which provide for the right of offset in the event of default or in the event of bankruptcy of either party to the transactions. The Company reports its assets and liabilities subject to these arrangements on a gross basis. The following tables present information regarding those assets and liabilities subject to such arrangements as if the Company had presented them on a net basis as of March 31, 2016 and December 31, 2015:

	Offsetting of Assets		Gross Amount Not Offset in the Balance Sheet <sup>(1)</sup>			Net Amount
	Gross Amount of Recognized Assets	Gross Amount Offset in the Balance Sheet	Net Amount of Assets Presented in the Balance Sheet	Financial Instruments Received as Collateral	Cash Received as Collateral	
March 31, 2016:						
Derivative assets	\$ 14,845	\$ —	—\$ 14,845	\$(14,845)	\$ —	—
December 31, 2015:						
Derivative assets	\$ 7,835	\$ —	—\$ 7,835	\$(7,835 )	\$ —	—



NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS  
DYNEX CAPITAL, INC.

(\$ in thousands except per share data)

	Offsetting of Liabilities		Net Amount of Liabilities Presented in the Balance Sheet	Gross Amount Not Offset in the Balance Sheet <sup>(1)</sup>		Net Amount
	Gross Amount of Recognized Liabilities	Gross Amount Offset in the Balance Sheet		Financial Instruments Posted as Collateral	Cash Posted as Collateral	
March 31, 2016:						
Derivative liabilities	\$90,487	\$ —	—\$90,487	\$(19,103 )	\$(71,384 )	\$ —
Repurchase agreements	2,722,019	—	2,722,019	(2,722,019 )	—	—
FHLB Advances	263,000	—	263,000	(263,000 )	—	—
	\$3,075,506	\$ —	—\$3,075,506	\$(3,004,122)	\$(71,384 )	\$ —
December 31, 2015:						
Derivative liabilities	\$41,205	\$ —	—\$41,205	\$(9,079 )	\$(32,111 )	\$ 15
Repurchase agreements	2,589,420	—	2,589,420	(2,589,420 )	—	—
FHLB advances	520,000	—	520,000	(520,000 )	—	—
	\$3,150,625	\$ —	—\$3,150,625	\$(3,118,499)	\$(32,111 )	\$ 15

Amount disclosed for collateral received by or posted to the same counterparty include cash and the fair value of (1)MBS up to and not exceeding the net amount of the asset or liability presented in the balance sheet. The fair value of the actual collateral received by or posted to the same counterparty may exceed the amounts presented.

NOTE 6 – FAIR VALUE OF FINANCIAL INSTRUMENTS

ASC Topic 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC Topic 820 clarifies that fair value should be based on the assumptions market participants would use when pricing an asset or liability and also requires an entity to consider all aspects of nonperformance risk, including the entity's own credit standing, when measuring fair value of a liability. ASC Topic 820 established a valuation hierarchy of three levels as follows:

Level 1 – Inputs are unadjusted, quoted prices in active markets for identical assets or liabilities as of the measurement date.

Level 2 – Inputs include quoted prices in active markets for similar assets or liabilities; quoted prices in inactive markets for identical or similar assets or liabilities; or inputs either directly observable or indirectly observable through correlation with market data at the measurement date and for the duration of the instrument's anticipated life.

Level 3 – Unobservable inputs are supported by little or no market activity. The unobservable inputs represent management's best estimate of how market participants would price the asset or liability at the measurement date. Consideration is given to the risk inherent in the valuation technique and the risk inherent in the inputs to the model.

The following table presents the fair value of the Company's assets and liabilities presented on its consolidated balance sheets, segregated by the hierarchy level of the fair value estimate, that are measured at fair value on a recurring basis as of the dates indicated:



NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS  
DYNEX CAPITAL, INC.

(\$ in thousands except per share data)

	March 31, 2016			
	Fair Value	Level 1 - Unadjusted Quoted Prices in Active Markets	Level 2 - Observable Inputs	Level 3 - Unobservable Inputs
<b>Assets:</b>				
Mortgage-backed securities	\$3,328,752	\$ —	\$3,314,046	\$ 14,706
Derivative assets	14,845	—	14,845	—
Total assets carried at fair value	\$3,343,597	\$ —	\$3,328,891	\$ 14,706
<b>Liabilities:</b>				
Derivative liabilities	\$90,487	\$ 41,283	\$49,204	\$ —
Total liabilities carried at fair value	\$90,487	\$ 41,283	\$49,204	\$ —
	December 31, 2015			
	Fair Value	Level 1 - Unadjusted Quoted Prices in Active Markets	Level 2 - Observable Inputs	Level 3 - Unobservable Inputs
<b>Assets:</b>				
Mortgage-backed securities	\$3,493,701	\$ —	\$3,477,266	\$ 16,435
Derivative assets	7,835	—	7,835	—
Total assets carried at fair value	\$3,501,536	\$ —	\$3,485,101	\$ 16,435
<b>Liabilities:</b>				
Derivative liabilities	\$41,205	\$ 29,097	\$12,108	\$ —
Total liabilities carried at fair value	\$41,205	\$ 29,097	\$12,108	\$ —

The Company did not have assets or liabilities measured at fair value on a non-recurring basis as of March 31, 2016 or December 31, 2015.

The Company's derivative assets and liabilities include interest rate swaps and Eurodollar futures. Interest rate swaps are valued using the income approach with the primary input being the forward interest rate swap curve, which is considered an observable input and thus their fair values are considered Level 2 measurements. Eurodollar futures are valued based on closing exchange prices on these contracts. Accordingly, the fair values of these financial futures are classified as Level 1 measurements.

Agency MBS, as well a majority of non-Agency MBS, are substantially similar to securities that either are currently actively traded or have been recently traded in their respective market. Their fair values are derived from an average of multiple dealer quotes and thus are considered Level 2 fair value measurements. The Company's remaining non-Agency MBS are comprised of securities for which there are not substantially similar securities that trade frequently, and their fair values are therefore considered Level 3 measurements. The Company determines the fair value of its Level 3 securities by discounting the estimated future cash flows derived from cash flow models using assumptions that are confirmed to the extent possible by third party dealers or other pricing indicators. Significant

inputs into those pricing models are Level 3 in nature due to the lack of readily available market quotes. Information utilized in those pricing models include the security's credit rating, coupon rate, estimated prepayment speeds, expected weighted average life, collateral composition, estimated future interest rates, expected credit losses, and credit enhancement as well as certain other relevant information. Significant changes in any of these inputs in isolation would result in a significantly different fair value measurement. Level 3 assets are generally most sensitive to the default rate and severity assumptions.



## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## DYNEX CAPITAL, INC.

(\$ in thousands except per share data)

The table below presents information about the significant unobservable inputs used in the fair value measurement for the Company's Level 3 non-Agency CMBS and RMBS as of March 31, 2016:

Quantitative Information about Level 3 Fair Value Measurements <sup>(1)</sup>

	Prepayment Speed	Default Rate	Severity	Discount Rate
Non-Agency CMBS 20 CPY		2.0 %	35.0 %	10.6 %
Non-Agency RMBS 10 CPR		1.0 %	20.0 %	6.4 %

(1) Data presented are weighted averages.

The activity of the instruments measured at fair value on a recurring basis using Level 3 inputs is presented in the following table for the period indicated:

	Level 3 Fair Value		
	Non-Agency CMBS	Non-Agency RMBS	Total assets
Balance as of December 31, 2015	\$14,903	\$ 1,532	\$16,435
Unrealized gain included in OCI	401	12	413
Principal payments	(2,345 )	(41 )	(2,386 )
Accretion	244	—	244
Balance as of March 31, 2016	\$13,203	\$ 1,503	\$14,706

The following table presents a summary of the recorded basis and estimated fair values of the Company's financial instruments as of the dates indicated:

	March 31, 2016		December 31, 2015	
	Recorded Basis	Fair Value	Recorded Basis	Fair Value
<b>Assets:</b>				
Mortgage-backed securities	\$3,328,752	\$3,328,752	\$3,493,701	\$3,493,701
Mortgage loans held for investment, net <sup>(1)</sup>	23,271	19,902	24,145	20,849
Investment in FHLB stock	11,475	11,475	11,475	11,475
Derivative assets	14,845	14,845	7,835	7,835
<b>Liabilities:</b>				
Repurchase agreements <sup>(2)</sup>	\$2,722,019	\$2,722,019	\$2,589,420	\$2,589,420
FHLB advances <sup>(2)</sup>	263,000	263,000	520,000	520,000
Non-recourse collateralized financing <sup>(1)</sup>	8,140	7,813	8,442	8,102
Derivative liabilities	90,487	90,487	41,205	41,205

The Company determines the fair value of its mortgage loans held for investment, net and its non-recourse (1) collateralized financing using internally developed cash flow models with inputs similar to those used to estimate the fair value of the Company's Level 3 non-Agency MBS.

(2) The carrying value of repurchase agreements and FHLB advances generally approximates fair value due to their short term maturities.

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## DYNEX CAPITAL, INC.

(\$ in thousands except per share data)

## NOTE 7 – SHAREHOLDERS' EQUITY

## Preferred Stock

The Company has 2,300,000 shares of its 8.50% Series A Preferred Stock and 2,250,000 shares of its 7.625% Series B Preferred Stock issued and outstanding as of March 31, 2016 (collectively, the "Preferred Stock"). The Preferred Stock has no maturity and will remain outstanding indefinitely unless redeemed or otherwise repurchased or converted into common stock pursuant to the terms of the Preferred Stock. Except under certain limited circumstances intended to preserve the Company's REIT status, upon the occurrence of a change in control as defined in Article IIIA, Section 7(d) of the Company's Articles of Incorporation, or to avoid the direct or indirect imposition of a penalty tax in respect of, or to protect the tax status of, any of the Company's real estate mortgage investment conduits ("REMIC") interests or a REMIC in which the Company may acquire an interest (as permitted by the Company's Articles of Incorporation), the Company may not redeem the Series A Preferred Stock prior to July 31, 2017 or the Series B Preferred Stock prior to April 30, 2018. On or after these dates, at any time and from time to time, the Preferred Stock may be redeemed in whole, or in part, at the Company's option at a cash redemption price of \$25.00 per share plus any accumulated and unpaid dividends. The Series A Preferred Stock pays a cumulative cash dividend equivalent to 8.50% of the \$25.00 liquidation preference per share each year and the Series B Preferred Stock pays a cumulative cash dividend equivalent to 7.625% of the \$25.00 liquidation preference per share each year. Because the Preferred Stock is redeemable only at the option of the issuer, it is classified as equity on the Company's consolidated balance sheet. The Company announced that it will pay its regular quarterly dividends on its Preferred Stock for the first quarter on April 15, 2016 to shareholders of record as of April 1, 2016.

## Common Stock

The following table presents a summary of the changes in the number of common shares outstanding for the periods presented:

	Three Months Ended	
	March 31,	
	2016	2015
Balance as of beginning of period	49,047,335	54,739,111
Common stock issued under DRIP	9,074	4,744
Common stock issued under stock and incentive plans	168,720	231,274
Common stock forfeited for tax withholding on share-based compensation	(80,888 )	(65,913 )
Common stock repurchased during the period	(48,444 )	(16,140 )
Balance as of end of period	49,095,797	54,893,076

The Company had 7,416,520 shares of common stock that remain available to offer and sell through its sales agent, JMP Securities LLC, under its "at the market", or "ATM" program, as of March 31, 2016.

The Company's Dividend Reinvestment and Share Purchase Plan ("DRIP") allows registered shareholders to automatically reinvest some or all of their quarterly common stock dividends in shares of the Company's common stock and provides an opportunity for investors to purchase shares of the Company's common stock, potentially at a discount to the prevailing market price. Of the 3,000,000 shares reserved for issuance under the Company's DRIP, there were 2,418,464 shares remaining for issuance as of March 31, 2016. The Company declared a first quarter common stock dividend of \$0.21 per share payable on April 29, 2016 to shareholders of record as of April 1, 2016.

There was no discount for shares purchased through the DRIP during the first quarter of 2016.

Of the \$50,000 authorized by the Company's Board of Directors for the repurchase of its common stock through December 31, 2016, approximately \$8,518 remains available for repurchase at the Company's option as of March 31, 2016.

2009 Stock and Incentive Plan. Of the 2,500,000 shares of common stock authorized for issuance under its 2009 Stock and Incentive Plan, the Company had 906,264 available for issuance as of March 31, 2016. Total stock-based compensation expense recognized by the Company for the three months ended March 31, 2016 was \$829 compared to \$693 for the three months ended March 31, 2015.

The following table presents a rollforward of the restricted stock activity for the periods indicated:

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## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## DYNEX CAPITAL, INC.

(\$ in thousands except per share data)

	Three Months Ended	
	March 31,	
	2016	2015
Restricted stock outstanding as of beginning of period	696,597	731,809
Restricted stock granted	168,720	231,274
Restricted stock vested	(317,831)	(266,264)
Restricted stock outstanding as of end of period	547,486	696,819

The combined grant date fair value of the restricted stock issued by the Company for the three months ended March 31, 2016 was \$1,049 compared to \$1,917 for the three months ended March 31, 2015. As of March 31, 2016, the fair value of the Company's outstanding restricted stock remaining to be amortized into compensation expense is \$3,718 which will be recognized over a weighted average period of 1.9 years.

## NOTE 8 – SUBSEQUENT EVENTS

Management has evaluated events and circumstances occurring as of and through the date this Quarterly Report on Form 10-Q was filed with the SEC and has determined that there have been no significant events or circumstances that qualify as a "recognized" subsequent event as defined by ASC Topic 855. Management has determined that the following events or circumstances qualify as "nonrecognized" subsequent events as defined by ASC Topic 855:

In May 2016, the Company and Wells Fargo Bank, N.A. amended the committed repurchase facility to increase the aggregate maximum borrowing capacity to \$350,000 and extend the maturity date to August 6, 2018.

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

The following discussion should be read in conjunction with our unaudited financial statements and the accompanying notes included in Part 1, Item 1. "Financial Statements" in this Quarterly Report on Form 10-Q and our audited financial statements and the accompanying notes included in Part II, Item 8 in our Annual Report on Form 10-K for the year ended December 31, 2015. References herein to "Dynex," the "Company," "we," "us," and "our" include Dynex Capital, Inc. and its consolidated subsidiaries, unless the context otherwise requires. In addition to current and historical information, the following discussion and analysis contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to our future business, financial condition or results of operations. For a description of certain factors that may have a significant impact on our future business, financial condition or results of operations, see "Forward-Looking Statements" at the end of this discussion and analysis.

For a complete description of our business including our operating policies, investment philosophy and strategy, financing and hedging strategies, and other important information, please refer to Part I, Item 1 of our Annual Report on Form 10-K for the year ended December 31, 2015.

### EXECUTIVE OVERVIEW

#### Company Overview

We are an internally managed mortgage real estate investment trust, or mortgage REIT, which invests in residential and commercial mortgage-backed securities on a leveraged basis. Our common stock is traded on the New York Stock Exchange ("NYSE") under the symbol "DX". We also have two series of preferred stock outstanding, our 8.50% Series A Cumulative Redeemable Preferred Stock (the "Series A Preferred Stock") which is traded on the NYSE under the symbol "DXPRA", and our 7.625% Series B Cumulative Redeemable Preferred Stock (the "Series B Preferred Stock") which is traded on the NYSE under the symbol "DXPRB". Our objective is to provide attractive risk-adjusted returns to our shareholders over the long term that are reflective of a leveraged, high quality fixed income portfolio with a focus on capital preservation. We seek to provide returns to our shareholders primarily through regular quarterly dividends, and also through capital appreciation.

We invest in Agency and non-Agency mortgage-backed securities ("MBS") consisting of residential MBS ("RMBS"), commercial MBS ("CMBS") and CMBS interest-only ("IO") securities. Agency MBS have a guaranty of principal payment by an agency of the U.S. government or a U.S. government-sponsored entity ("GSE") such as Fannie Mae and Freddie Mac. Non-Agency MBS have no such guaranty of payment. Due to the guaranty of principal payment by a GSE, Agency MBS are the highest credit quality MBS available for investment. We seek to invest in Agency MBS and higher quality non-Agency MBS (typically rated 'A' or better by one or more of the nationally recognized statistical rating organizations) to limit our exposure to credit losses and to minimize fluctuations in fair value from widening in credit spreads. In addition, Agency MBS and higher-rated non-Agency MBS are typically more liquid (i.e., they are more easily converted into cash either through sales or pledges as collateral for repurchase agreement borrowings) than lower-rated MBS.

Our primary source of income is net interest income, which is the excess of the interest income earned on our investments over the cost of financing these investments. We invest our capital pursuant to our Operating Policies as approved by our Board of Directors which include an Investment Policy and Investment Risk Policy as discussed further below. We use leverage to enhance the returns on our invested capital by pledging our investments as collateral for borrowings such as repurchase agreements as discussed further below.

RMBS. Our Agency RMBS investments include MBS collateralized by adjustable-rate mortgage loans ("ARMs"), which have interest rates that generally will adjust at least annually to an increment over a specified interest rate index, and hybrid adjustable-rate mortgage loans ("hybrid ARMs"), which are loans that have a fixed rate of interest for a specified period (typically three to ten years) and then adjust their interest rate at least annually to an increment over a specified interest rate

index. Agency ARMs also include hybrid Agency ARMs that are past their fixed-rate periods or within twelve months of their initial reset period. We may also invest in fixed-rate Agency RMBS from time to time.

We also invest in non-Agency RMBS, which do not carry a principal guarantee from the U.S. government or a GSE. Non-Agency RMBS are collateralized by non-conforming residential mortgage loans and are tranching into different credit classes of securities with payments to junior classes subordinate to senior classes. Some of the non-Agency RMBS that we invest in may be collateralized by loans which are delinquent, the repayment of which is expected to come from foreclosure and liquidation of the underlying real estate. We generally invest in senior classes of non-Agency RMBS which may include unrated securities. We seek to invest in non-Agency RMBS that we judge to have sufficiently high collateralization to be likely to protect the principal balance of our investment from credit losses on the underlying loans.

CMBS. Our Agency and non-Agency CMBS are collateralized by first mortgage loans and are primarily fixed-rate securities backed by multifamily housing and other commercial real estate property types such as office building, retail, hospitality, and health care. Loans underlying CMBS generally are geographically diverse, are fixed-rate, mature in ten to twelve years and have amortization terms of up to 30 years. Typically these loans have some form of prepayment protection provisions (such as prepayment lock-out) or prepayment compensation provisions (such as yield maintenance or prepayment penalty). Yield maintenance and prepayment penalty requirements are intended to create an economic disincentive for the loans to prepay. Non-Agency CMBS also includes securities that are backed by pools of single-family rental homes which have variable-rates that reset monthly based on an index rate, such as LIBOR.

CMBS IO. CMBS IO are interest-only securities issued as part of a CMBS securitization and represent the right to receive a portion of the monthly interest payments (but not principal cash flows) on the unpaid principal balance of the underlying pool of commercial mortgage loans. We invest in both Agency-issued and non-Agency issued CMBS IO. The loans collateralizing CMBS IO pools are very similar in composition to the pools of loans that generally collateralize CMBS as discussed above. Since CMBS IO securities have no principal associated with them, the interest payments received are based on the unpaid principal balance of the underlying pool of mortgage loans, which is often referred to as the notional amount. Because CMBS IO receive no principal payments, CMBS IO securities generally have some form of prepayment protection including absolute loan prepayment lock-outs, loan prepayment penalties, or yield maintenance requirements associated with the underlying loans similar to CMBS described above. In addition, payments received and therefore the yield on CMBS IO investments are dependent upon the underlying loan performance and can be negatively impacted by defaults and liquidations of the loans.

Financing. We finance our investments primarily through the use of uncommitted repurchase agreements. We pledge our MBS as collateral to secure the loans and advances made by the counterparty. Repurchase agreements carry a rate of interest which is usually based on a spread to LIBOR and fixed for the term of the borrowing which is typically 30-180 days. Repurchase agreement financing is provided principally by major financial institutions and broker-dealers.

During 2015, our captive insurance subsidiary, Mackinaw Insurance Company, LLC ("Mackinaw"), became a member of the Federal Home Loan Bank ("FHLB") of Indianapolis. As a member of the FHLB system, Mackinaw had access to a variety of services and products offered by the FHLB of Indianapolis, including the ability to secured advances against collateral pledged under an advances, pledge and security agreement which includes collateral requirements similar to our repurchase agreement borrowings. In January 2016, the Federal Housing Finance Administration ("FHFA") released a final rule on FHLB membership which excludes captive insurance entities from FHLB membership on a going-forward basis and provides termination rules for current captive insurance members. Because Mackinaw's membership in the FHLB became effective after the FHFA issued its proposed rule in September 2014, Mackinaw will be required to terminate its membership within one year of the rule's effective date of February 19, 2016 and will not be permitted new advances or renewals of existing advances during the transition period.

Because we maintain excess borrowing capacity at our repurchase agreement financing counterparties, we do not anticipate any difficulties in replacing the FHLB advances at or before their respective maturities. We along with other mortgage REITs are pursuing federal legislation to preserve the membership of captive insurers in the FHLB system by reversing the FHFA's final rule, or to explicitly admit mortgage REITs into the FHLB system.

Hedging. We use derivative instruments to mitigate our exposure to fluctuations in interest rates which could impact our earnings, cash flow or book value. Currently, we use interest rate swap agreements and Eurodollar futures as our principal hedging instruments. Given the nature of our investing and financing activities, in a period of rising interest rates our earnings and cash flow may be negatively impacted by borrowing costs increasing faster than income from our assets, and our book value



may decline as a result of declining market values of our MBS. We enter into derivative instruments in an attempt to partially or fully mitigate our exposure to these events.

#### Factors that Affect Our Results of Operations and Financial Condition

Our financial performance is driven by the performance of our investment portfolio and related funding and derivative hedging activity which are impacted by multiple factors, many of which are related to macroeconomic conditions and other factors beyond our control. These factors include, but are not limited to, the absolute level of interest rates, the relative steepness of interest rate curves, changes in market expectations of future interest rates, actual and estimated future prepayment rates on our investments, competition for investments, economic conditions and their impact on the credit performance of our investments, and market required yields as reflected by market credit spreads. All of these factors are influenced by market forces and generally are exacerbated during periods of market volatility as we experienced at the end of 2015 and the beginning of 2016.

In addition, the performance of our investment portfolio, the cost and availability of financing and the availability of investments at acceptable risk-adjusted returns could be influenced by regulatory actions and regulatory policy measures of the U.S. government including, but not limited to, the FHFA, the U. S. Department of the Treasury (the "Treasury"), and the Board of Governors of the Federal Reserve System (the "Federal Reserve") and could also be influenced by reactions in U.S. markets from activities of central banks around the world.

Our business model may also be impacted by other factors such as the availability and cost of financing and the state of the overall credit markets. Reductions in the availability of financing for our investments could significantly impact our business and force us to sell assets that we otherwise would not sell, potentially at losses depending on market conditions. Regulatory developments since the 2008 financial crisis have impacted large U.S. domiciled banks and their broker dealer subsidiaries by requiring such entities to hold more capital against their assets, including reverse repurchase agreements. In general, this has led to reduced lending capacity in the repurchase agreement market and higher costs. We have not yet experienced a reduction in the availability of repurchase agreement financing but have seen indications of higher costs from several lenders. Other factors that could also impact our business include changes in regulatory requirements, including requirements to qualify for registration under the 1940 Act, and REIT requirements.

We believe that regulatory impacts on financial institutions, many of which are our trading and financing counterparties, continue to pose a threat to the overall liquidity in the capital markets. In particular, higher capital requirements under U.S. banking regulations adopted in 2013 and 2014 and limitations on the proprietary trading activities of large U.S. financial institutions under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("the "Dodd-Frank Act") could result in reduced liquidity in times of market stress. U.S. federal banking regulators continue to explore further increasing regulatory and capital requirements for large U.S. financial institutions. While the Federal Reserve continues to reinvest principal payments received on its Agency RMBS portfolio, it is unlikely that this activity will provide enough liquidity to the market in times of stress, which could result in volatile asset prices. Further, the impact on market liquidity of our investments and the financing markets could be negatively impacted if the Federal Reserve's Federal Open Market Committee (or "FOMC") suddenly changes market expectations of the targeted Federal Funds Rate or takes other actions which have the effect of tightening monetary policy.

As discussed above, investing in mortgage-related securities on a leveraged basis subjects us to a number of risks including interest rate risk, prepayment and reinvestment risk, credit risk, market value risk and liquidity risk, which are discussed in "Liquidity and Capital Resources" within this Item 2 and in Part I, Item 3 of this Quarterly Report on Form 10-Q as well as in Item 1A, "Risk Factors" of Part I of our Annual Report on Form 10-K for the year ended December 31, 2015. Please see these Items for a detailed discussion of these risks and the potential impact on our results of operations and financial condition.

Highlights of the First Quarter of 2016

Management views comprehensive income as a better estimate of economic return to our shareholders and as a more complete measure of performance under GAAP than net income (loss) because the latter measure excludes changes in the fair value of MBS but includes changes in the fair value of our derivative instruments. Comprehensive income to common shareholders increased in the first quarter of 2016 compared to a \$(14.6) million comprehensive loss for the fourth quarter of 2015 due to the net increase in the fair value of MBS of \$41.7 million, partially offset by an increase in loss on derivatives instruments, net and

a decline in net interest income. For the first quarter of 2016, the increase in the fair value of MBS was due to lower interest rates in the first quarter of 2016 relative to the fourth quarter of 2015, partially offset by the unfavorable impact from further credit spread widening during the first quarter of 2016.

Core net operating income to common shareholders, a non-GAAP measure management uses as an estimate of the net interest earnings of the Company's portfolio including net periodic interest costs of effective derivative instruments and after operating expenses, was \$10.8 million for the three months ended March 31, 2016 versus \$12.7 million in the fourth quarter of 2015. Core net operating income declined as the Company reduced its investment portfolio during the quarter and funding costs increased primarily as a result of the increase in the targeted Federal Funds rate of 0.25% in the fourth quarter of 2015. These items were partially offset by prepayment compensation received on our CMBS and CMBS IO investments which increased to \$1.3 million for the first quarter of 2016 versus \$0.5 million for the fourth quarter of 2015.

During the first quarter of 2016, we did not reinvest paydowns received on our investment portfolio, instead choosing to use the proceeds to repay borrowings and modestly deleverage the balance sheet to build our liquidity. As further discussed below under "Market Conditions", we have been anticipating bouts of market volatility and management viewed that more liquidity was desirable given the potential severe fluctuations in asset and derivatives prices. The smaller investment portfolio and the increase in financing costs noted above led us to reduce the dividend to common shareholders to \$0.21 per common share for the first quarter of 2016 from \$0.24 per common share for the fourth quarter of 2015. This volatility ultimately led to a decline in book value of \$8.2 million as the net loss on derivative instruments and loss on sales of investments offset unrealized gains on MBS by a net \$10.5 million.

#### Market Conditions

The first quarter of 2016 was a continuation of the extreme market volatility that we saw in the second half of 2015. Market concerns over economic growth, the impact of the increase in the Federal Funds rate of 0.25% in the fourth quarter of 2015, and the efficacy of other central bank's stimulus measures caused risk premiums to widen (and asset prices to weaken) during the first quarter. Interest rates also exhibited large fluctuations during the quarter and over the last twelve months as noted in the graph below.

Today, there are many factors impacting global capital markets. Globally, the amount of public and private debt continues to inhibit economic performance, and extraordinary government involvement via central bank policy interventions and regulatory changes has led to a de facto currency war which is having unintended consequences. Technology has connected us globally and virtually seamless flows of capital globally have contributed to the extreme market volatility recently experienced. Given these issues and the interconnectedness of markets, we believe that the chance of a significant increase in interest rates in the near term is limited. We continue to expect intermittent periods of market volatility for the foreseeable future. These factors make it challenging for us to manage risks in our investment portfolio which is why we have reduced our leverage over the last several quarters.

### Management Outlook

Despite the recent volatility in markets, we believe that this environment remains attractive for us to continue to generate solid net interest income, but disciplined risk management and capital allocation are key. As noted above, we believe that a sustained move to higher interest rates in the near term is not likely. We have positioned our portfolio to take advantage of such a continuing low interest rate environment, and we continue to maintain a long-duration portfolio position. We have mostly benefited in recent quarters from a lower interest rate environment, which has helped to partially offset losses resulting from credit spread widening. However, losses from diverging movements in the prices of our assets and hedges have more than exceeded our gains from the drop in interest rates, leading to a decline in book value during the five most recent quarters. Nonetheless, we believe we have taken appropriate positions for the current environment. If interest rates do rise, we may be willing to reduce our hedging position further and to add to our duration position. We believe that our diversified asset strategy will benefit us in the long run, allowing us to earn higher net interest income while cushioning the portfolio in a variety of different environments.

### CRITICAL ACCOUNTING POLICIES

The discussion and analysis of our financial condition and results of operations are based in large part upon our consolidated financial statements, which have been prepared in accordance with GAAP. The preparation of our consolidated financial statements requires management to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and disclosure of contingent assets and liabilities. We base these estimates and judgments on historical experience and assumptions believed to be reasonable under current facts and circumstances. Actual results, however, may differ from the estimated amounts we have recorded. The discussion and analysis of our financial condition and results of operations also consider certain non-GAAP measures as described in "Non-GAAP Financial Measures" in this Part I, Item 2.

Critical accounting policies are defined as those that require management's most difficult, subjective or complex judgments, and which may result in materially different results under different assumptions and conditions. Our accounting policies that require the most significant management estimates, judgments, or assumptions, or that management believes includes the most significant uncertainties, and are considered most critical to our results of operations or financial position relate to fair value measurements, amortization of investment premiums, and other-than-temporary impairments. Our critical accounting policies are discussed in Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" of our Annual Report on Form 10-K for the year ended December 31, 2015 under "Critical Accounting Policies". There have been no significant changes in our critical accounting policies during the three months ended March 31, 2016.

### FINANCIAL CONDITION

Over recent quarters, we have been using principal payments on our investments and proceeds from sales to reduce balance sheet leverage and repurchase common stock. We have also been selectively selling certain assets that we believed would underperform in an environment in which interest rates are likely to remain range-bound for an extended period and where asset prices are likely to remain volatile within that range. We have favored investing in prepayment protected CMBS and CMBS IO as opposed to RMBS which carry a higher risk of prepayment in the current low interest rate environment and in light of marginal

improvements to certain domestic economic conditions. As of March 31, 2016, CMBS and CMBS IO constituted 53% of our investment portfolio compared to 45% as of the same time last year. The chart below presents the amortized cost of our MBS investments by collateral type as of the end of each quarter since March 31, 2015:

In addition to the sections below, please refer to Note 2 of the Unaudited Notes to the Consolidated Financial Statements contained within Part I, Item 1 of this Quarterly Report on Form 10-Q for additional information relating to our MBS. The following sections provide additional information on our investment portfolio as well as related financing.

## RMBS

Activity related to our RMBS for the three months ended March 31, 2016 is as follows:

(\$ in thousands)	Agency RMBS	Non-Agency RMBS	Total
Balance as of December 31, 2015	\$ 1,598,522	\$ 65,210	\$ 1,663,732
Purchases	—	—	—
Principal payments	(70,350 )	(4,658 )	(75,008 )
Sales	(46,603 )	—	(46,603 )
Net (amortization) accretion	(3,870 )	7	(3,863 )
Change in fair value	11,135	198	11,333
Balance as of March 31, 2016	\$ 1,488,834	\$ 60,757	\$ 1,549,591

Agency RMBS. As of March 31, 2016, approximately 98% of our variable-rate Agency RMBS portfolio resets based on one-year LIBOR, which was approximately 1.21% as of March 31, 2016 compared to 1.18% as of December 31, 2015. Of these investments, approximately 20% will reset their coupon within the next twelve months at a weighted average margin of 1.80% above one-year LIBOR. During the three months ended March 31, 2016, we sold certain lower yielding Agency ARMs that were at or near their interest rate reset periods and which were expected to reset at interest rates lower than their current coupon.

The underlying mortgage loans for variable-rate RMBS are subject to periodic interest rate caps which limit the amount by which the security's interest yield may change during any given period and lifetime interest rate caps which limit the maximum interest rate on the loans. As shown in the table below, our variable-rate Agency RMBS are generally well within their periodic and lifetime interest rate caps. The following table presents certain interest rate information for these investments by weighted average months to reset ("MTR") as of the dates indicated:

March 31, 2016								
(\$ in thousands)	Par Value	Reset Margin to		WAC	WAVG Periodic Interest		WAVG Life Interest	
		LIBOR			Cap	Cap		
0-12 MTR	\$275,718	1.80 %		2.65 %	2.34 %		9.99 %	
13-36 MTR	423,334	1.79 %		3.32 %	5.00 %		8.33 %	
37-60 MTR	53,212	1.80 %		3.68 %	5.00 %		8.68 %	
61-84 MTR	579,954	1.73 %		2.94 %	5.00 %		7.94 %	
85-120 MTR	91,052	1.62 %		2.69 %	5.00 %		7.69 %	
Total	1,423,270	1.76 %		3.01 %	4.48 %		8.46 %	

December 31, 2015								
	Par Value	Reset Margin to		WAC	WAVG Periodic Interest		WAVG Life Interest	
		LIBOR			Cap	Cap		
0-12 MTR	\$309,826	1.79 %		2.75 %	2.40 %		10.00 %	
13-36 MTR	380,455	1.79 %		3.47 %	5.00 %		9.01 %	
37-60 MTR	91,769	1.80 %		2.97 %	5.00 %		8.35 %	
61-84 MTR	541,720	1.76 %		3.09 %	5.00 %		8.48 %	
85-120 MTR	197,473	1.62 %		2.56 %	5.00 %		7.78 %	
ARMs and Hybrid ARMs	1,521,243	1.76 %		3.04 %	4.47 %		8.82 %	
Fixed	15,490	n/a		2.50 %	n/a		n/a	
Total	\$1,536,733			3.03 %				

Non-Agency RMBS. Our non-Agency RMBS portfolio consists primarily of senior tranches of securitizations collateralized by non-performing loans and re-performing loans which receive monthly principal and interest payments and have estimated average lives remaining in a range of one and two years. These securities have coupon step-up features of 3.0% if the securities are not fully repaid or redeemed by their expected maturity date which is generally three years from issuance. Although these investments do not have a credit rating issued by any of the nationally recognized statistical ratings organization, they have substantial credit enhancement within the securitization structure, and we believe that they offer an attractive return profile with relatively stable cash flows.

## CMBS

Activity related to our CMBS for the three months ended March 31, 2016 is as follows:

(\$ in thousands)	Agency CMBS	Non-Agency CMBS	Total
Balance as of December 31, 2015	\$885,931	\$ 154,183	\$1,040,114
Purchases	—	—	—
Principal payments	(14,846 )	(2,760 )	(17,606 )
Sales	—	(34,868 )	(34,868 )
Premium/discount (amortization)/accretion, net	(1,543 )	207	(1,336 )
Change in fair value	28,581	1,591	30,172
Balance as of March 31, 2016	\$898,123	\$ 118,353	\$1,016,476

Our Agency CMBS are collateralized primarily by fixed rate mortgage loans secured by multifamily properties. Our non-Agency CMBS are collateralized by fixed rate mortgage loans secured by income producing properties such as office, single-family rental, retail, and multifamily. Both Agency and non-Agency CMBS will generally have some form of prepayment protection provisions (such as prepayment lock-outs) or prepayment compensation provisions (such as yield maintenance or prepayment penalties) to prevent early voluntary prepayment of principal. During the first quarter of 2016, we sold certain non-Agency CMBS which had shorter cash flow duration and yields lower than our average portfolio.

The majority of our CMBS investments are collateralized by mortgages underwritten since 2009, which we believe are higher credit quality than prior years, in particular those originated prior to 2008. Since Agency CMBS are guaranteed by the GSEs with respect to return of principal, our credit exposure is limited to any premium on those securities. Non-Agency CMBS are not guaranteed and therefore our entire investment is exposed to credit losses from the underlying loans collateralizing the CMBS. The following table presents the par value, amortized cost, and weighted average months to estimated maturity of our CMBS investments as of the dates indicated by year of origination:

(\$ in thousands)	March 31, 2016			December 31, 2015		
	Par Value	Amortized Cost	Months to Estimated Maturity <sup>(1)</sup>	Par Value	Amortized Cost	Months to Estimated Maturity <sup>(1)</sup>
Year of Origination:						
2008 and prior	\$76,601	\$71,761	37	\$83,396	\$78,765	38
2009 to 2012	246,004	254,121	37	254,870	264,087	40
2013 to 2014	43,396	43,855	104	78,501	78,931	63
2015	614,468	614,541	117	616,202	616,304	120
	\$980,469	\$984,278	90	\$1,032,969	\$1,038,087	89

(1) Months to estimated maturity is an average weighted by the amortized cost of the investment.

The majority of the collateral underlying our non-Agency CMBS is comprised of single-family rental and multi-family properties. The percentage of our non-Agency CMBS collateralized with single-family rental properties declined approximately 15% since December 31, 2015 due to sales of these securities during the first quarter of 2016 as mentioned previously.

The following charts present the collateral underlying our non-Agency CMBS by property type as of the dates indicated:

The collateral underlying our non-Agency CMBS investments is geographically dispersed in order to mitigate exposure to any particular region of the country. The U.S. state with the largest percentage of collateral underlying our non-Agency CMBS was Florida at 34% and 32% as of March 31, 2016 and December 31, 2015, respectively, with no other state exceeding 12% as of those dates. The following charts present the geographic diversification of the collateral underlying our non-Agency CMBS by the top 5 states as of the dates indicated:



## CMBS IO

Activity related to our CMBS IO for the three months ended March 31, 2016 is as follows:

(\$ in thousands) <sup>(1)</sup>	Agency CMBS IO	Non-Agency CMBS IO	Total
Balance as of December 31, 2015	\$426,128	\$ 363,727	\$789,855
Purchases	1,348	3,622	4,970
Sales	—	—	—
Premium amortization, net	(18,825 )	(13,511 )	(32,336 )
Change in fair value	997	(801 )	196
Balance as of March 31, 2016	\$409,648	\$ 353,037	\$762,685

(1) Amounts shown for CMBS IO represent premium only and exclude underlying notional balances.

The majority of our CMBS IO investments are collateralized primarily by fixed rate mortgage loans. Agency CMBS IO are exclusively collateralized by multifamily properties and are issued by securitization trusts sponsored by one of the GSEs. Non-Agency CMBS IO are secured by income producing properties such as office, retail, and hotel. Both types of CMBS IO have some form of prepayment protection (such as prepayment lock-outs) or prepayment compensation provisions (such as yield maintenance or prepayment penalties). Our CMBS IO investments are investment grade-rated with the majority rated 'AAA' by at least one of the nationally recognized statistical ratings organizations.

Because income earned from CMBS IO is based on interest payments received on the underlying commercial mortgage loan pools, our return on these investments is negatively impacted by defaults, foreclosures, and liquidations on or of the underlying mortgage loans that result in involuntary prepayments. In order to manage our exposure to credit performance, we generally invest in senior tranches of these securities and where we have evaluated the credit profile of the underlying loan pool and can monitor credit performance. In addition, because underwriting standards vary over time, we consider the year of origination of the loans underlying CMBS IO in our selection of investments. The following table presents our CMBS IO investments as of March 31, 2016 by year of origination:

(\$ in thousands)	March 31, 2016			December 31, 2015		
	Amortized Cost	Fair Value	WAL (1)	Amortized Cost	Fair Value	WAL (1)
Year of Origination:						
2010	\$11,994	\$12,577	23	\$12,843	\$13,472	24
2011	42,669	45,127	27	45,731	48,482	28
2012	123,650	126,235	30	131,085	133,086	31
2013	148,168	149,646	37	154,445	155,299	38
2014	216,641	214,809	43	223,542	221,933	44
2015	216,923	214,291	49	219,765	217,583	50
	\$760,045	\$762,685	40	\$787,411	\$789,855	41

(1) Weighted average life ("WAL") represents an estimate of the number of months of interest earnings remaining for the investments by year of origination.

Approximately half of the collateral underlying our non-Agency CMBS IO is comprised of retail and multifamily properties. The following charts present the property type of the collateral underlying our non-Agency CMBS IO as of the dates indicated:

The collateral underlying our non-Agency CMBS IO investments is geographically dispersed in order to mitigate exposure to any particular region of the country. The U.S. state with the largest percentage of collateral underlying our non-Agency CMBS IO was California at 12% or less as of March 31, 2016 and December 31, 2015. The following charts present the geographic diversification of the collateral underlying our non-Agency CMBS IO by the top 5 states as of the dates indicated:

### Derivative Assets and Liabilities

Our derivative assets and liabilities consist of interest rate swap agreements and Eurodollar futures, which we use to hedge our earnings and book value exposure to fluctuations in interest rates. Eurodollar futures represent forward starting 3-month LIBOR contracts and allow us to synthetically replicate swap curves and/or hedge specific points on the swap curve where we may have duration risk by shorting contracts at various points of the LIBOR curve. We use both pay-fixed and receive-fixed interest rate swaps to manage our overall hedge position.

The following graphs present our hedging portfolio as of the dates indicated:

During the three months ended March 31, 2016, we added interest rate swaps with a combined notional of \$1.0 billion at a net weighted average pay-fixed rate of 0.69%. We terminated \$2.3 billion in pay-fixed interest rate swaps with a weighted average pay-fixed rate of 0.99%, which included the \$1.0 billion of interest rate swaps we added during the quarter. We regularly monitor and adjust our hedging portfolio in response to many factors including, but not limited to, changes in our investment allocations, shifts in the yield curve, and our expectations with respect to the future path of interest rates and interest rate volatility.

#### Repurchase Agreements and FHLB Advances

Our repurchase agreement borrowings increased approximately 5% since December 31, 2015 because we replaced our FHLB advances that matured during the first quarter of 2016 with repurchase agreement financing. Due to the final rule issued by the FHFA in January 2016, we cannot obtain new FHLB advances or renewals of existing advances. Our remaining FHLB advances of \$263.0 million mature in October 2016. The FHLB advances bear interest at a fixed rate of 0.51% as of March 31, 2016 and are collateralized by Agency MBS, principally Agency CMBS, with a fair value of approximately \$282.9 million.

The majority of our repurchase agreement borrowings are collateralized with Agency MBS which have historically had lower liquidity risk than non-Agency MBS. The following table presents the amount pledged and leverage against the fair value of our non-Agency MBS investments by credit rating as of March 31, 2016 and December 31, 2015:

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(\$ in thousands)	March 31, 2016			December 31, 2015		
	Fair Value	Amount Pledged	Related Borrowings	Fair Value	Amount Pledged	Related Borrowings
<b>Non-Agency CMBS:</b>						
AAA	\$35,967	\$35,967	\$ 31,896	\$60,192	\$53,589	\$ 48,400
AA	35,573	35,573	32,071	51,599	51,599	45,870
A	32,242	32,242	27,699	34,771	34,771	29,211
Below A/Not Rated	14,571	14,372	9,692	7,621	3,826	2,897
	\$118,353	\$118,154	\$ 101,358	\$154,183	\$143,785	\$ 126,378
<b>Non-Agency CMBS IO:</b>						
AAA	\$295,069	\$295,060	\$ 246,369	\$294,712	\$303,659	\$ 255,652
AA	51,995	51,158	42,908	53,974	53,111	44,940
Below A/Not Rated	5,973	5,973	5,115	15,041	2,581	2,180
	\$353,037	\$352,191	\$ 294,392	\$363,727	\$359,351	\$ 302,772
<b>Non-Agency RMBS:</b>						
Below A/Not Rated	\$60,757	\$60,053	\$ 48,542	\$65,210	\$64,286	\$ 52,128
	\$60,757	\$60,053	\$ 48,542	\$65,210	\$64,286	\$ 52,128

Please refer to Note 3 of the Notes to the Unaudited Consolidated Financial Statements contained within Part I of this Quarterly Report on Form 10-Q as well as "Interest Expense and Cost of Funds" within "Results of Operations" and "Liquidity and Capital Resources" contained within this Item 2 for additional information relating to our borrowings.

## RESULTS OF OPERATIONS

The discussions that follow include non-GAAP financial measures which management uses in its internal analysis of financial and operating performance. Please read the section "Non-GAAP Financial Measures" at the end of this section of this Quarterly Report on Form 10-Q for additional important information about these measures and the reconciliations of these measures to GAAP measures.

For the three months ended March 31, 2016, we recorded comprehensive income of \$2.0 million, which consisted of net loss to common shareholders of \$(39.7) million and other comprehensive income of \$41.7 million. Net loss to common shareholders consisted substantially of net interest income of \$18.8 million, loss on derivative instruments, net of \$(48.3) million, general and administrative expenses of \$(4.1) million, and preferred dividends of \$(2.3) million. Other comprehensive income consisted primarily of unrealized gains on our MBS portfolio of \$41.7 million resulting from lower interest rates during the first quarter of 2016, the benefit of which was partially offset by the impact of the widening in credit spreads on our portfolio during the quarter, particularly on CMBS IO and non-Agency CMBS. The discussions below provide more information on these items and others on our consolidated statements of comprehensive income.

### Net Interest Income and Net Interest Spread

The tables below present GAAP net interest income and related net interest spread for our interest-earning assets and interest-bearing liabilities and also present adjusted net interest income and adjusted net interest spread, which are non-GAAP measures. Adjusted net interest income and adjusted net interest spread include net periodic interest costs of derivative instruments as part of interest expense ("adjusted interest expense" which is discussed and reconciled later in this section) whereas GAAP net interest income and GAAP net interest spread do not.



	Three Months Ended			
	March 31,		2015	
(\$ in thousands)	Amount	Yield	Amount	Yield
GAAP interest income	\$25,089	2.78 %	\$24,099	2.62 %
GAAP interest expense	6,310	0.81 %	5,371	0.69 %
Net interest income/spread	18,779	1.97 %	18,728	1.93 %
Amortization of de-designated cash flow hedges <sup>(1)</sup>	27	— %	1,057	0.14 %
Net periodic interest costs of derivative instruments	(1,680 )	(0.21)%	(862 )	(0.11)%
Adjusted net interest income/spread	\$17,126	1.76 %	\$18,923	1.96 %
Average interest earning assets <sup>(2)</sup>	\$3,429,875		\$3,577,644	
Average balance of borrowings <sup>(3)</sup>	\$3,095,490		\$3,111,783	

(1) Amount recorded as a portion of "interest expense" in accordance with GAAP related to the amortization of the (1) balance remaining in accumulated other comprehensive loss as of June 30, 2013 as a result of our discontinuation of cash flow hedge accounting.

(2) Average balances are calculated as a simple average of the daily amortized cost and exclude unrealized gains and losses as well as securities pending settlement if applicable.

(3) Average balances are calculated as a simple average of the daily borrowings outstanding for both repurchase agreement and non-recourse collateralized financing.

Our net interest income and net interest spread increased slightly for the three months ended March 31, 2016 compared to the same period in 2015. Though our average balance of interest earning assets declined approximately 4% over the past year due to slower reinvestment of payments received on and proceeds from sales of MBS, we shifted the composition of our MBS portfolio into higher yielding CMBS and CMBS IO, which increased our interest income by \$1.0 million and our overall effective yield by 16 basis points compared to the same period in 2015. The increase in interest income was almost entirely offset by an increase in our interest expense as the weighted average interest rate on our repurchase agreements increased 31 basis points to 0.86% for the first quarter of 2016 compared to the same period in 2015 due primarily to the increase in the Federal Funds rate of 0.25% in December 2015. Our overall cost of funds for the first quarter of 2016 was 0.81% due to FHLB advances financing a portion of our MBS at a weighted average rate of 0.43% during the first quarter of 2016. Adjusted net interest income and adjusted net interest spread decreased for the three months ended March 31, 2016 compared to the same period in 2015 primarily due to the increase in net periodic interest costs of derivative instruments. More details on these factors impacting our net interest income are provided below.

Interest Income and Effective Yields on MBS. Interest income includes gross interest earned from the coupon rate on the securities, premium amortization and discount accretion, and other interest income resulting from prepayment penalty income or other yield maintenance items on CMBS and CMBS IO securities. Effective yields are calculated by dividing gross interest income and scheduled premium amortization/discount accretion (both of which are annualized for any reporting period less than 12 months) by the average balance of investments outstanding during the reporting period. Effective yields also include retrospective adjustments to premium amortization as well as prepayment penalty income; however, because these amounts are not annualized, they receive less weight when calculating effective yield as a percentage of the average balance than gross interest income and scheduled amortization.

The following table presents information regarding interest income earned and effective yield on our MBS by collateral type for the periods indicated:

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(\$ in thousands)	Three Months Ended					
	March 31, 2016			2015		
	Interest Income	Average Balance <sup>(1)</sup>	Effective Yield	Interest Income	Average Balance <sup>(1)</sup>	Effective Yield
<b>RMBS:</b>						
Agency	\$7,241	\$1,549,079	1.84 %	\$10,438	\$2,138,106	1.84 %
Non-Agency	579	64,025	3.62 %	367	39,076	3.77 %
	7,820	1,613,104	1.91 %	10,805	2,177,182	1.88 %
<b>CMBS:</b>						
Agency	7,316	879,727	3.01 %	3,596	418,796	3.30 %
Non-Agency	2,043	137,866	5.37 %	2,311	204,212	4.51 %
	9,359	1,017,593	3.33 %	5,907	623,008	3.70 %
<b>CMBS IO:</b>						
Agency	4,047	413,100	3.80 %	3,872	422,150	3.77 %
Non-Agency	3,614	362,288	3.92 %	3,143	320,476	3.90 %
	7,661	775,388	3.85 %	7,015	742,626	3.83 %
<b>Total MBS portfolio:</b> \$24,840 \$3,406,085 2.78 % \$23,727 \$3,542,816 2.61 %						

(1) Average balances are calculated as a simple average of the daily amortized cost and exclude unrealized gains and losses as well as securities pending settlement if applicable.

Our interest income from MBS for the three months ended March 31, 2016 increased compared to the same period in 2015 due primarily to our increased investment in CMBS and CMBS IO which have higher average yields than our Agency RMBS. Although the average balance of our MBS decreased overall, our portfolio composition shifted from Agency RMBS towards CMBS and CMBS IO, which increased to 53% of our average balance for the three months ended March 31, 2016 from 39% for the same period in 2016. Our interest income from MBS also benefited from a \$1.3 million increase in prepayment compensation, which includes prepayment penalties and yield maintenance payments, on our CMBS and CMBS IO.

The following table presents details on the calculation of effective yields for the periods indicated:

(\$ in thousands)	Three Months Ended			
	March 31, 2016		2015	
	\$	%	\$	%
<b>RMBS:</b>				
Coupon and scheduled amortization	7,674	1.90%	10,015	1.84 %
Prepayment adjustments <sup>(1)</sup>	146	0.01%	790	0.04 %
	7,820	1.91%	10,805	1.88 %
<b>CMBS:</b>				
Coupon and scheduled amortization	8,266	3.22%	5,707	3.67 %
Prepayment adjustments <sup>(1)</sup>	1,093	0.11%	200	0.03 %
	9,359	3.33%	5,907	3.70 %
<b>CMBS IO:</b>				
Coupon and scheduled amortization	7,404	3.82%	7,135	3.84 %
Prepayment adjustments <sup>(1)</sup>	257	0.03%	(120)	(0.01)%



7,661 3.85% 7,015 3.83 %

Prepayment adjustments represent effective interest amortization adjustments related to changes in actual and (1)projected prepayment speeds for RMBS and net prepayment compensation for CMBS and CMBS IO. Prepayment adjustments are not annualized in calculating the yields presented.

Effective yield on our CMBS for the three months ended March 31, 2016 declined 37 basis points compared to the same period in 2015 primarily because the purchases of CMBS over the past year were primarily new issue or recent vintage and originated in a lower interest rate environment than the CMBS held during the same period in 2015. The weighted average gross coupon rate earned on our CMBS for the three months ended March 31, 2016 was 3.55% compared to 4.42% for the same period in 2015. Our RMBS experienced a decline in the favorable effective interest amortization for the three months ended March 31, 2016 compared to the same period in 2015 related to a slow down in prepayments relative to our projected prepayments in 2015 that did not recur in the first quarter of 2016.

The following table present the estimated impact of changes in average balances, yields, and prepayment adjustments on interest income for the periods indicated:

(\$ in thousands)	Three Months Ended			
	March 31, 2016 vs. March 31, 2015			
	Increase Due to Change In			
	(Decrease)	Average	Coupon and	Prepayment
	in	Balance	Scheduled	Adjustments
	Interest	(1)	Amortization	(2)
	Income			
RMBS	\$(2,985)	\$(2,123)	\$ (218 )	\$ (644 )
CMBS	3,452	2,390	169	893
CMBS IO	646	378	(109 )	377
Total	\$1,113	\$645	\$ (158 )	\$ 626

(1) Average balance includes the impact of purchases and sales between the periods on the change in interest income .

Prepayment adjustments represent net prepayment compensation for CMBS and CMBS IO and effective interest (2)amortization adjustments related to changes in actual and projected prepayment speeds for RMBS. Prepayment adjustments are not annualized in calculating the yields presented.

The rate at which we amortize the premiums we pay for our investments is impacted by actual and forecasted prepayments, which is measured by the constant prepayment rate ("CPR") for Agency RMBS. We are projecting a 3 month CPR of 17.4% on our Agency RMBS for the second quarter of 2016. The following graph shows our actual CPRs for Agency RMBS for the periods indicated:

Interest Expense and Cost of Funds. The following table summarizes the components of interest expense as well as average balances and cost of funds for the periods indicated:

(\$ in thousands)	Three Months Ended March 31,	
	2016	2015
Interest expense on repurchase agreement borrowings	\$5,828	\$4,288
Interest expense on FHLB advances	436	—
Amortization of de-designated cash flow hedges <sup>(1)</sup>	27	1,057
Non-recourse collateralized financing and other interest expense	19	26
Total interest expense	\$6,310	\$5,371
Average balance of repurchase agreements	\$2,688,633	\$3,101,133
Average balance of FHLB advances	398,560	—
Average balance of non-recourse collateralized financing	8,297	10,650
Average balance of borrowings	\$3,095,490	\$3,111,783
Cost of funds <sup>(2)</sup>	0.81	% 0.69 %

(1) Amount recorded in accordance with GAAP related to the amortization of the balance remaining in accumulated other comprehensive loss as of June 30, 2013 as a result of our discontinuation of cash flow hedge accounting.

(2) Cost of funds is calculated by dividing annualized interest expense by the average balance of borrowings outstanding during the period.

The following table presents the differences in interest expense for the comparative periods presented:

(\$ in thousands)	Three Months Ended March 31, 2016 vs. March 31, 2015
Change in borrowing rates on repurchase agreements and FHLB advances	\$1,995
Decrease in average balance of repurchase agreements and FHLB advances	(19 )
(Decrease) increase in amortization of de-designated cash flow hedges	(1,030 )
Decrease in non-recourse collateralized financing and other interest expense	(7 )
Total change in interest expense	\$939

The majority of the increase in our interest expense for the first quarter of 2016 compared to the first quarter of 2015 was due to higher borrowing rates on our repurchase agreement financing. Our average borrowing rate on our repurchase agreements increased 31 basis points to 0.86% for the first quarter of 2016 compared to 0.55% to the first quarter of 2015. The borrowing rate for our FHLB advances was 0.43% for the first quarter of 2016, lowering our overall cost of funds to 0.81% for the first quarter of 2016. We did not have FHLB advances during the first quarter of 2015. As a result of the final rule issued by the FHFA in January 2016, we are no longer permitted new FHLB advances or renewals of existing advances. Our remaining FHLB advances of \$0.3 million will be paid off or replaced with repurchase agreement borrowings by their contractual maturities in October 2016.

Because we use derivative instruments as economic hedges of our interest rate risk exposure, management considers net periodic interest costs from effective derivative instruments to be an additional cost of financing investments. As

such, management utilizes a non-GAAP financial measure "adjusted interest expense" which includes the net periodic interest costs of our effective derivative instruments excluded from GAAP interest expense. The table below presents the reconciliation of GAAP interest expense and cost of funds to our adjusted interest expense and adjusted cost of funds for the periods indicated:

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(\$ in thousands)	Three Months Ended March 31,			
	2016		2015	
	Amount	Rate	Amount	Rate
Interest expense/cost of funds	\$6,310	0.81 %	\$5,371	0.69 %
Amortization of de-designated cash flow hedges <sup>(1)</sup>	(27 )	— %	(1,057 )	(0.14)%
Net periodic interest costs of derivative instruments	1,680	0.21 %	862	0.11 %
Adjusted interest expense/adjusted cost of funds	\$7,963	1.02 %	\$5,176	0.66 %

Amount recorded as a portion of "interest expense" in accordance with GAAP and is related to the amortization of (1) the balance in accumulated other comprehensive loss as of June 30, 2013 related to the derivatives for which we discontinued cash flow hedge accounting.

The increase in adjusted interest expense of \$2.8 million for the three months ended March 31, 2016 versus the same period in 2015 is due to higher repurchase agreement and FHLB financing costs of \$2.0 million as well as higher net periodic interest costs of \$0.8 million from our effective interest rate swaps which are discussed below.

#### Loss on Derivative Instruments, Net

The following table provides information on the components of our "loss on derivative instruments, net" for the periods indicated:

(\$ in thousands)	Three Months Ended March 31,					
	2016			2015		
Type of Derivative Instrument	Net Periodic Interest Costs	Change in Fair Value <sup>(1)</sup>	Total	Net Periodic Interest Costs	Change in Fair Value <sup>(1)</sup>	Total
Receive-fixed interest rate swaps	\$1,423	\$9,111	\$10,534	\$1,196	\$3,332	\$4,528
Pay-fixed interest rate swaps	(3,103 )	(43,509 )	(46,612 )	(2,058 )	(11,305 )	(13,363 )
Eurodollar futures	—	(12,186 )	(12,186 )	—	(16,488 )	(16,488 )
Loss on derivative instruments, net	\$(1,680)	\$(46,584)	\$(48,264)	\$(862 )	\$(24,461)	\$(25,323)

(1) Amount shown is inclusive of realized gains (losses) from terminated instruments.

Net periodic interest costs for the three months ended March 31, 2016 were \$0.8 million higher than the same period in 2015 due to a higher average notional balance of interest rate swaps outstanding of \$936.6 million at a net weighted average pay-fixed rate of 1.25% for the first quarter of 2016 compared to an average notional balance of interest rate swaps outstanding of \$381.3 million at a net weighted average pay-fixed rate of 1.08% for the same period in 2015. The majority of decline in the fair value of derivatives for the three months ended March 31, 2016 is due to the decline in rates primarily from 2019 and further out on the curve compared to the three months ended March 31, 2015.

#### (Loss) Gain on Sale of Investments, Net

Sales of our investments occur in the ordinary course of business as we manage our risk profile, manage liquidity, reduce leverage, and as we allocate capital to preferred investment opportunities. The following tables provide information related to our (loss) gain on sale of investments, net for the periods indicated:

(\$ in thousands)	Three Months Ended March 31,			
	2016		2015	
Type of Investment	Amortized cost basis sold	(Loss) gain on sale of investments, net	Amortized cost basis sold	(Loss) gain on sale of investments, net
Agency RMBS	\$46,603	\$ (2,713 )	\$60,666	\$ (321 )
Non-Agency CMBS	34,868	(1,228 )	—	—
Agency CMBS IO	—	—	28,312	1,474
Non-Agency CMBS IO	—	—	12,637	155
	\$81,471	\$ (3,941 )	\$101,615	\$ 1,308

The Agency RMBS we sold during the first quarter of 2016 were lower yielding ARMs that were at or near their interest rate reset periods and which were expected to reset at interest rates lower than their current coupon. Agency CMBS sold during the first quarter of 2016 were yielding significantly below the portfolio average. Sale proceeds were used to pay down repurchase agreement borrowings during the first quarter of 2016.

#### General and Administrative Expenses

Compensation and benefits for the three months ended March 31, 2016 was \$0.1 million higher compared to the same period in 2015 primarily due to higher amortization expenses for restricted stock-based compensation. Other general and administrative expenses were \$0.3 million lower for the three months ended March 31, 2016 compared to the same period in 2015 due to lower professional fees.

#### Non-GAAP Financial Measures

In addition to the Company's operating results presented in accordance with GAAP, the information presented within "Executive Overview" and "Results of Operations" contains the following non-GAAP financial measures: core net operating income to common shareholders (including per common share), adjusted interest expense and adjusted cost of funds, and adjusted net interest income and spread. Management uses core net operating income (including per common share) as an estimate of the net interest earnings from our investments after operating expenses. In connection with core net operating income, management uses adjusted interest expense, adjusted cost of funds, adjusted net interest income, and adjusted net interest spread because management considers net periodic interest costs related to the Company's derivative instruments as an additional cost of using repurchase agreements to finance investments. Because these measures are used in the Company's internal analysis of financial and operating performance, management believes that they provide greater transparency to our investors of management's view of our economic performance. Management also believes that the presentation of these measures, when analyzed in conjunction with the Company's GAAP operating results, allows investors to more effectively evaluate and compare the performance of the Company to that of its peers even though peer companies may present non-GAAP measures on a different basis than the Company's. Because these non-GAAP financial measures exclude certain items used to compute GAAP net income to common shareholders and GAAP interest expense, these non-GAAP measures should be considered as a supplement to, and not as a substitute for, the Company's GAAP results as reported on its consolidated statements of comprehensive income. In addition, because not all companies use identical calculations, the Company's presentation its non-GAAP measures may not be comparable to other similarly-titled measures of other companies.

Schedules reconciling adjusted interest expense, adjusted cost of funds, adjusted net interest income, and adjusted net interest spread to their related GAAP financial measures are provided above within "Results of Operations". Core net operating income is discussed in "Executive Overview". The following table presents a reconciliation of our GAAP net loss to our core net operating income for the periods presented:

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(\$ in thousands, except per share amounts)	Three Months Ended	
	March 31,	
	2016	2015
GAAP net loss to common shareholders	\$(39,725)	\$(11,766)
Amortization of de-designated cash flow hedges <sup>(1)</sup>	27	1,057
Change in fair value of derivative instruments, net	46,584	24,461
Loss (gain) on sale of investments, net	3,941	(1,308 )
Fair value adjustments, net	(24 )	(39 )
Core net operating income to common shareholders	\$10,803	\$12,405
Weighted average common shares outstanding	49,041	54,800
Core net operating income per common share	\$0.22	\$0.23

Amount recorded as a portion of "interest expense" in accordance with GAAP related to the amortization of the (1) balance remaining in accumulated other comprehensive loss as of June 30, 2013 as a result of our discontinuation of cash flow hedge accounting.

## LIQUIDITY AND CAPITAL RESOURCES

Our primary sources of liquidity include borrowings under repurchase arrangements, monthly principal and interest payments we receive on our investments, and cash generated from our operating results. Additional sources may also include proceeds from the sale of investments, equity offerings, issuances of collateralized financings, and payments received from counterparties from interest rate swap agreements. We use unencumbered cash, Agency MBS, and non-Agency MBS to support additional borrowings. We use our liquidity to fund our investment purchases and other operating costs, to pay down borrowings, to meet margin calls from our lenders, to make payments to counterparties as required under interest rate swap agreements, to repurchase shares of our common stock, and to pay dividends on our preferred and common stock.

Our liquid assets fluctuate based on our investment activities and changes in the fair value of our MBS and derivative instruments. We seek to maintain sufficient liquidity to support our operations and to meet our anticipated liquidity needs, including potential margin calls from lenders (as discussed further below). We measure, manage, and forecast our liquidity on a daily basis. Our available liquid assets include unrestricted cash and cash equivalents, unencumbered Agency MBS, and certain unencumbered non-Agency MBS that can be pledged as collateral for margin calls or converted reasonably quickly into cash. As of March 31, 2016, our available liquid assets were \$145.1 million which consisted of unrestricted cash and cash equivalents of \$82.9 million and unencumbered Agency MBS of \$62.2 million, compared to \$150.3 million as of December 31, 2015.

We perform sensitivity analysis on our liquidity based on changes in the fair value of our investments due to changes in interest rates, credit spreads, lender haircuts and prepayment speeds. In performing this analysis we will also consider the current state of the fixed income markets and the repurchase agreement markets in order to determine if market forces such as supply-demand imbalances or structural changes to these markets could change the liquidity of MBS or the availability of financing. The objective of our analysis is to assess the adequacy of our liquidity to withstand potential adverse events. We may change our leverage targets based on market conditions and our perceptions of the liquidity of our investments.

We closely monitor our debt-to-invested equity ratio (which is the ratio of debt financing to invested equity for any investment) as part of our liquidity management process as well as our overall enterprise level debt-to-equity ratio. We also monitor the ratio of our available liquidity to outstanding repurchase agreement borrowings, which fluctuates due to changes in the fair value of collateral we have pledged to our lenders. On an enterprise level basis, our current operating policies limit our total liabilities-to-shareholders' equity to 7 times our shareholders' equity. At the



individual investment level, our targeted leverage ranges from 3 to 10 times our invested equity capital depending on the investment type. The maximum targets represent fixed limits for leveraging our investment capital. Our total liabilities decreased to 6.4 times shareholders' equity as of March 31, 2016 from 6.5 times as of December 31, 2015. We used principal payments received on MBS and proceeds received from sales of MBS to pay down borrowings instead of reinvesting during the three months ended March 31, 2016. The decline in our overall leverage was less than anticipated due to our lower shareholder's equity, which resulted primarily from realized losses on sales of MBS and declines in the fair value of our derivatives, net of unrealized gains on MBS.

We have historically had ample sources of liquidity to fund our activities and operations. The ability to fund our operations in the future depends in large measure on the availability of credit through repurchase agreement financing and the liquidity of our investments. Credit markets have historically experienced brief periods of extreme volatility such as what occurred in 2008 and 2009. Such events are typically marked by concerns regarding counterparty credit, severe market illiquidity, and steep declines in asset prices. At other times, credit markets have experienced lesser volatility, only modestly impacting liquidity and asset prices. In addition, in recent periods U.S. financial regulatory agencies (such as the Office of Financial Research in the U.S. Treasury and the Federal Reserve) have expressed some concern about the stability of repurchase agreement financing for mortgage REITs in a rising interest rate environment, and regulatory reform in the form of certain provisions of the Basel III capital framework (and supplemental bank capital rules) and the Dodd-Frank Wall Street Reform and Consumer Protection Act could impact the overall availability of credit by restricting the number of repurchase agreement lenders and the credit made available by such lenders. In times of severe market stress, repurchase agreement availability could be rapidly reduced and the terms on which we can borrow could be materially altered, particularly given the focus on these markets by the federal financial and banking regulators. Competition from other REITs, banks, hedge funds, and the federal government for capacity with our repurchase agreement lenders could also reduce our repurchase agreement availability. While we do not anticipate such events in the near term, a reduction in our borrowing capacity could force us to sell assets in order to repay our lenders or could otherwise restrict our ability to operate our business.

Depending on our liquidity levels, the condition of the credit markets, and other factors, we may from time to time consider the issuance of debt, equity, or other securities, or sell investments, the proceeds of which could provide additional liquidity for our operations. While we will attempt to avoid dilutive or otherwise costly issuances, depending on market conditions, in order to manage our liquidity we could be forced to issue equity or debt securities which are dilutive to our capital base or our profitability.

#### Repurchase Agreements

The following table presents information regarding the balances of our repurchase agreement borrowings for the periods indicated:

	Balance	Average	Maximum
	Outstanding	Balance	Balance
(\$ in thousands)	As of	Outstanding	Outstanding
	Quarter End	For the	During the
		Quarter	Quarter
		Ended	Ended
March 31, 2016	\$ 2,722,019	\$ 2,688,633	\$ 2,838,607
December 31, 2015	2,589,420	2,766,755	3,097,492
September 30, 2015	3,055,069	3,220,391	3,405,692
June 30, 2015	3,402,964	3,301,590	3,447,628
March 31, 2015	3,185,843	3,101,133	3,239,247
December 31, 2014	3,013,110	3,043,298	3,137,204
September 30, 2014	3,150,254	3,352,599	3,469,491
June 30, 2014	3,447,050	3,454,884	3,496,521
March 31, 2014	3,485,544	3,497,167	3,580,997

Our repurchase agreement borrowings are generally renewable at the discretion of our lenders without guaranteed roll-over terms. Given the short-term and uncommitted nature of most of our repurchase agreement financing, we attempt to maintain unused capacity under our existing repurchase agreement credit lines with multiple counterparties which helps protect us in the event of a counterparty's failure to renew existing repurchase agreements either with favorable terms or at all. As of March 31, 2016, we had repurchase agreement borrowings outstanding with 18 of our 32 available repurchase agreement counterparties at a weighted average borrowing rate of 0.88% compared to 0.75%

as of December 31, 2015. Our repurchase agreement borrowings generally carry a rate of interest based on a spread to an index such as LIBOR.

For our repurchase agreement borrowings, we are required to post and maintain margin to the lender (i.e., collateral in excess of the repurchase agreement financing) in order to support the amount of the financing. This excess collateral is often referred to as a "haircut" (and which we also refer to as equity at risk). As the collateral pledged is generally MBS, the fair value of the collateral can fluctuate with changes in market conditions. If the fair value of the collateral falls below the haircut required by the lender, the lender has the right to demand additional margin, or collateral, to increase the haircut back to the initial amount. These demands are typically referred to as "margin calls". Declines in the value of investments occur for any number of reasons including but not limited to changes in interest rates, changes in ratings on an investment, changes in actual or perceived liquidity of the investment, or changes in overall market risk perceptions. Additionally, values in Agency RMBS will also decline from the payment delay feature of those securities. Agency RMBS have a payment delay feature whereby Fannie Mae and Freddie Mac

announce principal payments on Agency RMBS but do not remit the actual principal payments and interest for 20 days in the case of Fannie Mae and 40 days in the case of Freddie Mac. Because these securities are financed with repurchase agreements, the repurchase agreement lender generally makes a margin call for an amount equal to the product of their advance rate on the repurchase agreement and the announced principal payments on the Agency RMBS. This causes a temporary use of our liquidity to meet the margin call until we receive the principal payments and interest 20 to 40 days later.

The following table presents the weighted average minimum haircut contractually required by our counterparties for MBS pledged as collateral for our repurchase agreement borrowings as of the dates indicated:

	March 31, 2016	December 31, 2015	September 30, 2015	June 30, 2015	March 31, 2015
Agency RMBS and CMBS	5.1 %	5.0 %	5.0 %	5.1 %	5.3 %
Non-Agency RMBS and CMBS	16.0 %	14.5 %	14.1 %	13.5 %	16.0 %
CMBS IO	15.4 %	15.4 %	15.3 %	15.3 %	15.3 %

The counterparties with whom we have the greatest amounts of equity at risk may vary significantly during any given period due to the short-term and generally uncommitted nature of the repurchase agreement borrowings. Equity at risk is defined as the amount pledged as collateral to the counterparty in excess of the borrowed amount outstanding. This equity at risk represents the potential loss to the Company if the counterparty is unable or unwilling to return collateral securing the repurchase agreement borrowing at its maturity. The following tables present the five counterparties with whom we had the greatest amounts of equity at risk as of March 31, 2016 and as of December 31, 2015:

(\$ in thousands)	March 31, 2016	
	Amount Outstanding	Equity at Risk
Well Fargo Bank, N.A. and affiliates	\$286,672	\$56,502
JP Morgan Securities, LLC	311,455	49,202
South Street Financial Corporation	409,457	26,332
Royal Bank of Canada	176,763	22,698
Goldman Sachs	154,146	18,886
Remaining counterparties	1,383,526	88,732
	\$2,722,019	\$262,352

(\$ in thousands)	December 31, 2015	
	Amount Outstanding	Equity at Risk
Well Fargo Bank, N.A. and affiliates	\$297,916	\$56,193
JP Morgan Securities, LLC	298,823	46,197
South Street Financial Corporation	431,950	25,952
Royal Bank of Canada	187,993	23,091
BNP Paribas	102,211	15,038
Remaining counterparties	1,270,527	69,750
	\$2,589,420	\$236,221

The following table discloses our repurchase agreement amounts outstanding and the value of the related collateral pledged by geographic region of our counterparties as of March 31, 2016:

(\$ in thousands)	Amount Outstanding	Market Value of Collateral Pledged
North America	\$ 1,578,979	\$ 1,755,195
Asia	693,904	745,346
Europe	449,136	483,830
	\$ 2,722,019	\$ 2,984,371

Certain of our repurchase agreement counterparties require us to comply with various operating and financial covenants. The financial covenants include requirements that we maintain minimum shareholders' equity (usually a set minimum, or a percentage of the highest amount of shareholders' equity since the date of the agreement), maximum decline in shareholders' equity (expressed as a percentage decline in any given period), and limits on maximum leverage (as a multiple of shareholders' equity). Operating requirements include, among other things, requirements to maintain our status as a REIT and to maintain our listing on the NYSE. Violations of one or more of these covenants could result in the lender declaring an event of default which would result in the termination of the repurchase agreement and immediate acceleration of amounts due thereunder. In addition, some of the agreements contain cross default features, whereby default with one lender simultaneously causes default under agreements with other lenders. Violations could also restrict us from paying dividends or engaging in other transactions that are necessary for us to maintain our REIT status.

We monitor and evaluate on an ongoing basis the impact these customary financial covenants may have on our operating and financing flexibility. We have one repurchase agreement lender which requires that we maintain our enterprise level leverage as of quarter end at less than 7 times our shareholders' equity. Currently, we do not believe we are subject to any covenants that materially restrict our financing flexibility.

#### FHLB Advances

For information on FHLB advances obtained by our wholly-owned captive insurance subsidiary, Mackinaw, see "Financial Condition - Repurchase Agreements and FHLB Advances" in this Item 7. As a result of the final rule issued by the FHFA in January 2016, we will not be able to renew these FHLB advances as they mature in 2016. Because we maintain excess borrowing capacity at our financing counterparties, we do not anticipate any difficulties in replacing the FHLB advances at or before their respective maturities.

#### Derivative Instruments

Our derivative instruments require us to post initial margin at inception and variation margin based on subsequent changes in the fair value of the derivatives. The collateral posted as margin by us is typically in the form of cash or Agency MBS. Generally, as interest rates decline due to market changes, we will be required to post collateral with counterparties on our pay-fixed derivative instruments and receive collateral from our counterparties on our receive-fixed derivative instruments, and vice versa as interest rates increase. As of March 31, 2016, we had Agency MBS with a fair value of \$4.9 million and cash of \$86.9 million posted as credit support under these agreements.

Approximately \$370 million of the Company's interest rate swaps were entered into under bilateral agreements which contain cross-default provisions with other agreements between the parties. In addition, these bilateral agreements contain financial and operational covenants similar to those contained in our repurchase agreements, as described above.

#### Dividends

As a REIT, we are required to distribute to our shareholders amounts equal to at least 90% of our REIT taxable income for each taxable year after consideration of our tax NOL carryforwards. We generally fund our dividend distributions through our cash flows from operations. If we make dividend distributions in excess of our operating cash flows during the period, whether for purposes of meeting our REIT distribution requirements or other strategic reasons, those distributions are generally funded either through our existing cash balances or through the return of principal from our investments (either through repayment or sale).

We have a net operating tax loss ("NOL") carryforward that we could use to offset our REIT taxable income distribution requirement. This NOL carryforward had an estimated balance of approximately \$89.8 million at March 31, 2016. We also have approximately \$53.7 million of deferred tax hedge losses on terminated derivative instruments, which will be recognized over the

original periods that were being hedged by the terminated derivatives. These losses have already been recognized in our GAAP earnings but will reduce taxable income over the next ten years as noted in the following table. Dividend distributions to our shareholders in excess of REIT taxable income, if any, as a result of the hedge loss deductions for the years noted below, will be considered a return of capital to the shareholder.

	Tax Hedge
(\$ in thousands) Loss	
	Deduction
2016	27,845
2017	14,376
2018	3,730
2019 - 2026	7,717
	\$ 53,668

For the first quarter of 2016, we declared a common stock dividend of \$11.8 million. We estimate that approximately \$5.4 million of this dividend is a return of capital to shareholders and not a distribution of REIT taxable income, principally as a result of the amount of the tax hedge loss deduction for the quarter.

### Contractual Obligations

The following table summarizes our contractual obligations by payment due date as of March 31, 2016:

(\$ in thousands)	Payments due by period				
	Total	< 1 year	1-3 years	3-5 years	> 5 years
Contractual Obligations:					
Repurchase agreements <sup>(1)</sup>	\$2,723,530	\$2,723,530	\$—	\$—	\$—
FHLB advances <sup>(1)</sup>	263,750	263,750	—	—	—
Non-recourse collateralized financing <sup>(2)</sup>	8,267	2,241	2,991	1,685	1,350
Operating lease obligations	858	205	430	223	—
Total	\$2,996,405	\$2,989,726	\$3,421	\$1,908	\$1,350

(1) Includes estimated interest payments calculated using interest rates in effect as of March 31, 2016.

(2) Amounts shown are for principal only and exclude interest obligations as those amounts are not significant. Non-recourse collateralized financing represents securitization financing that is payable solely from loans and securities pledged as collateral. Payments due by period were estimated based on the principal repayments forecasted for the underlying loans and securities, substantially all of which is used to repay the associated financing outstanding.

### Other Matters

As of March 31, 2016, we do not believe that any off-balance sheet arrangements exist that are reasonably likely to have a material effect on our current or future financial condition, results of operations, or liquidity. In addition, we do not have any material commitments for capital expenditures and have not obtained any commitments for funds to fulfill any capital obligations.

### RECENT ACCOUNTING PRONOUNCEMENTS

There are no recently issued accounting pronouncements which have had or are expected to have a material impact on the Company's consolidated financial statements. Please refer to Note 1 to the Notes to Unaudited Consolidated Financial Statements contained in Part 1, Item 1 of the Form 10-Q for information regarding recently issued accounting pronouncements.

### FORWARD-LOOKING STATEMENTS

Certain written statements in this Quarterly Report on Form 10-Q that are not historical facts constitute “forward-looking statements” within the meaning of Section 27A of the 1933 Act and Section 21E of the Exchange Act . Statements in this report addressing expectations, assumptions, beliefs, projections, future plans and strategies, future events, developments that we expect or anticipate will occur in the future, and future operating results are forward-looking statements. Forward-looking statements are based upon management’s beliefs, assumptions, and expectations as of the date of this report regarding future events and operating performance, taking into account all information currently available to us, and are applicable only as of the date of this report. Forward-looking statements generally can be identified by use of words such as “believe”, “expect”, “anticipate”, “estimate”, “plan” “may”, “will”, “intend” “should”, “could” or similar expressions. We caution readers not to



place undue reliance on our forward-looking statements, which are not historical facts and may be based on projections, assumptions, expectations, and anticipated events that do not materialize. Except as required by law, we are not obligated to, and do not intend to, update or revise any forward-looking statement whether as a result of new information, future events, or otherwise.

Forward-looking statements in this Quarterly Report on Form 10-Q may include, but are not limited to:

- Our business and investment strategy including our ability to generate acceptable risk-adjusted returns and our target investment allocations;
- Monetary policy and regulatory initiatives of the Federal Reserve (including the FOMC) and other financial regulators;
- Our financing strategy including our target leverage ratios and anticipated trends in financing costs, and our hedging strategy including changes to the derivative instruments to which we are a party, and changes to government regulation of hedging instruments and our use of these instruments;
- Our investment portfolio composition and target investments;
- Our investment portfolio performance, including the fair value, yields, and forecasted prepayment speeds of our investments;
- Our liquidity and ability to access financing, including with respect to maturity and replacement of FHLB advances, and the anticipated availability and cost of financing;
- Our stock repurchase activity and the impact of stock repurchases;
- Our use of and restrictions on using our tax NOL carryforward;
- The status of pending litigation;
- The competitive environment in the future, including competition for investments and the availability of financing;
- Estimates of future interest expenses, including related to the Company's repurchase agreements and derivative instruments;
- The status of regulatory rule-making or review processes and the status of reform efforts and other business developments in the repurchase agreement financing market;
- Market, industry and economic trends, how these trends and related economic data may impact the behavior of market participants and financial regulators; and
- Interest rates.

Forward-looking statements are inherently subject to risks, uncertainties and other factors that could cause our actual results to differ materially from historical results or from any results expressed or implied by such forward-looking statements. Not all of these risks and other factors are known to us. New risks and uncertainties arise over time, and it is not possible to predict those events or how they may affect us. The projections, assumptions, expectations or beliefs upon which the forward-looking statements are based can also change as a result of these risks or other factors. If such a risk or other factor materializes in future periods, our business, financial condition, liquidity and results of operations may vary materially from those expressed or implied in our forward-looking statements.

While it is not possible to identify all factors, some of the factors that may cause actual results to differ from historical results or from any results expressed or implied by forward-looking statements, or that may cause our projections, assumptions, expectations or beliefs to change, include the following:

- the risks and uncertainties referenced in this Quarterly Report on Form 10-Q, particularly those set forth under and incorporated by reference into Part II, Item 1A, "Risk Factors";
- our ability to find suitable reinvestment opportunities;
- changes in economic conditions;
- changes in interest rates and interest rate spreads, including the repricing of interest-earning assets and interest-bearing liabilities;
- our investment portfolio performance particularly as it relates to cash flow, prepayment rates and credit performance;

actual or anticipated changes in Federal Reserve monetary policy;

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- adverse reactions in financial markets related to the budget deficit or national debt of the United States government;
- potential or actual default by the United States government on Treasury securities; and potential or actual downgrades to the sovereign credit rating of the United States;
- the cost and availability of financing, including the future availability of financing due to changes to regulation of, and capital requirements imposed upon, financial institutions;
- the cost and availability of new equity capital;
- changes in our use of leverage;
- changes to our investment strategy, operating policies, dividend policy or asset allocations;
- the quality of performance of third-party servicer providers of our loans and loans underlying our securities;
- the level of defaults by borrowers on loans we have securitized;
- changes in our industry;
- increased competition;
- changes in government regulations affecting our business;
- changes in the repurchase agreement financing markets and other credit markets;
- changes to the market for interest rate swaps and other derivative instruments, including changes to margin requirements on derivative instruments;
- government initiatives to support the U.S financial system and U.S. housing and real estate markets; or to reform the U.S. housing finance system including by imposing standards for originating residential mortgage loans;
- GSE reform or other government policies and actions;
- ownership shifts under Section 382 that further limit the use of our tax NOL carryforward; and
- exposure to current and future claims and litigation.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We seek to manage various risks inherent in our business strategy, which include interest rate, prepayment, reinvestment, market value, credit, and liquidity risks. These risks can and do cause fluctuations in our shareholders' equity, comprehensive income, and book value. We attempt to manage these risks and earn an acceptable return for our shareholders as discussed below.

#### Interest Rate Risk

Investing in interest-rate sensitive investments on a leveraged basis subjects our results to interest rate risk primarily from the mismatch between interest-rate reset dates (or maturity) of our assets and the maturity of our liabilities. Borrowing costs on our liabilities are generally based on prevailing market rates and reset more frequently than interest rates on our assets. During a period of rising interest rates (particularly short term rates in a flattening yield curve environment), our borrowing costs will increase faster than our asset yields, negatively impacting our net interest income. The amount of the impact will depend on the composition of portfolio and on the effectiveness of our hedging instruments at the time, as well as the magnitude and the duration of the increase in interest rates. In addition, our adjustable rate assets may have limits or caps on the amount that an interest rate may reset while our liabilities do not have interest rate reset caps. Because we are long duration as of March 31, 2016, increases in interest rates, particularly rapid changes, will also negatively impact the market value of our investments, thereby reducing our book value. In addition to the information set forth in the tables below, see "Market Value Risk" below for further discussion of the risks to the market value of our investments.

While having interest rate risk is a basic tenet of our investment strategy, we attempt to manage our exposure to changes in interest rates by investing in instruments that have short maturities/interest reset dates, entering into derivative instruments (such as interest rate swaps and Eurodollar futures) to hedge this risk and by managing our investment portfolio within interest rate risk tolerances set by our Board of Directors. Our current goal is to maintain net portfolio duration (a measure of interest rate risk) within a range of 0.5 to 1.5 years. Our portfolio duration may drift outside of this target range at various times based on the composition of our investment portfolio including

derivative instruments, and in light of our expectations with respect to interest rates and FOMC monetary policy. In addition, duration is driven by model inputs, and in the case of Agency RMBS, the most important inputs include anticipated prepayment speeds. Estimates of prepayment speeds can vary significantly by investor for the same security and therefore estimates of security and portfolio duration can vary significantly.

Effect of Changes in Interest Rates on Adjusted Net Interest Income and Market Value. The table below shows the projected sensitivity of our adjusted net interest income and the market value of our investments and derivative instruments carried at fair value as they existed as of March 31, 2016 based on an instantaneous parallel shift in market interest rates as set forth in the table below. In light of the low interest rate environment at March 31, 2016, the only declining rate scenario that we present is a downward shift of 25 basis points. In order to include the impact of changes in interest rates on our effective derivative instruments, we are presenting the percentage change in adjusted net interest income (instead of net interest income) because net interest income does not include the net interest payments/receipts on these instruments.

The "percentage change in adjusted net interest income" includes the impact of changes in expected prepayment speeds on our investments and assumes that net proceeds received from pay downs on the investment portfolio are reinvested in MBS in amounts proportionate to the portfolio composition that existed as of March 31, 2016 and at yields consistent with those as of that date, adjusted for the parallel shift in the rates below. Changes in types of investments, the returns earned on these investments, future interest rates, credit spreads, the shape of the yield curve, the availability of financing, and/or the mix of our investments and financings including derivative instruments may cause actual results to differ significantly from the modeled results. There can be no assurance that assumed events used for the model below will occur, or that other events will not occur, that will affect the outcomes; therefore, the tables below and all related disclosures constitute forward-looking statements.

Parallel Shift in Interest Rates	Percentage change in market value <sup>(1)</sup>	Percentage change in adjusted net interest income
+100	(1.04)%	(24.36)%
+50	(0.45)%	(11.22)%
-25	0.19%	4.57%

Includes changes in market value of our investments and derivative instruments, but excludes changes in market (1) value of our financings because they are not carried at fair value on our balance sheet. The projections for market value do not assume any change in credit spreads.

Management also considers changes in the shape of the interest rate curves in assessing and managing portfolio interest rate risk. Often interest rates do not move in a parallel fashion from quarter to quarter. The table below shows the projected change in market value of our investment portfolio net of derivative hedge instruments for instantaneous changes in the shape of the U.S. Treasury curve (with similar changes to the interest rate swap curve and Eurodollar curves) as of March 31, 2016.

Basis point change in 2-year yield	Basis point change in 10-year yield	Percentage change in market value <sup>(1)</sup>
0	+25	0.04%
+10	+50	(0.01)%
+10	+75	(0.02)%
+25	+75	(0.13)%
+25	+0	(0.16)%
+50	+0	(0.33)%
-10	-50	(0.06)%

Includes changes in market value of our investments and derivative instruments, but excludes changes in market (1) value of our financings because they are not carried at fair value on our balance sheet. The projections for market value do not assume any change in credit spreads.

As shown in the first table above, a downward parallel shift of 25 basis points leads to a projected increase in our aggregate market value of 0.19%, indicating we benefit from lower interest rates currently because we are in a long duration position as of March 31, 2016. In the second table, a downward shift of 10 basis points in the 2-year yield and a downward shift of 50 basis points in 10-year yield leads to a projected decrease in our aggregate market value of (0.06)% because as the yield



curve flattens, the negative impact of faster prepayments on our RMBS out strips the benefit of lower interest rates on our long duration position.

Our adjustable rate investments have interest rates which are predominantly based on one-year LIBOR and contain periodic (or interim) and lifetime interest rate caps which limit the amount by which the interest rate may reset on the investment. Please refer to "Financial Condition-RMBS" within Part 1, Item 2 of this Quarterly Report on Form 10-Q for details.

#### Market Value Risk

Our investments fluctuate in market value due to changes in credit spreads, spot and forward interest rates, actual and anticipated prepayments and other factors. Changes in the market values of our investments are reflected in other comprehensive income, shareholders' equity, and book value per common share. Changes in credit spreads represent the market's valuation of the perceived riskiness of assets relative to risk-free rates, and widening credit spreads reduces the market value of our investments as market participants require additional yield to hold riskier assets. Credit spreads could change based on macroeconomic or systemic factors as well as the factors specific to a particular security such as prepayment performance or credit performance. Other factors that could impact credit spreads include technical issues such as supply and demand for a particular type of security or FOMC monetary policy. Likewise, most of our investments are fixed rate or reset in rate over a period of time, and as interest rates rise, we would expect the market value of these investments to decrease. We use derivative instruments to hedge our exposure to rising interest rates, though often not on a one-to-one basis. We do not seek to hedge our exposure to credit spreads, prepayments or other factors other than through asset selection.

Fluctuations in credit spreads typically vary based on the type of investment. Though market conditions and technical factors such as FOMC monetary policy may impact Agency MBS credit spreads, Agency MBS credit spreads will generally have less volatility than non-Agency MBS credit spreads. This is due to the fact that market participants generally view Agency MBS, given their guarantee of principal by GSEs, as more liquid (i.e., more easily converted into cash) than non-Agency MBS.

The table below is an estimate of the projected change in our portfolio market value given the indicated change in market credit spreads as of March 31, 2016:

Basis Point Change in Market Credit Spreads	Percentage change in market value of investments
+50	(2.2)%
+25	(1.1)%
-25	1.1%
-50	2.3%

#### Prepayment and Reinvestment Risk

Prepayment risk is the risk of an early, unscheduled return of principal on an investment. We are subject to prepayment risk from premiums paid on investments which we acquire. Purchase premiums on our investments are amortized as a reduction in interest income using the effective yield method under GAAP, adjusted for the actual and anticipated prepayment activity of the investment. An increase in the actual or expected rate of prepayment will typically accelerate the amortization of purchase premiums, thereby reducing the yield/interest income earned on such assets. Principal prepayments on our investments are influenced by changes in market interest rates and a variety of economic, geographic, government policy and other factors beyond our control.

We have prepayment risk for all of our investments which we own at a premium to their par value. The majority of the loans underlying our RMBS are ARMs or hybrid ARMs and do not have any specific prepayment protection. Prepayments on these loans generally accelerate in a declining interest rate environment, as the loans age, and as the

loans near their respective interest rate reset dates, particularly the initial reset date. Our prepayment models anticipate acceleration of prepayments in these events. To the extent the actual prepayments exceed our modeled prepayments, or if we change our future prepayment expectations, we will record adjustments to our premium amortization which may negatively impact our net interest income and could impact the fair value of our RMBS.



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As an indication of our prepayment risk on our RMBS portfolio, the following table summarizes information for our Agency RMBS portfolio regarding the net premium and weighted average coupon by months until interest rate reset ("MTR") or until maturity in the case of fixed-rate securities as of the end of the past four quarters:

(\$ in thousands)	March 31, 2016		December 31, 2015		September 30, 2015		June 30, 2015	
	Net Premium	WAC	Net Premium	WAC	Net Premium	WAC	Net Premium	WAC
0-12 MTR	\$14,715	2.65%	\$18,098	2.75%	\$20,234	2.70%	\$20,752	2.69%
13-36 MTR	24,000	3.32%	23,401	3.47%	24,039	3.54%	22,874	3.63%
37-60 MTR	3,630	3.68%	4,202	2.97%	5,128	2.94%	10,126	3.07%
> 60 MTR	27,911	2.91%	31,924	2.95%	34,068	2.96%	36,501	2.97%
Fixed rate	—	—%	(8 )	2.50%	(8 )	2.50%	(9 )	2.50%
Total	\$70,256	3.01%	\$77,617	3.03%	\$83,461	3.04%	\$90,244	3.05%
Par balance	\$1,423,270		\$1,536,733		\$1,631,942		\$1,741,996	
Premium, net as a % of par value	4.9 %		5.1 %		5.1 %		5.2 %	

Loans underlying our CMBS and CMBS IO securities typically have some form of prepayment protection provisions (such as prepayment lock-outs) or prepayment compensation provisions (such as yield maintenance or prepayment penalties). Yield maintenance and prepayment penalty requirements are intended to create an economic disincentive for the loans to prepay; however, the amount of the prepayment penalty required to be paid may decline over time, and as loans age, interest rates decline, or market values of collateral supporting the loans increase, prepayment penalties may lessen as an economic disincentive to the borrower. Generally, our experience has been that prepayment lock-out and yield maintenance provisions result in stable prepayment performance from period to period. There are no prepayment protections, however, if the loan defaults and is partially or wholly repaid earlier as a result of loss mitigation actions taken by the underlying loan servicer. Historically, we have experienced low default rates on loans underlying CMBS and CMBS IO.

Because CMBS IO consist of rights to interest on the underlying commercial mortgage loan pools and do not have rights to principal payments on the underlying loans, prepayment risk on these securities would be particularly acute without these prepayment protection provisions. CMBS IO prepayment protection and compensation provisions vary by issuer of the security, (i.e. Freddie Mac, Fannie Mae, Ginnie Mae, or non-Agency). The majority of our Agency CMBS IO are issued by Freddie Mac and these securities generally have initial prepayment lock-outs followed by a defeasance period which on average extends to within six months of the stated maturities of the underlying loans. Non-Agency CMBS IO generally have prepayment protection in the form of prepayment lock-outs and defeasance provisions. The following table details the fair value of our CMBS IO portfolio by issuer as of the end of the periods indicated:

(\$ in thousands)	March 31, December	
	2016	31, 2015
Fannie Mae	\$23,418	\$24,177
Freddie Mac	386,230	401,951
Non-Agency CMBS IO	353,037	363,727
	\$762,685	\$789,855

We seek to manage our prepayment risk on our MBS by diversifying our investments, seeking investments which we believe will have superior prepayment performance, and investing in securities which have some sort of prepayment prohibition or yield maintenance (as is the case with CMBS and CMBS IO). With respect to RMBS, we will seek to invest in RMBS where we believe the underlying loans have favorable prepayment characteristics such as lower loan balances or favorable origination, borrower or geographic characteristics.

We are also subject to reinvestment risk as a result of the prepayment, repayment and sales of our investments. In order to maintain our investment portfolio size and our earnings, we need to reinvest capital received from these

events into new

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interest-earning assets. Yields on assets in which we have reinvested in recent periods have generally been lower than yields on existing assets due to lower overall interest rates and more competition for these as investment assets. As a result, our interest income has declined in recent periods and may continue to decline in the future, thereby reducing earnings per share. If we are unable to find suitable reinvestment opportunities, interest income on our investment portfolio and investment cash flows could be negatively impacted. In addition, based on market conditions, our leverage, and our liquidity profile, we may decide to not reinvest the cash flows we receive from our investment portfolio even when attractive reinvestment opportunities are available, or we may decide to reinvest in assets with lower yield but greater liquidity. If we retain rather than reinvest capital as in the first quarter of 2016, or if we invest it in lower yielding assets for liquidity reasons, the size of our investment portfolio and the amount of net interest income generated by our investment portfolio will likely decline.

### Credit Risk

Credit risk is the risk that we will not receive all contractual amounts due on investments that we own due to default by the borrower or due to a deficiency in proceeds from the liquidation of the collateral securing the obligation. We are also particularly exposed to credit risk on investments that we own at a premium. For investments owned at premiums, defaults on the underlying loan typically result in the complete loss of any remaining unamortized premium we paid.

We attempt to mitigate our credit risk by purchasing Agency MBS and higher quality non-Agency MBS. Agency MBS have credit risk to the extent that Fannie Mae or Freddie Mac fails to remit payments on the MBS for which they have issued a guaranty of payment. Given the improved financial performance and conservatorship of these entities and the continued support of the U.S. government, we believe this risk is low. For our non-Agency MBS, we seek to purchase investment grade securities (rated 'BBB' or better by a least one of the nationally recognized statistical ratings organizations) or securities that we believe are short-duration and which will have strong credit performance. We do not currently seek to purchase heavily discounted, credit sensitive MBS.

The majority of our non-Agency securities are CMBS and CMBS IO. The return we earn on these securities is dependent on the credit performance of the underlying commercial loans. In particular, since investments in CMBS IO pay interest from the underlying commercial mortgage loan pools, returns are more negatively impacted by liquidations of loans in the underlying loan pool.

In order to manage our exposure to credit performance, we generally invest in securities with higher credit ratings and in securities where we have evaluated the credit profile of the underlying loan pool and can monitor its credit performance. With respect to non-Agency RMBS, our purchases have been very short duration MBS backed by pools of re-performing or non-performing loans.

The following table presents information on our non-Agency MBS by credit rating as of March 31, 2016:

(\$ in thousands)	March 31, 2016					Percentage
	CMBS	CMBS IO	RMBS	Total		
AAA	\$35,967	\$295,069	\$—	\$331,036	62.2	%
AA	35,573	51,995	—	87,568	16.5	%
A	32,242	—	—	32,242	6.0	%
Below A or not rated	14,571	5,973	60,757	81,301	15.3	%
	\$118,353	\$353,037	\$60,757	\$532,147	100.0	%

### Liquidity Risk

We have liquidity risk principally from the use of recourse repurchase agreements to finance our ownership of securities. In general, our repurchase agreements provide a source of uncommitted short-term financing that finances a longer-term asset, thereby creating a mismatch between the maturity of the asset and of the associated financing. Our repurchase agreements are renewable at the discretion of our lenders and do not contain guaranteed roll-over terms. If we fail to repay the

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lender at maturity, the lender has the right to immediately sell the collateral and pursue us for any shortfall if the sales proceeds are inadequate to cover the repurchase agreement financing. In addition, repurchase agreements are collateral based and declines in the market value of our investments subject us to liquidity risk.

For further information, including how we attempt to mitigate liquidity risk and monitor our liquidity position, please refer to “Liquidity and Capital Resources” in Part 1, Item 2 of this Quarterly Report on Form 10-Q.

#### ITEM 4. CONTROLS AND PROCEDURES

Disclosure controls and procedures.

Our management evaluated, with the participation of our Principal Executive Officer and Principal Financial Officer, the effectiveness of our disclosure controls and procedures, as defined in Exchange Act Rule 13a-15(e), as of the end of the period covered by this report. Based on that evaluation, our Principal Executive Officer and Principal Financial Officer concluded that our disclosure controls and procedures were effective as of March 31, 2016 to ensure that information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to our management, including our Principal Executive Officer and Principal Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in internal control over financial reporting.

Our management is also responsible for establishing and maintaining adequate internal control over financial reporting as defined in Exchange Act Rule 13a-15(f). There were no changes in our internal control over financial reporting during the three months ended March 31, 2016 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

#### ITEM 1. LEGAL PROCEEDINGS

The Company and its subsidiaries are parties to various legal proceedings. Although the ultimate outcome of these legal proceedings cannot be ascertained at this time, and the results of legal proceedings cannot be predicted with certainty, the Company believes, based on current knowledge, that the resolution of any of these proceedings will not have a material adverse effect on the Company’s consolidated financial condition or liquidity. However, the resolution of any of the proceedings could have a material impact on consolidated results of operations or cash flows in a given future reporting period as the proceedings are resolved.

With respect to the case styled Basic Capital Management, Inc. et al. v. Dynex Commercial, Inc., et al., Cause No. DC-03-00675, 68th Judicial Dist. Ct., Dallas Co., Tex., on July 20, 2015, American Realty Trust, Inc. (“ART”) and other related entities obtained a final judgment in the principal amount of \$46.5 million against Dynex Commercial, Inc. (“DCI”), a former affiliate of the Company also known as DCI Commercial, Inc. ART’s portion of the judgment against DCI is \$24.9 million. As previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2013, the Company was a party to this lawsuit until the Fifth Court of Appeals in Dallas, Texas affirmed in May 2013 the trial court’s decision with respect to a take nothing judgment against the Company. On July 31, 2014, in a case styled ART Midwest, Inc., et al. v. David M. Clapper, et al., Cause No. 3:99-CV-2355-N, U.S. Dist. Ct., N.D. Tex., David M. Clapper, Atlantic XIII, LLC, and Atlantic Midwest, LLC (the “Clapper Parties”) obtained a final judgment against ART in the principal amount of \$46.9 million. In an effort to collect their judgment against ART, on July 31, 2015, the Clapper Parties filed an Application for Writ of Garnishment against DCI and the Company in U.S. Dist. Ct., N.D. Tex. (“Garnishment Action”). In the Garnishment Action, the Clapper Parties seek to garnish ART’s judgment against DCI and allege that the Company is “the apparent successor to DCI.” In September 2015, the Company filed a motion to dismiss the Garnishment Action against it on the grounds that, among other

things, the Clapper Parties alleged no facts to support any allegations against the Company and requested no relief against the Company. The Company's motion to dismiss was granted in March 2016.

## ITEM 1A. RISK FACTORS

Risks and uncertainties identified in our forward-looking statements contained in this Quarterly Report on Form 10-Q together with those previously disclosed in the Annual Report on Form 10-K for the year ended December 31, 2015 or those that are presently unforeseen could result in significant adverse effects on our financial condition, results of operations and cash flows. See “Forward-Looking Statements” contained in Part I, Item 2, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” within this Quarterly Report on Form 10-Q as well as Part I, Item 1A, “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2015.

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

## Issuer Purchases of Equity Securities

The Company has been authorized by its Board of Directors to repurchase up to \$50 million of its outstanding shares of common stock through December 31, 2016. Subject to applicable securities laws and the terms of the Series A Preferred Stock designation and the Series B Preferred Stock designation, both of which are contained in our Articles of Incorporation, future repurchases of common stock will be made at times and in amounts as the Company deems appropriate, provided that the repurchase price per share is less than the Company's estimate of the current net book value of a share of common stock. Repurchases may be suspended or discontinued at any time.

The following table summarizes repurchases of our common stock that occurred during the three months ended March 31, 2016:

	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs (in thousands)
January 1, 2016 - January 31, 2016	53,704	\$ 6.42	48,444	\$ 8,518
February 1, 2016 - February 29, 2016	53,580	—	—	8,518
March 1, 2016 - March 31, 2016	22,048	\$ —	—	8,518
Total	129,332	\$ 6.42	48,444	

(1) A portion of these shares were withheld from certain employees to satisfy tax withholding obligations arising upon the vesting of restricted shares. Accordingly, these shares are not included in the calculation of approximate dollar value of shares that may yet be purchased under the \$50 million repurchase plan authorized by the Company's Board of Directors.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

Exhibit No.	Description
3.1	Restated Articles of Incorporation, effective June 2, 2014 (incorporated herein by reference to Exhibit 3.1 to Dynex's Registration Statement on Form S-8 filed September 17, 2014).
3.2	Amended and Restated Bylaws, amended as of December 12, 2013 (incorporated herein by reference to Exhibit 3.2 to Dynex's Annual Report on Form 10-K filed March 4, 2014).
10.23.3	Amendment No. 3 to Master Repurchase and Securities Contract dated as of April 29, 2016 between Issued Holdings Capital Corporation, Dynex Capital, Inc. (as guarantor) and Wells Fargo Bank, N.A. (incorporated herein by reference to Exhibit 10.23.3 to Dynex's Current Report on Form 8-K filed May 3, 2016).
31.1	Certification of principal executive officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
31.2	Certification of principal financial officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
32.1	Certification of principal executive officer and principal financial officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith).
101	The following materials from Dynex Capital, Inc.'s Quarterly Report on Form 10-Q for the three months ended March 31, 2016, formatted in XBRL (Extensible Business Reporting Language), filed herewith: (i) Consolidated Balance Sheets (unaudited), (ii) Consolidated Statements of Comprehensive Income (unaudited), (iii) Consolidated Statement of Shareholders' Equity (unaudited), (iv) Consolidated Statements of Cash Flows (unaudited), and (v) Notes to the Unaudited Consolidated Financial Statements.



SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

DYNEX CAPITAL, INC.

Date: May 9, 2016 /s/ Byron L. Boston

Byron L. Boston  
Chief Executive Officer, President,  
Co-Chief Investment Officer, and Director  
(Principal Executive Officer)

Date: May 9, 2016 /s/ Stephen J. Benedetti

Stephen J. Benedetti  
Executive Vice President, Chief Financial Officer and Chief Operating Officer  
(Principal Financial Officer)