

Invesco Mortgage Capital Inc.  
Form 10-Q  
August 06, 2014  
Table of Contents

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2014

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission file number 001-34385

(Exact Name of Registrant as Specified in Its Charter)

Maryland  
(State or Other Jurisdiction of  
Incorporation or Organization) 26-2749336  
(I.R.S. Employer  
Identification No.)

1555 Peachtree Street, N.E., Suite 1800  
Atlanta, Georgia 30309  
(Address of Principal Executive Offices) (Zip Code)  
(404) 892-0896  
(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 website, 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. (Check one):

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

As of August 1, 2014, there were 123,095,889 outstanding shares of common stock of Invesco Mortgage Capital Inc.



Table of Contents

INVESCO MORTGAGE CAPITAL INC.  
TABLE OF CONTENTS

	Page
<u>PART I FINANCIAL INFORMATION</u>	<u>1</u>
Item 1. <u>Financial Statements</u>	<u>1</u>
<u>Consolidated Balance Sheets as of June 30, 2014 (unaudited) and December 31, 2013</u>	<u>1</u>
<u>Unaudited Consolidated Statements of Operations for the three and six months ended June 30, 2014 and 2013</u>	<u>2</u>
<u>Unaudited Consolidated Statements of Comprehensive Income for the three and six months ended June 30, 2014 and 2013</u>	<u>3</u>
Unaudited Consolidated Statements of Equity for the six months ended June 30, 2014	<u>4</u>
<u>Unaudited Consolidated Statements of Cash Flows for the six months ended June 30, 2014 and 2013</u>	<u>5</u>
<u>Notes to Consolidated Financial Statements</u>	<u>6</u>
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>44</u>
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>71</u>
Item 4. <u>Controls and Procedures</u>	<u>74</u>
<u>PART II OTHER INFORMATION</u>	<u>75</u>
Item 1. <u>Legal Proceedings</u>	<u>75</u>
Item 1A. <u>Risk Factors</u>	<u>75</u>
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>76</u>
Item 3. <u>Defaults Upon Senior Securities</u>	<u>76</u>
Item 4. <u>Mine Safety Disclosures</u>	<u>76</u>
Item 5. <u>Other Information</u>	<u>76</u>
Item 6. <u>Exhibits</u>	<u>78</u>

Table of Contents

## PART I

## ITEM 1. FINANCIAL STATEMENTS

## INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

\$ in thousands, except per share amounts	As of June 30, 2014 (Unaudited)	December 31, 2013
<b>ASSETS</b>		
Mortgage-backed securities, at fair value	18,247,789	17,348,657
Residential loans, held-for-investment, net of loan loss reserve	2,310,686	1,810,262
Commercial loans, held-for-investment, net of loan loss reserve	95,585	64,599
Cash and cash equivalents	126,128	210,612
Due from counterparties	30,413	1,500
Investment related receivable	399,499	515,404
Investments in unconsolidated ventures, at fair value	44,030	44,403
Accrued interest receivable	69,261	68,246
Derivative assets, at fair value	70,190	262,059
Deferred securitization and financing costs	13,280	13,894
Other investments	18,500	10,000
Other assets	879	1,343
Total assets <sup>(1)</sup>	21,426,240	20,350,979
<b>LIABILITIES AND EQUITY</b>		
<b>Liabilities:</b>		
Repurchase agreements	14,723,223	15,451,675
Secured loans	625,000	—
Asset-backed securities	2,016,923	1,643,741
Exchangeable senior notes	400,000	400,000
Derivative liability, at fair value	268,600	263,204
Dividends and distributions payable	64,972	66,087
Investment related payable	670,149	28,842
Accrued interest payable	25,393	26,492
Collateral held payable	14,199	52,698
Accounts payable and accrued expenses	2,266	4,304
Due to affiliate	9,904	10,701
Total liabilities <sup>(1)</sup>	18,820,629	17,947,744
<b>Equity:</b>		
Preferred Stock, par value \$0.01 per share; 50,000,000 shares authorized, 7.75% series A cumulative redeemable, 5,600,000 shares issued and outstanding (\$140,000 aggregate liquidation preference) at June 30, 2014 and December 31, 2013, respectively	135,356	135,356
Common Stock, par value \$0.01 per share; 450,000,000 shares authorized; 123,094,376 and 124,510,246 shares issued and outstanding at June 30, 2014 and December 31, 2013, respectively	1,231	1,245
Additional paid in capital	2,531,739	2,552,464
Accumulated other comprehensive income (loss)	355,093	(156,993 )
Retained earnings (distributions in excess of earnings)	(447,542 )	(155,957 )
Total shareholders' equity	2,575,877	2,376,115
Non-controlling interest	29,734	27,120

Edgar Filing: Invesco Mortgage Capital Inc. - Form 10-Q

Total equity	2,605,611	2,403,235
Total liabilities and equity	21,426,240	20,350,979

The Company's consolidated balance sheets include assets of consolidated variable interest entities ("VIEs") that can only be used to settle obligations and liabilities of the VIEs for which creditors do not have recourse to the primary beneficiary (IAS Asset I LLC, an indirect subsidiary of the Company). As of June 30, 2014 and December 31, (1) 2013, total assets of the consolidated VIEs were \$2,322,093 and \$1,819,295, respectively, and total liabilities of the consolidated VIEs were \$2,022,948 and \$1,648,400, respectively. Refer to Note 3 - "Variable Interest Entities" for further discussion.

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(Unaudited)

\$ in thousands, except per share data	Three Months Ended		Six Months Ended	
	June 30, 2014	2013	June 30, 2014	2013
Interest Income				
Mortgage-backed securities	151,920	168,736	303,659	329,080
Residential loans	20,471	6,889	38,175	7,026
Commercial loans	2,061	60	3,680	60
Total interest income	174,452	175,685	345,514	336,166
Interest Expense				
Repurchase agreements	47,822	68,463	96,893	134,792
Secured loans	176	—	176	—
Exchangeable senior notes	5,613	5,622	11,220	6,782
Asset-backed securities	15,826	5,377	29,761	5,456
Total interest expense	69,437	79,462	138,050	147,030
Net interest income	105,015	96,223	207,464	189,136
Provision for loan losses	(50 )	663	157	663
Net interest income after provision for loan losses	105,065	95,560	207,307	188,473
Other Income (loss)				
Gain (loss) on sale of investments, net	(20,766 )	5,692	(32,484 )	12,404
Equity in earnings and fair value change in unconsolidated ventures	3,894	2,157	4,335	3,747
Gain (loss) on interest rate derivative instruments, net	(167,816 )	53,314	(319,128 )	51,311
Realized and unrealized credit default swap income	292	180	621	531
Total other income (loss)	(184,396 )	61,343	(346,656 )	67,993
Expenses				
Management fee – related party	9,327	10,807	18,662	21,161
General and administrative	3,739	3,043	6,935	4,587
Total expenses	13,066	13,850	25,597	25,748
Net income (loss)	(92,397 )	143,053	(164,946 )	230,718
Net income (loss) attributable to non-controlling interest	(1,057 )	1,493	(1,879 )	2,455
Net income (loss) attributable to Invesco Mortgage Capital Inc.	(91,340 )	141,560	(163,067 )	228,263
Dividends to preferred shareholders	2,712	2,713	5,425	5,425
Net income (loss) attributable to common shareholders	(94,052 )	138,847	(168,492 )	222,838
Earnings (loss) per share:				
Net income (loss) attributable to common shareholders				
Basic	(0.76 )	1.03	(1.37 )	1.69
Diluted	(0.76 )	0.95	(1.37 )	1.61
Dividends declared per common share	0.50	0.65	1.00	1.30

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
\$ in thousands, except per share data	2014	2013	2014	2013
Net income (loss)	(92,397 )	143,053	(164,946 )	230,718
Other comprehensive income (loss)				
Unrealized gain (loss) on mortgage-back securities				
Change in fair value	273,222	(705,300 )	442,689	(768,723 )
Reclassification adjustments for (gain) loss included in gain (loss) on sale of investments, net	20,766	(5,692 )	32,484	(12,404 )
Unrealized gain (loss) on mortgage-backed securities, net	293,988	(710,992 )	475,173	(781,127 )
Unrealized gain (loss) on derivatives				
Change in fair value	—	274,660	—	257,489
Reclassification adjustments for loss included in gain (loss) on interest rate derivative instruments, net	—	37,409	—	72,970
Reclassification adjustments for loss included in repurchase agreements interest expense	21,532	—	42,828	—
Unrealized gain on derivatives, net	21,532	312,069	42,828	330,459
Total Other comprehensive income (loss)	315,520	(398,923 )	518,001	(450,668 )
Comprehensive income	223,123	(255,870 )	353,055	(219,950 )
Less: Comprehensive (income) loss attributable to non-controlling interest	(2,553 )	2,662	(4,036 )	2,258
Less: Dividends to preferred shareholders	(2,712 )	(2,713 )	(5,425 )	(5,425 )
Comprehensive income attributable to common shareholders	217,858	(255,921 )	343,594	(223,117 )

The accompanying notes are an integral part of these consolidated financial statements.

Table of ContentsINVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF EQUITY

For the six months ended June 30, 2014

(Unaudited)

\$ in thousands, except per share amounts	Preferred Stock		Common Stock		Attributable to Common Shareholders		Accumulated Other Comprehensive Income (loss)	Retained Earnings (Distributions in excess of earnings)	Total Shareholder Equity	Non- Controlling Interest	Total Equity
	Shares	Amount	Shares	Amount	Additional Paid in Capital						
Balance at January 1, 2014	5,600,000	135,356	124,510,246	1,245	2,552,464	(156,993)	(155,957)	2,376,115	27,120	2,403,235	
Net loss	—	—	—	—	—	—	(163,067)	(163,067)	(1,879)	(164,946)	
Other comprehensive income	—	—	—	—	—	512,086	—	512,086	5,915	518,001	
Proceeds from issuance of common stock, net of offering costs	—	—	8,235	—	135	—	—	135	—	135	
Repurchase of shares of common stock	—	—	(1,438,213)	(14)	(21,114)	—	—	(21,128)	—	(21,128)	
Stock awards	—	—	14,108	—	—	—	—	—	—	—	
Common stock dividends	—	—	—	—	—	—	(123,093)	(123,093)	—	(123,093)	
Common unit dividends	—	—	—	—	—	—	—	—	(1,425)	(1,425)	
Preferred stock dividends	—	—	—	—	—	—	(5,425)	(5,425)	—	(5,425)	
Amortization of equity-based compensation	—	—	—	—	254	—	—	254	3	257	
Balance at June 30, 2014	5,600,000	135,356	123,094,376	1,231	2,531,739	355,093	(447,542)	2,575,877	29,734	2,605,611	

The accompanying notes are an integral part of this consolidated financial statement.



Table of Contents

INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

\$ in thousands	Six Months Ended June 30,	
	2014	2013
Cash Flows from Operating Activities		
Net income (loss)	(164,946	) 230,718
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Amortization of mortgage-backed securities premiums and discounts, net	66,983	97,379
Amortization of residential loan and asset-backed securities premiums (discount)	1,278	164
Amortization of commercial loan origination fees	—	(9
Origination fee received net of cost paid	—	145
Provision for loan losses	157	663
Unrealized (gain) loss on interest rate derivative instruments	181,621	(24,152
Unrealized loss on credit default swap	107	568
(Gain) loss on sale of mortgage-backed securities	32,484	(12,404
(Gain) loss on interest rate derivative instruments	33,861	(27,159
Equity in earnings and fair value change in unconsolidated ventures	(4,335	) (3,747
Amortization of equity-based compensation	257	186
Amortization of deferred securitization and financing costs	1,459	857
Amortization of deferred swap losses from de-designation	42,828	—
Non cash interest income capitalized in commercial loans	(768	) —
Changes in operating assets and liabilities:		
(Increase) decrease in accrued interest receivable	(917	) (15,011
(Increase) decrease in other assets	464	(655
Increase (decrease) in accrued interest payable	(1,099	) 8,319
Increase (decrease) in due to affiliate	(797	) 2,419
Increase (decrease) in accounts payable and accrued expenses	(2,038	) 1,213
Net cash provided by operating activities	186,599	259,494
Cash Flows from Investing Activities		
Purchase of mortgage-backed securities	(3,104,313	) (6,114,762
Distributions from investment in unconsolidated ventures, net	4,708	2,633
Change on investment in other assets	(8,500	) —
Principal payments from mortgage-backed securities	878,516	1,572,612
Proceeds from sale of mortgage-backed securities	2,451,742	1,407,453
Payment of premiums for interest rate swaptions	(7,738	) (49,446
Proceeds from termination of interest rate swaptions	—	47,855
Payments for termination of futures contracts and TBA	(10,586	) —
Purchase of residential loans	(557,763	) (1,562,819
Principal payments from residential loans	55,213	8,636
Principal payments from commercial loans	401	—
Origination and advances of commercial loans, net of origination fees	(30,619	) (9,070
Net cash used in investing activities	(328,939	) (4,696,908
Cash Flows from Financing Activities		
Proceeds from issuance of common stock	135	396,503
Repurchase of common stock	(21,128	) —
Cost of issuance of preferred stock	—	(6

Edgar Filing: Invesco Mortgage Capital Inc. - Form 10-Q

Due from counterparties	(27,190	) —
Collateral held payable	(32,705	) 91,368
Proceeds from repurchase agreements	74,527,163	96,451,813
Principal repayments of repurchase agreements	(75,255,615	) (94,265,538 )
Proceeds from issuance of exchangeable senior notes	—	400,000
Proceeds from asset-backed securities	422,466	1,440,755
Principal repayments of asset-backed securities	(48,367	) (8,413 )
Proceeds from issuance of secured loans	1,585,247	—
Principal repayments on secured loans	(960,247	) —
Payments of deferred costs	(845	) (15,551 )
Payments of dividends and distributions	(131,058	) (170,214 )
Net cash provided by financing activities	57,856	4,320,717
Net change in cash and cash equivalents	(84,484	) (116,697 )
Cash and cash equivalents, beginning of period	210,612	286,474
Cash and cash equivalents, end of period	126,128	169,777
Supplement Disclosure of Cash Flow Information		
Interest paid	95,066	138,204
Non-cash Investing and Financing Activities Information		
Net change in unrealized gain (loss) on mortgage-backed securities and hedged derivatives	475,173	(450,668 )
Dividends and distributions declared not paid	64,972	91,528
(Receivable) / payable for mortgage-backed securities sold / purchased, net	749,469	(921,299 )
Repurchase agreements, not settled	—	(27,842 )
Collateral held payable, not settled	(5,794	) —
Net change in due from counterparties	(1,723	) —
The accompanying notes are an integral part of these consolidated financial statements.		

Table of Contents

INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(unaudited)

Note 1 – Organization and Business Operations

Invesco Mortgage Capital Inc. (the “Company”) is a Maryland corporation focused on investing in, financing and managing residential and commercial mortgage-backed securities and mortgage loans. The Company invests in residential mortgage-backed securities (“RMBS”) for which a U.S. government agency such as the Government National Mortgage Association (“Ginnie Mae”), the Federal National Mortgage Association (“Fannie Mae”) or the Federal Home Loan Mortgage Corporation (“Freddie Mac”) guarantees payments of principal and interest on the securities (collectively “Agency RMBS”). The Company’s Agency RMBS investments include mortgage pass-through securities and collateralized mortgage obligations (“CMOs”). The Company also invests in RMBS that are not guaranteed by a U.S. government Agency (“non-Agency RMBS”), credit risk transfer securities issued by government-sponsored enterprises (“GSE CRT”), commercial mortgage-backed securities (“CMBS”), residential and commercial mortgage loans, and other real estate-related financing agreements. The Company is externally managed and advised by Invesco Advisers, Inc. (the “Manager”), a registered investment adviser and an indirect, wholly-owned subsidiary of Invesco Ltd. (“Invesco”), a leading independent global investment management firm.

The Company conducts its business through IAS Operating Partnership LP (the “Operating Partnership”) as its sole general partner. As of June 30, 2014, the Company owned 98.9% of the Operating Partnership, and Invesco Investments (Bermuda) Ltd., a direct, wholly-owned subsidiary of Invesco, owned the remaining 1.1%. The Company has one operating segment.

The Company finances its Agency RMBS, non-Agency RMBS, GSE CRT and CMBS investments primarily through short-term borrowings structured as repurchase agreements and secured loans. The Company has secured commitments with a number of repurchase agreement counterparties. The Company finances its residential loans held-for-investment through asset-backed securities (“ABS”) issued by securitization trusts for which the Company has determined it is the primary beneficiary. In addition, the Company may use other sources of financing including committed borrowing facilities and other private financing.

The Company elected to be taxed as a real estate investment trust (“REIT”) for U.S. federal income tax purposes under the provisions of the Internal Revenue Code of 1986, as amended, commencing with the Company's taxable year ended December 31, 2009. To maintain the Company’s REIT qualification, the Company is generally required to distribute at least 90% of its taxable income to its shareholders annually.

Note 2 – Summary of Significant Accounting Policies

Basis of Quarterly Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“U.S. GAAP”) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X, promulgated by the Securities and Exchange Commission (the “SEC”). In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the financial position and the results of operations of the Company for the interim periods presented have been included. Certain disclosures included in the Company’s annual report on Form 10-K are not required to be included on an interim basis in the company’s quarterly reports on Forms 10-Q. The Company has condensed or omitted these disclosures. The interim consolidated financial statements should be read in conjunction with the Company’s consolidated financial statements and related notes thereto included in the Company’s annual report on Form 10-K for the year ended December 31, 2013, which was filed with the SEC on March 3, 2014. The results of operations for the period ended June 30, 2014 are not necessarily indicative of the results to be expected for the full year or any other future period.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries. The consolidated financial statements also include the consolidation of certain securitization trusts that meet the definition of a variable

interest entity ("VIE") if the Company is deemed the primary beneficiary. These trusts hold pools of residential mortgage loans and each trust issues series of ABS payable from the cash flows generated by the underlying pools of residential mortgage loans. Generally, a portion of the ABS issued by these trusts is sold to unaffiliated third parties and the balance is purchased by the Company. The underlying loans owned by the securitization trusts are classified as residential loans held for investment on the Company's consolidated balance sheets. The ABS issued to third parties by the securitization trusts are recorded as liabilities and shown as asset-backed securities. In the Company's consolidated statements of operations, the Company records interest

## Table of Contents

income on the residential loans owned by the VIEs and interest expense on the ABS issued by the VIEs. All intercompany balances and transactions have been eliminated.

### Variable Interest Entity

A VIE is an entity that lacks one or more of the characteristics of a voting interest entity. A VIE is defined as an entity in which equity investors do not have the characteristics of a controlling financial interest or where investors do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. The determination of whether an entity is a VIE includes both a qualitative and quantitative analysis. The Company reassesses its initial evaluation of an entity as a VIE upon the occurrence of certain reconsideration events. The entity that consolidates a VIE is known as its primary beneficiary and is generally the entity with (i) the power to direct the activities that most significantly impact the VIE's economic performance, and (ii) the right to receive benefits from the VIE or the obligation to absorb losses of the VIE that could be significant to the VIE. For VIEs that do not have substantial ongoing activities, the power to direct the activities that most significantly impact the VIE's economic performance may be determined by a company's involvement with the design of the VIE.

In determining if a securitized trust should be consolidated, the Company evaluates whether it is a VIE and, if so, whether the Company's direct involvement in the VIE reflects a controlling financial interest that would result in the Company being deemed the primary beneficiary. The Company reassesses its initial evaluation of an entity as a VIE upon the occurrence of certain reconsideration events. The Company has consolidated the underlying assets and liabilities of the securitization trusts for which the Company is considered the primary beneficiary, at their fair value and, as such, no gain or loss was recorded upon consolidation. The securitizations are non-recourse financing for the residential mortgage loans held-for-investment. The senior securities issued by the securitization trusts sold to unaffiliated third parties are presented in the consolidated balance sheets as "Asset-backed securities."

### Use of Estimates

The accounting and reporting policies of the Company conform to U.S. GAAP. The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Examples of estimates include, but are not limited to, estimates of the fair values of financial instruments, interest income on mortgage-backed securities ("MBS"), allowance for loan losses and other-than-temporary impairment charges. Actual results may differ from those estimates.

### Cash and Cash Equivalents

The Company considers all highly liquid investments that have original or remaining maturity dates of three months or less when purchased to be cash equivalents. At June 30, 2014, the Company had cash and cash equivalents, including amounts restricted, in excess of the FDIC deposit insurance limit of \$250,000 per institution. The Company mitigates its risk of loss by actively monitoring the counterparties.

### Due from Counterparties / Collateral Held Payable

Due from counterparties represents cash posted with the Company's counterparties as collateral for the Company's interest rate derivatives and repurchase agreements. Collateral held payable represents cash posted with the Company by its counterparties as collateral under the Company's interest rate derivatives and repurchase agreements. In addition, Collateral held payable may include non-cash collateral in which the Company has the obligation to return the collateral upon the Company either selling or pledging the non-cash collateral. To the extent the Company receives collateral other than cash from its counterparties such assets are not included in the Company's consolidated balance sheets. Notwithstanding the foregoing, if the Company either sells such assets or pledges the assets as collateral pursuant to a repurchase agreement, the cash received and the corresponding liability is reflected on the consolidated balance sheets.

### Underwriting Commissions and Offering Costs

Underwriting commissions and direct costs incurred in connection with the Company's stock offerings are reflected as a reduction of additional paid-in-capital.

### Deferred Costs

Included in deferred costs are costs associated with the issuance of beneficial interests by consolidated VIEs incurred by the Company and costs incurred in connection with the issuance by the Company of its exchangeable senior notes. These costs may include underwriting, rating agency, legal, accounting and other fees. These deferred costs are amortized as an adjustment

## Table of Contents

to interest expense using the effective interest method, based upon actual repayments of the associated beneficial interests issued to third parties and over the stated legal maturity of the exchangeable senior notes.

### Repurchase Agreements

The Company finances its Agency RMBS, non-Agency RMBS, GSE CRT and CMBS investment portfolio primarily through the use of repurchase agreements. Repurchase agreements are treated as collateralized financing transactions and are carried at their contractual amounts, including accrued interest, as specified in the respective agreements.

In instances where the Company acquires Agency RMBS, non-Agency RMBS, GSE CRT or CMBS through repurchase agreements with the same counterparty from whom such assets were purchased, the Company records the assets and the related financing on a gross basis on its consolidated balance sheets, and the corresponding interest income and interest expense in its consolidated statements of operations if the transaction complies with the criteria for gross presentation. All of the following criteria must be met for gross presentation in the circumstance where the repurchase assets are financed with the same counterparty:

- the initial transfer of and repurchase financing cannot be contractually contingent;
- the repurchase financing entered into between the parties provides full recourse to the transferee and the repurchase price is fixed;
- the financial asset has an active market and the transfer is executed at market rates; and
- the repurchase agreement and financial asset do not mature simultaneously.

The Company currently reflects all proceeds from repurchase agreements borrowings and repayment of repurchase agreement borrowings on a gross basis on the consolidated statements of cash flows. If the transaction does not comply with the criteria for gross presentation, the Company would account for the purchase commitment and repurchase agreement on a net basis and record a forward commitment to purchase such assets as a derivative instrument. Forward commitments are recorded at fair value with subsequent changes in fair value recognized in income. Additionally, the Company records the cash portion of its investment in Agency RMBS, non-Agency RMBS, GSE CRT and CMBS as a mortgage related receivable from the counterparty on its consolidated balance sheets.

### Secured Loans

In March 2014, the Company's wholly-owned subsidiary, IAS Services LLC, became a member of the Federal Home Loan Bank of Indianapolis ("FHLBI"). As a member of the FHLBI, IAS Services LLC may borrow funds from the FHLBI in the form of secured loans.

As of June 30, 2014, IAS Services LLC had secured loans from the FHLBI with short-term maturities. FHLBI advances are treated as secured financing transactions and are carried at their contractual amounts.

### Asset-Backed Securities

ABS are recorded at principal balance net of unamortized premiums or discounts.

### Fair Value Measurements

The Company discloses the fair value of its financial instruments according to a fair value hierarchy (Levels 1, 2, and 3, as defined). In accordance with U.S. GAAP, the Company is required to provide enhanced disclosures regarding instruments in the Level 3 category (which require significant management judgment), including a separate reconciliation of the beginning and ending balances for each major category of assets and liabilities.

To determine fair value of its financial instruments, the Company generally obtains one price per instrument from its primary valuation service. If this service cannot provide a price, the Company will seek a value from other vendors. The valuation services use various observable inputs which may include a combination of benchmark yields, trades, broker/dealer quotes, issuer spreads, bids, offers and benchmark securities to determine prices. Both the Company and the pricing vendor continuously monitor market indicators and economic events to determine if any may have an impact on the valuations.

Overrides of prices from pricing vendors are rare in the current market environment and with the assets the Company holds. Examples of instances that would cause an override include if the Company recently traded the same security or there is an indication of market activity that would cause the vendor price to be unreliable. In the rare instance where a price is adjusted, the Company has a control process to monitor the reason for such adjustment.





Table of Contents

To gain comfort that vendor prices are representative of current market information, the Company compares the transaction prices of security purchases and sales to the valuation levels provided by the vendors. Price differences exceeding pre-defined tolerance levels are identified and investigated and may be challenged. Trends are monitored over time and if there are indications that the valuations are not comparable to market activity, the vendors are asked to provide detailed information regarding their methodology and inputs. Transparency tools are also available from the vendors which help clients observe data points and/or market inputs used for pricing securities.

In addition, the Company performs due diligence procedures on all vendors on at least an annual basis. A questionnaire is sent to vendors which requests information such as changes in methodologies, business recovery preparedness, internal controls and confirmation that evaluations are generated based on market data. Physical visits are also made to each vendor's office.

As described in Note 11 - "Financial Instruments," the Company evaluates the source used to provide the market price for each security and makes a determination on its categorization within the fair value hierarchy. If the price of a security is obtained from quoted prices for identical instruments in active markets, the security is classified as a level 1 security. If the price of a security is obtained from quoted prices for similar instruments or model-derived valuations whose inputs are observable, the security is classified as a level 2 security. If the inputs appear to be unobservable, the security would be classified as a level 3 security.

Additionally, U.S. GAAP permits entities to choose to measure many financial instruments and certain other items at fair value (the "fair value option"). Unrealized gains and losses on items for which the fair value option has been elected are recognized in earnings at each subsequent reporting date.

The Company elected the fair value option for its investments in unconsolidated ventures. The Company has the one-time option to elect fair value for these financial assets on the election date. The changes in the fair value of these instruments are recorded in equity in earnings and fair value change in unconsolidated ventures in the consolidated statements of operations.

For assets representing available-for-sale investment securities, any change in fair value is reported through consolidated other comprehensive income (loss) with the exception of impairment losses, which are recorded in the consolidated statements of operations.

Securities

The Company designates securities as held-to-maturity, available-for-sale, or trading depending on its ability and intent to hold such securities to maturity. Trading and securities available-for-sale are reported at fair value, while securities held-to-maturity are reported at amortized cost. Although the Company generally intends to hold most of its RMBS and CMBS until maturity, the Company may, from time to time, sell any of its RMBS, GSE CRT or CMBS as part of its overall management of its investment portfolio and therefore classifies its RMBS, GSE CRT and CMBS as available-for-sale securities.

All securities classified as available-for-sale are reported at fair value, based on market prices from third-party sources, with unrealized gains and losses excluded from earnings and reported as a separate component of shareholders' equity.

The Company considers its portfolio of Agency RMBS to be of high credit quality under applicable accounting guidance. For non-Agency RMBS, GSE CRT and CMBS, the Company does not rely on ratings from third party agencies to determine the credit quality of the investment. To determine expected future losses, the Company uses internal models that analyze the individual loans underlying each security and evaluate factors including, but not limited to, delinquency status, loan-to-value ratios, borrower credit scores, occupancy status and geographic concentration to estimate the expected future cash flows. The Company places reliance on this internal model in determining credit quality and the corresponding accounting treatment.

While non-Agency RMBS, GSE CRT and CMBS with expected future losses are generally purchased at a discount to par, the potential for a significant adverse change in expected cash flows remains. The Company therefore considers each security for other-than-temporary impairment at least quarterly and more frequently when economic or market conditions warrant such evaluation.

The determination of whether a security is other-than-temporarily impaired involves judgments and assumptions based on subjective and objective factors. Consideration is given to (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of recovery in fair value of the security, and (iii) the Company's intent and ability to retain its investment in the security for a period of time sufficient to allow for any anticipated recovery in fair value.

Table of Contents

For debt securities, the Company recognizes in earnings and reflects as a reduction in the cost basis of the security the amount of any other-than-temporary impairment related to credit losses or impairments on securities that the Company has the intent to sell or for which it is more likely than not that the Company will need to sell before recoveries. The amount of the other-than-temporary impairment on debt securities related to other factors is recorded consistent with changes in the fair value of all other available-for-sale securities as a component of consolidated shareholders' equity in other comprehensive income or loss with no change to the cost basis of the security.

Residential Loans Held-For-Investment

Loans held-for-investment include securitized residential mortgage loans held by VIEs in which the Company has determined it is the primary beneficiary and which are included in the Company's consolidated balance sheets, and are carried at unpaid principal balance net of any premiums and allowance for loan losses. The Company expects that it will be required to continue to consolidate the VIEs in which such loans are held and generally does not have the authority to sell the residential loans held in the VIEs.

Commercial Loans Held-For-Investment

Commercial loans held-for-investment by the Company are carried at cost, net of any allowance for loan losses. An allowance for loan losses will be recognized only if past and current events indicate it is probable that all amounts due will not be collected according to the terms of the loan agreement.

Interest Income Recognition

Securities

Interest income on available-for-sale MBS, which includes accretion of discounts and amortization of premiums on such MBS, is recognized over the life of the investment using the effective interest method. Management estimates, at the time of purchase, the future expected cash flows and determines the effective interest rate based on these estimated cash flows and the Company's purchase price. As needed, these estimated cash flows are updated and a revised yield is computed based on the current amortized cost of the investment. In estimating these cash flows, there are a number of assumptions that are subject to uncertainties and contingencies, including the rate and timing of principal payments (prepayments, repurchases, defaults and liquidations), the pass through or coupon rate and interest rate fluctuations. In addition, management must use its judgment to estimate interest payment shortfalls due to delinquencies on the underlying mortgage loans. These uncertainties and contingencies are difficult to predict and are subject to future events that may impact management's estimates and its interest income. Security transactions are recorded on the trade date. Realized gains and losses from security transactions are determined based upon the specific identification method and recorded as gain (loss) on sale of investments, net in the consolidated statements of operations.

Residential Loans

Interest income from the Company's residential loans is recognized on an accrual basis with the related premiums being amortized into interest income using the effective interest method over the weighted average life of these loans. In estimating these cash flows, there are a number of assumptions that are subject to estimation, including the interest rate and timing of principal payments (prepayments, repurchases, defaults and liquidations) and other factors. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due, at which point the loan is placed on nonaccrual status. Interest previously accrued for loans that have been placed on non-accrual status is reversed against interest income in the period it becomes nonaccrual. Residential loans delinquent more than 90 days or in foreclosure are characterized as delinquent. Cash principal and interest that is advanced from servicers subsequent to a loan becoming greater than 90 days past due is recorded as a liability due to the servicer. When a delinquent loan previously placed on nonaccrual status has cured, meaning all delinquent principal and interest have been remitted by the borrower, the loan is placed back on accrual status. Alternately, nonaccrual loans may be placed back on accrual status if restructured and after the loan is considered re-performing. A restructured loan is considered re-performing when the loan has been current for at least 12 months.

Commercial Loans

Interest is recognized as revenue when earned and deemed collectible, or until a loan becomes past due based on the terms of the loan agreement, with the related originating fees, net of origination cost, being amortized into interest income using the effective interest method over the life of the loan. Interest received subsequent to a loan becoming

past due or impaired is used to reduce the outstanding loan principal balance. When a delinquent loan previously placed on nonaccrual status has cured, meaning all delinquent principal and interest have been remitted by the borrower, the loan is placed back on accrual status. Alternately, loans that have been individually impaired may be placed back on accrual status if restructured and

## Table of Contents

after the loan is considered re-performing. A restructured loan is considered re-performing when the loan has been current for at least 12 months.

### Allowance for Loan Losses

#### Residential Loans

For residential loans classified as held-for-investment, an allowance for loan losses is established based on the Company's estimate of credit losses. In calculating the allowance for loan losses, the Company assesses expected losses by estimating the probability of default and expected loss severities on the loans. The following factors are considered in the quarterly evaluation of the allowance for loan losses:

• Loan-to-value ratios, property values, credit scores, occupancy status, geographic concentration and other observable data available from third party providers;

• Historical prepayments, default rates and loss severities; and

• Trends in delinquencies, loan liquidations, foreclosure timelines, liquidation expenses, servicer advances of delinquent principal and interest, and other observable data related to the servicing of the loans.

#### Commercial Loans

For commercial loans classified as held-for-investment, the Company establishes a specific allowance for loan losses for loans the Company has determined to be impaired at the reporting date. An individual loan is considered impaired when it is deemed probable that the Company will not be able to collect all amounts due according to the contractual terms of the loan.

The Company's methodology for assessing the adequacy of the allowance for loan losses begins with a quarterly formal review of each commercial loan in the portfolio to determine whether the loan is impaired. The Company generally considers the following factors in evaluating each loan:

• Loan-to-value ratios upon origination or acquisition of the loan;

• The most recent financial information available for each loan and associated properties, including net operating income, debt service coverage ratios, occupancy rates, rent rolls, as well as any other loss factors the Company considers relevant, such as, but not limited to, specific loan trigger events that would indicate an adverse change in expected cash flows or payment delinquency;

• Economic trends, both macroeconomic as well as those directly affecting the properties associated with the loans, and the supply and demand of competing projects in the sub-market in which the subject property is located; and

• The loan sponsor or borrowing entity's ability to ensure that properties associated with the loan are managed and operated sufficiently.

Where an individual commercial loan is deemed to be impaired, the Company records an allowance to reduce the carrying value of the loan to the current present value of expected future cash flows discounted at the loan's effective rate, with a corresponding charge to provision for loan losses on the Company's consolidated statements of operations.

#### Investments in Unconsolidated Ventures

The Company has investments in unconsolidated ventures. In circumstances where the Company has a non-controlling interest but is deemed to be able to exert significant influence over the affairs of the enterprise, the Company utilizes the equity method of accounting. Under the equity method of accounting, the initial investment is increased each period for additional capital contributions and a proportionate share of the entity's earnings and decreased for cash distributions and a proportionate share of the entity's losses.

The Company elected the fair value option for its investments in unconsolidated ventures. The election was made upon initial recognition in the financial statements. The Company has elected the fair value option for the purpose of enhancing the transparency of its financial condition. The Company measures the fair value on the basis of the net asset value per share of the investments.

Table of Contents

Dividends and Distributions Payable

Dividends and distributions payable represent dividends declared at the balance sheet date which are payable to common shareholders and preferred shareholders, and distributions declared at the balance sheet date which are payable to the non-controlling interest common unit holder of the Operating Partnership, respectively.

Earnings (Loss) per Share

The Company calculates basic earnings (loss) per share by dividing net income attributable to common shareholders for the period by weighted-average shares of the Company's common stock outstanding for that period. Diluted earnings per share takes into account the effect of dilutive instruments, such as units of limited partnership interest in the Operating Partnership ("OP Units"), exchangeable debt, and unvested restricted stock, but uses the average share price for the period in determining the number of incremental shares that are to be added to the weighted-average number of shares outstanding.

Comprehensive Income

Comprehensive income is comprised of net income, as presented in the consolidated statements of operations, adjusted for changes in unrealized gains or losses on available for sale securities, changes in the fair value of derivatives accounted for as cash flow hedges and amortization of deferred swap losses resulting from the de-designation of derivatives previously accounted for as cash flow hedges.

Accounting for Derivative Financial Instruments

U.S. GAAP provides disclosure requirements for derivatives and hedging activities with the intent to provide users of financial statements with an enhanced understanding of: (i) how and why an entity uses derivative instruments; (ii) how derivative instruments and related hedged items are accounted for; and (iii) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. U.S. GAAP requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.

The Company records all derivatives on the consolidated balance sheets at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Derivatives may also be designated as hedges of the foreign currency exposure of a net investment in a foreign operation. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into derivative contracts, such as credit default swaps, that are intended to economically hedge certain of its risks, even though hedge accounting does not apply or the Company elects not to apply hedge accounting under U.S. GAAP.

Effective December 31, 2013, the Company voluntarily discontinued hedge accounting for its interest rate swap agreements by de-designating the interest rate swaps as cash flow hedges. No interest rate swaps were terminated in conjunction with this action, and the Company's risk management and hedging practices were not impacted. However, the Company's accounting for these transactions will change prospectively. All of the Company's interest rate swaps had previously been accounted for as cash flow hedges under the applicable guidance. As a result of discontinuing hedge accounting, beginning January 1, 2014, changes in the fair value of the interest rate swap agreements are recorded in gain (loss) on interest rate derivative instruments, net in the Company's consolidated statements of operations, rather than in accumulated other comprehensive income (loss) ("AOCI"). Also, net interest paid or received under the interest rate swaps, which up through December 31, 2013 was recognized in interest expense, is now recognized in gain (loss) on interest rate derivative instruments, net on the Company's consolidated statements of

operations. The interest rate swaps continue to be reported as assets or liabilities on the Company's consolidated balance sheets at their fair value.

As long as the forecasted transactions that were being hedged (i.e., rollovers of the Company's repurchase agreement borrowings) are still expected to occur, the balance in AOCI from the interest rate swap activity up through December 31, 2013 will remain in AOCI and be recognized in the Company's consolidated statements of operations as interest expense over the remaining term of the interest rate swaps. Refer to Note 9 - "Derivatives and Hedging Activities" for further information.

## Table of Contents

The Company evaluates the terms and conditions of its holdings of swaptions, futures contracts and to-be-announced ("TBA") securities to determine if an instrument has the characteristics of an investment or should be considered a derivative under U.S. GAAP. Accordingly swaptions, futures contracts and TBAs having the characteristics of derivatives are accounted for at fair value with such changes recognized in gain (loss) on derivative instruments, net in the consolidated statements of operations. The fair value of these swaptions, futures contracts and TBAs is included in derivative asset or derivative liability on the consolidated balance sheets.

### Income Taxes

The Company elected to be taxed as a REIT, commencing with the Company's taxable year ended December 31, 2009. Accordingly, the Company will generally not be subject to U.S. federal and applicable state and local corporate income tax to the extent that the Company makes qualifying distributions to its common shareholders, and provided the Company satisfies on a continuing basis, through actual investment and operating results, the REIT requirements including certain asset, income, distribution and stock ownership tests. If the Company fails to qualify as a REIT, and does not qualify for certain statutory relief provisions, it will be subject to U.S. federal, state and local income taxes and may be precluded from qualifying as a REIT for the subsequent four taxable years following the year in which the Company lost its REIT qualification. Accordingly, the Company's failure to qualify as a REIT could have a material adverse impact on its results of operations and amounts available for distribution to its shareholders.

A REIT's dividend paid deduction for qualifying dividends to the Company's shareholders is computed using its taxable income as opposed to net income reported on the consolidated financial statements. Taxable income, generally, will differ from net income because the determination of taxable income is based on tax regulations and not financial accounting principles.

The Company may elect to treat certain of its future subsidiaries as taxable REIT subsidiaries ("TRS"). In general, a TRS may hold assets and engage in activities that the Company cannot hold or engage in directly and generally may engage in any real estate or non-real estate-related business. A TRS is subject to U.S. federal, state and local corporate income taxes.

If a TRS generates net income, the TRS can declare dividends to the Company which will be included in its taxable income and necessitate a distribution to its shareholders. Conversely, if the Company retains earnings at a TRS level, no distribution is required and the Company can increase book equity of the consolidated entity. The Company has no adjustments regarding its tax accounting treatment of any uncertainties. The Company expects to recognize interest and penalties related to uncertain tax positions, if any, as income tax expense, which will be included in general and administrative expense.

### Share-Based Compensation

The Company has adopted an equity incentive plan under which its independent directors, as part of their compensation for serving as directors, are eligible to receive quarterly stock awards. In addition, the Company may compensate the officers and employees of the Manager and its affiliates under this plan pursuant to the management agreement.

Share-based compensation arrangements include share options, restricted share awards, performance-based awards, share appreciation rights, and employee share purchase plans. Compensation costs relating to share-based payment transactions are recognized in the consolidated financial statements, based on the fair value of the equity or liability instruments issued on the date of grant, for awards to the Company's independent directors. Compensation related to stock awards to officers and employees of the Manager and its affiliates is recorded at the estimated fair value of the award during the vesting period. The Company makes an upward or downward adjustment to compensation expense for the difference in the fair value at the date of grant and the date the award is earned.

### Dividend Reinvestment and Stock Purchase Plan

The Company has implemented a dividend reinvestment and stock purchase plan (the "DRSPP"). Under the terms of the DRSPP, shareholders who participate in the DRSPP may purchase shares of common stock directly from the Company. DRSPP participants may also automatically reinvest all or a portion of their dividends for additional shares of common stock.

### Reclassifications



The presentation of certain prior period reported amounts has been reclassified to be consistent with the current presentation. Such reclassifications had no impact on net income or equity attributable to common shareholders.

Recent Accounting Pronouncements

None

Table of Contents

## Recent Accounting Pronouncements Not Yet Adopted

In April 2014, the Financial Accounting Standards Board issued updated guidance that changes the requirements for reporting discontinued operations. Under the new guidance, a discontinued operation is defined as a component of an entity or group of components of an entity that is disposed of or is classified as held for sale and represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results. The guidance is effective for annual periods beginning on or after December 15, 2014 and interim periods within annual periods beginning on or after December 15, 2015. Early adoption is permitted but only for disposals (or classifications as held for sale) that have not been reported in financial statements previously issued or available for issue. The new guidance is not expected to have a material impact on the Company's consolidated financial statements.

In June 2014, the Financial Accounting Standards Board issued guidance that changes the accounting for repurchase-to-maturity transactions and repurchase financing arrangements. The new guidance aligns the accounting for repurchase-to-maturity transactions and repurchase agreements executed as a repurchase financing with the accounting for other typical repurchase agreements. These transactions would all be accounted for as secured borrowings. The guidance eliminates sale accounting for repurchase-to-maturity transactions and supersedes the guidance under which a transfer of a financial asset and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward agreement, which has resulted in outcomes referred to as off-balance-sheet accounting. In addition, the guidance requires additional disclosures. The guidance is effective for the first interim or annual period beginning after December 15, 2014. Earlier application for a public company is prohibited. The new guidance is not expected to have a material impact on the Company's consolidated financial statements.

## Note 3 – Variable Interest Entities

During the three months ended June 30, 2014, the Company purchased and consolidated a controlling interest in a securitization trust. The following table presents a summary of the assets and liabilities of the VIEs as of June 30, 2014 and December 31, 2013. Intercompany balances have been eliminated for purposes of this presentation.

\$ in thousands	June 30, 2014	December 31, 2013
Residential loans, held-for-investment	2,310,686	1,810,262
Accrued interest receivable	7,416	5,647
Deferred costs	3,991	3,386
Total assets	2,322,093	1,819,295
Accrued interest and accrued expenses payable	6,025	4,659
Asset-backed securities	2,016,923	1,643,741
Total liabilities	2,022,948	1,648,400

The Company is not contractually required and has not provided any additional financial support to the VIEs for the period ended June 30, 2014. Refer to Note 8 - "Borrowings" for additional details on the ABS.

On June 13, 2014, the Company committed to purchase securities of a securitization trust to be issued in August 2014. The newly formed securitization is expected to issue a series of ABS having an aggregate original principal amount of approximately \$401.3 million, of which the Company intends to retain approximately \$30.1 million. The Company's preliminary assessment is that it is the primary beneficiary and will consolidate the securitized trust upon the completion of the transaction. As of June 30, 2014, the Company has recorded the purchase and sale of the MBS as an unsettled trade, presented in investment related payable and investment related receivable on the consolidated balance sheets, respectively, with the resulting net MBS included in Mortgage-backed securities on the consolidated balance sheets.

The Company also purchases interests in securitization trusts, for which the Company has determined it is not the primary beneficiary. These investments are accounted for as available-for-sale MBS as described in Note 2 - "Summary of Significant Accounting Policies." As of June 30, 2014 and December 31, 2013, the carrying amount of the investment in the VIEs for which we are not considered the primary beneficiary was \$62.6 million and \$155.4

million, respectively. The Company's maximum exposure to loss on these investments is limited to the amount of its investment. Refer to Note 4 - "Mortgage-Backed Securities" for additional details regarding the carrying amounts and classifications of these investments.

Note 4 – Mortgage-Backed Securities

All of the Company's MBS are classified as available-for-sale and, as such, are reported at fair value, which is determined by obtaining valuations from an independent source. If the fair value of a security is not available from a third-party pricing service, or such data appears unreliable, the Company may estimate the fair value of the security using a variety of

Table of Contents

methods including other pricing services, repurchase agreement pricing, discounted cash flow analysis, matrix pricing, option adjusted spread models and other fundamental analysis of observable market factors.

The following tables present certain information about the Company's MBS portfolio as of June 30, 2014 and December 31, 2013.

June 30, 2014

\$ in thousands	Principal Balance	Unamortized Premium (Discount)	Amortized Cost	Unrealized Gain/(Loss), net	Fair Value	Net Weighted Average Coupon (1)	Period-end Weighted Average Yield (2)	Quarterly Weighted Average Yield (3)
Agency RMBS:								
15 year fixed-rate	1,395,263	69,737	1,465,000	30,999	1,495,999	4.04	% 2.60	% 2.57
30 year fixed-rate	5,848,240	394,803	6,243,043	(3,048)	6,239,995	4.17	% 3.01	% 3.03
ARM	545,715	9,431	555,146	6,138	561,284	2.86	% 2.55	% 2.29
Hybrid ARM	2,555,585	37,078	2,592,663	20,674	2,613,337	2.79	% 2.52	% 2.23
Total Agency pass-through	10,344,803	511,049	10,855,852	54,763	10,910,615	3.74	% 2.81	% 2.75
Agency-CMO <sup>(4)</sup>	1,789,639	(1,270,882)	518,757	(8,322)	510,435	2.57	% 4.46	% 3.42
Non-Agency RMBS <sup>(5)(6)(7)</sup>	3,816,728	(632,014)	3,184,714	97,811	3,282,525	3.63	% 4.14	% 4.70
GSE CRT <sup>(8)</sup>	431,000	28,798	459,798	46,837	506,635	5.17	% 4.07	% 4.04
CMBS <sup>(9)</sup>	4,928,396	(2,023,533)	2,904,863	132,716	3,037,579	3.52	% 4.56	% 4.54
Total	21,310,566	(3,386,582)	17,923,984	323,805	18,247,789	3.60	% 3.41	% 3.36

(1) Net weighted average coupon ("WAC") as of June 30, 2014 is presented net of servicing and other fees.

(2) Period-end weighted average yield is based on amortized cost as of June 30, 2014 and incorporates future prepayment and loss assumptions.

Quarterly weighted average portfolio yield for the period was calculated by dividing interest income, including amortization of premiums and discounts, by the Company's average of the amortized cost of the investments. All yields are annualized.

(4) Included in Agency-CMO are interest-only securities, which represent 23.6% of the balance based on fair value.

(5) Included in non-Agency RMBS are securities of \$26.0 million for a future securitization not yet settled.

(6) Non-Agency RMBS held by the Company is 63.4% variable rate, 30.9% fixed rate, and 5.7% floating rate based on fair value (excluding securities for a future securitization not yet settled).

(7) Of the total discount in non-Agency RMBS, \$390.5 million is non-accretable.

GSE CRT are general obligations of Fannie Mae or Freddie Mac that are structured to provide credit protection to the GSE issuer with respect to defaults and other credit events within reference pools of residential mortgage loans that collateralize MBS issued and guaranteed by such GSE.

(9) Included in the CMBS are interest-only securities and commercial real estate mezzanine loan pass-through certificates which represent 6.2% and 1.5% of the balance based on fair value, respectively.

Table of Contents

December 31, 2013

\$ in thousands	Principal Balance	Unamortized Premium (Discount)	Amortized Cost	Unrealized Gain/(Loss), net	Fair Value	Net Weighted Average Coupon (1)	Period-end Weighted Average Yield (2)	Quarterly Weighted Average Yield (3)
Agency RMBS:								
15 year fixed-rate	1,637,988	83,799	1,721,787	22,494	1,744,281	4.02	% 2.54	% 2.61
30 year fixed-rate	6,494,723	435,680	6,930,403	(228,250)	6,702,153	4.11	% 2.96	% 3.13
ARM	251,693	992	252,685	597	253,282	2.80	% 2.62	% 2.41
Hybrid ARM	1,764,472	9,470	1,773,942	(3,384)	1,770,558	2.69	% 2.46	% 2.06
Total Agency pass-through	10,148,876	529,941	10,678,817	(208,543)	10,470,274	3.82	% 2.80	% 2.90
Agency-CMO <sup>(4)</sup>	1,532,474	(1,051,777)	480,697	(6,183)	474,514	2.76	% 3.82	% 3.47
Non-Agency RMBS <sup>(5)(6)</sup>	4,217,230	(640,797)	3,576,433	30,895	3,607,328	3.72	% 2.80	% 4.63
GSE CRT	144,500	22,163	166,663	1,318	167,981	7.13	% 5.17	% 5.85
CMBS <sup>(7)</sup>	4,630,363	(2,032,945)	2,597,418	31,142	2,628,560	3.38	% 4.62	% 4.51
Total	20,673,443	(3,173,415)	17,500,028	(151,371)	17,348,657	3.63	% 3.30	% 3.51

(1) Net WAC as of December 31, 2013 is presented net of servicing and other fees.

(2) Period-end weighted average yield based on amortized cost as of December 31, 2013 incorporates future prepayment and loss assumptions.

(3) Quarterly weighted average portfolio yield for the period was calculated by dividing interest income, including amortization of premiums and discounts, by the Company's average of the amortized cost of the investments. All yields are annualized.

(4) Included in Agency-CMO are interest-only securities, which represent 25.0% of the balance based on fair value.

(5) Non-Agency RMBS held by the Company is 61.1% variable rate, 33.9% fixed rate, and 5.0% floating rate based on fair value.

(6) Of the total discount in non-Agency RMBS, \$438.1 million is non-accretable.

(7) Included in the CMBS are interest-only securities and commercial real estate mezzanine loan pass-through certificates which represent 7.5% and 1.0% of the balance based on fair value, respectively.

The following table summarizes the Company's non-Agency RMBS portfolio by asset type as of June 30, 2014 and December 31, 2013, respectively:

\$ in thousands	June 30, 2014	% of Non-Agency	December 31, 2013	% of Non-Agency
Re-REMIC	1,295,129	39.7	% 1,444,376	40.0
Prime	1,138,352	35.1	% 1,336,821	37.1
Alt-A	802,754	24.6	% 801,919	22.2
Subprime	20,240	0.6	% 24,212	0.7
Total Non-Agency <sup>(1)</sup>	3,256,475	100.0	% 3,607,328	100.0

(1) Excluded from non-Agency RMBS are securities of \$26.0 million for a future securitization not yet settled.

Table of Contents

The following table summarizes certain characteristics of the Company's re-securitization of real estate mortgage investment conduit ("Re-REMIC") holdings as of June 30, 2014 and December 31, 2013:

Re-REMIC Subordination <sup>(1)</sup>	Percentage of Re-REMIC Holdings at Fair Value			
	June 30, 2014		December 31, 2013	
0-10	5.4	%	4.8	%
10-20	3.7	%	3.5	%
20-30	15.1	%	14.7	%
30-40	25.3	%	25.2	%
40-50	36.5	%	38.6	%
50-60	9.3	%	8.5	%
60-70	4.7	%	4.7	%
Total	100.0	%	100.0	%

Subordination refers to the credit enhancement provided to the Re-REMIC tranche by any junior Re-REMIC tranche or tranches in a resecuritization. This figure reflects the percentage of the balance of the underlying (1) security represented by any junior tranche or tranches at the time of resecuritization. Generally, principal losses on the underlying security in excess of the subordination amount would result in principal losses on the Re-REMIC tranche.

The components of the carrying value of the Company's MBS portfolio at June 30, 2014 and December 31, 2013 are presented below:

\$ in thousands	June 30, 2014	December 31, 2013
Principal balance	21,310,566	20,673,443
Unamortized premium	641,091	646,189
Unamortized discount	(4,027,673	) (3,819,604
Gross unrealized gains	493,772	291,725
Gross unrealized losses	(169,967	) (443,096
Fair value	18,247,789	17,348,657

The following table summarizes certain characteristics of the Company's investment portfolio, at fair value, according to estimated weighted average life classifications as of June 30, 2014 and December 31, 2013:

\$ in thousands	June 30, 2014	December 31, 2013
Less than one year	245,994	101,251
Greater than one year and less than five years	7,620,772	5,958,852
Greater than or equal to five years	10,381,023	11,288,554
Total	18,247,789	17,348,657

Table of Contents

The following tables present the estimated fair value, the gross unrealized losses and the number of securities of the Company's MBS by length of time that such securities have been in a continuous unrealized loss position at June 30, 2014 and December 31, 2013, respectively:

June 30, 2014

\$ in thousands	Less than 12 Months			12 Months or More			Total		
	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities
Agency RMBS:									
15 year fixed-rate	1,010	(4 )	1	125,311	(1,873 )	7	126,321	(1,877 )	8
30 year fixed-rate	23,639	(47 )	2	3,133,497	(114,344 )	101	3,157,136	(114,391 )	103
ARM	24,699	(89 )	1	13,671	(67 )	2	38,370	(156 )	3
Hybrid ARM	337,694	(1,013 )	19	28,686	(278 )	2	366,380	(1,291 )	21
Total Agency pass-through	387,042	(1,153 )	23	3,301,165	(116,562 )	112	3,688,207	(117,715 )	135
Agency-CMO	309,450	(14,490 )	22	76,203	(5,762 )	5	385,653	(20,252 )	27
Non-Agency RMBS	262,404	(3,940 )	30	489,584	(18,939 )	30	751,988	(22,879 )	60
GSE CRT	76,750	(228 )	2	—	—	—	76,750	(228 )	2
CMBS	141,482	(1,562 )	13	481,510	(7,331 )	36	622,992	(8,893 )	49
Total	1,177,128	(21,373 )	90	4,348,462	(148,594 )	183	5,525,590	(169,967 )	273

December 31, 2013

\$ in thousands	Less than 12 Months			12 Months or More			Total		
	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities
Agency RMBS:									
15 year fixed-rate	431,527	(4,964 )	18	11,100	(259 )	1	442,627	(5,223 )	19
30 year fixed-rate	3,710,679	(228,167 )	126	641,259	(56,754 )	27	4,351,938	(284,921 )	153
ARM	94,447	(968 )	7	—	—	—	94,447	(968 )	7
Hybrid ARM	1,129,488	(9,715 )	48	—	—	—	1,129,488	(9,715 )	48
Total Agency pass-through	5,366,141	(243,814 )	199	652,359	(57,013 )	28	6,018,500	(300,827 )	227
Agency-CMO	311,935	(16,599 )	13	8,883	(3,736 )	4	320,818	(20,335 )	17
Non-Agency RMBS	1,307,036	(58,326 )	76	91,651	(1,726 )	8	1,398,687	(60,052 )	84
GSE CRT	—	—	—	—	—	—	—	—	—
CMBS	1,118,270	(61,882 )	84	—	—	—	1,118,270	(61,882 )	84
Total	8,103,382	(380,621 )	372	752,893	(62,475 )	40	8,856,275	(443,096 )	412

Gross unrealized losses on the Company's Agency RMBS were \$117.7 million at June 30, 2014. Due to the inherent credit quality of Agency RMBS, the Company determined that at June 30, 2014, any unrealized losses on its Agency RMBS portfolio are temporary.

Gross unrealized losses on the Company's MBS-CMO, non-Agency RMBS, GSE CRT and CMBS were \$52.3 million at June 30, 2014. The Company does not consider these unrealized losses to be credit related, but rather due to non-credit related factors such as interest rate spreads, prepayment speeds, and market fluctuations. These investment securities are included in the Company's assessment for other-than-temporary impairment on at least a quarterly basis.



Table of Contents

The following table presents the impact of the Company's MBS on its accumulated other comprehensive income for the three and six months ended June 30, 2014 and 2013.

\$ in thousands	Three Months ended June 30, 2014	Three Months ended June 30, 2013	Six Months ended June 30, 2014	Six Months ended June 30, 2013
Accumulated other comprehensive income from investment securities:				
Unrealized gain (loss) on MBS at beginning of period	29,817	453,590	(151,368 )	523,725
Unrealized gain (loss) on MBS, net	293,988	(710,992 )	475,173	(781,127 )
Balance at the end of period	323,805	(257,402 )	323,805	(257,402 )

During the three months ended June 30, 2014 and 2013, the Company reclassified \$20.8 million of net unrealized losses and \$5.7 million of net unrealized gains, respectively, from other comprehensive income into gain (loss) on sale of investments as a result of the Company selling certain investments.

During the six months ended June 30, 2014 and 2013, the Company reclassified \$32.5 million of net unrealized losses and \$12.4 million of net unrealized gains, respectively, from other comprehensive income into gain (loss) on sale of investments as a result of the Company selling certain investments.

The Company assesses its investment securities for other-than-temporary impairment on at least a quarterly basis and more frequently when economic or market conditions warrant such evaluation. When the fair value of an investment is less than its amortized cost at the balance sheet date of the reporting period for which impairment is assessed, the impairment is designated as either "temporary" or "other-than-temporary." The Company evaluates each security that has had a fair value less than amortized cost for three or more consecutive months for other-than-temporary impairment. This analysis includes evaluating the individual loans in each security to determine estimated future cash flows. Individual loan characteristics reviewed include, but are not limited to, delinquency status, loan-to-value ratios, borrower credit scores, occupancy status and geographic concentration. To the extent a security is deemed impaired, the amount by which the amortized cost exceeds the security's market value would be considered other-than-temporary impairment.

The Company did not have other-than-temporary impairments for the three and six months ended June 30, 2014 and 2013.

The following table presents components of interest income on the Company's MBS portfolio for the three and six months ended June 30, 2014 and 2013.

For the three months ended June 30, 2014

\$ in thousands	Coupon Interest	Net (Premium Amortization)/Discount Accretion	Interest Income
Agency	105,094	(27,064 )	78,030
Non-Agency	34,917	3,733	38,650
GSE CRT	4,993	(1,361 )	3,632
CMBS	41,514	(9,901 )	31,613
Other	(5 )	— )	(5 )
Total	186,513	(34,593 )	151,920

Table of Contents

For the three months ended June 30, 2013

\$ in thousands	Coupon Interest	Net (Premium Amortization)/Discount Accretion	Interest Income
Agency	142,846	(46,956 )	95,890
Non-Agency	41,325	2,001	43,326
GSE CRT	—	—	—
CMBS	35,670	(6,252 )	29,418
Other	102	—	102
Total	219,943	(51,207 )	168,736

For the six months ended June 30, 2014

\$ in thousands	Coupon Interest	Net (Premium Amortization)/Discount Accretion	Interest Income
Agency	210,577	(50,728 )	159,849
Non-Agency	70,472	4,668	75,140
GSE CRT	9,369	(1,361 )	8,008
CMBS	80,126	(19,562 )	60,564
Other	98	—	98
Total	370,642	(66,983 )	303,659

For the six months ended June 30, 2013

\$ in thousands	Coupon Interest	Net (Premium Amortization)/Discount Accretion	Interest Income
Agency	286,259	(92,069 )	194,190
Non-Agency	77,737	3,142	80,879
GSE CRT	—	—	—
CMBS	62,320	(8,452 )	53,868
Other	143	—	143
Total	426,459	(97,379 )	329,080

## Note 5 – Residential Loans Held-for-Investment

Residential loans held-for-investment includes residential mortgage loans which are secured by a lien on the residential property. The following table details the carrying value for residential loans held-for-investment at June 30, 2014 and December 31, 2013. These loans are held by the seven VIEs, which the Company consolidates.

\$ in thousands	June 30, 2014	December 31, 2013
Principal balance	2,287,914	1,783,983
Unamortized premium (discount), net	23,813	27,163
Recorded investment	2,311,727	1,811,146
Allowance for loan losses	(1,041 )	(884 )
Carrying value	2,310,686	1,810,262

The Company considers a number of factors when evaluating the credit risks associated with its residential loans held-for-investment portfolio, including but not limited to year of origination, delinquency status, historical losses, geographic concentration and existing economic conditions.



Table of Contents

The following table displays certain characteristics of the Company's residential loans held-for-investment at June 30, 2014 by year of origination.

\$ in thousands	2014	2013	2012	2009	2008	Total
Portfolio Characteristics:						
Number of Loans <sup>(1)</sup>	25	2,372	602	6	3	3,008
Current Principal Balance	17,392	1,768,805	497,726	1,929	2,062	2,287,914
Net Weighted Average Coupon Rate	4.82	% 3.63	% 3.51	% 3.84	% 6.14	% 3.61
Weighted Average Maturity (years)	28.78	28.91	28.53	24.96	24.16	28.82
Current Performance:						
Current	17,392	1,768,805	496,436	1,929	2,062	2,286,624
30 Day Delinquent	—	—	1,290	—	—	1,290
60 Days Delinquent	—	—	—	—	—	—
90+ Days Delinquent	—	—	—	—	—	—
Bankruptcy/Foreclosure	—	—	—	—	—	—
Total	17,392	1,768,805	497,726	1,929	2,062	2,287,914

(1) None for 2011 and 2010

The following table presents the five largest geographic concentrations of the Company's residential loans held-for-investment at June 30, 2014 based on principal balance outstanding:

State	Percent
California	49.8
Illinois	5.5
Massachusetts	4.4
Maryland	3.9
New York	3.8
Other states (none greater than 4%)	32.6
Total	100.0

The following table presents future minimum annual principal payments under the residential loans held-for-investment at June 30, 2014:

\$ in thousands	June 30, 2014
Scheduled Principal	43,190
Within one year	91,573
One to three years	98,959
Three to five years	2,054,192
Greater than or equal to five years	2,287,914
Total	

Table of Contents

## Allowance for Loan Losses on Residential Loans

For residential loans held-for-investment, the Company establishes an allowance for loan losses. The following table summarizes the activity in the allowance for loan losses for the six months ended June 30, 2014:

\$ in thousands	June 30, 2014
Balance at beginning of period	(884 )
Charge-offs, net	—
Provision for loan losses	(157 )
Balance at end of period	(1,041 )

During the quarter ended June 30, 2014 there were no charge-offs of residential loans.

## Note 6 – Commercial Loans Held-for-Investment

Commercial loans held-for-investment include mezzanine loans, first mortgage loans and preferred equity investments purchased or originated by the Company.

As of June 30, 2014, the Company had five commercial loans outstanding which were purchased or originated by the Company (one was originated in 2014) and were not delinquent on payment. Included in the five commercial loans are mezzanine loans with an outstanding carrying value of \$52.7 million, inclusive of unamortized fees of \$89,000, one first mortgage loan with a carrying value of \$19.9 million inclusive of unamortized costs of \$64,000 and one preferred equity investment with a carrying value of \$23.0 million. As of June 30, 2014, the Company had unfunded commitments on the mezzanine loans and first mortgage loan of \$7.2 million and \$1.8 million, respectively. These loans were not impaired and no allowance for loan loss has been recorded.

The Company evaluates the credit quality indicators for the mezzanine, first mortgage loans and preferred equity investments on a quarterly basis. Credit quality indicators for the first mortgage loan includes net operating income, debt service coverage ratios and debt yield. Credit quality indicators for the mezzanine loans and preferred equity investments include net operating income, net cash flow, loan-to-value ratio and debt yield.

## Note 7 – Investments in Unconsolidated Ventures

The Company's non-controlling, unconsolidated ownership interests in these entities are accounted for under the equity method. Capital contributions, distributions, profits and losses of the entities are allocated in accordance with the terms of the entities' operating agreements. Such allocations may differ from the stated percentage interests, if any, as a result of preferred returns and allocation formulas as described in such agreements. The Company has made the fair value election for its investments in all unconsolidated ventures. The fair value measurement for the investments in unconsolidated ventures is based on the net asset value per share of the investment, or its equivalent.

Invesco Mortgage Recovery Feeder Fund, L.P. and Invesco Mortgage Recovery Loans AIV, L.P.

The Company invested in certain non-Agency RMBS, CMBS and residential and commercial mortgage loans by contributing equity capital to the Invesco Mortgage Recovery Feeder Fund L.P. managed by the Company's Manager ("Invesco IMRF Fund"). In addition, the Manager identified a whole loan transaction for the Company, which resulted in the Company's admission into an alternative investment vehicle, the Invesco Mortgage Recovery Loans AIV, L.P. ("AIV Fund"). The Company has a commitment to invest up to \$100.0 million in the Invesco IMRF Fund and AIV Fund. As of June 30, 2014, \$94.6 million of the Company's commitment has been called. On December 31, 2013, the investment period ended. The Company is committed to fund \$5.4 million in additional capital to cover future expenses should they occur. The Company realized approximately \$1.9 million (2013: \$561,000) and \$2.1 million (2013: \$906,000) of equity in earnings for the three and six months ended June 30, 2014, respectively, related to these investments. The Company also had \$1.3 million of unrealized gain (2013: \$1.3 million gain) and \$1.4 million of unrealized gain (2013: \$1.5 million gain) from these investments for the three and six months ended June 30, 2014, respectively.

## IMRF Loan Portfolio Member LLC

In September 2011, the Company invested in a portfolio of commercial mortgage loans by contributing \$16.9 million, net of distributions, of equity capital to IMRF Loan Portfolio Member LLC ("IMRF LLC"), a limited liability company

managed by AIV Fund. The Company has fully funded its commitment to IMRF LLC. The Company realized a gain of approximately \$1.6 million (2013: \$197,000 gain) and \$1.7 million (2013: \$92,000 gain) of equity in earnings for the three and six months ended June 30, 2014, respectively. The Company also had \$959,000 of unrealized loss (2013: \$84,000 gain) and \$919,000 of

Table of Contents

unrealized loss (2013: \$1.3 million gain) from these investments for the three and six months ended June 30, 2014, respectively.

## Note 8 – Borrowings

The Company has entered into repurchase agreements, secured loans and issued exchangeable senior notes to finance the majority of its portfolio of investments. The following table summarizes certain characteristics of the Company's borrowings at June 30, 2014 and December 31, 2013:

\$ in thousands	June 30, 2014			December 31, 2013		
	Amount Outstanding	Weighted Average Interest Rate	Weighted Average Remaining Maturity (days)	Amount Outstanding	Weighted Average Interest Rate	Weighted Average Remaining Maturity (days)
Repurchase Agreements:						
Agency RMBS	10,031,609	0.32	% 20	10,281,154	0.38	% 19
Non-Agency RMBS	2,711,799	1.54	% 30	3,066,356	1.55	% 33
GSE CRT	347,447	1.56	% 41	21,708	1.50	% 42
CMBS	1,632,368	1.37	% 22	2,082,457	1.39	% 23
Secured Loans	625,000	0.25	% 101	—	—	% 0
Exchangeable Senior Notes	400,000	5.00	% 1,354	400,000	5.00	% 1,535
Total	15,748,223	0.78	% 59	15,851,675	0.86	% 60

## Repurchase Agreements

The repurchase agreements bear interest at a contractually agreed rate. The repurchase obligations mature and typically reinvest every thirty days to one year. Repurchase agreements are being accounted for as secured borrowings since the Company maintains effective control of the financed assets. Under the repurchase agreements, the respective lender retains the right to mark the underlying collateral to fair value. A reduction in the value of pledged assets would require the Company to provide additional collateral or fund margin calls. In addition, the repurchase agreements are subject to certain financial covenants. The Company was in compliance with these covenants at June 30, 2014.

Table of Contents

The following tables summarize certain characteristics of the Company's repurchase agreements at June 30, 2014 and December 31, 2013:

June 30, 2014

\$ in thousands	Amount Outstanding	Percent of Total Amount Outstanding	Company MBS Held as Collateral	
Repurchase Agreement Counterparties				(1 )
Credit Suisse Securities (USA) LLC	1,635,598	11.0	% 2,045,230	
South Street Securities LLC	1,058,257	7.2	% 1,113,213	
Banc of America Securities LLC	951,719	6.5	% 1,038,176	
Citigroup Global Markets Inc.	903,037	6.1	% 1,049,651	
Wells Fargo Securities, LLC	888,022	6.0	% 1,060,729	
HSBC Securities (USA) Inc	811,137	5.5	% 836,622	
JP Morgan Securities Inc.	758,758	5.2	% 876,577	
Pierpont Securities LLC	696,734	4.7	% 725,832	
ING Financial Market LLC	680,130	4.6	% 723,067	
Industrial and Commercial Bank of China Financial Services LLC	668,172	4.5	% 703,348	
Mitsubishi UFJ Securities (USA), Inc.	663,555	4.5	% 698,836	
Royal Bank of Canada	645,074	4.4	% 778,212	
Morgan Stanley & Co. Incorporated	644,052	4.4	% 698,930	
Scotia Capital	606,928	4.1	% 635,314	
RBS Securities Inc.	585,658	4.0	% 712,227	
BNP Paribas Securities Corp.	533,500	3.6	% 595,846	
Nomura Securities International, Inc.	449,541	3.1	% 475,390	
Deutsche Bank Securities Inc.	413,703	2.8	% 467,375	
KGS-Alpha Capital Markets, L.P.	308,908	2.1	% 326,124	
Goldman, Sachs & Co.	229,246	1.6	% 244,063	
Guggenheim Liquidity Services, LLC	130,533	0.9	% 138,522	
Barclays Capital Inc.	116,827	0.8	% 138,148	
Cantor Fitzgerald & Co.	111,921	0.8	% 119,656	
Daiwa Capital Markets America Inc	105,476	0.7	% 111,207	
TD Securities	68,146	0.5	% 72,467	
Mizuho Securities USA Inc.	58,591	0.4	% 70,720	
Total	14,723,223	100.0	% 16,455,482	

(1) Includes \$268.8 million of MBS held as collateral which are eliminated in consolidation.



Table of Contents

December 31, 2013

\$ in thousands	Amount	Percent of Total	Company	
Repurchase Agreement Counterparties	Outstanding	Amount	MBS Held as	
		Outstanding	Collateral	(1)
Credit Suisse Securities (USA) LLC	1,809,896	11.8	% 2,203,883	
South Street Securities LLC	1,236,812	8.0	% 1,286,384	
Banc of America Securities LLC	1,043,689	6.8	% 1,146,151	
Citigroup Global Markets Inc.	1,027,210	6.6	% 1,164,162	
JP Morgan Securities Inc.	875,201	5.7	% 1,001,116	
Wells Fargo Securities, LLC	857,824	5.6	% 996,151	
Pierpont Securities LLC	791,572	5.1	% 824,184	
HSBC Securities (USA) Inc.	787,462	5.1	% 809,230	
RBS Securities Inc.	720,457	4.7	% 854,978	
Royal Bank of Canada	710,705	4.6	% 850,870	
Morgan Stanley & Co. Incorporated	691,599	4.5	% 758,761	
ING Financial Market LLC	676,644	4.4	% 718,086	
Mitsubishi UFJ Securities (USA), Inc.	625,703	4.0	% 656,046	
Nomura Securities International, Inc.	578,265	3.7	% 608,193	
Industrial and Commercial Bank of China Financial Services LLC	493,906	3.2	% 518,775	
BNP Paribas Securities Corp.	471,372	3.1	% 499,106	
Scotia Capital	443,534	2.9	% 461,066	
Deutsche Bank Securities Inc.	423,405	2.7	% 468,939	
Goldman, Sachs & Co.	404,094	2.6	% 423,598	
KGS-Alpha Capital Markets, L.P.	202,677	1.3	% 214,033	
Barclays Capital Inc.	156,904	1.0	% 165,605	
TD Securities	155,099	1.0	% 163,512	
Daiwa Capital Markets America Inc.	112,309	0.7	% 117,551	
Cantor Fitzgerald & Co.	68,261	0.4	% 71,910	
Mizuho Securities USA Inc.	53,962	0.3	% 62,423	
Guggenheim Liquidity Services, LLC	33,113	0.2	% 34,664	
Total	15,451,675	100.0	% 17,079,377	

(1) Includes \$133.8 million of MBS held as collateral which are eliminated in consolidation.

Company MBS held by counterparties as security for repurchase agreements was \$16.5 billion and \$17.1 billion at June 30, 2014 and December 31, 2013, respectively. This represents a collateral ratio (Company MBS Held as Collateral/Amount Outstanding) of 112% and 111% for June 30, 2014 and December 31, 2013, respectively.

No cash collateral was held by the counterparties at June 30, 2014 and December 31, 2013.

**Secured Loans**

In March 2014, the Company's wholly-owned subsidiary, IAS Services LLC, became a member of the FHLBI. As a member of the FHLBI, IAS Services LLC may borrow funds from the FHLBI in the form of secured loans.

As of June 30, 2014, IAS Services LLC had \$625.0 million in outstanding secured loans from the FHLBI and access to an additional \$625.0 million of available uncommitted credit for borrowings which amount may be adjusted at the sole discretion of the FHLBI.

For the three and six months ended June 30, 2014, IAS Services LLC had average borrowings of \$318.5 million and \$160.1 million with a weighted average borrowing rate of 0.22% and 0.22%, respectively.



Table of Contents

The ability to borrow from the FHLBI is subject to the Company's continued creditworthiness, pledging of sufficient eligible collateral to secure advances, and compliance with certain agreements with the FHLBI. Each secured loan or advance will require approval by the FHLBI and will be secured by collateral in accordance with the FHLBI's credit and collateral guidelines, as may be revised from time-to-time by the FHLBI.

As of June 30, 2014, IAS Services LLC's FHLBI advances had the following remaining maturities:

\$ in thousands	June 30, 2014
≤ 30 days	—
> 30 days and ≤ 90 days	215,000
> 90 days (1)	410,000
Total	625,000

(1) Greater than 90 days includes FHLB advances with maturity dates of 129 days.

As of June 30, 2014, all FHLBI advances were collateralized by CMBS with a fair value of \$843.4 million.

The FHLBI retains the right to mark the underlying collateral for FHLBI advances to fair value. A reduction in the value of pledged assets would require IAS Services LLC to provide additional collateral. In addition, as a condition to membership in the FHLBI, IAS Services LLC is required to purchase and hold a certain amount of FHLBI stock, which is based, in part, upon the outstanding principal balance of advances from the FHLBI. As of June 30, 2014 and December 31, 2013, the Company had stock in the FHLBI totaling \$18.5 million and \$0, respectively, which is included in other investments on the consolidated balance sheets as of June 30, 2014 and December 31, 2013.

#### Asset-Backed Securities

During the six months ended June 30, 2014, the Company purchased controlling interests in two securitization trusts for which it determined it is the primary beneficiary. The securitization trusts securitized residential mortgage loans with an aggregate principal balance of \$559.1 million, and issued \$559.1 million aggregate principal amount of ABS, of which \$409.1 million was purchased by the Company. The Company subsequently sold \$266.4 million of the original principal balance to a third party. The ABS issued by the securitization trusts and sold to third parties are recorded as non-recourse liabilities in the Company's consolidated balance sheets. During the six months ended June 30, 2014, ABS held by unaffiliated third parties was paid down by \$48.4 million. The Company has purchased controlling interests in a total of seven securitization trusts for which it determined it is the primary beneficiary to date.

The carrying value of the ABS is based on its amortized cost, which is equal to the remaining principal balance net of unamortized premiums or discounts. The following table provides summary information of the carrying value of the ABS, along with other relevant information, at June 30, 2014.

\$ in thousands	ABS	Residential loans
	Outstanding	Held as Collateral
Principal balance	2,001,751	2,287,914
Interest-only securities	13,939	—
Unamortized premium	12,983	33,020
Unamortized discount	(11,750)	(9,207)
Loan loss reserve	—	(1,041)
Carrying value	2,016,923	2,310,686
Range of weighted average interest rates	2.9% - 4.0%	
Number of series	7	



Table of Contents

The following table presents the estimated principal repayment schedule of the VIEs' ABS at June 30, 2014, based on estimated cash flows of the residential mortgage loans, as adjusted for projected prepayments and losses on such loans.

\$ in thousands	June 30, 2014
Estimated principal repayment	
Within one year	210,975
One to three years	366,263
Three to five years	298,450
Greater than or equal to five years	1,126,063
Total	2,001,751

The maturity of the VIEs' ABS is dependent upon cash flows received from the underlying residential mortgage loans. The estimated principal repayments may differ from actual amounts to the extent prepayments and/or loan losses vary. Refer to Note 5 "Residential Loans Held-for-Investment" for a more detailed discussion of the residential loans collateralizing the VIEs' ABS.

#### Exchangeable Senior Notes

In the first quarter of 2013, a wholly-owned subsidiary of the Company issued \$400.0 million in aggregate principal amount of Exchangeable Senior Notes (the "Notes") due 2018. The total net proceeds to the Company after deducting financing expenses was \$387.7 million.

The terms of the Notes are governed by an indenture (the "Indenture") by and among the wholly-owned subsidiary, as issuer, the Company, as guarantor, and The Bank of New York Mellon Trust Company, N.A., as trustee (the "Trustee").

The Notes bear interest at 5.00% per annum, payable semi-annually in arrears on March 15 and September 15 of each year, beginning September 15, 2013. The Notes may be exchanged for shares of the Company's common stock at the applicable exchange rate at any time prior to the close of business on the second scheduled trading day prior to the maturity date. The initial exchange rate for each \$1,000 aggregate principal amount of the Notes is 42.0893 shares of the Company's common stock, equivalent to an exchange price of approximately \$23.76 per share, and the maximum exchange rate is 48.4027 shares of the Company's common stock, equivalent to an exchange price of approximately \$20.66 per share. The initial and maximum exchange rates of the Notes are subject to adjustment in certain events.

The Notes have not been registered under the Securities Act of 1933, as amended. Pursuant to the registration rights agreement between the Company and the initial purchasers of the Notes, the Company filed a prospectus supplement in August 2013 registering for resale 605,034 shares of common stock issuable upon exchange of the Notes. The Company may be required to register additional shares of common stock issuable upon exchange of the Notes from time to time at the request of holders as required by the registration rights agreement. Accrued interest payable on the Notes was approximately \$5.9 million as of June 30, 2014.

#### Note 9 – Derivatives and Hedging Activities

##### Risk Management Objective of Using Derivatives

The Company is exposed to certain risks arising from both its business operations and economic conditions. The Company principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity, and credit risk primarily by managing the amount, sources, and duration of its investments, debt funding, and the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Company's derivative financial instruments are used to manage differences in the amount, timing, and duration of the Company's known or expected cash receipts and its known or expected cash payments principally related to the Company's investments and borrowings.

The Company also utilizes credit derivatives such as credit default swaps ("CDS") to provide credit event protection based on a financial index or specific security in exchange for receiving a fixed-rate fee or premium over the term of the contract. These instruments enable the Company to synthetically assume the credit risk of a reference security,

portfolio of securities or index of securities. The counterparty pays a premium to the Company and the Company agrees to make a payment to compensate the counterparty for losses upon the occurrence of a specified credit event. Although contract specific, credit events generally include bankruptcy, failure to pay, restructuring, obligation acceleration, obligation default, or repudiation/moratorium. Upon the occurrence of a defined credit event, the difference between the value of the reference securities and the CDS's notional amount is recorded as a realized loss in the consolidated statements of operations.

Table of Contents

## Credit Derivatives

The Company's only CDS contract was entered into in the fourth quarter of 2010. The Company sold protection against losses on a specific pool of non-Agency RMBS in the event they exceed a specified loss limit of 25% of the balance of the non-Agency RMBS on the trade date. The maximum exposure is the remaining unpaid principal balance of the underlying RMBS in excess of the specified loss threshold. In exchange, the Company is paid a stated fixed rate fee of 3% of the notional amount of the CDS. The remaining notional amount of the CDS at June 30, 2014 was \$44.0 million (\$51.8 million at December 31, 2013), and the Company estimated the fair market value of the CDS to be approximately \$547,000 at June 30, 2014 (\$654,000 at December 31, 2013). As of June 30, 2014, the Company has not made any payments related to the CDS contract.

At June 30, 2014 and December 31, 2013, the open CDS sold by the Company is summarized as follows:

\$ in thousand	June 30, 2014	December 31, 2013
Fair value amount	547	654
Notional amount	44,016	51,823
Maximum potential amount of future undiscounted payments	44,016	51,823
Recourse provisions with third parties	—	—
Collateral held by counterparty	6,802	7,979

## Interest Rate Swaps

The Company finances its activities primarily through repurchase agreements, which are usually settled on a short-term basis, usually from one to twelve months. At each settlement date, the Company refinances each repurchase agreement at the market interest rate at that time. Since the interest rate on its repurchase agreements change on a one to twelve month basis, the Company is exposed to changing interest rates. The Company's objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposures to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps as part of its interest rate risk management strategy. Interest rate swaps involve the receipt of variable-rate amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the agreements without exchange of the underlying notional amount.

Through December 31, 2013, the Company elected cash flow hedge accounting for its interest rate swaps. Under cash flow hedge accounting, effective hedge gains or losses are initially recorded in AOCI and subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings while the ineffective portion is recorded on a current basis in earnings. Effective December 31, 2013, the Company voluntarily discontinued cash flow hedge accounting for its interest rate swaps in order to gain greater flexibility in managing interest rate exposures. Amounts reported in AOCI related to the cash flow hedges through December 31, 2013 will remain in AOCI and will be reclassified to interest expense, repurchase agreements on the consolidated statements of operations as interest is accrued and paid on the related repurchase agreements over the remaining life of the interest rate swap agreements. The Company reclassified \$21.5 million and \$42.8 million as an increase to interest expense for the three and six months ended June 30, 2014, respectively. During the next 12 months, the Company estimates that \$77.8 million will be reclassified as an increase to interest expense, repurchase agreements.

The Company will continue to hedge its exposure to variability in future funding costs via interest rate swaps. As a result of discontinuing hedge accounting, beginning January 1, 2014, changes in the fair value of the Company's interest rate swaps are recorded in gain (loss) on interest rate derivative instruments, net on the consolidated statements of operations, consistent with the Company's historical accounting for futures contracts, described below. Monthly net cash settlements under swaps are recorded in gain (loss) on interest rate derivative instruments, net on the consolidated statements of operations, prospectively.

Table of Contents

As of June 30, 2014, the Company had the following interest rate swaps outstanding:

\$ in thousands	Notional	Maturity Date	Fixed Interest Rate in Contract	
Counterparty				
SunTrust Bank	100,000	7/15/2014	2.79	%
Deutsche Bank AG	200,000	1/15/2015	1.08	%
Deutsche Bank AG	250,000	2/15/2015	1.14	%
Credit Suisse International	100,000	2/24/2015	3.26	%
Credit Suisse International	100,000	3/24/2015	2.76	%
Wells Fargo Bank, N.A.	100,000	7/15/2015	2.85	%
Wells Fargo Bank, N.A.	50,000	7/15/2015	2.44	%
Morgan Stanley Capital Services, LLC	300,000	1/24/2016	2.12	%
The Bank of New York Mellon	300,000	1/24/2016	2.13	%
Morgan Stanley Capital Services, LLC	300,000	4/5/2016	2.48	%
Citibank, N.A.	300,000	4/15/2016	1.67	%
Credit Suisse International	500,000	4/15/2016	2.27	%
The Bank of New York Mellon	500,000	4/15/2016	2.24	%
JPMorgan Chase Bank, N.A.	500,000	5/16/2016	2.31	%
Goldman Sachs Bank USA	500,000	5/24/2016	2.34	%
Goldman Sachs Bank USA	250,000	6/15/2016	2.67	%
Wells Fargo Bank, N.A.	250,000	6/15/2016	2.67	%
JPMorgan Chase Bank, N.A.	500,000	6/24/2016	2.51	%
Citibank, N.A.	500,000	10/15/2016	1.93	%
Deutsche Bank AG	150,000	2/5/2018	2.90	%
ING Capital Markets LLC	350,000	2/24/2018	0.95	%
Morgan Stanley Capital Services, LLC	100,000	4/5/2018	3.10	%
ING Capital Markets LLC	300,000	5/5/2018	0.79	%
JPMorgan Chase Bank, N.A.	200,000	5/15/2018	2.93	%
UBS AG	500,000	5/24/2018	1.10	%
ING Capital Markets LLC	400,000	6/5/2018	0.87	%
The Royal Bank of Scotland Plc	500,000	9/5/2018	1.04	%
CME Clearing House	(3) (4) 300,000	2/5/2021	2.50	%
CME Clearing House	(3) (4) 300,000	2/5/2021	2.69	%
Wells Fargo Bank, N.A.	200,000	3/15/2021	3.14	%
Citibank, N.A.	200,000	5/25/2021	2.83	%
HSBC Bank USA, National Association	(1) 550,000	2/24/2022	2.45	%
The Royal Bank of Scotland Plc	(2) 400,000	3/15/2023	2.39	%
UBS AG	(2) 400,000	3/15/2023	2.51	%
HSBC Bank USA, National Association	250,000	6/5/2023	1.91	%
HSBC Bank USA, National Association	250,000	7/5/2023	1.97	%
The Royal Bank of Scotland Plc	500,000	8/15/2023	1.98	%
CME Clearing House	(4) 600,000	8/24/2023	2.88	%
UBS AG	250,000	11/15/2023	2.23	%
HSBC Bank USA, National Association	500,000	12/15/2023	2.20	%
Total	12,800,000		2.12	%

(1) Forward start date of February 2015

(2) Forward start date of March 2015

(3) Forward start date of February 2016

(4)



Beginning June 10, 2013, regulations promulgated under The Dodd-Frank Wall Street Reform and Consumer Protection Act mandate that the Company clear new interest rate swap transactions through a central counterparty. Transactions that are centrally cleared result in the Company facing a clearing house, rather than a swap dealer, as counterparty. Central clearing requires the Company to post collateral in the form of initial and variation margin to the clearing house which reduces default risk.

At June 30, 2014, the Company's counterparties held \$30.4 million net cash margin deposits and approximately \$282.4 million in Agency RMBS as collateral against its interest rate swaps, CDS, TBAs and futures contracts. In addition, several counterparties posted securities of approximately \$62.4 million and \$14.2 million of cash as collateral with the Company. Cash

Table of Contents

margin posted by the Company is classified as due from counterparties, and cash margin posted by counterparties that are restricted in use, if any, is classified as restricted cash. As of June 30, 2014 and December 31, 2013, the Company did not have any restricted cash. The Agency RMBS collateral posted by the Company is included in the total mortgage-backed securities on the Company's consolidated balance sheets. Cash collateral that is not restricted for use by the Company is included in Cash and cash equivalents and the liability to return the collateral is included in Collateral held payable on the consolidated balance sheets. Non-cash collateral posted by counterparties to the Company would be recognized if any counterparty defaults or if the Company sold the pledged collateral. As of June 30, 2014, the Company did not recognize any non-cash collateral held as collateral.

**Interest Rate Swaptions**

The Company has purchased interest rate swaptions to help mitigate the potential impact of increases or decreases in interest rates on the performance of a portion of the Company's investment portfolio (referred to as "convexity risk"). The interest rate swaptions provide the Company the option to enter into interest rate swap agreements for a predetermined notional amount, stated term and pay and receive interest rates in the future. The premium paid for interest rate swaptions is reported as an asset in the Company's consolidated balance sheets. The premium is valued at an amount equal to the fair value of the swaption that would have the effect of closing the position adjusted for nonperformance risk, if any. The difference between the premium and the fair value of the swaption is reported in gain (loss) on interest rate derivative instruments, net in the Company's consolidated statements of operations. If an interest rate swaption expires unexercised, the loss on the interest rate swaption would be equal to the premium paid. If the Company sells or exercises an interest rate swaption, the realized gain or loss on the interest rate swaption would be equal to the difference between the cash or the fair value of the underlying interest rate swap received and the premium paid. The Company's interest rate swaptions expired unexercised during the three and six months ended June 30, 2014, realizing a loss of \$8.2 million and \$23.3 million, respectively. For the three and six months ended June 30, 2014, the Company had \$4.7 million and \$15.8 million of unrealized gain, respectively, which represents the change in fair value of the Company's interest rate swaptions that are recognized directly in earnings.

As of June 30, 2014, the Company had the following outstanding interest rate swaptions:

Interest Rate Swaptions	Option	Expiration	Cost	Fair Value	Average Months to Expiration	Notional Amount	Underlying Swap			
							Average Fixed Pay Rate	Average Receive rate	Average Term (Years)	
Payer	< 6 Months	—	—	—	0.0	—	%	3M Libor	0.00	
Payer	> 6 Months	7,738	2,608	2,608	8.3	750,000	3.13	%	3M Libor	6.70
		7,738	2,608	2,608	8.3	750,000	3.13	%		6.70

**TBAs and Futures Contracts**

The Company purchases or sells certain TBAs and U.S. Treasury futures contracts to help mitigate the potential impact of changes in interest rates on the performance of the Company's portfolio. Realized and unrealized gains and losses associated with the purchase or sales of the TBAs and U.S. Treasury futures contracts are recognized in gain (loss) on interest rate derivative instruments, net in the Company's consolidated statements of operations.

The following table presents information with respect to the Company's interest rate derivative instruments:

\$ in thousands	Notional Amount as of January 1, 2014	Additions	Settlement, Termination, Expiration or Exercise	Notional Amount as of June 30, 2014	Amount of Realized Gain, net on Interest Rate Derivative Instruments (excluding net interest paid or received)
Interest Rate Swaptions	1,150,000	750,000	(1,150,000 )	750,000	(23,275 )
Interest Rate Swaps	12,800,000	—	—	12,800,000	—
Purchase of TBAs	—	150,000	(150,000 )	—	188

Edgar Filing: Invesco Mortgage Capital Inc. - Form 10-Q

Sale of TBAs	—	481,000	(280,000 )	201,000	(1,588	)
Futures Contracts	100,000	256,500	(200,000 )	156,500	(9,186	)
Total	14,050,000	1,637,500	(1,780,000 )	13,907,500	(33,861	)

30

---

Table of Contents

## Tabular Disclosure of the Effect of Derivative Instruments on the Balance Sheet

The table below presents the fair value of the Company's derivative financial instruments, as well as their classification on the consolidated balance sheets as of June 30, 2014 and December 31, 2013.

\$ in thousands

Asset Derivatives				Liability Derivatives			
As of June 30, 2014		As of December 31, 2013		As of June 30, 2014		As of December 31, 2013	
Balance Sheet	Fair Value	Balance Sheet	Fair Value	Balance Sheet	Fair Value	Balance Sheet	Fair Value
Interest Rate Swap Asset	66,439	Interest Rate Swap Asset	256,449	Interest Rate Swap Liability	267,018	Interest Rate Swap Liability	263,204
CDS Contract	547	CDS Contract	654	Futures Contracts	347	Futures Contracts	—
Interest Rate Swaptions	2,608	Swaption	2,365	TBA's	1,235	TBA's	—
Futures Contracts	596	Futures Contracts	2,591				

## Tabular Disclosure of the Effect of Derivative Instruments on the Income Statement

The table below presents the effect of the Company's derivative financial instruments on the statements of operations for the three and six months ended June 30, 2014 and 2013.

Three months ended June 30, 2014

\$ in thousands

Derivative type for cash flow hedge	Amount of gain (loss) recognized in OCI on derivative (effective portion)	Location of gain (loss) reclassified from accumulated OCI into income (effective portion)	Amount of gain (loss) reclassified from accumulated OCI into income (effective portion)	Location of gain (loss) recognized in income on derivative (ineffective portion)	Amount of gain (loss) recognized in income on derivative (ineffective portion)
Interest Rate Swap	—	Interest Expense, Repurchase Agreements	(21,532)	Gain (loss) on interest rate derivative instruments	—

Six months ended June 30, 2014

\$ in thousands

Derivative type for cash flow hedge	Amount of gain (loss) recognized in OCI on derivative (effective portion)	Location of gain (loss) reclassified from accumulated OCI into income (effective portion)	Amount of gain (loss) reclassified from accumulated OCI into income (effective portion)	Location of gain (loss) recognized in income on derivative (ineffective portion)	Amount of gain (loss) recognized in income on derivative (ineffective portion)
Interest Rate Swaps	—	Interest Expense, Repurchase Agreements	(42,828)	Gain (loss) on interest rate derivative instruments, net	—



Table of Contents

Three months ended June 30, 2013

\$ in thousands

Derivative type for cash flow hedge	Amount of gain (loss) recognized in OCI on derivative (effective portion)	Location of gain (loss) reclassified from accumulated OCI into income (effective portion)	Amount of gain (loss) reclassified from accumulated OCI into income (effective portion)	Location of gain (loss) recognized in income on derivative (ineffective portion)	Amount of gain (loss) recognized in income on derivative (ineffective portion)
Interest Rate Swap	274,660	Interest Expense, Repurchase Agreements	(37,409 )	Gain (loss) on interest rate derivative instruments	294

Six months ended June 30, 2013

\$ in thousands

Derivative type for cash flow hedge	Amount of gain (loss) recognized in OCI on derivative (effective portion)	Location of gain (loss) reclassified from accumulated OCI into income (effective portion)	Amount of gain (loss) reclassified from accumulated OCI into income (effective portion)	Location of gain (loss) recognized in income on derivative (ineffective portion)	Amount of gain (loss) recognized in income on derivative (ineffective portion)
Interest Rate Swaps	257,489	Interest Expense, Repurchase Agreements	(72,970 )	Gain (loss) on interest rate derivative instruments, net	293

Derivative not designated as hedging instrument	Location of unrealized gain (loss) recognized in income on derivative	Amount of unrealized gain (loss) recognized in income on derivative	Three months ended June 30, 2014	Three months ended June 30, 2013
CDS Contract	Realized and unrealized credit default swap income	(60 )	(345 )	

Derivative not designated as hedging instrument	Location of unrealized gain (loss) recognized in income on derivative	Amount of unrealized gain (loss) recognized in income on derivative	Six months ended June 30, 2014	Six months ended June 30, 2013
CDS Contract	Realized and unrealized credit default swap income	(107 )	(568 )	

Table of Contents

The following table summarizes the effect of interest rate swaps, swaption contracts, TBAs and futures contracts reported in gain (loss) on interest rate derivative instruments, net on the consolidated statements of operations for the three and six months ended June 30, 2014 and 2013:

\$ in thousands		Three months ended June 30, 2014			
Derivative not designated as hedging instrument	Realized gain (loss) on settlement, termination, expiration or exercise, net	Contractual interest expense	Unrealized gain (loss), net	Gain (loss) on interest rate derivatives, net	
Interest Rate Swaps	—	(52,205	) (103,633	) (155,838	)
Swaption Contracts	(8,200	) —	4,654	(3,546	)
TBAs	(1,400	) —	(1,938	) (3,338	)
Futures Contracts	(5,437	) —	343	(5,094	)
Total	(15,037	) (52,205	) (100,574	) (167,816	)

\$ in thousands		Six months ended June 30, 2014			
Derivative not designated as hedging instrument	Realized gain (loss) on settlement, termination, expiration or exercise, net	Contractual interest expense	Unrealized gain (loss), net	Gain (loss) on interest rate derivatives, net	
Interest Rate Swaps	—	(103,646	) (193,825	) (297,471	)
Swaption Contracts	(23,275	) —	15,781	(7,494	)
TBAs	(1,400	) —	(1,235	) (2,635	)
Futures Contracts	(9,186	) —	(2,342	) (11,528	)
Total	(33,861	) (103,646	) (181,621	) (319,128	)

\$ in thousands		Three months ended June 30, 2013			
Derivative Instrument	Realized gain (loss) on settlement, termination, expiration or exercise, net	Contractual interest expense	Unrealized gain (loss), net	Gain (loss) on interest rate derivatives, net	
Interest Rate Swaps ineffectiveness	—	—	294	294	
Swaption Contracts	27,159	—	25,861	53,020	
Total	27,159	—	26,155	53,314	

\$ in thousands		Six months ended June 30, 2013			
Derivative Instrument	Realized gain (loss) on settlement, termination, expiration or exercise, net	Contractual interest expense	Unrealized gain (loss), net	Gain (loss) on interest rate derivatives, net	
Interest Rate Swaps ineffectiveness	—	—	293	293	

Edgar Filing: Invesco Mortgage Capital Inc. - Form 10-Q

Swaption Contracts	27,159	—	23,859	51,018
Total	27,159	—	24,152	51,311

33

---



Table of Contents

## Credit-risk-related Contingent Features

The Company has agreements with each of its bilateral derivative counterparties. Some of those agreements contain a provision whereby if the Company defaults on any of its indebtedness, including default whereby repayment of the indebtedness has not been accelerated by the lender, then the Company could also be declared in default on its derivative obligations.

The Company's agreements with certain of its derivative counterparties provide that if the Company's net asset value declines by certain percentages over specified time periods, then the Company could be declared in default on its derivative obligations with that counterparty. The Company's agreements with certain of its derivative counterparties provide that if the Company's shareholders' equity declines by certain percentages over specified time periods, then the Company could be declared in default on its derivative obligations with that counterparty.

The Company's agreements with certain of its derivative counterparties provide that if the Company fails to maintain a minimum shareholders' equity or market value of \$100 million and \$80 million, respectively, then the Company could be declared in default on its derivative obligations with that counterparty.

At June 30, 2014, the fair value of derivatives in a net liability position, which includes accrued interest but excludes any adjustment for non-performance risk related to these agreements, was \$236.1 million. The Company has minimum collateral posting thresholds with certain of its derivative counterparties and has posted collateral of \$282.4 million of Agency RMBS and \$30.4 million of cash as of June 30, 2014. If the Company had breached any of these provisions at June 30, 2014, it could have been required to settle its obligations under the agreements at their termination value.

In addition, as of June 30, 2014, the Company has an agreement with a central clearing counterparty. The fair value of such derivatives in a net liability position, which includes accrued interest but excludes any adjustment for non-performance risk related to this agreement, was \$31.1 million.

The Company was in compliance with all of the financial provisions of these agreements through June 30, 2014.

## Note 10 – Offsetting Assets and Liabilities

The following tables present information about certain assets and liabilities that are subject to master netting agreements (or similar agreements) and can potentially be offset on the Company's consolidated balance sheets at June 30, 2014 and December 31, 2013.

## Offsetting of Derivative Assets

As of June 30, 2014

\$ in thousands Description	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Consolidated Balance Sheets	Net Amounts of Assets presented in the Consolidated Balance Sheets	Gross Amounts Not Offset in the Consolidated Balance Sheets		
				Financial Instruments (1)	Cash Collateral Received	Net Amount
Derivatives	70,190	—	70,190	(6,577 )	(11,976 )	51,637
Total	70,190	—	70,190	(6,577 )	(11,976 )	51,637

Table of ContentsOffsetting of Derivative Liabilities, Repurchase Agreements and Secured Loans  
As of June 30, 2014

\$ in thousands Description	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Consolidated Balance Sheets	Net Amounts of Assets presented in the Consolidated Balance Sheets	Gross Amounts Not Offset in the Consolidated Balance Sheets		
				Financial Instruments (2)(3)(5)	Cash Collateral Posted (2)(4)(5)	Net Amount
Derivatives	268,600	—	268,600	(268,600 )	—	—
Repurchase Agreements	14,723,223	—	14,723,223	(14,723,223 )	—	—
Secured Loans	625,000	—	625,000	(625,000 )	—	—
	15,616,823	—	15,616,823	(15,616,823 )	—	—

Offsetting of Derivative Assets  
As of December 31, 2013

\$ in thousands Description	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Consolidated Balance Sheets	Net Amounts of Assets presented in the Consolidated Balance Sheets	Gross Amounts Not Offset in the Consolidated Balance Sheets		
				Financial Instruments (1)	Cash Collateral Received	Net Amount
Derivatives	262,059	—	262,059	(671 )	(48,607 )	212,781
Total	262,059	—	262,059	(671 )	(48,607 )	212,781

Offsetting of Derivative Liabilities and Repurchase Agreements  
As of December 31, 2013

\$ in thousands Description	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Consolidated Balance Sheets	Net Amounts of Assets presented in the Consolidated Balance Sheets	Gross Amounts Not Offset in the Consolidated Balance Sheets		
				Financial Instruments (2)(3)	Cash Collateral Posted (2)(4)	Net Amount

Edgar Filing: Invesco Mortgage Capital Inc. - Form 10-Q

Derivatives	263,204	—	263,204	(263,204	)	—	—
Repurchase Agreements	15,451,675	—	15,451,675	(15,451,675	)	—	—
	15,714,879	—	15,714,879	(15,714,879	)	—	—

Table of Contents

- (1) Amounts represent interest rate derivatives in an asset position which could potentially be offset against interest rate derivatives in a liability position at June 30, 2014 and December 31, 2013, subject to a netting arrangement.
- (2) Amounts represent collateral pledged that is available to be offset against liability balances associated with repurchase agreements, secured loans and interest rate derivatives.  
The fair value of securities pledged against the Company's borrowing under repurchase agreements was \$16.5 billion and \$17.1 billion at June 30, 2014 and December 31, 2013, respectively, including securities held as
- (3) collateral that are eliminated in consolidation of \$268.8 million and \$133.8 million, respectively at June 30, 2014 and December 31, 2013.  
Total cash received on the Company's derivatives was \$14.2 million and \$52.7 million at June 30, 2014 and December 31, 2013, respectively. Total non-cash collateral received on the Company's derivatives was \$62.4
- (4) million and \$207.0 million at June 30, 2014 and December 31, 2013, respectively. Total cash posted by the Company on its Derivatives was \$30.4 million and \$1.5 million at June 30, 2014 and December 31, 2013, respectively.
- (5) The fair value of securities pledged against IAS Services LLC's borrowing under secured loans was \$854.4 million and \$0 at June 30, 2014 and December 31, 2013, respectively.

In the Company's consolidated balance sheets, all balances associated with the repurchase agreement and derivatives transactions are presented on a gross basis.

Certain of the Company's repurchase agreement and derivative transactions are governed by underlying agreements that generally provide for a right of setoff in the event of default or in the event of a bankruptcy of either party to the transaction. For one repurchase agreement counterparty, the underlying agreement provides for an unconditional right of setoff.

Note 11 – Financial Instruments

U.S. GAAP defines fair value, provides a consistent framework for measuring fair value under U.S. GAAP, and Accounting Standards Codification (“ASC”) Topic 820 expands fair value financial statement disclosure requirements. ASC Topic 820 does not require any new fair value measurements and only applies to accounting pronouncements that already require or permit fair value measures, except for standards that relate to share-based payments.

Valuation techniques are based on observable and unobservable inputs. Observable inputs reflect readily obtainable data from independent sources, while unobservable inputs reflect the Company's market assumptions. The three levels are defined as follows:

Level 1 Inputs – Quoted prices for identical instruments in active markets.

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

Level 3 Inputs – Instruments with primarily unobservable value drivers.

Table of Contents

The fair values on a recurring basis of the Company's MBS and interest rate hedges based on the level of inputs at June 30, 2014 and December 31, 2013 are summarized below:

\$ in thousands	June 30, 2014			Total at Fair Value
	Fair Value Measurements Using:			
	Level 1	Level 2	Level 3	
Assets				
Mortgage-backed securities <sup>(1)</sup>	—	18,247,789	—	18,247,789
Investments in unconsolidated ventures	—	—	44,030	44,030
Derivatives	596	69,047	547	70,190
Total	596	18,316,836	44,577	18,362,009
Liabilities				
Derivatives	347	268,253	—	268,600
Total	347	268,253	—	268,600
\$ in thousands	December 31, 2013			Total at Fair Value
	Fair Value Measurements Using:			
	Level 1	Level 2	Level 3	
Assets				
Mortgage-backed securities <sup>(1)</sup>	—	17,348,657	—	17,348,657
Investments in unconsolidated ventures	—	—	44,403	44,403
Derivatives	2,591	258,814	654	262,059
Total	2,591	17,607,471	45,057	17,655,119
Liabilities				
Derivatives	—	263,204	—	263,204
Total	—	263,204	—	263,204

(1) For more detail about the fair value of the Company's MBS, refer to Note 4 - Mortgage-Backed Securities in these consolidated financial statements.

Table of Contents

The following table presents additional information about the Company's investments in unconsolidated ventures which are measured at fair value on a recurring basis for which the Company has utilized Level 3 inputs to determine fair value:

\$ in thousands	June 30, 2014	December 31, 2013
Beginning balance, at beginning of the year	44,403	35,301
Purchases	971	11,717
Sales and settlements	(5,679	) (7,960
Total net gains included in net income		
Realized gains, net	3,821	2,757
Unrealized gains, net	514	2,588
Unrealized gains/(losses), net included in other comprehensive income	—	—
Ending balance	44,030	44,403

The following table presents additional information about the Company's CDS contract, which is measured at fair value on a recurring basis for which the Company has utilized Level 3 inputs to determine fair value:

\$ in thousands	June 30, 2014	December 31, 2013
Beginning balance, at beginning of the year	654	1,519
Purchases	—	—
Sales and settlements	—	—
Total net gains/(losses) included in net income		
Realized gains/(losses), net	—	—
Unrealized gains/(losses), net	(107	) (865
Unrealized gains/(losses), net included in other comprehensive income	—	—
Ending balance	547	654

The following table summarizes quantitative information about Level 3 fair value measurements:

\$ in thousands	Fair Value at June 30, 2014	Valuation Technique	Unobservable Input	Range	Weighted Average	
CDS Contract	547	Discounted cash flow	Swap Rate		2.39	%
			Discount Rate		0.56	%
			Credit Spread		0.27	%
			Constant Prepayment Rate	1.0% - 20.0%	5.53	%
			Constant Default Rate	0.6% - 100.0%	4.60	%
			Loss Severity	0.4% - 67.9%	41.13	%

The significant unobservable inputs used in the fair value measurement of the CDS contract are the swap rate, discount rate, credit spread, constant prepayment rate, constant default rate, and loss severity in the event of default. These inputs change according to market conditions and security performance expectations. Significant increases (decreases) in swap rate, discount rate, credit spread, constant prepayment rate, constant default rate or loss severity in isolation would result in a lower (higher) fair value measurement. Generally, a change in the assumption used for the constant default rate would likely be accompanied by a directionally similar change in the assumptions used for swap rate, credit spread and loss severity and a directionally opposite change in the assumption used for discount rate and constant prepayment rate. If the inputs had not changed during the quarter, the fair value of the CDS contract would have been \$21,000 more than the actual fair value at June 30, 2014.

Table of Contents

The following table presents the carrying value and estimated fair value of the Company's financial instruments that are not carried at fair value on the consolidated balance sheets, at June 30, 2014 and December 31, 2013:

\$ in thousands	June 30, 2014		December 31, 2013	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
<b>Financial Assets</b>				
Residential loans, held-for-investment	2,310,686	2,325,101	1,810,262	1,709,385
Commercial loans, held-for-investment	95,585	95,585	64,599	64,599
Other investments	18,500	18,500	10,000	10,000
Total	2,424,771	2,439,186	1,884,861	1,783,984
<b>Financial Liabilities</b>				
Repurchase agreements	14,723,223	14,729,026	15,451,675	15,459,452
Secured loans	625,000	625,000	—	—
Asset-backed securities	2,016,923	1,956,995	1,643,741	1,543,217
Exchangeable senior notes	400,000	386,000	400,000	368,250
Total	17,765,146	17,697,021	17,495,416	17,370,919

The following describes the Company's methods for estimating the fair value for financial instruments.

The fair value of the residential loans, held-for-investment and commercial loans, held-for-investment are a Level 3 fair value measurement which is based on an expected present value technique. This method discounts future estimated cash flows using rates the Company determined best reflect current market interest rates that would be offered for loans with similar characteristics and credit quality.

In December 2012, the Company acquired a \$10.0 million debt security from a repurchase lending counterparty that matures October 31, 2016. The debt security pays interest quarterly at the rate of 4.0% above the three-month LIBOR rate. The debt security is included in "Other Investments" and its fair value is a Level 3 fair value measurement based on an expected present value technique. This method discounts future estimated cash flows using rates the Company determined best reflect current market interest rates that would be offered for securities with similar characteristics and credit quality. The debt security was repaid in March 2014 at carrying value.

The fair value of other investments at June 30, 2014 is a Level 3 fair value measurement. Restricted FHLBI stock may only be sold back to the FHLBI at its discretion at cost. As a result, the cost of the FHLBI stock approximates its fair value.

The fair value of the repurchase agreements is a Level 3 fair value measurement based on an expected present value technique. This method discounts future estimated cash flows using rates the Company determined best reflect current market interest rates that would be offered for repurchase agreements with similar characteristics and credit quality. The fair value of the ABS is a Level 3 fair value measurement based on an expected present value technique. This method discounts future estimated cash flows using rates the Company determined best reflect current market interest rates that would be offered for securities with similar characteristics and credit quality.

The fair value of secured loans at June 30, 2014 is a Level 3 fair value measurement. The secured loans mature in less than one year, and the carrying amount approximates fair value due to the short maturities.

The fair value of the exchangeable senior notes issued is a Level 2 fair value measurement based on obtaining valuations from an independent source. The value was based on a value obtained from a third-party pricing service.

#### Note 12 – Related Party Transactions

The Company is externally managed and advised by the Manager. Pursuant to the terms of the management agreement, the Manager and its affiliates provide the Company with its management team, including its officers, along with appropriate support personnel. Each of the Company's officers is an employee of the Manager or one of its affiliates. The Company does not have any employees. The Manager is not obligated to dedicate any of its employees exclusively to the Company, nor are the Manager or its employees obligated to dedicate any specific portion of its or

their time to the Company's business. The Manager is at all times subject to the supervision and oversight of the Company's Board of Directors and has only such functions and authority as the Company delegates to it.



## Table of Contents

### Management Fee

The Company pays the Manager a management fee equal to 1.50% of the Company's shareholders' equity per annum, which is calculated and payable quarterly in arrears. For purposes of calculating the management fee, shareholders' equity is equal to the sum of the net proceeds from all issuances of equity securities since inception (allocated on a pro rata daily basis for such issuances during the fiscal quarter of any such issuance), plus retained earnings at the end of the most recently completed calendar quarter (without taking into account any non-cash equity compensation expense incurred in current or prior periods), less any amount paid to repurchase common stock since inception, and excluding any unrealized gains, losses or other items that do not affect realized net income (regardless of whether such items are included in other comprehensive income or loss, or in net income). This amount will be adjusted to exclude one-time events pursuant to changes in U.S. GAAP, and certain non-cash items after discussions between the Manager and the Company's independent directors and approval by a majority of the Company's independent directors.

The Manager has agreed to reduce (but not below zero) the management fee payable by the Company under the management agreement with respect to any equity investment managed by the Manager. The fee reduction occurs at the equity investment level.

For the three months ended June 30, 2014, the Company incurred management fees of \$9.3 million (2013: \$10.8 million), of which \$9.3 million (2013: \$10.8 million) was accrued but has not been paid.

For the six months ended June 30, 2014, the Company incurred management fees of \$18.7 million (2013: \$21.2 million), of which \$9.3 million (2013: \$10.8 million) was accrued but has not been paid.

### Expense Reimbursement

Pursuant to the management agreement, the Company is required to reimburse the Manager for operating expenses related to the Company incurred by the Manager, including directors and officers insurance, accounting services, auditing and tax services, filing fees, and miscellaneous general and administrative costs. The Company's reimbursement obligation is not subject to any dollar limitation.

The Company incurred costs, originally paid by Invesco, of approximately \$1.3 million (2013: \$1.8 million) and \$3.1 million (2013: \$2.9 million) for the three and six months ended June 30, 2014, respectively. Approximately \$1.3 million (2013: \$1.6 million) and \$3.1 million (2013: \$2.5 million) was either prepaid or expensed for the three and six months ended June 30, 2014, respectively. Approximately \$0 (2013: \$184,000) and \$0 (2013: \$418,000) was charged against equity as a cost of raising capital for the three and six months ended June 30, 2014, respectively. There were no capitalization to other assets as of June 30, 2014.

### Termination Fee

A termination fee is due to the Manager upon termination of the management agreement by the Company equal to three times the sum of the average annual management fee earned by the Manager during the 24-month period prior to such termination, calculated as of the end of the most recently completed fiscal quarter.

### Note 13 – Shareholders' Equity

#### Securities Convertible into Shares of Common Stock

The limited partner who holds units of the OP Units has the right to cause the Operating Partnership to redeem their OP Units for cash equal to the market value of an equivalent number of shares of common stock, or at the Company's option, the Company may purchase their OP Units by issuing one share of common stock for each OP Unit redeemed. The Company has also adopted an equity incentive plan which includes the ability of the Company to grant securities convertible into the Company's common stock to the independent directors and the executive officers of the Company and the personnel of the Manager and its affiliates.

#### Exchangeable Senior Notes

In the first quarter of 2013, a wholly-owned subsidiary of the Company issued \$400.0 million in aggregate principal amount of the Notes due 2018. The total net proceeds to the Company after deducting financing expenses was \$387.7 million. The Notes may be exchanged for shares of the Company's common stock at the applicable exchange rate at any time prior to the close of business on the second scheduled trading day prior to the maturity date. The initial exchange rate for each \$1,000 aggregate principal amount of the Notes is 42.0893 shares of the Company's common

stock, equivalent to an exchange price of approximately \$23.76 per share, and the maximum exchange rate is 48.4027 shares of the Company's common stock,

## Table of Contents

equivalent to an exchange price of approximately \$20.66 per share. The initial and maximum exchange rates of the Notes are subject to adjustment in certain events.

### Registration Rights

The Company entered into a registration rights agreement with regard to the common stock and OP Units owned by the Manager and Invesco Investments (Bermuda) Ltd., respectively, upon completion of the Company's IPO and any shares of common stock that the Manager may elect to receive under the management agreement or otherwise. Pursuant to the registration rights agreement, the Company has granted to the Manager and Invesco Investments (Bermuda) Ltd. (i) unlimited demand registration rights to have the shares purchased by the Manager or granted to it in the future and the shares that the Company may issue upon redemption of the OP Units purchased by Invesco Investments (Bermuda) Ltd. registered for resale and (ii) in certain circumstances, the right to "piggy-back" these shares in registration statements the Company might file in connection with any future public offering so long as the Company retains the Manager under the management agreement.

On March 12, 2013, in connection with the issuance and sale of the Notes, the Operating Partnership and the Company also entered into a registration rights agreement with the initial purchasers of the Notes. Pursuant to the registration rights agreement, the Company has designated its automatic shelf registration statement filed on April 2, 2013 to be used for resales of the common stock, if any, issuable upon exchange of the Notes. The Company has filed a supplement to the underlying prospectus in that shelf registration statement to cover resales of the common stock by one noteholder and has agreed to file additional prospectus supplements if requested by noteholders to add such noteholders as selling securityholders. If the shelf registration statement ceases to be effective, then subject to certain exceptions, additional interest will accrue on the Notes.

### Common Stock

During the six months ended June 30, 2014, the Company issued 8,235 shares of common stock at an average price of \$16.55 under the DRSP with total proceeds to the Company of approximately \$136,000, net of issuance costs of \$0.

### Preferred Stock

Holders of the Company's Series A Preferred Stock are entitled to receive dividends at an annual rate of 7.75% of the liquidation preference of \$25 per share or \$1.9375 per share per annum. These dividends are cumulative and payable quarterly in arrears. The shares are not convertible into or exchangeable for any other property or any other securities of the Company at the election of the holders. However, the Company, at its option after July 26, 2017, may redeem the shares at a redemption price of \$25.00, plus any accrued unpaid distributions through the date of the redemption.

### Share Repurchase Program

On December 12, 2011, the Company's board of directors approved a share repurchase program to purchase up to 7,000,000 shares of its common shares with no stated expiration date. On December 2, 2013, the Company's board of directors approved an additional share repurchase of up to 20,000,000 of its common shares with no stated expiration date. Shares of the Company's common stock may be purchased in the open market, including through block purchases, or through privately negotiated transactions, or pursuant to any trading plan that may be adopted in accordance with Rules 10b5-1 and 10b-18 of the Securities Exchange Act of 1934, as amended. The timing, manner, price and amount of any repurchases will be determined at the Company's discretion and the program may be suspended, terminated or modified at any time for any reason. The program does not obligate the Company to acquire any specific number of shares, and all repurchases will be made in accordance with Rule 10b-18, which sets certain restrictions on the method, timing, price and volume of stock repurchases.

During the three months ended June 30, 2014, the Company did not repurchase any shares of its common stock.

During the six months ended June 30, 2014, the Company repurchased 1,438,213 shares of its common stock at an average repurchase price of \$14.69 per share for a net cost of \$21.1 million, including acquisition expenses. During the six months ended June 30, 2013, the Company did not repurchase any shares of its common stock. As of June 30, 2014, the Company had authority to purchase 14,841,784 additional shares of its common stock through this program.



Table of Contents

## Share-Based Compensation

The Company established the 2009 Equity Incentive Plan for grants of restricted common stock and other equity based awards to the independent directors and the executive officers of the Company and personnel of the Manager and its affiliates (the "Incentive Plan"). Under the Incentive Plan, a total of 1,000,000 shares of common stock are currently reserved for issuance. Unless terminated earlier, the Incentive Plan will terminate in 2019, but will continue to govern the unexpired awards. The Company recognized compensation expense of approximately \$60,000 (2013: \$38,000) and approximately \$112,000 (2013: \$75,000) related to the Company's non-executive directors for the three and six months ended June 30, 2014, respectively. During the three months ended June 30, 2014, the Company issued 3,079 shares (2013: 1,839 shares) of stock pursuant to the Incentive Plan to the Company's non-executive directors. During the six months ended June 30, 2014, the Company issued 5,824 shares (2013: 3,609 shares) of stock pursuant to the Incentive Plan to the Company's non-executive directors. The fair market value of the shares granted was determined by the closing stock market price on the date of the grant.

The Company recognized compensation expense of approximately \$80,000 (2013: \$49,000) and \$161,000 (2013: \$111,000) for the three and six months ended June 30, 2014, respectively, related to awards to officers and employees of the Manager and its affiliates which is reimbursed by the Manager under the management agreement.

During March 2014, the Company issued 8,284 shares of common stock (net of tax withholding) in exchange for 12,599 restricted stock units that vested under the Incentive Plan. In addition, during the six months ended June 30, 2014, the Company awarded 20,732 restricted stock units to officers and employees of the Manager and its affiliates.

## Dividends

On June 16, 2014, the Company declared a dividend of \$0.50 per share of common stock. The dividend was paid on July 28, 2014 to shareholders of record as of the close of business on June 27, 2014.

On June 16, 2014, the Company declared a dividend of \$0.4844 per share of Series A Preferred Stock. The dividend was paid on July 25, 2014 to shareholders of record as of the close of business on July 1, 2014.

## Note 14 – Earnings per Common Share

Earnings per share for the three and six months ended June 30, 2014 and 2013 is computed as follows:

\$ and share amounts in thousands	Three Months Ended		Six Months Ended	
	June 30, 2014	2013	June 30, 2014	2013
Numerator (Income)				
Basic Earnings				
Net income (loss) available to common shareholders	(94,052 )	138,847	(168,492 )	222,838
Effect of dilutive securities:				
Income allocated to exchangeable senior debt	—	5,622	—	6,782
Income (loss) allocated to non-controlling interest	(1,057 )	1,493	(1,879 )	2,455
Dilutive net income (loss) available to shareholders	(95,109 )	145,962	(170,371 )	232,075
Denominator (Weighted Average Shares)				
Basic Earnings:				
Shares available to common shareholders	123,091	135,105	123,108	132,013
Effect of dilutive securities:				
Restricted Stock Awards	—	38	—	32
OP Units	1,425	1,425	1,425	1,425
Exchangeable senior notes	—	16,836	—	10,325
Dilutive Shares	124,516	153,404	124,533	143,795

The following potential common shares (in thousands) were excluded from diluted earnings per common share for the three and six months ended June 30, 2014 as the Company had a net loss for the period: 16,836 (in thousands) for the

Exchangeable senior notes, respectively, and 46 (in thousands) and 43 (in thousands) for Restricted Stock Awards.

Table of Contents

Note 15 – Non-controlling Interest—Operating Partnership

Non-controlling interest represents the aggregate OP Units in the Operating Partnership held by limited partners (the “Unit Holders”). Income allocated to the non-controlling interest is based on the Unit Holders’ ownership percentage of the Operating Partnership. The ownership percentage is determined by dividing the number of OP Units held by the Unit Holders by the total number of dilutive shares of common stock. The issuance of common stock (“Share” or “Shares”) or OP Units changes the percentage ownership of both the Unit Holders and the holders of common stock. Since an OP unit is generally redeemable for cash or Shares at the option of the Company, it is deemed to be equivalent to a Share. Therefore, such transactions are treated as capital transactions and result in an allocation between shareholders’ equity and non-controlling interest in the accompanying consolidated balance sheets to account for the change in the ownership of the underlying equity in the Operating Partnership. As of June 30, 2014, non-controlling interest related to the outstanding 1,425,000 OP Units represented a 1.1% interest (2013: 1.0%) in the Operating Partnership. Expense allocated to the Operating Partnership non-controlling interest for the three months ended June 30, 2014 was approximately \$1.1 million (2013: \$1.5 million income). Expense allocated to the Operating Partnership non-controlling interest for the six months ended June 30, 2014 was \$1.9 million (2013: \$2.5 million income). For the three months ended June 30, 2014, distributions paid to the non-controlling interest were \$712,000 (2013: \$926,000). For the six months ended June 30, 2014, distributions paid to the non-controlling interest were \$1.4 million (2013: \$1.9 million). As of June 30, 2014, distributions payable to the non-controlling interest were approximately \$712,000 (2013: \$926,000).

Note 16 – Subsequent Events

On July 2, 2014, IAS Services LLC refinanced its short-term fixed rate secured loans with FHLBI having an aggregate principal amount outstanding of \$625.0 million into a single 10-year term secured loan that bears interest at three-month LIBOR plus 15 basis points. In addition, on July 3, 2014, IAS Services LLC entered into a 10-year \$625.0 million aggregate principal amount secured loan with FHLBI that bears interest at the three-month FHLB swap rate plus 28 basis points. Both loans are secured by Agency RMBS and CMBS collateral. The Company estimates that these secured loans will extend its consolidated average liability days to maturity from approximately 2 months to approximately 12 months.

Table of Contents

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

In this quarterly report on Form 10-Q, or this “Report,” we refer to Invesco Mortgage Capital Inc. and its consolidated subsidiaries as “we,” “us,” “our Company,” or “our,” unless we specifically state otherwise or the context indicates otherwise. We refer to our external manager, Invesco Advisers, Inc., as our “Manager,” and we refer to the indirect parent company of our Manager, Invesco Ltd. (NYSE:IVZ) together with its consolidated subsidiaries (which does not include us), as “Invesco.”

The following discussion should be read in conjunction with our consolidated financial statements and the accompanying notes to our consolidated financial statements, which are included in Item 1 of this Report, as well as the information contained in our most recent Form 10-K filed with the Securities and Exchange Commission (the “SEC”).

Forward-Looking Statements

We make forward-looking statements in this Report and other filings we make with the SEC within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and such statements are intended to be covered by the safe harbor provided by the same. Forward-looking statements are subject to substantial risks and uncertainties, many of which are difficult to predict and are generally beyond our control. These forward-looking statements include information about possible or assumed future results of our business, investment strategies, financial condition, liquidity, results of operations, plans and objectives. When we use the words “believe,” “expect,” “anticipate,” “estimate,” “plan,” “continue,” “intend,” “should,” “may,” “will,” “could,” “would,” and any other similar expressions and future or conditional verbs such as “will,” “may,” “could,” “should,” and “would,” and any other statement that necessarily depends on future events, we intend to identify forward-looking statements. Factors that could cause actual results to differ from those expressed in our forward-looking statements include, but are not limited to:

- our business and investment strategy;
- our investment portfolio;
- our projected operating results;
- actions and initiatives of the U.S. governmental agencies and changes to U.S. government policies, including the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), mortgage loan modification programs and the reduction of the Federal Reserve long-term asset purchases (quantitative easing or “QE”) and our ability to respond to and comply with such actions, initiatives and changes;
- the availability of financing sources, including our ability to obtain additional financing arrangements and the terms of such arrangements;
- financing and advance rates for our target assets;
- changes to our expected leverage;
- general volatility of the markets in which we invest;
- general volatility of foreign financial markets and their governments’ responses;
- our expected investments;
- our expected book value per share of common stock;
- interest rate mismatches between our target assets and our borrowings used to fund such investments;
- the adequacy of our cash flow from operations and borrowings to meet our short-term liquidity needs;
- our ability to maintain sufficient liquidity to meet any margin calls;
- changes in the credit rating of the U.S. government;
- changes in interest rates and interest rate spreads and the market value of our target assets;
- changes in prepayment rates on our target assets;
- the impact of any deficiencies in foreclosure practices of third parties and related uncertainty in the timing of collateral disposition;
- our reliance on third parties in connection with services related to our target assets;





Table of Contents

- effects of hedging instruments on our target assets;
- rates of default or decreased recovery rates on our target assets;
- modifications to whole loans or loans underlying securities;
- the degree to which our hedging strategies may or may not protect us from interest rate volatility;
  - the degree to which derivative contracts expose us to contingent liabilities;
- counterparty defaults;
- changes in governmental regulations, tax law and rates, and similar matters and our ability to respond to such changes;
- our ability to maintain our qualification as a real estate investment trust for U.S. federal income tax purposes;
- our ability to maintain our exception from the definition of “investment company” under the Investment Company Act of 1940, as amended (the “1940 Act”);
- availability of investment opportunities in mortgage-related, real estate-related and other securities;
- availability of U.S. Government Agency guarantees with regard to payments of principal and interest on securities;
- the market price and trading volume of our capital stock;
- availability of qualified personnel;
- the relationship with our Manager;
- estimates relating to taxable income and our ability to continue to make distributions to our shareholders in the future;
- estimates relating to fair value of our target assets and loan loss reserves;
- our understanding of our competition;

• changes to generally accepted accounting principles in the United States of America (“U.S. GAAP”); and

• market trends in our industry, interest rates, real estate values, the debt securities markets or the general economy.

These forward-looking statements are based upon information presently available to our management and are inherently subjective, uncertain and subject to change. There can be no assurance that actual results will not differ materially from our expectations. We caution investors not to rely unduly on any forward-looking statements and urge you to carefully consider the risks identified under the captions “Risk Factors,” “Forward-Looking Statements” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in this Report and our most recent Form 10-K and subsequent Form 10-Qs, which are available on the SEC’s website at [www.sec.gov](http://www.sec.gov). All written or oral forward-looking statements that we make, or that are attributable to us, are expressly qualified by this cautionary notice. We expressly disclaim any obligation to update the information in any public disclosure if any forward-looking statement later turns out to be inaccurate, except as may otherwise be required by law. The following discussion should be read in conjunction with our consolidated financial statements and the accompanying notes to our consolidated financial statements, which are included in this Report.

Overview

We are a Maryland corporation primarily focused on investing in, financing and managing residential and commercial mortgage-backed securities (“MBS”) and mortgage loans. We are externally managed and advised by Invesco Advisers, Inc., our Manager, which is an indirect, wholly-owned subsidiary of Invesco Ltd. We elected to be taxed as a real estate investment trust (“REIT”) for U.S. federal income tax purposes under the provisions of the Internal Revenue Code of 1986, as amended (“Code”), commencing with our taxable year ended December 31, 2009. To maintain our REIT qualification, we are generally required to distribute at least 90% of our taxable income to our shareholders annually. We operate our business in a manner that permits our exclusion from the definition of “Investment Company” under the 1940 Act.

Our objective is to provide attractive risk-adjusted returns to our investors, primarily through dividends and secondarily through capital appreciation. To achieve this objective, we primarily invest in the following: Agency residential mortgage-backed securities (“RMBS”), for which a U.S. government agency such as the Government National Mortgage Association (“Ginnie Mae”) or a federally chartered corporation such as the Federal National Mortgage Association (“Fannie Mae”) or the Federal Home Loan Mortgage Corporation (“Freddie Mac”) guarantees payments of principal and interest on the securities;



Table of Contents

• Non-Agency RMBS, which are RMBS that are not guaranteed by a U.S. government agency or a federally chartered corporation;

• Credit risk transfer securities issued by government-sponsored enterprise ("GSE CRT"), which are general obligations of Fannie Mae or Freddie Mac that are structured to provide credit protection to the GSE issuer with respect to defaults and other credit events within reference pools of residential mortgage loans that collateralize MBS issued and guaranteed by such GSE;

• Commercial mortgage-backed securities ("CMBS");

• Residential and commercial mortgage loans; and

• Other real estate-related financing arrangements.

We finance our investments in Agency RMBS, non-Agency RMBS, GSE CRT and CMBS primarily through short-term borrowings structured as repurchase agreements, secured loans, committed facilities and other forms of private financing. We finance our residential loans held-for-investment through asset-backed securities ("ABS") issued by securitization trusts for which we have determined we are the primary beneficiary. We have also issued exchangeable notes to finance investments in our target assets.

Capital Activities

On June 16, 2014, we declared a dividend of \$0.50 per share of common stock. The dividend was paid on July 28, 2014 to shareholders of record as of the close of business on June 27, 2014.

On June 16, 2014, we declared a dividend of \$0.4844 per share of Series A Preferred Stock. The dividend was paid on July 25, 2014 to shareholders of record as of the close of business on July 1, 2014.

During the three months ended June 30, 2014, we did not repurchase any shares of our common stock. During the six months ended June 30, 2014, we repurchased 1,438,213 shares of our common stock at an average repurchase price of \$14.69 per share for a net cost of \$21.1 million, including acquisition expenses. On December 2, 2013, our board of directors authorized the repurchase of an additional 20,000,000 shares of our common stock with no stated expiration date. Our board of directors has approved an aggregate repurchase of 27,000,000 shares of our common stock to date. As of June 30, 2014, we had authority to purchase 14,841,784 additional shares of our common stock through this program.

Factors Impacting Our Operating Results

Our operating results can be affected by a number of factors and primarily depend on, among other things, the level of our net interest income, the market value of our assets and the supply of, and demand for, the target assets in which we invest. Our net interest income, which includes the amortization of purchase premiums and accretion of purchase discounts, varies primarily as a result of changes in market interest rates and prepayment speeds, as measured by the constant prepayment rate ("CPR") on our target assets. Interest rates and prepayment speeds vary according to the type of investment, conditions in the financial markets, competition and other factors, none of which can be predicted with any certainty.

Market Conditions

Macroeconomics factors that affect our business include credit spread premiums, market interest rates, Federal Reserve policy initiatives, residential and commercial real estate prices, employment and inflation. There are a number of reasons to believe the U.S. economy is improving despite a meager 1.5% year-over-year increase in real gross domestic product ("GDP"). Year-over-year GDP has dropped given the -2.9% real growth rate in the first quarter of 2014, causing the Federal Open Market Committee and the consensus of private economists to lower their full year 2014 GDP forecast to 2.2% and 1.7%, respectively. In addition, interest rates have continued to fall since the first quarter of 2014.

For the second quarter of 2014, the unemployment rate fell to 6.1% and monthly payrolls increased by 272,000 jobs per month. Home and automobile sales during the second quarter each made strong increases. The low interest rate environment should be stimulative to economic growth since current policy rates are much lower than that which would be indicated by unemployment and inflation indicators alone. Households are once again increasing their debt levels, albeit at a low rate, which increases their ability to consume goods and services. Inflation data has recently been higher than expected with core personal consumption expenditures prices having increased 1.5% year-over-year

and 1.7% over the past three months.

Despite these indicators of apparent strength describe above, including surprisingly robust employment data, interest rates fell in the second quarter of 2014. Underlying this decline is the notion that economic growth is likely to disappoint and that the Federal Reserve is likely to keep the funds rate near 0% for the next year, and be very gradual in raising rates when they do. Factors that seem to support this view include: the U.S. and other large countries must overcome a heavy debt burden such that

Table of Contents

fiscal policies in the U.S. and abroad will be a drag on economic growth; companies are more focused on margins and stock repurchases than on growth strategies; disinflation is entrenched in the collective psyche of consumers; there is risk of deflation in Europe; China is a concern for global growth; and geo-political concerns seem to be on the rise. In this environment the 10-year U.S. Treasury note yield has moved in an extraordinarily tight band, generally hovering between 2.5% and 2.7%. Actual interest rate volatility has continued to decline in the second quarter of 2014, as has the volatility implied by interest rate options. U.S. Treasury interest rates ended the second quarter lower, with the 10-year note lower by about 19 basis points and longer maturities declined by more than shorter maturities. This has been supportive for the Agency RMBS market generally as the prepayment option embedded in MBS is less onerous given lower expected interest rate volatility. Further, MBS investors seem much less concerned over the market impact from Federal Reserve tapering of MBS purchases. There has been adequate demand from investors and limited supply of new MBS to offset the decline in demand from the Federal Reserve. The environment has also been supportive of credit spreads (i.e. the additional yield premium earned by investors over risk-free term interest rates for accepting credit risk in non-government guaranteed bonds). In the second quarter of 2014, yields required by investors on CMBS and non-Agency RMBS fell by more than similar duration U.S. Treasury notes and U.S. interest rate swaps. This had a beneficial impact on the prices of our holdings and caused our book value to increase.

We believe we have reduced the interest rate sensitivity of our investment portfolio, resulting in greater book value stability. The driving force behind the 6.9% increase in book value in the second quarter was the improvement in credit spread premiums, as described above. Our core earnings benefited from slow prepayment rates. It is possible that we may realize losses on the sale of assets in future periods and these losses may cause our GAAP earnings to be negative. In addition, as of December 31, 2013 we elected to discontinue hedge accounting for our portfolio of interest rate swaps. As a result of discontinuing hedge accounting, beginning January 1, 2014, changes in the fair value of the interest rate swap agreements are recorded in gain (loss) on interest rate derivative instruments, net in our consolidated statements of operations, rather than in accumulated other comprehensive income (loss) ("AOCI"). This change will cause our net income to be more volatile in future periods and could contribute to us recording a net loss in future periods. Refer to Note 9 - "Derivatives and Hedging Activities" for further information.

The impact of regulatory initiatives on the economy may also affect our business and our financial results. The Dodd-Frank Act, enacted in July 2010, contains numerous provisions affecting the financial and mortgage industries, many of which may have an impact on our operating environment and the target assets in which we invest. Consequently, the Dodd-Frank Act may affect our cost of doing business, may limit our investment opportunities and may affect the competitive balance within our industry and market areas. Under the Dodd-Frank Act, new underwriting requirements for residential mortgage loans have been adopted. The Ability-to-Repay ("ATR") rule requires lenders to make a reasonable, good-faith determination that the borrower has a reasonable ability to repay the loan. In addition to the ATR rule, the Consumer Financial Protection Bureau adopted a Qualified Mortgage ("QM") framework that provides certain legal protections to lenders related to residential mortgage loans that meet the QM criteria, which include restrictions on loan features and borrower debt-to-income ratios. While we are not directly subject to compliance with the implementation of rules regarding the origination of residential mortgage loans, the effect of these regulations and others could affect our ability to securitize or invest in newly originated loans in the future.

There are also a number of pending legislative proposals related to the eventual wind-down or phase out of the GSEs, including the Corker-Warner and Johnson-Crapo bills, which would replace the GSEs with a new government agency, the Federal Mortgage Insurance Corporation. In the second quarter there was a bi-partisan effort in the U.S. Senate to bring about mortgage finance reform via the Johnson-Crapo bill. The bill did not receive enough votes in committee to get to the floor for a vote. At this point it seems unlikely there will be mortgage finance reform legislation in 2014. A meaningful resurrection of a fully functioning primary market for private label securitizations is unlikely to occur in the near term. We have been successful in participating in securitizations despite the environment, having consolidated in our financial statements an additional prime jumbo securitization in each of the first two quarters of 2014. We expect to close and consolidate at least one additional prime jumbo securitization in the third quarter of 2014. The high credit quality of the loans underlying these securitizations is showing through in strong monthly

performance data.

In addition, the regulatory landscape for our repurchase agreement counterparties continues to evolve following the adoption of new capital rules which generally affects the manner in which banks lend. Regulators are also focused on liquidity requirements which will likely affect how banks fund themselves. While we are not directly subject to compliance with the implementation of rules regarding financial institutions, the effect of these regulations and others could affect our ability to finance our assets in the future.

#### Investment Activities

In the second quarter of 2014, we continued to position the investment portfolio to take advantage of opportunities created by an improving housing market and the availability of high credit quality, newly originated residential mortgage loans.

Table of Contents

During 2013 and 2014, we participated in seven residential loan securitizations that are consolidated on our balance sheet, and have participated in GSE CRT transactions issued by both Fannie Mae and Freddie Mac at a fair value of \$506.6 million compared to \$0 one year ago. In addition, during the second quarter of 2014, we committed to purchase securities in an additional residential loan securitization, and upon settlement, we anticipate the residential loan securitization to be consolidated on our balance sheet. During 2013, we also began a commercial real estate lending program. Since its inception, we have purchased or originated five loans in addition to investing in securitized mezzanine loans. We expect to continue to pursue opportunities to increase the percentage of our equity invested in each of these three areas during 2014: commercial mortgage loans, subordinate interests in residential loan securitizations and GSE CRT transactions.

To provide economic stimulus, the Federal Reserve has been purchasing Agency RMBS through its QE program which has had the effect of holding mortgage interest rates low. In 2014, the Federal Reserve has reduced purchases under their QE program of U.S. Treasuries and Agency RMBS, but they have continued buying a large percentage of issuance, which has also declined. The interest rate and credit spread premium environment and our views on how they will change have a significant impact on our portfolio decisions. We have taken the opportunity to reduce our lower coupon 30 year Agency RMBS positions by nearly 50% from \$12.2 billion at March 31, 2013 to \$6.2 billion at June 30, 2014. We reinvested proceeds of sales and prepayments in part into agency hybrid ARM assets. We have also reduced our repurchase agreement debt from 6.4 times equity at June 30, 2013 to 5.6 times equity at June 30, 2014. In addition, we increased the notional amount of our interest rate swaps from \$12.2 billion at June 30, 2013 to \$12.8 billion at June 30, 2014, or by 4.9%. We also entered into payer swaptions to further reduce interest rate risk in the second quarter. As a result of all of these actions, we believe we have reduced interest rate and funding risk relative to the prior quarter and the prior year.

The table below shows the allocation of our equity as of June 30, 2014 and 2013:

	As of June 30,		
	2014	2013	
Agency RMBS	39.3	% 52.3	%
Non-Agency RMBS	29.8	% 36.5	%
GSE CRT	5.6	% —	%
CMBS	31.7	% 19.9	%
Residential Loans	3.4	% 4.8	%
Commercial Loans	3.7	% 0.3	%
Unconsolidated Ventures	1.7	% 1.4	%
Exchangeable Senior Notes	(15.2	)% (15.2	)%
Total	100.0	% 100.0	%

We have continued to hold 30 year fixed-rate Agency RMBS securities that offer higher coupons and which we expect to prepay relatively slowly based on the collateral attributes. Our sales of 30 year fixed-rate Agency RMBS have been primarily in 3% and 3.5% coupons. Therefore the average coupon of our 30 year fixed-rate Agency RMBS continued to increase to 4.17% at June 30, 2014, compared to 4.12% at March 31, 2014 and 3.92% at June 30, 2013. In addition, we hold 15 year fixed-rate Agency RMBS securities, Agency Hybrid ARM RMBS and Agency ARM RMBS that we believe to have lower durations and better cash flow certainty relative to current 30 year fixed-rate Agency RMBS. Further, we own Agency collateralized mortgage obligations ("CMO"), some of which are interest-only securities.



Table of Contents

The table below shows the breakdown of our investment portfolio as of June 30, 2014 and 2013:

\$ in thousands	As of June 30,	
	2014	2013
Agency RMBS:		
30 year fixed-rate, at fair value	6,239,995	10,561,425
15 year fixed-rate, at fair value	1,495,999	1,956,448
Hybrid ARM, at fair value	2,613,337	440,170
ARM, at fair value	561,284	68,769
Agency CMO, at fair value	510,435	511,476
Non-Agency RMBS, at fair value <sup>(1)</sup>	3,282,525	3,750,428
GSE CRT, at fair value	506,635	—
CMBS, at fair value	3,037,579	2,517,442
Residential loans, at amortized cost	2,310,686	1,553,006
Commercial loans, at amortized cost	95,585	8,954
Total MBS and Loans portfolio	20,654,060	21,368,118

(1) Included in non-Agency RMBS are securities of \$26.0 million for a future securitization not yet settled.

Our portfolio of investments that have credit exposure include non-Agency RMBS, GSE CRT, CMBS and residential and commercial real estate loans. We use our proprietary models to perform a detailed review of each investment which often includes loan level analysis of expected performance. We do not place any reliance on ratings by various agencies as we believe our models more accurately evaluate the performance based on our assumptions about market conditions and are updated more frequently than agency ratings. As shown in the table above, we have increased our exposure to credit assets as we believe the improving economy will provide better risk-adjusted returns for this asset class while having lower interest rate exposure.

With respect to our non-Agency RMBS portfolio, we primarily invest in RMBS collateralized by prime and Alt-A loans. In addition, we have invested in re-securitization of real estate mortgage investment conduit ("Re-REMIC") RMBS that we believe provide attractive risk adjusted returns. We also invest in GSE CRT. Based on our view of the improving housing market and relative value opportunities, we added to our position of non-Agency RMBS and GSE CRT during 2014.

Our CMBS portfolio generally consists of assets originated prior to 2007, assets originated after 2010 ("CMBS 2.0") and multi-family CMBS issued by Freddie Mac under their "K" program. Since June 30, 2013, we grew our CMBS portfolio \$520.1 million based on our view of the improving risk and return offered by this asset class. The primary focus of our investments was in the CMBS 2.0, where we grew the percentage of CMBS in our MBS portfolio to approximately 16.6% as of June 30, 2014 from approximately 12.7% as of June 30, 2013.

During 2013 and 2014, we expanded our portfolio of credit assets by adding subordinate securities backed by residential loans. The residential loans collateralizing these securities consist are prime jumbo mortgages that were generally originated in 2011 or later. We believe these loans have high credit quality based on their risk characteristics, including but not limited to high FICO scores, low historical delinquencies and low loan-to-value ratios based on current home values. For further details on the loan portfolio, refer to Note 5 - "Residential Loans Held-for-Investment."

We also added commercial real estate loans during 2013 and 2014. Our commercial real estate loan portfolio includes mezzanine loans, first mortgage loans and preferred equity investments we purchased or originated. For further details on the loan portfolio, refer to Note 6 - "Commercial Loans Held-for-Investment."

Table of Contents

## Portfolio Characteristics

The table below represents the vintage of our MBS credit assets as of June 30, 2014 as a percentage of the fair value:

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Total
Re-REMIC <sup>(1)</sup>	— %	— %	— %	— %	0.3 %	— %	0.8 %	3.5 %	25.7 %	9.0 %	0.4 %	— %	39.7 %
Prime	0.5 %	1.4 %	5.7 %	4.4 %	11.2 %	2.2 %	— %	— %	0.2 %	— %	6.5 %	3.0 %	35.1 %
Alt-A	— %	0.5 %	10.2 %	6.4 %	7.5 %	— %	— %	— %	— %	— %	— %	— %	24.6 %
Subprime	— %	— %	— %	0.1 %	0.5 %	— %	— %	— %	— %	— %	— %	— %	0.6 %
Total													
Non-Agency <sup>(2)</sup>	0.5 %	1.9 %	15.9 %	10.9 %	19.5 %	2.2 %	0.8 %	3.5 %	25.9 %	9.0 %	6.9 %	3.0 %	100.0 %
GSE CRT	— %	— %	— %	— %	— %	— %	— %	— %	— %	— %	56.6 %	43.4 %	100.0 %
CMBS	— %	— %	10.6 %	11.4 %	0.7 %	— %	— %	8.8 %	25.4 %	14.0 %	18.0 %	11.1 %	100.0 %

For Re-REMICs, the table reflects the year in which the resecuritizations were issued. The vintage distribution of (1) the securities that collateralize the Company's Re-REMIC investments is 10.6% 2005, 37.7% 2006 and 51.7% 2007.

(2) Excluded from non-Agency RMBS are securities of \$26.0 million for a future securitization not yet settled.

The tables below represent the geographic concentration of the underlying collateral for our MBS portfolio as of June 30, 2014:

Non-Agency RMBS State	Percentage	GSE CRT State	Percentage	CMBS State	Percentage
California	47.0	% California	27.6	% California	14.7
Florida	7.2	% Texas	5.2	% New York	12.5
New York	6.7	% Virginia	4.1	% Texas	9.5
Virginia	3.6	% New York	3.9	% Florida	5.9
New Jersey	3.5	% Maryland	3.8	% Illinois	5.1
Maryland	3.4	% Illinois	3.8	% Pennsylvania	4.1
Washington	2.9	% Colorado	3.6	% New Jersey	3.3
Illinois	2.3	% Washington	3.5	% Ohio	3.0
Arizona	2.2	% New Jersey	3.4	% Virginia	2.7
Colorado	2.0	% Florida	3.0	% North Carolina	2.7
Other	19.2	% Other	38.1	% Other	36.5
Total	100.0	%	100.0	% Total	100.0

The vintage and geographic concentrations have not significantly changed since March 31, 2014.

Table of Contents

The following table displays certain characteristics of our residential loans held-for-investment at June 30, 2014 by year of origination.

\$ in thousands	2014	2013	2012	2009	2008	Total
Portfolio Characteristics:						
Number of Loans <sup>(1)</sup>	25	2,372	602	6	3	3,008
Current Principal Balance	17,392	1,768,805	497,726	1,929	2,062	2,287,914
Net Weighted Average Coupon Rate	4.82	% 3.63	% 3.51	% 3.84	% 6.14	% 3.61
Weighted Average Maturity (years)	28.78	28.91	28.53	24.96	24.16	28.82
Current Performance:						
Current	17,392	1,768,805	496,436	1,929	2,062	2,286,624
30 Day Delinquent	—	—	1,290	—	—	1,290
60 Days Delinquent	—	—	—	—	—	—
90+ Days Delinquent	—	—	—	—	—	—
Bankruptcy/Foreclosure	—	—	—	—	—	—
Total	17,392	1,768,805	497,726	1,929	2,062	2,287,914

(1) None for 2011 and 2010

The following table presents the five largest geographic concentrations of our residential loans held-for-investment at June 30, 2014 based on principal balance outstanding:

State	Percent
California	49.8 %
Illinois	5.5 %
Massachusetts	4.4 %
Maryland	3.9 %
New York	3.8 %
Other states (none greater than 4%)	32.6 %
Total	100.0 %

#### Financing and Other Liabilities

We enter into repurchase agreements to finance the majority of our target assets. These agreements are secured by our Agency RMBS, non-Agency RMBS, GSE CRT and CMBS. In addition, these agreements are generally settled on a short-term basis, usually from one to twelve months, and bear interest at rates that have historically moved in close relationship to the London Interbank Offer Rate (“LIBOR”). At each settlement date, we refinance each repurchase agreement at the market interest rate at that time. As of June 30, 2014, we had entered into repurchase agreements totaling \$14.7 billion (2013: \$17.9 billion). The decrease in the amount of the repurchase agreement balance was due to a decrease in our MBS portfolio, a decrease in leverage as we reallocated our investment portfolio and replacing some of our repurchase borrowings with secured loans, as discussed below.

In March 2014, the Company’s wholly-owned subsidiary, IAS Services LLC, became a member of the Federal Home Loan Bank of Indianapolis (“FHLBI”). As a member of the FHLBI, IAS Services LLC may borrow funds from the FHLBI in the form of secured loans. As of June 30, 2014, IAS Services LLC had \$625.0 million in outstanding secured advances and an additional \$625.0 million of available uncommitted credit for borrowings which amount may be adjusted at the sole discretion of the FHLBI. For the three and six months ended June 30, 2014, IAS Services LLC had an average borrowing of \$318.5 million and \$160.1 million with a weighted average borrowing rate of 0.22% and 0.22%, respectively.

We have also committed to invest up to \$100.0 million in the Invesco Mortgage Recovery Feeder Fund L.P. managed by the our Manager (“Invesco IMRF Fund”) and Invesco Mortgage Recovery Loans AIV, L.P. (“AIV Fund”), which, in turn, invests in our target assets. As of June 30, 2014, \$94.6 million (2013: \$83.3 million) of our commitment to the Invesco IMRF Fund and AIV Fund has been called. On December 31, 2013, the investment period ended. We are committed to fund an additional \$5.4 million in capital to cover future expenses should they occur.



Table of Contents

The Company records the liability for MBS purchased for which settlement has not taken place as an investment related payable. As of June 30, 2014 and December 31, 2013, we had investment related payables of \$670.1 million, and \$28.8 million, respectively, of which no items were outstanding greater than thirty days. The change in balance was due to an increase in unsettled MBS purchases at the quarter ended June 30, 2014, including \$406.4 million for securities for future securitizations. The Company records a receivable for mortgage-backed securities sold for which settlement has not taken place as an investment-related receivable. As of June 30, 2014 and December 31, 2013, the Company had investment related receivables of \$399.5 million and \$515.4 million, respectively, of which no items were outstanding greater than thirty days. The change in balance was due to a decrease in unsettled sold MBS as of June 30, 2014. Included in June 30, 2014 are unsettled securities for future securitizations of \$380.3 million.

**Hedging Instruments.** We generally hedge as much of our interest rate risk as we deem prudent in light of market conditions. No assurance can be given that our hedging activities will have the desired beneficial impact on our results of operations or financial condition. Our investment policies do not contain specific requirements as to the percentages or amount of interest rate risk that we are required to hedge.

Interest rate hedging may fail to protect or could adversely affect us because, among other things:

- available interest rate hedging may not correspond directly with the interest rate risk for which protection is sought;

- the duration of the hedge may not match the duration of the related liability;

- the party owing money in the hedging transaction may default on its obligation to pay;

- the credit quality of the party owing money on the hedge may be downgraded to such an extent that it impairs our ability to sell or assign our side of the hedging transaction; and

- the value of derivatives used for hedging may be adjusted from time-to-time in accordance with accounting rules to reflect changes in fair value. Downward adjustments or mark-to-market losses would reduce our shareholders' equity.

On December 31, 2013, we discontinued hedge accounting for our interest rate swap agreements by de-designating the interest rate swaps as cash flow hedges. No interest rate swaps were terminated in conjunction with this action, and our risk management and hedging practices are not impacted. However, our accounting for these transactions changed prospectively. All of our interest rate swaps had previously been accounted for as cash flow hedges under the applicable guidance. As a result of discontinuing hedge accounting, beginning January 1, 2014, changes in the fair value of the interest rate swap agreements are recorded in gain (loss) on interest rate derivative instruments, net in our consolidated statements of operations, rather than in AOCI. Also, net interest paid or received under the interest rate swaps, which up through December 31, 2013 was recognized in interest expense, repurchase agreements is recognized in gain (loss) on interest rate derivatives, net in our consolidated statements of operations. Refer to Note 9 - "Derivatives and Hedging Activities" for further information.

As of June 30, 2014, we have entered into interest rate swap agreements designed to mitigate the effects of increases in interest rates under a portion of our repurchase agreements. These swap agreements provide for fixed interest rates indexed off of one-month LIBOR and effectively fix the floating interest rates on \$12.8 billion (2013: \$12.2 billion) of borrowings under our repurchase agreements. As of June 30, 2014, included in this amount we had forward starting swaps with a total notional amount of approximately \$2.0 billion, with starting dates ranging from February 24, 2015 to February 5, 2016. The increase in the amount of interest rate swaps was due to our view of interest rate risk and the expected duration of our investment portfolio and liabilities.

As of June 30, 2014, we held \$750.0 million (2013: \$2.4 billion) in interest rate swaptions as an asset with a fair value of \$2.6 million (2013: \$57.6 million). During the six months ended June 30, 2014, interest rate swaptions expired unexercised with a notional amount of approximately \$1.2 billion (2013: \$1.8 billion sold) and realized loss of \$23.3 million (2013: \$27.2 million gain). We purchase interest rate swaptions to reduce the impact that interest rate volatility has on our portfolio. The change in the notional amount of swaptions held was due to our views on the potential for change in volatility as the Federal Reserve tapers its purchases under its QE program.

As of June 30, 2014, we held \$60.0 million (2013: \$0) in notional amount of short U.S. Treasury futures contracts as a liability with a fair value of \$347,000 (2013: \$0), and \$96.5 million (2013: \$0) in notional amount as an asset with fair value of \$596,000 (2013: \$0). During the six months ended June 30, 2014, we sold U.S. Treasury futures contracts of \$200.0 million (2013: \$0) in notional amount and realized a loss of \$9.2 million (2013: \$0). We invest in U.S.

Treasury futures contracts to help mitigate the potential impact of changes in interest rates on the performance of our portfolio.

As of June 30, 2014, we held \$201.0 million (2013: \$0) in notional amount of to-be-announced securities ("TBA") as a liability with a fair value of \$1.2 million (2013: \$0). During the six months ended June 30, 2014, \$430.0 million notional TBA were settled with loss \$1.4 million. TBAs are contracts for which we agree to purchase or deliver in the future Agency RMBS

## Table of Contents

with certain principal and interest terms. We purchase or sell certain TBAs to help mitigate the potential impact of changes in interest rates on the performance of our portfolio.

### Book Value per Share

Our book value per common share was \$19.80 and \$17.97 as of June 30, 2014 and December 31, 2013, respectively, on a fully diluted basis, after giving effect to our units of limited partnership interest in our operating partnership, which may be converted to common shares at our sole election. The change in our book value was primarily due to the change in valuation of our investment portfolio and our interest rate hedges that through December 31, 2013 were recorded in Other Comprehensive Income (Loss) on our consolidated balance sheets and subsequently in gain (loss) on interest rate derivative instruments, net on our consolidated statements of operations. Refer to Note 4 – “Mortgage-Backed Securities” for information regarding the impact of changes in accumulated other comprehensive income on our investment portfolio. The value of our assets and liabilities change daily based on market conditions. Refer to Item 3. “Quantitative and Qualitative Disclosures About Market Risks” for interest rate risk and its impact on fair value.

### Critical Accounting Policies

Our consolidated financial statements are prepared in accordance with U.S. GAAP, which requires the use of estimates and assumptions that involve the exercise of judgment and use of assumptions as to future uncertainties. Accounting estimates and assumptions discussed in this section are those that we consider to be the most critical to an understanding of our financial statements because they involve significant judgments and uncertainties. All of these estimates reflect our best judgment about current, and for some estimates, future economic and market conditions and their effects based on information available as of the date of these financial statements. If conditions change from those expected, it is possible that the judgments and estimates described below could change, which may result in a change in valuation of our investment portfolio, future impairments of our MBS, change in our interest income recognition, allowance for loan losses, inclusion of the change in derivative values in our income rather than other comprehensive income and an increase in our tax liability among other effects.

**Securities.** We record our MBS as available-for-sale and report them at fair value based on prices received from third-party sources. The valuation service uses various observable inputs which may change with market conditions. It is possible that changes in these inputs could change the valuation estimate and lead to impairment of our MBS portfolio. Further information is provided in Note 2 - "Summary of Significant Accounting Policies" and Note 4 - "Mortgage-Backed Securities."

**Other-than-temporary Impairment.** We regularly review our available-for-sale portfolio for other-than-temporary impairment. This determination involves both qualitative and quantitative data. It is possible that estimates may be incorrect, economic conditions may change or we may be forced to sell the investment before recovery of our amortized cost. Further information is provided in Note 2 - "Summary of Significant Accounting Policies" and Note 4 - "Mortgage-Backed Securities."

**Residential and Commercial Loans.** Residential loans held-for-investment are carried at unpaid principal balance net of any allowance for loan losses. Commercial loans held-for-investment are carried at cost net of any allowance for loan losses. An allowance for loan losses is established based on credit losses inherent in the portfolio. These estimates require consideration of various observable inputs including, but not limited to, historical loss experience, delinquency status, borrower credit scores, geographic concentrations and loan-to-value ratios, and are adjusted for current economic conditions as deemed necessary by management. In addition, since we have not incurred any direct losses on our portfolio, we use national historical credit performance information from a third party vendor to assist in our analysis. Changes in our estimates can significantly impact the allowance for loan losses and provision expense. It is also possible that we will experience credit losses that are different from our current estimates or that the timing of those losses may differ from our estimates. Further information on the allowance for loan losses is provided in Note 2 - "Summary of Significant Accounting Policies."

Interest Income Recognition. Interest income on available-for-sale securities, which includes accretion of discounts and amortization of premiums, is recognized over the life of the investment using the effective interest method. Management estimates, at the time of purchase, the future expected cash flows and determines the effective interest rate based on these estimated cash flows and the Company's purchase price. As needed, these estimated cash flows are updated and a revised yield is computed based on the current amortized cost of the investment. In estimating these cash flows, there are a number of assumptions that are subject to uncertainties and contingencies, including the rate and timing of principal payments (prepayments, repurchases, defaults and liquidations), the pass through or coupon rate and interest rate fluctuations. In addition, management must use its judgment to estimate interest payment shortfalls due to delinquencies on the underlying mortgage loans. These uncertainties and contingencies are difficult to predict and are subject to future events that may impact management's estimates and interest income. Interest income from the Company's residential loans is recognized on an accrual basis with the related premiums being amortized into interest income using the effective interest method over the weighted



Table of Contents

average life of these loans. As needed, these estimated cash flows are updated and a revised yield is computed based on the current amortized cost of the investment. Interest is recognized as revenue when earned and deemed collectible or until a loan becomes past due based on the terms of the loan agreement.

**Accounting for Derivative Financial Instruments.** We use derivatives to manage interest rate risk. Accounting for derivatives as hedges requires that, at inception and over the term of the arrangement, the derivatives meet the requirements for hedge accounting. The rules and interpretations related to hedge accounting are complex. Failure to apply this complex guidance correctly or electing to discontinue the use of hedge accounting, will result in changes in the fair value of the derivative being reported in earnings rather than other comprehensive income. Further information including information on our discontinued use of hedge accounting effective on December 31, 2013 is provided in Note 9 - "Derivatives and Hedging Activities".

**Income Taxes.** We have elected to be taxed as a REIT. Accordingly, we generally will not be subject to U.S. federal and applicable state and local corporate income tax to the extent that we make qualifying distributions and provided we satisfy on a continuing basis, through actual investment and operating results, the REIT requirements including certain asset, income, distribution and stock ownership tests. The REIT qualifications rules are complex and failure to apply them correctly could subject the Company to U.S. federal, state and local income taxes.

**Expected Impact of New Authoritative Guidance on Future Financial Information**

In April 2014, the Financial Accounting Standards Board issued updated guidance that changes the requirements for reporting discontinued operations. Under the new guidance, a discontinued operation is defined as a disposal of a component of an entity or group of components of an entity that is disposed of or is classified as held for sale and represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results. The guidance is effective prospectively as of the first quarter of 2015, with early adoption permitted for new disposals or new classifications as held-for-sale. The guidance is effective for annual periods beginning on or after December 15, 2014 and interim periods within annual periods beginning on or after December 15, 2015. Early adoption is permitted but only for disposals (or classifications as held for sale) that have not been reported in financial statements previously issued or available for issue. The new guidance is not expected to have a material impact on our consolidated financial statements.

In June 2014, the Financial Accounting Standards Board issued guidance that changes the accounting for repurchase-to-maturity transactions and repurchase financing arrangements. The new guidance aligns the accounting for repurchase-to-maturity transactions and repurchase agreements executed as a repurchase financing with the accounting for other typical repurchase agreements. These transactions would all be accounted for as secured borrowings. The guidance eliminates sale accounting for repurchase-to-maturity transactions and supersedes the guidance under which a transfer of a financial asset and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward agreement, which has resulted in outcomes referred to as off-balance-sheet accounting. In addition, the guidance requires additional disclosures. The guidance is effective for the first interim or annual period beginning after December 15, 2014. Earlier application for a public company is prohibited. The new guidance is not expected to have a material impact on our consolidated financial statements.

Table of Contents

## Results of Operations

The table below presents certain information from our consolidated statements of operations for the three and six month periods ending June 30, 2014 and 2013.

\$ in thousands, except per share data	Three Months Ended		Six Months Ended	
	June 30, 2014	2013	June 30, 2014	2013
Interest Income				
Mortgage-backed securities	151,920	168,736	303,659	329,080
Residential loans	20,471	6,889	38,175	7,026
Commercial loans	2,061	60	3,680	60
Total interest income	174,452	175,685	345,514	336,166
Interest Expense				
Repurchase agreements	47,822	68,463	96,893	134,792
Secured loans	176	—	176	—
Exchangeable senior notes	5,613	5,622	11,220	6,782
Asset-backed securities	15,826	5,377	29,761	5,456
Total interest expense	69,437	79,462	138,050	147,030
Net interest income	105,015	96,223	207,464	189,136
Provision for loan losses	(50 )	663	157	663
Net interest income after provision for loan losses	105,065	95,560	207,307	188,473
Other Income (loss)				
Gain (loss) on sale of investments, net	(20,766 )	5,692	(32,484 )	12,404
Equity in earnings and fair value change in unconsolidated ventures	3,894	2,157	4,335	3,747
Gain (loss) on interest rate derivative instruments, net	(167,816 )	53,314	(319,128 )	51,311
Realized and unrealized credit default swap income	292	180	621	531
Total other income (loss)	(184,396 )	61,343	(346,656 )	67,993
Expenses				
Management fee – related party	9,327	10,807	18,662	21,161
General and administrative	3,739	3,043	6,935	4,587
Total expenses	13,066	13,850	25,597	25,748
Net income (loss)	(92,397 )	143,053	(164,946 )	230,718
Net income (loss) attributable to non-controlling interest	(1,057 )	1,493	(1,879 )	2,455
Net income (loss) attributable to Invesco Mortgage Capital Inc.	(91,340 )	141,560	(163,067 )	228,263
Dividends to preferred shareholders	2,712	2,713	5,425	5,425
Net income (loss) attributable to common shareholders	(94,052 )	138,847	(168,492 )	222,838
Earnings (loss) per share:				
Net income (loss) attributable to common shareholders (basic)	(0.76 )	1.03	(1.37 )	1.69
Net income (loss) attributable to common shareholders (diluted)	(0.76 )	0.95	(1.37 )	1.61
Dividends declared per common share	0.50	0.65	1.00	1.30
Weighted average number of shares of common stock:				
Basic	123,091	135,105	123,108	132,013
Diluted	124,516	153,404	124,533	143,795

Table of Contents

The table below presents certain information for our portfolio for the three and six month periods ending June 30, 2014 and 2013.

\$ in thousands	Three Months Ended		Six Months Ended		
	June 30, 2014	2013	June 30, 2014	2013	
Average Balances*:					
Agency RMBS:					
15 year fixed-rate, at amortized cost	1,490,857	1,949,617	1,544,072	1,997,076	
30 year fixed-rate, at amortized cost	6,277,003	11,524,578	6,501,011	11,512,548	
ARM, at amortized cost	526,816	69,149	407,650	83,227	
Hybrid ARM, at amortized cost	2,441,988	447,599	2,154,029	487,269	
MBS-CMO, at amortized cost	505,949	505,811	490,979	504,182	
Non-Agency RMBS, at amortized cost (1)	3,241,721	3,815,772	3,382,454	3,530,088	
GSE CRT, at amortized cost	418,635	—	366,914	—	
CMBS, at amortized cost	2,788,361	2,491,250	2,677,553	2,275,552	
Residential loans, at amortized cost	2,240,066	807,876	2,114,219	415,132	
Commercial loans, at amortized cost	94,541	2,919	86,653	2,919	
Average MBS and Loans portfolio	20,025,937	21,614,571	19,725,534	20,807,993	
Average Portfolio Yields (2):					
Agency RMBS:					
15 year fixed-rate	2.57	% 2.17	% 2.69	% 2.18	%
30 year fixed-rate	3.03	% 2.77	% 3.09	% 2.81	%
ARM	2.29	% 2.39	% 2.31	% 2.24	%
Hybrid ARM	2.23	% 2.41	% 2.28	% 2.37	%
MBS - CMO	3.42	% 1.84	% 3.77	% 1.65	%
Non-Agency RMBS	4.70	% 4.54	% 4.44	% 4.58	%
GSE CRT	4.04	% —	% 4.37	% —	%
CMBS	4.54	% 4.72	% 4.52	% 4.73	%
Residential loans	3.66	% 3.41	% 3.60	% 3.38	%
Commercial loans	8.72	% 11.21	% 8.49	% 11.21	%
Average MBS and Loans portfolio	3.48	% 3.25	% 3.50	% 3.23	%
Average Borrowings*:					
Agency RMBS	10,040,134	13,185,918	9,865,448	13,063,927	
Non-Agency RMBS	2,790,149	2,815,765	2,895,918	2,669,977	
GSE CRT	307,237	—	261,052	—	
CMBS (3)	2,033,655	1,989,660	2,032,975	1,832,302	
Exchangeable senior notes	400,000	400,000	400,000	242,222	
Asset-backed securities	1,975,573	747,883	1,870,367	382,257	
Total borrowed funds	17,546,748	19,139,226	17,325,760	18,190,685	
Maximum borrowings during the period (4)	17,765,146	19,710,901	17,765,146	19,710,901	

Table of Contents

## Average Cost of Funds (5):

Agency RMBS	0.32	% 0.40	% 0.34	% 0.41	%
Non-Agency RMBS	1.55	% 1.54	% 1.53	% 1.63	%
GSE CRT	1.50	% —	% 1.47	% —	%
CMBS (3)	1.24	% 1.44	% 1.31	% 1.46	%
Exchangeable senior notes	5.61	% 5.62	% 5.61	% 5.60	%
Asset-backed securities	3.20	% 2.88	% 3.18	% 2.85	%
Unhedged cost of funds (6)	1.09	% 0.88	% 1.10	% 0.81	%
Hedged / Effective cost of funds (non-GAAP measure)	2.28	% 1.66	% 2.30	% 1.62	%
Average Equity (7):	2,470,933	2,774,374	2,403,467	2,743,484	
Average debt/equity ratio (average during period)	7.10x	6.90x	7.21x	6.63x	
Debt/equity ratio (as of period end)	6.82x	7.63x	6.82x	7.63x	

\* Average amounts for each period are based on weighted month-end balances; all percentages are annualized. For the three and six months ended June 30, 2014, the average balances are presented on an amortized cost basis.

(1) Non-Agency RMBS average balance excludes securities of \$26.0 million for a future securitization not yet settled.

(2) Average portfolio yield for the period was calculated by dividing interest income, including amortization of premiums and discounts, by our average of the amortized cost of the investments. All yields are annualized.

(3) CMBS average borrowing and cost of funds include borrowings under repurchase agreements and secured loans.

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

(5) Average cost of funds is calculated by dividing annualized interest expense by our average borrowings.

(6) Excludes amortization of deferred swap losses from de-designation.

(7) Average equity is calculated based on a weighted balance basis.

## Net Income (Loss) Summary

For the three months ended June 30, 2014, our net loss attributable to common shareholders was \$94.1 million (2013: \$138.8 million net income) or \$0.76 basic loss (2013: \$1.03 basic income) per weighted average share available to common shareholders and \$0.76 diluted loss (2013: \$0.95 diluted income) per weighted average share available to common shareholders.

For the six months ended June 30, 2014, our net loss attributable to common shareholders was \$168.5 million (2013: \$222.8 million net income) or \$1.37 basic loss (2013: \$1.69 basic income) per weighted average share available to common shareholders and \$1.37 diluted loss (2013: \$1.61 diluted income) per weighted average share available to common shareholders.

The change in net income (loss) attributable to common shareholders for the three months ended June 30, 2014 versus 2013 is primarily attributable to the de-designation of interest rate swaps, realized losses on interest rate derivative instruments and the sale of MBS at a loss during 2014 versus 2013.

The change in net income (loss) attributable to common shareholders for the six months ended June 30, 2014 versus 2013 is primarily attributable to the de-designation of interest rate swaps, realized losses on interest rate derivative instruments and the sale of MBS at a loss during 2014 versus 2013.

As a result of discontinuing hedge accounting, beginning January 1, 2014, changes in the fair value of the interest rate swap agreements are recorded in gain (loss) on interest rate derivative instruments, net in our consolidated statements of operations, rather than in AOCI. For the three months ended June 30, 2014, we recognized unrealized losses for the change in fair value of our interest rates swaps of \$103.6 million. For the six months ended June 30, 2014, we recognized unrealized losses for the change in fair value of our interest rates swaps of \$193.8 million. In addition, during the three months ended June 30, 2014, we recognized amortization of deferred swap losses from de-designation previously recognized in other comprehensive income of \$21.5 million, and during the six months ended June 30, 2014, we recognized amortization of deferred swap losses from de-designation previously recognized in other comprehensive income of \$42.8 million.



Table of Contents

## Non-GAAP Financial Measures

We are presenting the following non-GAAP financial measures: core earnings, effective interest expense (and by calculation, effective cost of funds) and effective net interest income (and by calculation, effective interest rate margin). Our management uses these non-GAAP financial measures in our internal analysis of results and believes these measures are useful to investors for the reasons explained below. The most directly comparable U.S. GAAP measures are net income attributable to common shareholders, total interest expense (and by calculation, cost of funds) and net interest income (and by calculation, net interest rate margin).

These non-GAAP financial measures should not be considered as substitutes for any measures derived in accordance with U.S. GAAP and may not be comparable to other similarly titled measures of other companies. An analysis of any non-GAAP financial measure should be made in conjunction with results presented in accordance with U.S. GAAP. Additional reconciling items may be added in the future to these non-GAAP measures if deemed appropriate.

## Core Earnings

We calculate core earnings as U.S. GAAP net income attributable to common shareholders adjusted for gain (loss) on sale of investments, net, realized gain on interest rate derivative instruments (excluding contractual net interest on interest rate swaps), unrealized loss on interest rate derivative instruments, amortization of deferred swap losses from de-designation and adjustments attributable to non-controlling interest.

We believe the presentation of core earnings allows investors to evaluate and compare our performance to that of our peers because core earnings measures investment portfolio performance over multiple reporting periods by removing realized and unrealized gains and losses. We record changes in the valuation of our investment portfolio, and through December 31, 2013 certain interest rate swaps, in other comprehensive income. Effective December 31, 2013, we elected to discontinue hedge accounting for our interest rate swaps. As a result of our election, starting January 1, 2014 the change in market value of our interest rate swaps and the amortization of deferred swap losses remaining in other comprehensive income at December 31, 2013 are included in U.S. GAAP net income. In addition, we use interest rate swaptions, invest in TBAs and U.S. Treasury futures contracts that do not qualify under U.S. GAAP for inclusion in other comprehensive income, and, as such, the changes in valuation are recorded in net income the period in which they occur. For internal portfolio analysis, our management deducts these gains and losses from U.S. GAAP net income to provide a consistent view of investment portfolio performance across reporting periods. As such, we believe that the disclosure of core earnings is useful and meaningful to our investors.

However, we caution that core earnings should not be considered as an alternative to net income (determined in accordance with U.S. GAAP), or an indication of our cash flow from operating activities (determined in accordance with U.S. GAAP), a measure of our liquidity, or an indication of amounts available to fund our cash needs, including our ability to make cash distributions.

The table below provides a reconciliation of U.S. GAAP net income attributable to common shareholders to core earnings for the following periods:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
\$ in thousands, except per share data	2014	2013	2014	2013
Net income (loss) attributable to common shareholders	(94,052	) 138,847	(168,492	) 222,838
Adjustments				
(Gain) loss on sale of investments, net	20,766	(5,692	) 32,484	(12,404
Realized loss on interest rate derivative instruments (excluding contractual net interest on interest rate swaps of \$52,205, \$0, and \$103,646 and \$0, respectively)	15,037	(27,159	) 33,861	(27,159
Unrealized (gain) loss on interest rate derivative instruments	100,574	(26,155	) 181,621	(24,152
Amortization of deferred swap losses from de-designation	21,532	—	42,828	—
Subtotal	157,909	(59,006	) 290,794	(63,715
Adjustment attributable to non-controlling interest	(1,807	) 613	(3,318	) 663

Edgar Filing: Invesco Mortgage Capital Inc. - Form 10-Q

Core earnings	62,050	80,454	118,984	159,786
Basic earnings (loss) per common share	(0.76	) 1.03	(1.37	) 1.69
Core earnings per share attributable to common shareholders	0.50	0.60	0.97	1.22

58

---

Table of Contents

## Effective Interest Expense / Effective Cost of Funds / Effective Net Interest Income / Effective Interest Rate Margin

Effective interest expense, effective cost of funds, effective net interest income and effective interest rate margin include adjustments for the net interest component related to our interest rate swaps and excludes amortization of deferred swap losses from de-designation. Although, as of January 1, 2014 we have elected to discontinue hedge accounting for our interest rate swaps, such derivative instruments are viewed by us as an economic hedge against increases in future market interest rates on our liabilities and therefore the effective cost of funds reflects total interest expense adjusted to include the realized loss (i.e., the interest expense component) for all of our interest rate swaps and add back the unrealized loss from swap losses that were previously recorded in other comprehensive income and is being amortized into total interest expense over the remaining swap lives. In addition, we view the cost of the associated repurchase agreements (interest expense), borrowing costs on our exchangeable senior notes, and borrowing costs on our ABS as a component of our effective cost of funds.

We believe the presentation of effective interest expense, effective costs of funds, effective net interest income and effective interest rate margin measures, when considered together with U.S. GAAP financial measures, provide information that is useful to investors in understanding our borrowing costs, as viewed by management.

The following tables reconcile total interest expense to effective interest expense and cost of funds to effective cost of funds for the following periods:

	Three Months Ended June 30, 2014		2013	
	Reconciliation / Effective Cost of Funds	Cost of Funds	Reconciliation / Effective Cost of Funds	Cost of Funds
\$ in thousands				
Total interest expense	69,437	1.58 %	79,462	1.66 %
Less: Amortization of deferred swap losses from de-designation	(21,532 )	(0.49 )%	—	— %
Add: Net interest paid - interest rate swaps	52,205	1.19 %	—	— %
Effective interest expense	100,110	2.28 %	79,462	1.66 %

	Six Months Ended June 30, 2014		2013	
	Reconciliation / Effective Cost of Funds	Cost of Funds	Reconciliation / Effective Cost of Funds	Cost of Funds
\$ in thousands				
Total interest expense	138,050	1.59 %	147,030	1.62 %
Less: Amortization of deferred swap losses from de-designation	(42,828 )	(0.49 )%	—	— %
Add: Net interest paid - interest rate swaps	103,646	1.20 %	—	— %
Effective interest expense	198,868	2.30 %	147,030	1.62 %

The following tables reconcile net interest income to effective net interest income and net interest rate margin to effective interest rate margin for the following periods:

	Three Months Ended June 30, 2014		2013	
	Reconciliation Net Interest Rate Margin /	Net Interest Rate Margin /	Reconciliation Net Interest Rate Margin /	Net Interest Rate Margin /
\$ in thousands				



Edgar Filing: Invesco Mortgage Capital Inc. - Form 10-Q

		Effective Interest Rate Margin		Effective Interest Rate Margin	
Net interest income	105,015	1.90	% 96,223	1.59	%
Add: Amortization of deferred swap losses from de-designation	21,532	0.49	% —	—	
Less: Net interest paid - interest rate swaps	(52,205	) (1.19	)% —	—	
Effective net interest income	74,342	1.20	% 96,223	1.59	%

59

---

Table of Contents

\$ in thousands	Six Months Ended June 30, 2014			2013		
	Reconciliation	Net Interest Rate Margin / Effective Interest Rate Margin		Reconciliation	Net Interest Rate Margin / Effective Interest Rate Margin	
Net interest income	207,464	1.91	%	189,136	1.61	%
Add: Amortization of deferred swap losses from de-designation	42,828	0.49	%	—	—	
Less: Net interest paid - interest rate swaps	(103,646 )	(1.20	)%	—	—	
Effective net interest income	146,646	1.20	%	189,136	1.61	%

**Interest Income and Average Earning Asset Yield**

Our primary source of income is interest earned on our investment portfolio. We had average earning assets of approximately \$20.0 billion (2013: \$21.6 billion) and earned interest income of \$174.5 million (2013: \$175.7 million) for the three months ended June 30, 2014. The yield on our average investment portfolio was 3.48% (2013: 3.25%) for the respective period. Our average investment portfolio decreased \$1.6 billion for the three months ended June 30, 2014 versus June 30, 2013.

We had average earning assets of \$19.7 billion (2013: \$20.8 billion) and earned interest income of \$345.5 million (2013: \$336.2 million) for the six months ended June 30, 2014. The yield on our average investment portfolio was 3.50% (2013: 3.23%) for the respective period. Our average investment portfolio decreased \$1.1 billion for the six months ended June 30, 2014 versus June 30, 2013.

The change in our average assets and portfolio yield during the three and six months ended June 30, 2014 compared to 2013 was primarily attributable to the change in our portfolio composition. We continue to evaluate our investment portfolio and make adjustments based on our views of the market opportunities. Refer to the average balance table in the “Results of Operations” section above for changes in average portfolio balance and asset mix.

Our interest income is subject to interest rate risk. Refer to Item 3. “Quantitative and Qualitative Disclosures about Market Risk” for more information relating to interest rate risk and its impact on our operating results.

The CPR of our portfolio impacts the amount of premium and discount on the purchase of securities that is recognized into income. Our Agency, non-Agency RMBS and GSE CRT had a weighted average CPR of 10.0 and 8.2 for the three months ended June 30, 2014 and March 31, 2014, respectively. The table below shows the three month CPR for our RMBS compared to bonds with similar characteristics (“Cohorts”).

	June 30, 2014		March 31, 2014	
	Company	Cohorts	Company	Cohorts
15 year Agency RMBS	12.3	13.3	9.8	12.4
30 year Agency RMBS	9.4	9.8	7.2	8.2
Agency Hybrid ARM RMBS	9.4	NA	5.9	NA
Non-Agency RMBS	11.2	NA	10.5	NA
GSE CRT	4.5	NA	4.3	NA
Weighted average	10.0	NA	8.2	NA

**Interest Expense and the Cost of Funds**

Through December 31, 2013, interest expense includes borrowing costs under repurchase agreements, exchangeable senior notes, ABS and secured loans, as well as any hedging costs. Beginning January 1, 2014, we de-designated our interest rate swaps as cash flow hedges. As a result of de-designating, net interest paid or received under our interest rate swaps are no longer reflected in interest expense on our consolidated statements of operations, instead it is included in gain (loss) on interest rate derivative instruments, net. In addition, unrealized swap losses previously

included in other comprehensive income are prospectively amortized into interest expense over the remaining term of the interest rate swap, as long as the forecasted transactions that were being hedged are still expected to occur. No reclassifications or adjustments were made to the three and six months ended June 30, 2013 interest expense as a result of the de-designation.

Table of Contents

Our largest expense is the interest expense on borrowed funds. We had average borrowed funds of \$17.5 billion (2013: \$19.1 billion) and total interest expense of \$69.4 million (2013: \$79.5 million) for the three months ended June 30, 2014. We had average borrowed funds of \$17.3 billion (2013: \$18.2 billion) and total interest expense of \$138.1 million (2013: \$147.0 million) for the six months ended June 30, 2014. We compute our effective interest expense (non-GAAP measure) and effective cost of funds (non-GAAP measure) by including the net interest component related to our interest rate swaps and excluding the amortization of the deferred swap losses from de-designation from our interest expense. Effective interest expense (non-GAAP measure) was \$100.1 million (2013: \$79.5 million) for the three months ended June 30, 2014. Effective interest expense (non-GAAP measure) was \$198.9 million (2013: \$147.0 million) for the six months ended June 30, 2014. The change in average borrowed funds and interest expense was primarily the result of the change in the size and composition of our investment portfolio.

For the three months ended June 30, 2014, our cost of funds was 1.58% (2013: 1.66%), and for the six months ended June 30, 2014, our cost of funds was 1.59% (2013: 1.62%). For the three months ended June 30, 2014, our effective cost of funds (non-GAAP measure) was 2.28% (2013: 1.66%), and for the six months ended June 30, 2014, our effective cost of funds (non-GAAP measure) was 2.30% (2013: 1.62%). Since a substantial portion of our repurchase agreements are short term, changes in market rates are directly reflected in our interest expense.

**Net Interest Income**

Our net interest income, which equals interest income less interest expense, totaled \$105.0 million (2013: \$96.2 million) for the three months ended June 30, 2014 and \$207.5 million (2013: \$189.1 million) for the six months ended June 30, 2014. Our net interest rate margin was 1.90% (2013: 1.59%) for the three months ended June 30, 2014 and 1.91% (2013: 1.61%) for the six months ended June 30, 2014.

Our effective net interest income (non-GAAP measure), which equals net interest income less effective interest expense (non-GAAP measure), totaled \$74.3 million (2013: \$96.2 million) for the three months ended June 30, 2014 and \$146.6 million (2013: \$189.1 million) for the six months ended June 30, 2014. Our effective interest rate margin (non-GAAP measure) was 1.20% (2013: 1.59%) for the three months ended June 30, 2014 and 1.20% (2013: 1.61%) for the six months ended June 30, 2014.

The decrease in effective net interest income and our effective interest rate margin for the three and six months ended June 30, 2014 compared to 2013 was a direct result of the change in prepayment speeds on the MBS portfolio and a change in our portfolio composition. Refer to the average balance table in the “Results of Operations” section above for changes in average portfolio balance and asset mix.

**Provision for Loan Losses**

We evaluated our residential and commercial loans, held-for-investment to determine if it is probable that all amounts due will not be collected according to the terms of the loan agreements. Based upon this analysis, we recorded a decrease in the provision for loan losses of \$50,000 (2013: \$663,000 increase) for the three months ended June 30, 2014, and an increase of \$157,000 (2013: \$663,000) for the six months ended June 30, 2014, primarily associated with the acquisition of additional residential loans.

**Gain (loss) on Sale of Investments**

As part of our investment process, all of our MBS are continuously reviewed to determine if they continue to meet our risk and return targets. This process involves looking at changing market assumptions and the impact those assumptions will have on the individual securities. The changes in interest rates resulted in a decline in the value of Agency RMBS. We continued to reposition the portfolio to be less sensitive to interest rate changes. We sold securities and recognized a net loss of \$20.8 million (2013: \$5.7 million net gain) for the three months ended June 30, 2014 and a net loss of \$32.5 million (2013: \$12.4 million net gain) for for the six months ended June 30, 2014.

**Loss on Other-Than-Temporary Impaired Securities**

For the three and six months ended June 30, 2014 and 2013, we did not recognize any losses on other-than-temporarily impaired securities in the consolidated statements of operations which had been previously included in accumulated other comprehensive income. Refer to Note 4 – “Mortgage-Backed Securities” for the assessment of other-than-temporary impairment on our investment securities.



Table of Contents

## Equity in Earnings and Change in Fair Value of Unconsolidated Ventures

For the three months ended June 30, 2014, we recognized equity in earnings of approximately \$1.9 million (2013: \$561,000), and unrealized gain on the change in fair value of our investment in the Invesco IMRF Fund of \$1.3 million (2013: \$1.3 million gain). The increase in equity in earnings was primarily the result of an increase in earnings from the remaining investments in the Invesco IMRF Fund.

For the six months ended June 30, 2014, we recognized equity in earnings of approximately \$2.1 million (2013: \$906,000), and unrealized gain on the change in fair value of our investment in the Invesco IMRF Fund of \$1.4 million (2013: \$1.5 million gain). The increase in equity in earnings was primarily the result of an increase in earnings from the remaining investments in the Invesco IMRF Fund.

In 2011, we invested in a portfolio of commercial mortgage loans by contributing \$16.9 million, net of distributions, of equity capital to IMRF Loan Portfolio Member LLC ("IMRF LLC"). For the three months ended June 30, 2014, we recognized equity in earnings and unrealized depreciation on the change in fair value of our investment in the IMRF LLC of approximately \$1.6 million (2013: \$197,000 gain) and \$959,000 (2013: \$84,000 appreciation), respectively. For the six months ended June 30, 2014, we recognized equity in earnings and unrealized depreciation on the change in fair value of our investment in the IMRF LLC of approximately \$1.7 million (2013: \$92,000 gain) and \$919,000 loss (2013: \$1.3 million appreciation), respectively.

## Other Income (Loss)

Since the interest rate on repurchase agreements change on a one to twelve month basis, we are continuously exposed to changing interest rates. Our objectives in using interest rate derivatives are to add stability to interest expense and to manage our exposure to interest rate movements. To accomplish these objectives, we primarily use interest rate derivative instruments, including interest rate swaps, interest rate swaptions, U.S. Treasury futures contracts and TBAs as part of our interest rate risk management strategy. Interest rate swaps involve the receipt of variable-rate amounts from a counterparty in exchange for us making fixed-rate payments over the life of the agreements without exchange of the underlying notional amount. The interest rate swaption provides us the option to enter into an interest rate swap agreement for a predetermined notional amount, stated term and pay and receive interest rates in the future. The premium paid for interest rate swaptions is reported as an asset in our consolidated balance sheets. The premium is valued at an amount equal to the fair value of the swaption that would have the effect of closing the position adjusted for nonperformance risk, if any. TBAs are reported on the balance sheet as an asset or liability at its fair value.

Effective December 31, 2013, we elected to discontinue hedge accounting for our interest rate swap agreements by de-designating the swaps as cash flow hedges. As a result of the de-designation, the accounting treatment for interest rate swap agreements is changed prospectively. Refer to Note 9 - "Derivatives and Hedging Activities" for further information.

The tables below summarize our realized and unrealized gain (loss) on interest rate derivative instruments, net for the following periods:

\$ in thousands	Three months ended June 30, 2014			
	Realized gain (loss) on settlement, termination, expiration or exercise, net	Contractual interest expense	Unrealized gain (loss), net	Gain (loss) on interest rate derivatives, net
Interest Rate Swaps	—	(52,205	) (103,633	) (155,838
Swaption Contracts	(8,200	) —	4,654	(3,546
TBAs	(1,400	) —	(1,938	) (3,338
Futures Contracts	(5,437	) —	343	(5,094
Total	(15,037	) (52,205	) (100,574	) (167,816



Table of Contents

\$ in thousands	Six months ended June 30, 2014			
Derivative not designated as hedging instrument	Realized gain (loss) on settlement, termination, expiration or exercise, net	Contractual interest expense	Unrealized gain (loss), net	Gain (loss) on interest rate derivatives, net
Interest Rate Swaps Swaption Contracts	—	(103,646	) (193,825	) (297,471
TBAs	(23,275	) —	15,781	(7,494
Futures Contracts	(1,400	) —	(1,235	) (2,635
Total	(9,186	) —	(2,342	) (11,528
	(33,861	) (103,646	) (181,621	) (319,128

\$ in thousands	Three months ended June 30, 2013			
Derivative Instrument	Realized gain (loss) on settlement, termination, expiration or exercise, net	Contractual interest expense	Unrealized gain (loss), net	Gain (loss) on interest rate derivatives, net
Interest Rate Swaps ineffectiveness	—	—	294	294
Swaption Contracts	27,159	—	25,861	53,020
Total	27,159	—	26,155	53,314

\$ in thousands	Six months ended June 30, 2013			
Derivative Instrument	Realized gain (loss) on settlement, termination, expiration or exercise, net	Contractual interest expense	Unrealized gain (loss), net	Gain (loss) on interest rate derivatives, net
Interest Rate Swaps ineffectiveness	—	—	293	293
Swaption Contracts	27,159	—	23,859	51,018
Total	27,159	—	24,152	51,311

## Expenses

For the three months ended June 30, 2014, we incurred management fees of \$9.3 million (2013: \$10.8 million) and \$18.7 million (2013: \$21.2 million) for the six months ended June 30, 2014, which are payable to our Manager under our management agreement. The decrease in management fees is attributable to a decrease in shareholders' equity resulting from stock repurchase program during the three months ended March 31, 2014 and three months ended December 31, 2013. See Note 12 – "Related Party Transactions" for a discussion of the management fee and our relationship with our Manager.

For the three months ended June 30, 2014, our general and administrative expense of \$3.7 million (2013: \$3.0 million) and \$6.9 million (2013: \$4.6 million) for the six months ended June 30, 2014 includes operating expenses not covered under our management agreement. These expenses primarily consist of directors and officers insurance, accounting services, auditing and tax services, filing fees, and miscellaneous general and administrative costs. The increase in general and administrative costs is primarily attributable to acquisition and direct operating costs of our consolidated VIEs acquired during the three and six months ended June 30, 2014, which amount to \$1.8 million and \$3.2 million, respectively, in 2014 versus \$1.3 million and \$1.7 million for the three and six months ended June 30, 2013. In



addition, costs for audit and tax services, accounting and legal services increased due to an increase in investment activities in the second half of 2013 and year to date 2014.

Table of Contents**Net Income (loss) after Preferred Dividends and Return on Average Equity**

Our net loss after preferred dividends was \$95.1 million (2013: \$140.3 million net income) for the three months ended June 30, 2014. Our annualized loss on average equity was 15.40% (2013: 20.23% annualized return) for the three months ended June 30, 2014. The change in net income after preferred dividends and return on average equity was primarily the result of the de-designation of interest rate swaps, realized losses on expired unexercised interest rate swaptions, the sale of MBS at a loss during 2014 versus 2013, as well as an increase in our borrowing costs. As a result of the de-designation of our interest rate swaps, beginning January 1, 2014 the changes in the fair value of our interest rate swaps are included in net income as opposed to other comprehensive income. For the three months ended June 30, 2014, we recognized unrealized losses for the change in fair value of our interest rates swaps of \$103.6 million. In addition, during the three months ended June 30, 2014, we recognized amortization of deferred swap losses from de-designation previously recognized in other comprehensive income of \$21.5 million.

Our net loss after preferred dividends was \$170.4 million (2013: \$225.3 million net income) for the six months ended June 30, 2014. Our annualized loss on average equity was 14.18% (2013: 16.42% annualized return) for the six months ended June 30, 2014. The change in net income after preferred dividends and return on average equity was primarily the result of the de-designation of interest rate swaps, realized losses on expired unexercised interest rate swaptions, the sale of MBS at a loss during 2014 versus 2013, as well as an increase in our borrowing costs. As a result of the de-designation of our interest rate swaps, beginning January 1, 2014 the changes in the fair value of our interest rate swaps are included in net income as opposed to other comprehensive income. For the six months ended June 30, 2014, we recognized unrealized losses for the change in fair value of our interest rates swaps of \$193.8 million. In addition, during the six months ended June 30, 2014, we recognized amortization of deferred swap losses from de-designation previously recognized in other comprehensive income of \$42.8 million.

**Liquidity and Capital Resources**

Liquidity is a measurement of our ability to meet potential cash requirements, including ongoing commitments to pay dividends, fund investments, repayment of borrowings and other general business needs. Our primary sources of funds for liquidity consist of the net proceeds from our common and preferred equity offerings, net cash provided by operating activities, cash from repurchase agreements and other financing arrangements and future issuances of equity and/or debt securities.

We currently believe that we have sufficient liquidity and capital resources available for the acquisition of additional investments, repayments on borrowings, margin requirements and the payment of cash dividends as required for continued qualification as a REIT. We generally maintain liquidity to pay down borrowings under repurchase arrangements to reduce borrowing costs and otherwise efficiently manage our long-term investment capital. Because the level of these borrowings can be adjusted on a daily basis, the level of cash and cash equivalents carried on our consolidated balance sheets is significantly less important than our potential liquidity available under borrowing arrangements. However, there can be no assurance that we will maintain sufficient levels of liquidity to meet any margin calls.

We held cash and cash equivalents of \$126.1 million (2013: \$169.8 million) at June 30, 2014. Our cash and cash equivalents decreased due to normal fluctuations in cash balances related to the timing of principal and interest payments, repayments of debt, and asset purchases and sales.

Our operating activities provided net cash of approximately \$186.6 million (2013: \$259.5 million) for the six month period ended June 30, 2014. The cash provided by operating activities decreased due primarily to an increase in borrowing costs for the six months ended June 30, 2014 as compared to the six months ended June 30, 2013.

Our investing activities used net cash of \$328.9 million (2013: used \$4.7 billion) for the six month period ended June 30, 2014. During the six month period ended June 30, 2014, we utilized cash to purchase \$3.1 billion (2013: \$6.1 billion) in securities and \$557.8 million (2013: \$1.6 billion) in residential loans which were offset by proceeds from asset sales of \$2.5 billion (2013: \$1.4 billion) and principal payments on securities of \$878.5 million (2013: \$1.6 billion) and principal repayments on residential loans of \$55.2 million (2013: \$8.6 million). In addition, we originated or funded commercial loans of \$30.6 million (2013: \$9.1 million). The decrease in principal payments resulted from

slower prepayment speeds on the MBS portfolio and a change in the composition of these assets.

Our financing activities for the six months ended June 30, 2014 consisted of net proceeds of our repurchase agreements of \$728.5 million (2013: \$2.2 billion borrowings), net proceeds from our asset-backed securities of \$422.5 million (2013: \$1.4 billion), net proceeds from our dividend reinvestment and share purchase plan (“DRSPP”) in which we raised approximately \$136,000 (2013: \$396.5 million, including the proceeds from common stock offering) in equity, offset by principal repayments of asset-backed securities of \$48.4 million (2013: \$8.4 million). In addition, during the six month period ended June 30, 2014

Table of Contents

we repurchased shares of common stock totaling \$21.1 million (2013: \$0), and during the six months ended June 30, 2013, we had proceeds from the issuance of our exchangeable senior notes of \$384.4 million net of issuance costs. The table below shows the allocation of our equity and repurchase agreement debt-to-equity ratio as of June 30, 2014. The amount of equity allocated to an asset class as well as the amount of leverage applied has a direct impact on our interest income. Repurchase agreement borrowings are short-term and subject to refinancing risk. We generally limit our repurchase agreement financing debt-to-equity ratio to approximately 7 times. Our leverage on each class of assets may periodically exceed this amount as we adjust our portfolio allocations and related borrowings to obtain the best available financing sources and minimize total interest expense.

\$ in millions	Agency	Non-Agency	GSE CRT	CMBS	Total
Repurchase agreements <sup>(1)</sup>	10,032	2,712	347	1,632	14,723
Equity allocation <sup>(2)</sup>	1,024	866	147	607	2,644
Repurchase Agreement Debt / Equity Ratio	9.8	3.1	2.4	2.7	5.6

(1) Non-Agency repurchase agreements include borrowings that are collateralized by securities that are eliminated in consolidation.

(2) Equity allocation is generally equal to the asset balances for the listed category less borrowings. We also allocate other balance sheet assets and liabilities to each asset type. The total equity allocated to repurchase agreements exceeds the total equity on our consolidated balance sheets since we do not allocate the exchangeable senior notes to individual asset categories.

As of June 30, 2014, we had \$625.0 million in outstanding secured loans from the FHLBI and access to an additional \$625.0 million of available uncommitted credit for borrowings which amount may be adjusted at the sole discretion of the FHLBI. All FHLBI advances are collateralized by CMBS with a fair value of \$843.4 million as of June 30, 2014.

As of June 30, 2014, the weighted average margin requirement, or the percentage amount by which the collateral value must exceed the loan amount, which we also refer to as the “haircut,” under our repurchase agreements for Agency RMBS was approximately 4.62% (weighted by borrowing amount), under our repurchase agreements for non-Agency RMBS was approximately 19.25%, GSE CRT was approximately 28.65% and under our repurchase agreements for CMBS was approximately 19.65%. Across our repurchase facilities for Agency RMBS, the haircuts range from a low of 3% to a high of 10%, for non-Agency RMBS ranges from a low of 10% to a high of 50%, GSE CRT ranges from a low of 25% to a high of 35% and for CMBS range from a low of 10% to a high of 30%. Our effective cost of funds (non-GAAP measure) was 2.30% (2013: 1.62%) as of June 30, 2014. Declines in the value of our securities portfolio can trigger margin calls by our lenders under our repurchase agreements. An event of default or termination event would give some of our counterparties the option to terminate all repurchase transactions existing with us and require any amount due by us to the counterparties to be payable immediately.

Our total debt-to-equity ratio, which includes longer term financing, was 6.8x as of June 30, 2014 (2013: \$7.6x). The decrease in total debt-to-equity was primarily due to an increase in the value of our assets and lower interest rates on secured loans we entered into during 2014.

In 2011, we implemented the DRSP. We have registered and reserved for issuance 15,000,000 shares of our common stock under the DRSP. Under the terms of the DRSP, shareholders who participate in the DRSP may purchase shares of our common stock directly from us, in cash investments up to \$10,000, or greater than \$10,000 if we grant a request for waiver. At our sole discretion, we may accept optional cash investments in excess of \$10,000 per month, which may qualify for a discount from the market price of 0% to 3%. The DRSP participants may also automatically reinvest all or a portion of their dividends for additional shares of our stock. During the six months ended June 30, 2014, we issued 8,235 shares (2013: 1,761,054 shares) of common stock at an average price of \$16.55 under the DRSP with total proceeds of approximately \$136,000, of which no shares of common stock were issued under the waiver feature of the DRSP.

Edgar Filing: Invesco Mortgage Capital Inc. - Form 10-Q

On December 12, 2011, our board of directors approved a share repurchase program to purchase up to 7,000,000 shares of our common shares with no stated expiration date. On December 2, 2013, our board of directors approved an additional share repurchase of up to 20,000,000 of our common shares with no expiration date. As of June 30, 2014, there were 14,841,784 shares available for purchase under the program. Shares of our common stock may be purchased in the open market, including through block purchases, or through privately negotiated transactions, or pursuant to any trading plan that may be adopted in accordance with Rules 10b5-1 and 10b-18 of the Securities Exchange Act of 1934, as amended. The timing, manner, price and amount of any repurchases will be determined at our discretion and the program may be suspended, terminated or modified at

## Table of Contents

any time for any reason. The program does not obligate us to acquire any specific number of shares, and all repurchases will be made in accordance with Rule 10b-18, which sets certain restrictions on the method, timing, price and volume of stock repurchases.

During the six months ended June 30, 2014, we repurchased 1,438,213 shares of our common stock at an average repurchase price of \$14.69 per share for a net cost of \$21.1 million, including acquisition expenses. During the six months ended June 30, 2013, we did not repurchase any shares of our common stock. As of June 30, 2014, we had authority to purchase 14,841,784 additional shares of our common stock through this program.

### Effects of Margin Requirements, Leverage and Credit Spreads

Our securities have values that fluctuate according to market conditions and, as discussed above, the market value of our securities will decrease as prevailing interest rates or credit spreads increase. When the value of the securities pledged to secure a repurchase loan decreases to the point where the positive difference between the collateral value and the loan amount is less than the haircut, our lenders may issue a “margin call,” which means that the lender will require us to pay the margin call in cash or pledge additional collateral to meet that margin call. Under our repurchase facilities, our lenders have full discretion to determine the value of the securities we pledge to them. Most of our lenders will value securities based on recent trades in the market. Lenders also issue margin calls as the published current principal balance factors change on the pool of mortgages underlying the securities pledged as collateral when scheduled and unscheduled paydowns are announced monthly.

We experience margin calls in the ordinary course of our business. In seeking to effectively manage the margin requirements established by our lenders, we maintain a position of cash and unpledged securities. We refer to this position as our “liquidity.” The level of liquidity we have available to meet margin calls is directly affected by our leverage levels, our haircuts and the price changes on our securities. If interest rates increase as a result of a yield curve shift or for another reason or if credit spreads widen, then the prices of our collateral (and our unpledged assets that constitute our liquidity) will decline, we will experience margin calls, and we will use our liquidity to meet the margin calls. There can be no assurance that we will maintain sufficient levels of liquidity to meet any margin calls. If our haircuts increase, our liquidity will proportionately decrease. In addition, if we increase our borrowings, our liquidity will decrease by the amount of additional haircut on the increased level of indebtedness.

We intend to maintain a level of liquidity in relation to our assets that enables us to meet reasonably anticipated margin calls but that also allows us to be substantially invested in securities. We may misjudge the appropriate amount of our liquidity by maintaining excessive liquidity, which would lower our investment returns, or by maintaining insufficient liquidity, which would force us to liquidate assets into unfavorable market conditions and harm our results of operations and financial condition.

### Forward-Looking Statements Regarding Liquidity

Based upon our current portfolio, leverage rate and available borrowing arrangements, we believe that cash flow from operations and available borrowing capacity will be sufficient to enable us to meet anticipated short-term (one year or less) liquidity requirements to fund our investment activities, pay fees under our management agreement, fund our distributions to shareholders and for other general corporate expenses.

Our ability to meet our long-term (greater than one year) liquidity and capital resource requirements will be subject to obtaining additional debt financing. We may increase our capital resources by obtaining long-term credit facilities or through public or private offerings of equity or debt securities, possibly including classes of preferred stock, common stock, and senior or subordinated notes. Such financing will depend on market conditions for capital raises and our ability to invest such offering proceeds. If we are unable to renew, replace or expand our sources of financing on substantially similar terms, it may have an adverse effect on our business and results of operations.

### Contractual Obligations

We have entered into an agreement with our Manager pursuant to which our Manager is entitled to receive a management fee and the reimbursement of certain expenses. The management fee is calculated and payable quarterly in arrears in an amount equal to 1.50% of our shareholders’ equity, per annum. Our Manager uses the proceeds from its management fee in part to pay compensation to its officers and personnel who, notwithstanding that certain of those

individuals are also our officers, receive no cash compensation directly from us. We are required to reimburse our Manager for operating expenses related to us incurred by our Manager, including expenses relating to legal, accounting, due diligence and other services. Expense reimbursements to our Manager are made in cash on a monthly basis following the end of each month. Our reimbursement obligation is not subject to any dollar limitation. Refer to Note 12 – “Related Party Transactions” for details of our reimbursements to our Manager.

Table of Contents

## Contractual Commitments

As of June 30, 2014, we had the following contractual commitments and commercial obligations:

\$ in thousands	Payments Due by Period				
	Total	Less than 1 year	1-3 years	3-5 years	After 5 years
Obligations of Invesco Mortgage Capital Inc.					
Repurchase agreements	14,723,223	14,723,223	—	—	—
Secured loans	625,000	625,000	—	—	—
Invesco IMRF Fund and AIV Fund	5,359	5,359	—	—	—
Exchangeable senior notes	400,000	—	—	400,000	—
Commercial loans	8,990	7,202	1,788	—	—
Total contractual obligations <sup>(1)</sup>	15,762,572	15,360,784	1,788	400,000	—
Obligations of entities consolidated for financial reporting purposes					
Consolidated ABS <sup>(2)</sup>	2,001,751	210,975	366,263	298,450	1,126,063
Anticipated interest payments on ABS <sup>(3)</sup>	1,133,555	65,998	128,105	122,568	816,884
Total obligations of entities consolidated for financial reporting purposes	3,135,306	276,973	494,368	421,018	1,942,947
Total consolidated obligations and commitments	18,897,878	15,637,757	496,156	821,018	1,942,947

Excluded from total contractual obligations are the amounts due to our Manager under the management agreement, (1) as those obligations do not have fixed and determinable payments. Refer to "Contractual Obligations" above for further details.

All consolidated ABS issued by VIEs are collateralized by residential mortgage loans. The ABS obligations will (2) pay down as the principal balances of these residential mortgage loans pay down. The amounts shown are the estimated principal repayments, adjusted for projected prepayments and losses.

The anticipated interest payments on consolidated ABS issued by VIEs are calculated based on estimated principal (3) balances, adjusted for projected prepayments and losses.

As of June 30, 2014, we have approximately \$94.8 million, \$81.2 million and \$418,000 in contractual interest payments related to our repurchase agreements, exchangeable senior notes and secured loans, respectively.

## Off-Balance Sheet Arrangements

We committed to invest up to \$100.0 million in the Invesco IMRF Fund and AIV Fund, which, in turn, invests in our target assets. As of June 30, 2014, \$94.6 million (2013: \$83.3 million) of our commitment to the Invesco IMRF Fund and AIV Fund has been called. On December 31, 2013, the investment period ended. We are committed to fund an additional \$5.4 million in capital to cover future expenses should they occur.

We also utilize credit derivatives, such as credit default swaps, to provide credit event protection based on a financial index or specific security in exchange for receiving a fixed-rate fee or premium over the term of the contract. These instruments enable us to synthetically assume the credit risk of a reference security, portfolio of securities or index of securities. The counterparty pays a premium to us and we agree to make a payment to compensate the counterparty for losses upon the occurrence of a specified credit event. Although contract specific, credit events generally include bankruptcy, failure to pay, restructuring, obligation acceleration, obligation default, or repudiation/moratorium. Upon the occurrence of a defined credit event, the difference between the value of the reference securities and the CDS's notional amount is recorded as realized loss in the statements of operations.

Our only CDS contract was entered into in December 2010. We sold protection against losses on a specific pool of non-Agency RMBS in the event they exceed a specified loss limit of 25% of the balance of the non-Agency RMBS on the trade date. The maximum exposure is the remaining unpaid principal balance of the underlying RMBS in excess of



the specified loss threshold. In exchange, we are paid a stated fixed rate fee of 3%. We are required to post collateral as security for potential loss payments. We posted collateral to secure potential loss payments of \$6.8 million as of June 30, 2014 (2013: \$10.1 million). The remaining notional amount of the CDS at June 30, 2014 is \$44.0 million (2013: \$64.5 million), and we estimated the fair

## Table of Contents

market value of the CDS to be approximately \$547,000 at June 30, 2014 (2013: \$950,000). As of June 30, 2014, we have not made any payments related to the CDS contract.

As of June 30, 2014 we held contracts to sell ("short position") with an aggregate notional amount of \$201.0 million (2013: \$0) for \$209.4 million (2013: \$0) TBAs on a forward basis. If a counterparty of one of the TBA agreements that we entered into defaults on its obligations, we may not receive payment or securities due under the TBA agreement and we may lose any unrealized gain associated with that TBA transaction.

As of June 30, 2014, we have unfunded commitments on commercial loans of \$9.0 million (2013: \$32.4 million).  
Shareholders' Equity

During the six months ended June 30, 2014, we issued 8,235 shares (2013: 1,761,054 shares) of common stock at an average price of \$16.55 (2013: \$21.34) under the DRSP with total proceeds to us of approximately \$136,000 (2013: \$37.4 million), net of issuance costs of \$0 (2013: \$219,000).

During the six months ended June 30, 2014, we repurchased 1,438,213 shares of our common stock at an average repurchase price of \$14.69 per share for a net cost of \$21.1 million, including acquisition expenses. During the six months ended June 30, 2013, we did not repurchase any shares of our common stock. As of June 30, 2014, we had authority to purchase 14,841,784 additional shares of our common stock through this program.

### Unrealized Gains and Losses

Since we account for our investment securities as "available-for-sale," unrealized fluctuations in market values of assets do not impact our U.S. GAAP income, but rather are reflected on our consolidated balance sheets by changing the carrying value of the asset and shareholders' equity under "Accumulated Other Comprehensive Income (Loss)." In addition, unrealized fluctuations in market values of our cash flow hedges that qualify for hedge accounting are also reflected in "Accumulated Other Comprehensive Income (Loss)." On December 31, 2013, we discontinued hedge accounting on our interest rate swap derivatives resulting in the future unrealized fluctuations in market value of interest rate swap derivatives previously recorded in other comprehensive income are now recognized in gain (loss) on derivative instruments, net and the amortization of deferred losses is recognized in interest expense repurchase agreements in our consolidated statements of operations.

For the three months ended June 30, 2014, net unrealized gain included in shareholders' equity was \$315.5 million (2013: \$398.9 million loss).

For the six months ended June 30, 2014, net unrealized gain included in shareholders' equity was \$518.0 million (2013: \$450.7 million loss).

The increase in net unrealized gain (loss) is primarily attributable to changes in the market value of our RMBS portfolio and amortization of deferred losses on interest rate swap derivatives no longer reported under hedge accounting. Refer to Note 4 – "Mortgage-Backed Securities" and Note 9 – "Derivative and Hedging Activities" for more details on the unrealized gains and losses in both our investment securities and our cash flow hedges. On December 31, 2013, we discontinued hedge accounting for our interest rate swap agreements by de-designating the swaps as cash flow hedges. Refer to Note 9 - "Derivatives and Hedging Activities" for further information.

As a result of this mark-to-market accounting treatment, our book value and book value per share are likely to fluctuate far more than if we used historical amortized cost accounting. As a result, comparisons with companies that use historical cost accounting for some or all of their balance sheet may not be meaningful.

### Share-Based Compensation

We established the 2009 Equity Incentive Plan for grants of restricted common stock and other equity based awards to our independent directors and the executive officers and personnel of the Manager and its affiliates (the "Incentive Plan"). Under the Incentive Plan, a total of 1,000,000 shares of common stock are currently reserved for issuance. Unless terminated earlier, the Incentive Plan will terminate in 2019, but will continue to govern the unexpired awards. We recognized compensation expense of approximately \$112,000 (2013: \$75,000) related to the company's non-executive directors for the six months ended June 30, 2014. During the six months ended June 30, 2014, we issued 5,824 shares (2013: 3,609 shares) of stock pursuant to the Incentive Plan to our non-executive directors. The fair market value of the shares granted was determined by the closing stock market price on the date of the grant.



## Table of Contents

We recognized compensation expense of approximately \$161,000 (2013: \$111,000) for the six months ended June 30, 2014 related to awards to officers and employees of the Manager and its affiliates which is reimbursed by the Manager under the management agreement.

During March 2014, we issued 8,284 shares of common stock (net of tax withholding) in exchange for 12,599 restricted stock units that vested under the Incentive Plan. In addition, during the six months ended June 30, 2014, we awarded 20,732 restricted stock units to officers and employees of the Manager and its affiliates.

### Dividends

We intend to continue to make regular quarterly distributions to holders of our common stock and preferred stock. U.S. federal income tax law generally requires that a REIT to distribute annually at least 90% of its REIT taxable income, determined without regard to the deduction for dividends paid and excluding net capital gains, and that it pay tax at regular corporate rates to the extent that it annually distributes less than 100% of its taxable income. Before we pay any dividend, whether for U.S. federal income tax purposes or otherwise, we must first meet both our operating requirements and debt service on our repurchase agreements and other debt payable. If our cash available for distribution is less than our taxable income, we could be required to sell assets or borrow funds to make cash distributions, or we may make a portion of the required distribution in the form of a taxable stock distribution or distribution of debt securities.

### Inflation

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

### Unrelated Business Taxable Income

We have not engaged in transactions that would result in a portion of our income being treated as unrelated business taxable income.

### Other Matters

We believe that we satisfied each of the asset tests in Section 856(c)(4) of the Code for the period ended June 30, 2014. We also believe that our revenue qualifies for the 75% source of income test and for the 95% source of income test rules for the period ended June 30, 2014. Consequently, we believe we met the REIT income and asset test as of June 30, 2014. We also met all REIT requirements regarding the ownership of our common stock and the distribution of dividends of our net income as of June 30, 2014. Therefore, as of June 30, 2014, we believe that we qualified as a REIT under the Code.

At all times, we intend to conduct our business so that neither we nor our Operating Partnership nor the subsidiaries of our Operating Partnership are required to register as an investment company under the 1940 Act. If we were required to register as an investment company, then our use of leverage would be substantially reduced. Because we are a holding company that conducts our business through our Operating Partnership and the Operating Partnership's wholly-owned or majority-owned subsidiaries, the securities issued by these subsidiaries that are excepted from the definition of "investment company" under Section 3(c)(1) or Section 3(c)(7) of the 1940 Act, together with any other investment securities the Operating Partnership may own, may not have a combined value in excess of 40% of the value of the Operating Partnership's total assets (exclusive of U.S. government securities and cash items) on an unconsolidated basis, which we refer to as the 40% test. This requirement limits the types of businesses in which we are permitted to engage in through our subsidiaries. In addition, we believe neither we nor the Operating Partnership are considered an investment company under Section 3(a)(1)(A) of the 1940 Act because they do not engage primarily or hold themselves out as being engaged primarily in the business of investing, reinvesting or trading in securities. Rather, through the Operating Partnership's wholly-owned or majority-owned subsidiaries, we and the Operating Partnership are primarily engaged in the non-investment company businesses of these subsidiaries. IAS Asset I LLC and certain of the Operating Partnership's other subsidiaries that we may form in the future rely upon the exclusion from the definition of "investment company" under the 1940 Act provided by Section 3(c)(5)(C) of the 1940 Act, which is available for entities "primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." This exclusion generally requires that at least 55% of each subsidiary's portfolio be

comprised of qualifying assets and at least 80% be comprised of qualifying assets and real estate-related assets (and no more than 20% comprised of miscellaneous assets). Qualifying assets for this purpose generally include mortgage loans fully secured by real estate and other assets, such as whole pool Agency and non-Agency RMBS, that the SEC or its staff in various no-action letters has determined are the functional equivalent of mortgage loans fully secured by real estate. Real estate-related assets generally include CMBS, debt and equity securities of companies primarily engaged in real estate businesses, Agency partial pool certificates and securities issued by pass-through entities of which substantially all of the assets consist of qualifying assets and/or real estate-

Table of Contents

related assets. Additionally, unless certain mortgage securities represent all the certificates issued with respect to an underlying pool of mortgages, the MBS may be treated as securities separate from the underlying mortgage loans and, thus, may not be considered qualifying interests for purposes of the 55% requirement. We calculate that as of June 30, 2014, we conducted our business so as not to be regulated as an investment company under the 1940 Act.

Table of Contents

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

The primary components of our market risk are related to interest rate, principal prepayment and market value. While we do not seek to avoid risk completely, we believe the risk can be quantified from historical experience and we seek to actively manage that risk, to earn sufficient compensation to justify taking those risks and to maintain capital levels consistent with the risks we undertake.

**Interest Rate Risk**

Interest rate risk is highly sensitive to many factors, including governmental, monetary and tax policies, domestic and international economic and political considerations, and other factors beyond our control. We are subject to interest rate risk in connection with our investments and our repurchase agreements. Our repurchase agreements are typically of limited duration and will be periodically refinanced at current market rates. We mitigate this risk through utilization of derivative contracts, primarily interest rate swap agreements, TBAs and futures contracts.

**Interest Rate Effect on Net Interest Income**

Our operating results depend in large part upon differences between the yields earned on our investments and our cost of borrowing and interest rate hedging activities. Most of our repurchase agreements provide financing based on a floating rate of interest calculated on a fixed spread over LIBOR. The fixed spread will vary depending on the type of underlying asset which collateralizes the financing. Accordingly, the portion of our portfolio which consists of floating interest rate assets are match-funded utilizing our expected sources of short-term financing, while our fixed interest rate assets are not match-funded. During periods of rising interest rates, the borrowing costs associated with our investments tend to increase while the income earned on our fixed interest rate investments may remain substantially unchanged. This increase in borrowing costs results in the narrowing of the net interest spread between the related assets and borrowings and may even result in losses. Further, during this portion of the interest rate and credit cycles, defaults could increase and result in credit losses to us, which could adversely affect our liquidity and operating results. Such delinquencies or defaults could also have an adverse effect on the spread between interest-earning assets and interest-bearing liabilities.

Hedging techniques are partly based on assumed levels of prepayments of our RMBS. If prepayments are slower or faster than assumed, the life of the RMBS will be longer or shorter, which would reduce the effectiveness of any hedging strategies we may use and may cause losses on such transactions. Hedging strategies involving the use of derivative securities are highly complex and may produce volatile returns.

**Interest Rate Effects on Fair Value**

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

We primarily assess our interest rate risk by estimating the duration of our assets and the duration of our liabilities. Duration measures the market price volatility of financial instruments as interest rates change. We generally calculate duration using various financial models and empirical data. Different models and methodologies can produce different duration numbers for the same securities.

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

**Prepayment Risk**

As we receive prepayments of principal on our investments, premiums paid on these investments are amortized against interest income. In general, an increase in prepayment rates will accelerate the amortization of purchase premiums, thereby reducing the interest income earned on the investments. Conversely, discounts on such investments are accreted into interest income. In general, an increase in prepayment rates will accelerate the accretion of purchase discounts, thereby increasing the interest income earned on the investments.





Table of Contents

## Extension Risk

We compute the projected weighted-average life of our investments based upon assumptions regarding the rate at which the borrowers will prepay the underlying mortgages. In general, when a fixed-rate or hybrid adjustable-rate security is acquired with borrowings, we may, but are not required to, enter into an interest rate swap agreement or other hedging instrument that effectively fixes our borrowing costs for a period close to the anticipated average life of the fixed-rate portion of the related assets. This strategy is designed to protect us from rising interest rates, because the borrowing costs are fixed for the duration of the fixed-rate portion of the related target asset.

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

## Market Risk

## Market Value Risk

Our available-for-sale securities are reflected at their estimated fair value with unrealized gains and losses excluded from earnings and reported in other comprehensive income pursuant to ASC Topic 320. The estimated fair value of these securities fluctuates primarily due to changes in interest rates and other factors. Generally, in a rising interest rate environment, the estimated fair value of these securities would be expected to decrease; conversely, in a decreasing interest rate environment, the estimated fair value of these securities would be expected to increase.

The sensitivity analysis table presented below shows the estimated impact of an instantaneous parallel shift in the yield curve, up and down 50 and 100 basis points, on the market value of our interest rate-sensitive investments and net interest income, including net interest paid or received under interest rate swaps, at June 30, 2014, assuming a static portfolio. When evaluating the impact of changes in interest rates, prepayment assumptions and principal reinvestment rates are adjusted based on our Manager's expectations. The analysis presented utilized assumptions, models and estimates of our Manager based on our Manager's judgment and experience.

Change in Interest Rates	Percentage Change in Projected Net Interest Income	Percentage Change in Projected Portfolio Value
+1.00%	23.27	% (1.40) )%
+0.50%	28.65	% (0.74) )%
-0.50%	(24.22)	)% 0.02 %
-1.00%	(60.40)	)% (0.06) )%

## Real Estate Risk

Residential and commercial property values are subject to volatility and may be adversely affected by a number of factors, including, but not limited to: national, regional and local economic conditions (which may be adversely affected by industry slowdowns and other factors); local real estate conditions (such as the supply of housing stock); changes or continued weakness in specific industry segments; construction quality, age and design; demographic factors; and retroactive changes to building or similar codes. In addition, decreases in property values reduce the value of the collateral and the potential proceeds available to a borrower to repay our loans, which could also cause us to suffer losses.

## Credit Risk

We believe that our investment strategy will generally keep our credit losses and financing costs low. However, we retain the risk of potential credit losses on all of the residential and commercial mortgage investments. We seek to manage this risk through our pre-acquisition due diligence process. In addition, with respect to any particular asset, our Manager's investment team evaluates, among other things, relative valuation, supply and demand trends, shape of yield curves, prepayment rates, loan delinquencies, default rates and loss severity rates of various collateral types.



Table of Contents

Risk Management

To the extent consistent with maintaining our REIT qualification, we seek to manage risk exposure to protect our investment portfolio against the effects of major interest rate changes. We generally seek to manage this risk by:

- monitoring and adjusting, if necessary, the reset index and interest rate related to our target assets and our financings;
- attempting to structure our financing agreements to have a range of different maturities, terms, amortizations and interest rate adjustment periods;
- using hedging instruments, primarily interest rate swap agreements but also financial futures, options, interest rate cap agreements, floors and forward sales to adjust the interest rate sensitivity of our target assets and our borrowings; and
- actively managing, on an aggregate basis, the interest rate indices, interest rate adjustment periods, and gross reset margins of our target assets and the interest rate indices and adjustment periods of our financings.

Table of Contents

ITEM 4. CONTROLS AND PROCEDURES.

Our management is responsible for establishing and maintaining disclosure controls and procedures that are designed to ensure that information we are required to disclose in the reports that we file or submit under the Securities Exchange Act of 1934, as amended (the "Exchange Act") is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include controls and procedures designed to ensure that the required information is accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required disclosure.

We have evaluated, with the participation of our principal executive officer and principal financial officer, the effectiveness of our disclosure controls and procedures as of June 30, 2014. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives. Based upon our evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the applicable rules and forms, and that it is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

No change occurred in our internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) of the Exchange Act) during the quarter ended June 30, 2014 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II – OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

From time to time, we may be involved in various claims and legal actions arising in the ordinary course of business. Further, one of our subsidiaries is a captive insurance company, and is subject to scrutiny by government regulators, which could result in enforcement proceedings or litigation related to regulatory compliance matters. As of June 30, 2014, we were not involved in any such legal proceedings or regulatory compliance matters.

ITEM 1A. RISK FACTORS.

There were no material changes during the period covered by this Report to the risk factors previously disclosed in our annual report on Form 10-K for the year ended December 31, 2013, as filed with the SEC on March 3, 2014, other than those disclosed below and in our Form 10-Q for the quarter ended March 31, 2014. Additional risks not presently known, or that we currently deem immaterial, also may have a material adverse effect on our business, financial condition and results of operation.

Risks Related to Financing and Hedging

We use leverage in executing our business strategy, which may adversely affect the return on our assets and may reduce cash available for distribution to our shareholders, as well as increase losses when economic conditions are unfavorable.

We use leverage to finance our assets through borrowings from repurchase agreements and other secured and unsecured forms of borrowing (including Federal Home Loan Bank advances), and we contribute capital to equity investments. Although we are not required to maintain any particular debt-to-equity leverage ratio, the amount of leverage we may deploy for particular assets will depend upon our Manager's assessment of the credit and other risks of those assets.

Our access to financing depends upon a number of factors over which we have little or no control, including:

- general market conditions;
- the lender's view of the quality of our assets, valuation of our assets and our liquidity;
- the lender's perception of our growth potential;
- regulatory requirements of the Federal Housing Finance Authority or Federal Home Loan Bank;
- our current and potential future earnings and cash distributions; and
- the market price of the shares of our capital stock.

Any weakness or volatility in the financial markets, the residential and commercial mortgage markets or the economy generally could adversely affect the factors listed above. In addition, such weakness or volatility could adversely affect one or more of our potential lenders and could cause one or more of our potential lenders to be unwilling or unable to provide us with financing or to increase the costs of that financing. Current market conditions have affected different types of financing for mortgage-related assets to varying degrees, with some sources generally being unavailable, others being available but at a higher cost, with still others being largely unaffected. Some of our target assets may be more difficult to finance than others and the market for such financing can change based on many factors over which we have little or no control.

The return on our assets and cash available for distribution to our shareholders may be reduced to the extent that market conditions prevent us from leveraging our assets or cause the cost of our financing to increase relative to the income that can be derived from the assets acquired. Our financing costs will reduce cash available for distributions to shareholders. We may not be able to meet our financing obligations and, to the extent that we cannot, we risk the loss of some or all of our assets to liquidation or sale to satisfy the obligations.

The repurchase agreements and secured loans that we use to finance our investments may require us to provide additional collateral and may restrict us from leveraging our assets as fully as desired.

The amount of financing we receive, or may in the future receive, under our repurchase agreements and secured loans, is directly related to the lenders' valuation of the assets that secure the outstanding borrowings. Lenders under our repurchase agreements and secured loans typically have the absolute right to reevaluate the market value of the assets that secure outstanding borrowings at any time. If a lender determines in its sole discretion that the value of the assets has decreased, it has

Table of Contents

the right to initiate a margin call. A margin call would require us to transfer additional assets to such lender without any advance of funds from the lender for such transfer or to repay a portion of the outstanding borrowings. Any such margin call could have a material adverse effect on our results of operations, financial condition, business, liquidity and ability to make distributions to our shareholders, and could cause the value of our capital stock to decline. We may be forced to sell assets at significantly depressed prices to meet such margin calls and to maintain adequate liquidity, which could cause us to incur losses. Moreover, to the extent we are forced to sell assets at such time, given market conditions, we may be selling at the same time as others facing similar pressures, which could exacerbate a difficult market environment and which could result in our incurring significantly greater losses on our sale of such assets. In an extreme case of market duress, a market may not even be present for certain of our assets at any price. Such a situation would likely result in a rapid deterioration of our financial condition and possibly necessitate a filing for bankruptcy protection.

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

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

During the three months ended June 30, 2014, the Company did not repurchase any shares of its common stock.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES.**

None.

**ITEM 4. MINE SAFETY DISCLOSURES.**

Not applicable.

**ITEM 5. OTHER INFORMATION.**

None.

**ITEM 6. EXHIBITS.**

A list of exhibits to this Form 10-Q is set forth on the Exhibit Index and is incorporated herein by reference.

Table of Contents

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.

INVESCO MORTGAGE CAPITAL INC.

August 6, 2014

By: /s/ Richard J. King  
Richard J. King  
President and Chief Executive Officer

August 6, 2014

By: /s/ Richard Lee Phegley, Jr.  
Richard Lee Phegley, Jr.  
Chief Financial Officer



Table of Contents

EXHIBIT INDEX

Item 6. Exhibits

Exhibit No.	Description
3.1	Articles of Amendment and Restatement of Invesco Mortgage Capital Inc., incorporated by reference to Exhibit 3.1 to our Quarterly Report on Form 10-Q, filed with the Securities and Exchange Commission on August 12, 2009.
3.2	Amended and Restated Bylaws of Invesco Mortgage Capital Inc., incorporated by reference to Exhibit 3.2 to Amendment No. 8 to our Registration Statement on Form S-11 (No. 333-151665), filed with the Securities and Exchange Commission on June 18, 2009.
31.1	Certification of Richard J. King pursuant to Rule 13a-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Richard Lee Phegley, Jr. pursuant to Rule 13a-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Richard J. King pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Richard Lee Phegley, Jr. pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
	The following series of unaudited XBRL-formatted documents are collectively included herewith as Exhibit 101. The financial information is extracted from Invesco Mortgage Capital Inc.'s unaudited consolidated interim financial statements and notes that are included in this Form 10-Q Report.
	101.INS XBRL Instance Document
	101.SCH XBRL Taxonomy Extension Schema Document
101	101.CAL XBRL Taxonomy Calculation Linkbase Document
	101.LAB XBRL Taxonomy Label Linkbase Document
	101.PRE XBRL Taxonomy Presentation Linkbase Document
	101.DEF XBRL Taxonomy Definition Linkbase Document