VODAFONE GROUP PUBLIC LTD CO
Form 20-F
June 08, 2005

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 20-F

REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934

VODAFONE GROUP PUBLIC LIMITED COMPANY

(formerly VODAFONE AIRTOUCH PUBLIC LIMITED COMPANY)

(Exact name of Registrant as specified in its charter)

England

(Jurisdiction of incorporation or organization)

Vodafone House, The Connection, Newbury, Berkshire RG14 2FN, England

(Address of principal executive offices)

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

Title of each class	Name of each exchange on which registered
Ordinary shares of $0.10 each	New York Stock Exchange*

* Listed, not for trading, but only in connection with the registration of American Depositary Shares, pursuant to the requirements of the Securities and Exchange Commission.

Securities registered or to be registered pursuant to Section 12(g) of the Act:

None

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

None

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report.

Ordinary Shares of $0.10 each	64,566,632,941
7% Cumulative Fixed Rate Shares of £1 each	50,000

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 which financial statements item the registrant has elected to follow:

Item 17 Item 18

Vodafone Group Plc

Annual Report

For the year ended 31 March 2005

Building our future

Our vision is to be the world’s mobile communications leader enriching our customers’ lives through the unique power of mobile communications

Contents

This constitutes the Annual Report on Form 20-F (the "20-F") of Vodafone Group Plc (the "Company") in accordance with the requirements of the US Securities and Exchange Commission (the "SEC") and is dated 8 June 2005. This document contains the information set out within the Company's Annual Report in accordance with United Kingdom ("UK") requirements, dated 24 May 2005, as updated or supplemented at the time of filing of the 20-F with the SEC, which may be later amended if necessary. The content of the Group's website (www.vodafone.com) should not be considered to form part of this 20-F or the Annual Report.

References to the "Group" or "Vodafone" are references to the Company and its subsidiary undertakings and, where the context requires, its interests in joint ventures and associated undertakings.

In the discussion of the Group's reported financial position and results for the year ended 31 March 2005, information in addition to that contained within the Consolidated Financial Statements is presented on the basis that it provides readers with additional financial information regularly reviewed by management. This information is provided to assist investor assessment of the Group's performance from period to period. However, the additional information presented is not uniformly defined by all companies in the Group's industry. Accordingly, it may not be comparable with similarly titled measures and disclosures by other companies. Definitions of the terms and measures presented are shown on pages 28 and 29.

In presenting and discussing the Group's reported financial position, operating results and cash flows, certain information is derived from amounts calculated in accordance with UK generally accepted accounting principles ("UK GAAP"), but this information is not itself an expressly permitted GAAP measure. Such non-GAAP measures should not be viewed in isolation as an alternative to the equivalent GAAP measure. An explanation as to the use of these measures and reconciliations to their nearest equivalent GAAP measure can be found on pages 52 to 54.

This Annual Report contains forward-looking statements within the meaning of the United States Private Securities Litigation Reform Act of 1995 with respect to the Group's financial condition, results of operations and business management and strategy, plans and objectives for the Group. For further details, please see "Cautionary Statement Regarding Forward-Looking Statements" and "Risk Factors and Legal Proceedings – Risk Factors" for a discussion of the risks associated with these statements.

Vodafone, Vodafone live!, Vodafone Mobile Connect, Vodafone Wireless Office, Vodafone Simply and Vodafone Passport are trademarks of the Vodafone Group. Other product and company names mentioned herein may be the trademarks of their respective owners.

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Financial Highlights

The selected financial data set out on the following pages is derived from the Consolidated Financial Statements of the Company on pages 77 to 136 and as such should be read in conjunction with them. Certain trends within the financial data presented below have been impacted by business acquisitions and disposals, the most significant of which are described in "Business Overview – History and Development of the Company". The Consolidated Financial Statements are prepared in accordance with UK GAAP, on the basis set out in note 1 to the Consolidated Financial Statements, which differ in certain significant respects from US GAAP. For further details, see note 36 to the Consolidated Financial Statements, "US GAAP information". Solely for convenience, amounts represented below in dollars have been translated at $1.8888: £1, the Noon Buying Rate on 31 March 2005.

	At/year ended 31 March					
	2005	**2005**	2004	2003	2002	2001
	$m	**£m**	£m	£m	£m	£m
Consolidated Profit and Loss Account Data						
UK GAAP						
Group turnover	**64,470**	**34,133**	33,559	30,375	22,845	15,004
Of which in respect of: continuing operations	**64,470**	**34,133**	32,741	28,547	21,767	15,004
discontinued operations	—	—	818	1,828	1,078	—
Total Group operating (loss)/profit	**(7,765)**	**(4,111)**	(4,230)	(5,451)	(11,834)	(6,989)
Of which in respect of: continuing operations	**(7,765)**	**(4,111)**	(4,296)	(5,208)	(11,408)	(6,989)
discontinued operations	—	—	66	(243)	(426)	—
Loss for the financial year	**(14,242)**	**(7,540)**	(9,015)	(9,819)	(16,155)	(9,885)
US GAAP						
Group turnover	**56,424**	**29,873**	27,653	22,416	16,561	11,103
Loss for the financial year(1)(2)	**(26,031)**	**(13,782)**	(8,127)	(9,055)	(16,688)	(7,071)
Consolidated Cash Flow Data						
Net cash inflow from operating activities	**24,012**	**12,713**	12,317	11,142	8,102	4,587
Net cash outflow for capital expenditure and financial investment	**(9,006)**	**(4,768)**	(4,267)	(5,359)	(4,441)	(18,988)
Free cash flow (Non-GAAP measure)(3)	**14,821**	**7,847**	8,521	5,171	2,365	(13,278)
Consolidated Balance Sheet Data						
UK GAAP						
Equity shareholders' funds	**187,590**	**99,317**	111,924	128,630	130,540	144,979
Net assets	**192,913**	**102,135**	114,931	131,493	133,395	147,400
Total assets	**252,922**	**133,906**	147,129	163,239	162,867	172,362
US GAAP						

Equity shareholders funds	**202,564**	**107,245**	125,029	140,436	140,887	155,522
Total assets(4)	**348,591**	**184,557**	213,527	234,447	205,997	214,380

Group Turnover

Year ended 31 March

Total Group operating loss

Year ended 31 March

Net cash inflow from operating activities

Year ended 31 March

2 Highlights

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	At/year ended 31 March					
	2005	**2005**	2004	2003	2002	2001
Earnings Per Share (EPS)(5)						
Weighted average number of shares (millions)						
Basic and diluted	**66,196**	**66,196**	68,096	68,155	67,961	61,439
UK GAAP						
Total Group operating loss (per ordinary share)	**(11.73)¢**	**(6.21)p**	(6.21)p	(8.00)p	(17.42)p	(11.38)p
Total Group operating loss from continuing operations (per ordinary share)	**(11.73)¢**	**(6.21)p**	(6.31)p	(7.64)p	(16.79)p	(11.38)p
Basic and diluted loss per ordinary share	**(21.51)¢**	**(11.39)p**	(13.24)p	(14.41)p	(23.77)p	(16.09)p
Basic and diluted loss per ADS	**(215.1)¢**	**(113.9)p**	(132.4)p	(144.1)p	(237.7)p	(160.9)p
US GAAP						
Basic and diluted loss per ordinary share(1)(2)	**(39.32)¢**	**(20.82)p**	(11.93)p	(13.29)p	(24.56)p	(11.51)p
Basic and diluted loss per ADS	**(393.2)¢**	**(208.2)p**	(119.3)p	(132.9)p	(245.6)p	(115.1)p
Cash dividends(5)(6)						
Amount per ordinary share	**7.68¢**	**4.07p**	2.0315p	1.6929p	1.4721p	1.4020p
Amount per ADS	**76.8¢**	**40.7p**	20.315p	16.929p	14.721p	14.020p
Other Data						
UK GAAP						
Ratio of earnings to fixed charges(7)						
Deficit	**$(7,055)m**	**£(3,735)m**	£(3,647)m	£(4,828)m	£(11,267)m	£(6,947)m
US GAAP						
Ratio of earnings to fixed charges(7)						
Deficit	**$(17,145)m**	**£(9,077)m**	£(9,059)m	£(8,436)m	£(14,425)m	£(7,811)m

Notes:
(1) 2005 net loss includes the cumulative effect of accounting changes related to intangible assets and post employment benefits that increase net loss by £6,372 million or 9.63p per ordinary share. See note 36 of the Consolidated Financial Statements for further details on these changes in accounting policy.
(2) 2002 net loss includes the cumulative effect of accounting change related to derivative financial instruments reducing net loss by £17 million or 0.02p per ordinary share.
(3) Refer to Non-GAAP Information on pages 52 to 54 for a reconciliation of this non-GAAP measure to the most comparable GAAP measure and a discussion of this measure.
(4) Certain prior year amounts have been reclassified to conform to current year presentation. See note 36 of the Consolidated Financial Statements on page 126 for further details on this change in presentation.
(5) See note 10 to the Consolidated Financial Statements, Loss per share. Earnings per American Depository Share (ADS) is calculated by multiplying earnings per ordinary share by ten, the number of ordinary shares per ADS. Dividend per ADS is calculated similarly.
(6) The final dividend for the year ended 31 March 2005 was proposed by the directors on 24 May 2005.
(7)

For the purposes of calculating these ratios, earnings consist of income on ordinary activities before taxation adjusted for fixed charges, dividend income from associated undertakings, share of profits and losses from associated undertakings and profits and losses on ordinary activities before taxation from discontinued operations. Fixed charges comprise one-third of payments under operating leases, representing the interest element of these payments, interest payable and similar charges and preferred share dividends.

Free cash flow(3)
Year ended 31 March

Dividends per share
Year ended 31 March

Basic EPS
Year ended 31 March

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Chairman's Statement

It is my pleasure to report another year of achievement for your company, with robust increases in customer numbers, mobile revenue and operating cash flow, enabling us to substantially increase returns to shareholders.

Lord MacLaurin of Knebworth, DL Chairman

Executing our strategic goals

Last year we outlined six strategic goals, designed then to ensure the delivery of increased value to our customers and shareholders as we move into a new era in mobile telecommunications. I believe we have made significant progress, particularly with the consumer launch of 3G and the ongoing implementation of our One Vodafone programme.

In November, we announced the full roll-out of our consumer 3G offering across 13 markets. This was an important step in our 3G strategy and followed the success of the Vodafone Mobile Connect 3G/GPRS data card introduced in February last year. The enhancements that 3G brings will enable us to build on the success we have achieved with Vodafone live! since the service started in October 2002. We now have almost 31 million active Vodafone live! users and have a total of 2.4 million 3G devices registered on our networks.

Vodafone live! and Vodafone Mobile Connect are prime examples of how we offer services that are focused on specific customer needs. The most recent examples of this approach have been the launch of Vodafone Simply, which caters for those customers who want an uncomplicated and straight-forward mobile experience, and the simplification of our roaming tariffs with the introduction of Vodafone Travel Promise.

Our ability to launch common services across so many markets at the same time is evidence of how Vodafone is beginning to deliver the advantages of scale and scope and, in particular, shows the benefit of creating central marketing and technology functions last year. We are building on these achievements through our One Vodafone programme to drive further benefits from our global footprint.

Extending our global reach

We have continued to pursue selective opportunities to expand our geographic footprint, with a particular focus on Central and Eastern Europe. In March, we announced that we had entered into conditional agreements with TIW of Canada to acquire 79% of the share capital of MobiFon S.A. in Romania, in which we already have a 20% interest, and 100% of the share capital of Oskar Mobil a.s. in the Czech Republic. Both companies are fast growing mobile operators that will benefit further from the global services and scale benefits that Vodafone can deliver. This transaction completed on 31 May 2005.

In October, the merger of Vodafone Holdings K.K. and Vodafone K.K. in Japan was completed following our successful tender offer to increase our shareholdings in both companies. This clearly demonstrates our long-term commitment to the strategically important mobile market in Japan. The merger has created a simplified company structure which has already contributed towards greater operational effectiveness and financial efficiencies and, although the business is currently not performing as well as we would wish, I am confident that, in time, our investment will prove to be very rewarding.

In December, we signed a Partner Network Agreement with SmarTone in Hong Kong, bringing the number of our Partner Networks to fourteen. SmarTone, now fully rebranded SmarTone-Vodafone, is one of Hong Kong's leading mobile operators in multimedia services.

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Responsible behaviour

Mobile telecommunications brings many positive social, environmental and economic benefits, although for some it also brings concerns about possible health effects. Our approach is to continue to support research aligned with the World Health Organisation's priorities and to provide customers and local communities everywhere we operate with up to date, reliable information in plain language. We are committed to communicating clearly to ensure people have the information they want to make decisions on mobile telecommunications.

For Vodafone, corporate responsibility is about understanding the expectations of our stakeholders and taking appropriate action to meet those expectations. We are, therefore, integrating corporate responsibility into the business and this is reflected in our strategic goals, our values and our Business Principles.

During the year, Vodafone and its operating companies made charitable contributions of £33 million to The Vodafone Group Foundation, local Vodafone Foundations and social projects. To support the humanitarian rescue operation following the Asia Tsunami disaster, Vodafone, its employees and Foundations committed total funds of £2.5 million, including the provision of free calls to and from the affected region as well as employee matched donations in a number of countries. A summary of our corporate responsibility activity in the year is set out later in this report, with full details available in our Corporate Responsibility report, which I believe you will be pleased to read.

Delivering value to shareholders

Your Board believes that with the continuing financial strength of your Company it is possible to increase returns to shareholders through enhanced dividend payments and share purchases. In November, the interim dividend was increased by 100% and the directors are now recommending that the final dividend is also increased by 100%.

We have also continued with our share purchase programme and in the year to 31 March 2005 purchased approximately 3 billion shares at a cost of £4 billion. We shall be seeking shareholder approval at the Annual General Meeting ("AGM") for the purchase of up to a further £4.5 billion of shares during the current financial year and I look forward to your support.

Effective leadership

As part of a new organisational structure designed to assist in the delivery of the Group's strategic goals, Sir Julian Horn-Smith was appointed Deputy Chief Executive on 1 January this year. In this role, Sir Julian leads a new function, Global Business Development, which is responsible for delivering Vodafone's products and services portfolio into the Group's affiliates and Partner Networks. The Global Business Development team has also assumed responsibility for expanding and consolidating our footprint through our Partner Network programme and any acquisition activities. It was a great pleasure for us all that the Queen awarded Julian a Knighthood in her last birthday honours list. The honour was very much deserved and is appropriate recognition of the outstanding contribution he has made to the success of your Company.

At the conclusion of the AGM to be held in July, our Financial Director, Ken Hydon, will retire. Ken was one of the first directors of your Company and he has done a superb job in helping to guide the Company from its origins to the world leader it is today. His financial discipline and acumen has enabled Vodafone to invest significantly in customers, infrastructure and acquisitions whilst maintaining financial strength and flexibility at all times. He will be missed by his colleagues and we wish him a very happy and well deserved retirement.

Also retiring at the AGM will be Sir David Scholey, a non-executive director since 1998. David’s wise counsel will also be missed and we thank him for his service and contribution to the Board over many years.

We have announced that Andy Halford, who, until the end of December, was Chief Financial Officer at our US affiliate, Verizon Wireless, will succeed Ken Hydon. Andy Halford joined Vodafone in 1999 as Financial Director, Vodafone UK. In 2001 he was given regional responsibility as Financial Director for the UK, Northern Europe, Middle East and Africa before moving to his position with Verizon Wireless in 2002.

On 1 January, I was delighted to welcome Sir John Bond to the Board as a non-executive director. Sir John, who is Group Chairman of HSBC Holdings plc, one of the world’s largest banks, brings with him many years experience and a track record of success in international markets, particularly in Asia and the Americas. His skills will be of great benefit to the Board.

For the first time, all the directors are retiring and seeking re-election this year. This is a responsible step forward as we seek to maintain the highest standards of corporate governance.

It is only with the support and commitment of all employees, at all levels, that we are able to continue the growth of Vodafone. In thanking them all, I look forward to their ongoing contribution to achieving further progress in the current year.

Lord MacLaurin of Knebworth, DL
Chairman

Strategy **5**

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Chief Executive's Review

Delivering operating performance

Delighting our customers

Implementing One Vodafone

Increasing shareholder returns

Executing our strategy

Arun Sarin Chief Executive

This has been another successful year for Vodafone. We closed the year with nearly 155 million proportionate customers, having generated £7.8 billion of free cash flow from £12.7 billion of operating cash flow. Cash shareholder returns increased to £6 billion as we doubled the dividend and purchased £4 billion of our shares. We also launched 3G for consumers and firmly established our One Vodafone plan — key drivers for our future growth.

Delivering operational performance

Our results are built on the base of a strong overall Group operational performance that has delivered on all our key targets.

Organic growth of 12% in proportionate customers was driven by particularly strong performances in the year in Germany, Spain and the US. Customer growth has again been the driver for the increase in revenue but, as average customer spend has reduced, this led to growth in Group mobile revenue of 4%, or 5% on an organic basis.

Group revenue increased by 2% to £34.1 billion. Removing the effect of acquisitions and disposals and adverse foreign exchange movements, organic revenue growth was 6%.

Cash flow generation continues to be robust, reflecting the underlying strength of our operations and financial structure. Operating cash flow increased by £0.4 billion to £12.7 billion, driven by higher revenue. Free cash flow for the year was £7.8 billion, compared to £8.5 billion last year that included one-off items amounting to £0.8 billion. This strong cash flow supports our significant increases in shareholder returns this year.

This past financial year we added a further £5.1 billion of fixed assets, primarily in respect of our mobile network infrastructure. This amount is only slightly higher than the prior year, even though we continue to invest significantly in our 3G networks.

Our operating performance in Europe remains robust. In the US, Verizon Wireless has performed exceptionally well, delivering impressive financial performance across all metrics. We have a productive working relationship with our partner, Verizon Communications, and believe that we will continue to benefit from our investment in Verizon Wireless as we go forward.

We face challenges in Japan, where we are half way through a two year plan to turnaround our business. This plan has three main objectives: to improve the attractiveness of 3G handsets and content in that market, to increase the effectiveness of our distribution channels and to improve the coverage of our 3G network.

Japan remains a strategically important mobile market for us and is a significant profit generator for the Group, contributing £0.8 billion of operating profit before goodwill amortisation in the last year. However, the pace of change and advanced state of 3G there requires additional focus to improve our competitive position. Together with our three main objectives, we have strengthened the management team and remain focused on a successful execution of our recovery plan.

As we look forward, we see both greater opportunities and greater challenges. The potential for growth in voice and data is significant. However, penetration levels in many of our markets are now reaching saturation and competition is intensifying through existing network operators and the introduction of many more low cost operators and resellers. Greater choice in the market place is leading to rising customer demands. We are also seeing continued regulatory led termination rate reductions.

In this environment, we see winners and losers. We believe Vodafone is uniquely positioned to succeed through our scale and scope and the customer focus of all our employees. To achieve this success, we are focused on the execution of the six strategic goals that we outlined last year; delighting our customers, leveraging our scale and scope, expanding market boundaries, building the best global team, being a responsible business and providing superior shareholder returns.

Delighting our customers

Focus on customer needs

A core strategic goal is delighting our customers. Vodafone has nearly 155 million proportionate customers around the world, all with the common need to communicate with friends, family and colleagues wherever they are. Within this common need, our customers have different communication requirements. Some may need constant and real time access to their email. Others may want to download music and games. Others just want to talk. However, all of our customers desire simplicity and transparency. Vodafone aims to deliver increasing value to its customers by creating innovative services that meet these different needs, supported by world class customer service.

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Proportionate customers

Turnover

Cash flow

One of the key elements in delighting our customers was the launch in November 2004 of our 3G consumer service, Vodafone live! with 3G. This service fundamentally changes mobile telecommunications for our customers and gives Vodafone a platform to deliver a market leading, differentiated proposition. Most importantly, it represents a significant ongoing growth opportunity for the Group through new and enhanced services, additional network capacity and innovative pricing.

Creating new and enhanced services

Customers have been enjoying Vodafone live! services on 2.5G since its launch in October 2002. With the introduction of 3G, these services are enhanced through greater data speed and capacity, providing a better customer experience. Faster network speed, more network capacity and increasingly sophisticated devices also means many new services can be delivered to the mobile. The result is clearer pictures, more exciting games and better music and sound quality. We now offer 3D games, full track music downloads with CD-like quality in addition to real music and polyphonic ringtones and a wider range of video based services, including video calling and higher quality film, music and entertainment clips. We have also significantly increased the range and depth of content as mobile has become a more attractive channel to content providers.

But 3G is not all about consumer services, as it provides a significant enhancement to business offerings as well. This has been most evident with the Vodafone Mobile Connect data card, which enables business customers to connect to their office systems whilst on the move. Greater speed and capacity means much easier access and use of email and other office applications – our customers can now use their laptops as if they were in the office. We have expanded our push email offerings recently and are also working closely with a number of leading IT industry players to bring historically fixed line internet services to the mobile world.

Capturing more minutes

3G provides significantly more capacity in our networks. This gives us the ability to drive voice minutes that are currently carried on fixed lines onto mobile networks, so called fixed to mobile substitution, and therefore generate additional revenue. To put this opportunity into perspective, approximately two thirds of all voice traffic in Europe today is carried on fixed line networks, offering significant market expansion potential for Vodafone in voice minutes.

Offering innovative pricing

Whilst we can now offer a much richer customer experience, the key to generating additional revenue is to encourage customers to use more services and increase their mobile spending, in an environment where people want simplicity and more value at lower cost.

To deliver on this basic customer need, we plan progressively to introduce price plans that bundle voice and data services together within an attractive value proposition for our customers, whilst at the same time encouraging higher usage. The more cost efficient nature of the new technology also enables us to provide these additional services and revenue without incurring a substantial change in underlying costs, thereby creating value for shareholders.

Customer management

With rising customer expectations and increasing choice, effective customer management is increasingly important. We seek regular feedback on customer satisfaction and brand preference and closely monitor network performance. We also offer a wide range of attractive loyalty schemes so as to maximise customer retention. In highly penetrated markets, customer retention is a critical driver of market and financial success.

Driving revenue growth

We aim to delight our customers through tailoring services to what they really want. We believe the combination of new and enhanced services, greater value offerings and effective customer management will drive revenue growth.

Vodafone live! with 3G delivers an end-to-end customer service through the combined effect of being first to market with the widest and best range of handsets and the most exciting services; providing content from leading providers; offering innovative and value driving pricing; and all of this in a common way across our high quality networks.

But we are doing more than just focusing on 3G; we are expanding our business services, offering an uncomplicated mobile experience through Vodafone Simply and have simplified and increased the value to customers of our roaming tariffs. Our focus on customer needs provides the basis for the future.

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Implementing One Vodafone

Leverage scale and scope

Another key goal is to deliver fully the benefits of our scale and scope. As the Group has expanded over the past few years, we have been able to achieve some significant scale benefits. For example, as the volumes of network equipment and handsets we have purchased from the same suppliers have increased, we have secured better pricing. We have also harmonised the brand in many of our markets and started offering common products and services. The One Vodafone programme builds on this to further integrate our businesses and create sustainable competitive advantage.

The programme is focused on six major areas of our business, defined as networks, service platforms, IT delivery, terminals, customer management and roaming. We aim to leverage scale and scope through a combination of standardising designs and processes, reducing duplication, centralising certain functions and sharing best practice. The effect will be to improve our time to market with new offerings, create a consistent customer experience across our networks and enable us to achieve a strategic, lowest cost position.

During the year to March 2005, we have established objectives, plans and the supporting organisation to deliver on our programme. Whilst we are in the early stages, some initiatives are more advanced than others.

We are establishing an integrated network planning process to harmonise network specifications across our operations and we have significantly reduced the duplication of research projects across the Group. We have also created operational hosting centres in Germany and Italy for the delivery of common services and our European operations will be migrating to these centres over the next 18 months.

In May 2005, we announced our new roaming proposition that will be available across 14 markets, leveraging our unrivalled footprint. This is a significant step in reducing roaming complexity for our customers. It offers simple pricing that is transparent to customers so that they will know exactly what their charges will be when abroad. The basic principle is that, where available, a customers home tariff will apply abroad, with the same call set-up fee being charged for each call made.

The consumer launch of 3G saw us begin to offer converged, global handsets as we introduced ten common handsets across our markets and we will develop this portfolio going forward whilst still catering for specific local market needs.

IT delivery is one of the most complex areas as we aim to consolidate our business-critical billing and customer support systems and will take place over a longer time frame than the other initiatives. This will simplify our systems and lead to a lower cost structure in the future.

For the year ahead, our focus will be on implementing our plans and beginning to deliver improvements. The net benefit to us in the short term will be limited as we will incur costs in centralising certain activities. The first substantial benefits are expected in the year to March 2007, with the programme fully up and running in the year to March 2008.

Financial targets

The One Vodafone programme is targeted to deliver £2.5 billion of incremental pre-tax operating free cash flow improvements in the year ending March 2008. This is an annual benefit and is made up of cost savings of £1.4 billion and revenue enhancements of £1.1 billion.

We expect that, in the year to March 2008, combined mobile operating and capital expenditures will be broadly similar, in absolute terms, to the year to March 2004, even after four years of projected revenue growth and assuming no significant changes in foreign exchange rates and after adjusting for acquisitions and disposals.

Our revenue targets are equivalent to at least 1% additional revenue market share in the year to March 2008 compared to the year to March 2005. We will measure this in our five major controlled markets compared to our principal established competitors.

Build the best global Vodafone team

With effect from the beginning of 2005, we restructured the business to create a flatter organisational structure that is better positioned to respond to the rising expectations of our customers and to deliver on 3G and One Vodafone.

The previous regional structure has been simplified so that major countries and business areas report directly to me. This new structure focuses more attention on customers in Vodafone's local markets, enhances our ability to deliver seamless services and speeds up execution.

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Increasing shareholder returns

Overall, the business is performing well. We are generating strong cash flows and, through our focus on customers and leveraging our scale and scope, we continue to see strong growth prospects for the business.

These factors have enabled us to deliver a substantial increase in shareholder returns in the year. At our interim results we doubled the dividend and indicated we would do the same for the final dividend, which we have now proposed for approval at the AGM. In addition to increasing the dividend, we re-purchased £4 billion of our shares in the year to March 2005. The result was an increase in cash returns to shareholders compared to the previous year from £2.3 billion to £6 billion.

Through our shareholder returns policy, we wish to continue to provide shareholders with a mix of dividends and share purchases, whilst retaining flexibility within our debt capacity to pursue selective acquisition opportunities should they arise. Given our strong financial position, we see no need for the business to reduce absolute levels of debt in the future.

Having increased the dividend by 100% in the year, we currently expect future increases in dividends to be in line with underlying growth in earnings. We also intend to continue to purchase shares on an ongoing basis, although this is subject to gaining shareholder approval each year. For the year to March 2006, we are targeting another £4.5 billion of share purchases. Given our expectations for cash generation in the year ahead, we would expect shareholder returns to represent a pay out ratio of approximately 100%.

Expanding market boundaries

The acquisition of TIWs mobile interests in Romania and the Czech Republic, which completed on 31 May 2005, is very much in line with our acquisition strategy, focusing on selected opportunities, primarily in Central and Eastern Europe. These businesses are fast growing and we believe they will benefit fully from the global services and scale benefits that our Group can deliver. Retaining financial flexibility to pursue these incremental opportunities enables us to act quickly and decisively when the ability to enhance shareholder value arises.

Executing our strategy

We have made excellent progress in executing against our strategic goals in the year but there is still much to do. We have restructured the business to more closely align ourselves to these goals and have outstanding and passionate leaders and people in the organisation to deliver them. Our commitment to deliver on our goals is underlined by our values, which state that everything we do is driven by our passion for customers, our people, results and the world around us.

Outlook

For the year ahead, we see continued good growth in mobile revenue. We expect to add approximately a further £5 billion of fixed assets as we continue to expand our 3G networks. Free cash flow is anticipated to be in the £6.5 billion to £7 billion range, with a lower level of dividends expected from Verizon Wireless combined with higher cash expenditure on taxation and fixed assets offsetting growth in operating cash flow.

This year Vodafone has taken important steps to deliver ongoing growth and increased shareholder returns. The future for mobile telecommunications is both challenging and exciting. We face increasing competition and differing regulatory environments but the opportunities for us remain significant. We are in a unique position and, through our launch of 3G and the establishment of One Vodafone, we are creating platforms to deliver differentiated services to the benefit of both our customers and shareholders.

Arun Sarin
Chief Executive

Cash returns to shareholders	Executing our strategic goals

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Business Overview

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Overview

Vodafone Group Plc is the world's leading mobile telecommunications company, with a significant presence in Europe, the United States and the Asia Pacific region through the Company's subsidiary undertakings, associated undertakings and investments. The Group also has arrangements to market certain of its services in additional territories, through "Partner Networks", without the need for equity investment. The Group provides a wide range of mobile telecommunications services, including voice and data telecommunications. The Group also has a controlling interest in a non-mobile telecommunications business in Germany.

The Company's ordinary shares are listed on the London Stock Exchange and the Company's ADSs are listed on the New York Stock Exchange ("NYSE"). The Company had a total market capitalisation of approximately £94 billion at 23 May 2005, making it the third largest company in the Financial Times Stock Exchange 100 index, or FTSE 100, and the eleventh largest company in the world based on market capitalisation at that date.

Mobile Telecommunications

Business strategy

Vodafone is at the centre of three enormously valuable markets – telecommunications, infotainment and IT productivity. The Vodafone strategy is to mobilise these markets and, through this process, grow voice and data service revenue. In doing this, Vodafone is particularly seeking to leverage third generation ("3G") mobile technology to develop new, enhanced service offerings for consumers and business customers.

The Group's strategic roadmap identifies six key goals:

- delight our customers;
- build the best global Vodafone team;
- leverage our global scale and scope;
- expand our market boundaries;
- be a responsible business; and,
- provide superior returns to shareholders.

Vodafone has built a global footprint of mobile operations and is leveraging this global presence to provide cost and time to market advantages. The One Vodafone

programme is designed to leverage this scale by enabling solutions to be designed once and deployed multiple times. Vodafones marketing proposition roadmap delivers an increasingly seamless and unique range of services to targeted customer segments on a multi-market basis, combining the benefits of global scale and scope with the advantages of local market understanding and responsiveness.

Underpinning all aspects of Vodafones strategy is a focus on the unique power of mobility. With nearly 155 million proportionate mobile customers at the end of the financial year, and using the benefits of early experience in commercialising the next generation of wireless access technologies, Vodafone is well positioned to continue to lead in mobile service provision in developed and emerging markets.

Local operations

At 31 March 2005, the Company had equity interests in 26 countries, through its subsidiary undertakings, associated undertakings and investments. Partner Network arrangements extend to a further 14 countries.

At 31 March 2005, based on the registered customers of mobile telecommunications ventures in which it had ownership interests at that date, the Group had approximately 154.8 million customers, calculated on a proportionate basis in accordance with the Groups percentage interest in these ventures, and 431.8 million registered venture customers. The table on the next page sets out a summary of the Companys worldwide mobile operations at 31 March 2005 and venture customer growth in the year then ended (the 2005 financial year).

Competition

The Group faces a high degree of competition in each of its geographic markets. It is subject to indirect competition from providers of other telecommunications services in the domestic markets in which it operates in addition to direct competition from existing network operators of mobile telecommunications services and mobile virtual network operators (MVNOs) who do not operate a mobile telecommunications network. Competitive pressures have led to reductions in tariffs and continued focus on customer acquisition and retention initiatives, both of which have assisted the management of the level of customer churn.

The Group expects that competition will continue from existing operators as well as from a number of new market entrants, including those arising following the award of new 3G licences and MVNOs. The scope of this increased competition, and the impact on the results of operations, is discussed further in Risk Factors and Legal Proceedings.

A summary of the Groups network operator competitors in its markets at 31 March 2005 is also provided in the following table.

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Summary of Group mobile telecommunications businesses at 31 March 2005

Country by region(1)	Percentage ownership (2)	Venture customers (3) (’000)	Venture customer growth (%) (4)	Registered proportionate customers (’000)	Registered prepaid (%) (5)	Names of competitor network operators(6)
Germany	100.0	27,223	9	27,223	52	E-Plus, O_2 , T-Mobile
Italy	76.8	22,502	6	17,280	92	TIM, Wind, 3
UK	100.0	15,324	9	15,324	61	Orange, O_2, T-Mobile, 3
Other EMEA						
Spain	100.0	11,472	18	11,472	53	Amena, Telefónica Móviles
Albania	99.9	649	23	648	97	AMC
Egypt	50.1	4,136	44	2,072	85	MobiNil
Greece	99.8	4,004	9	3,996	66	Cosmote, Q-Telecom, TIM
Hungary	100.0	1,735	21	1,735	76	Pannon GSM, T-Mobile
Ireland	100.0	1,952	5	1,952	72	Meteor, O_2, 3
Malta	100.0	167	4	167	90	Go Mobile
Netherlands	99.9	3,793	11	3,789	56	KPN Mobile, Orange, T-Mobile, Telfort
Portugal	100.0	3,586	10	3,586	78	Optimus, TMN
Sweden	100.0	1,541	7	1,541	38	SpringMobil, Tele2, Telia, 3
Belgium	25.0	4,293	(1)	1,073	60	BASE (KPN), Mobistar (Orange)
Kenya	35.0	2,513	64	879	98	Kencell[12]
France(7)	43.9	15,969	11	7,011	45	Bouygues, Orange
Poland	19.6	7,360	28	1,443	53	Centertel, ERA
Romania	20.1	5,023	37	1,010	65	Orange, Cosmorom, Zapp
South Africa(8)	35.0	15,482	59	5,087	87	Cell C, MTN
Switzerland	25.0	3,971	3	993	36	Orange, Sunrise, Tele2
TOTAL		87,646	22	48,454	64	
Americas						
United States(9)	44.4	45,452	17	20,173	5	National operators[10]: Cingular Wireless, Nextel[11], Sprint PCS [11], T-Mobile
Asia Pacific						
Japan	97.7	15,041	1	14,692	11	au, NTT DoCoMo, Tu-ka
Australia	100.0	2,731	10	2,731	69	Optus, Orange, Telstra, 3
New Zealand	100.0	1,891	18	1,891	78	Telecom, TelstraClear
Fiji	49.0	155	36	76	93	

China(13)	3.3	213,874	42	6,994	72	China Netcom, China Telecom, China Unicom
TOTAL		233,692	38	26,384	68	
GROUP TOTAL		431,839	27	154,838	61	

Notes:

(1) All controlled networks operate under the Vodafone brand. Networks in which the Company does not have a controlling interest operate under the following brands: Belgium – Proximus; France – SFR; Poland – Plus GSM; Switzerland – Swisscom Mobile; Romania – Connex; United States – Verizon Wireless; Fiji – Vodafone; China – China Mobile; South Africa – Vodacom; Kenya – Safaricom.

(2) All ownership percentages are stated as at 31 March 2005 and exclude options, warrants or other rights or obligations of the Group to increase or decrease ownership in any venture as detailed in "Operating and Financial Review and Prospects – Liquidity and Capital Resources – Option agreements" and also exclude the acquisition of controlling stakes in MobiFon and Oskar as detailed in "Business Overview – History and Development of the Company". Ownership interests have been rounded to the nearest tenth of one percent.

(3) See page 28 for a definition of a customer.

(4) Venture customer growth is for the twelve month period to 31 March 2005.

(5) Prepaid customer percentages are calculated on a venture basis.

(6) Table excludes MVNOs and other competitors who do not operate a mobile telecommunications network.

(7) At 31 March 2005, the Group's associate in France had subsidiaries in La Réunion and La Mayotte. Customers in these subsidiaries have been included in the Group's customer figures since September 2004. Hence, customer growth in the financial year includes 515,000 venture customers which had previously been excluded from the Group's customer base. At 31 March 2005, the Group's proportionate customers included 226,000 customers in respect of these subsidiaries.

(8) At 31 March 2005, the Group's associate in South Africa had subsidiaries in the Democratic Republic of the Congo, Lesotho, Mozambique and Tanzania. Customers in these subsidiaries have been included in the Group's customer figures since September 2004. Hence, customer growth in the financial year includes 2,645,000 venture customers which had previously been excluded from the Group's customer base. At 31 March 2005, the Group's proportionate customers included 594,000 customers in respect of these subsidiaries.

(9) The Group's ownership interest in Verizon Wireless is 45.0%. However, the Group's proportionate customer base has been adjusted for Verizon Wireless's proportionate ownership of its customer base across all its network interests of approximately 98.6% at 31 March 2005. In the absence of acquired interests, this proportionate ownership will vary slightly from period to period depending on the underlying mix of net additions across each of these networks.

(10) This is not a full list of US network operators. In the United States, in addition to the national operators shown, there are several regional and numerous local operators.

(11) On 15 December 2004, Sprint PCS and Nextel announced their intention to merge. This merger is subject to US regulatory approval.

(12) The Kenyan Government has awarded a third licence but the operator had not commenced service at 24 May 2005.

(13) Customer growth in the financial year in China includes 26,831,000 venture customers from the acquisition of Chinese provincial network operators in the year.

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Business Overview continued

Licences and network infrastructure

Licences

The Group is dependent on the licences it holds to operate mobile telecommunications services. Further detail on the issue and regulation of licences can be found in Regulation. The table below summarises the significant licences held by the Groups subsidiary companies and details of their related network infrastructure:

Country by region	Licence type	Licence expiry date	Network type	Date of commencement of commercial service
Germany	2G	December 2009	GSM/GPRS	June 1992
	3G	December 2020	W-CDMA	February 2004
Italy	2G	January 2015	GSM/GPRS	December 1995
	3G	December 2021	W-CDMA	February 2004
UK	2G	See note (1)	GSM/GPRS	December 1991
	3G	December 2021	W-CDMA	February 2004
Other EMEA				
Spain	2G	July 2023 (2)	GSM/GPRS	October 1995
	3G	April 2020	W-CDMA	February 2004
Albania	2G	June 2016	GSM	August 2001
Egypt	2G	May 2013	GSM/GPRS	November 1998
Greece	2G	September 2012	GSM/GPRS	July 1993
	3G	August 2021	W-CDMA	July 2004
Hungary	2G	July 2014 (3)	GSM/GPRS	November 1999
	3G	December 2019	W-CDMA	
Ireland	2G	December 2014	GSM/GPRS	March 1993
	3G	October 2022	W-CDMA	May 2003
Malta	2G(4)	September 2010	GSM/GPRS	July 1997
Netherlands	2G	February 2013(2)	GSM/GPRS	September 1995
	3G	December 2016	W-CDMA	February 2004
Portugal	2G	October 2006	GSM/GPRS	October 1992
	3G	January 2016	W-CDMA	February 2004
Sweden	2G	December 2010(2)	GSM/GPRS	September 1995
	3G	March 2015	W-CDMA	February 2004
Asia Pacific				
Japan	2G	See note (5)	PDC	April 1994
	3G	See note (5)	W-CDMA	December 2002

Australia	2G	June 2017 (6)	GSM/GPRS	September 1993
	3G	October 2017	W-CDMA	
New Zealand	2G	March 2021	GSM/GPRS	October 2001
	3G	March 2021	W-CDMA	

Notes:
(1) Indefinite licence with a one-year notice of revocation.
(2) Date relates to 1800MHz spectrum licence. Vodafone Netherlands, Vodafone Spain and Vodafone Sweden also have separate 900MHz spectrum licences which expire in March 2010, March 2010 and December 2010, respectively.
(3) There is an option to extend this licence for seven years.
(4) Also refers to 3G services.
(5) Licences are issued for a five year term with a presumption of renewal where there is a continuing commercial need for spectrum.
(6) Date refers to 900MHz spectrum licence. Various licences are held for 1800MHz licences, which are issued by specific regional regulators. The earliest expires in June 2013 and the latest in March 2015.

Mobile network infrastructure

Network infrastructure is fundamental to the Group being able to provide mobile services. The mobile network enables the Group's customers to place and receive voice calls and allows the Group to provide other services, such as text messaging.

When a voice call or data transmission is made on a mobile device, voice or data is sent from the device and transmitted by low powered radio signals to the nearest base station, which in turn is connected to the Group's network. Each base station provides coverage over a given geographic area, often referred to as a cell. Cells can be as small as an individual building or as large as 20 miles across. Each cell is equipped with its own radio transmitter and receiver antenna. This network of cells provides, within certain limitations, coverage over the service area. When a customer using a mobile device approaches the boundary of one cell, the mobile network senses that the signal is becoming weak and automatically hands over the call to the transmission unit in the next cell into which the device is moving.

If the voice call or data transmission is intended for delivery to another device which is not on the Vodafone network, the information is delivered through a public or private fixed line telephone network or the Internet.

In a 2G network, each cell contains a base station using a number of radio frequencies or channels. A group of base stations is connected to a base station controller, which in turn is connected to a mobile switching centre and then via a gateway support node for access to a fixed line network or the Internet.

In a 3G network, voice or data traffic is passed through a Node B, being similar to a base station in a 2G network, to a radio network controller which is then connected to a mobile switching centre, similar to a 2G network.

Base stations and Node Bs form a core element of a mobile network and an insufficient number of base stations can result in loss of service for customers. In addition, the correct deployment of the right base stations is instrumental in achieving the network quality and coverage that are crucial to customer satisfaction.

2G

Vodafone operates 2G networks in all its mobile operating subsidiaries, principally through Global System for Mobile Communications ("GSM") networks, offering customers services such as voice, text messaging ("SMS") and basic data services. In addition, the majority of the Group's controlled networks operate General Packet Radio Service ("GPRS"), often referred to as 2.5G. GPRS allows mobile devices to be used for sending and receiving data over an Internet Protocol based network, enabling wireless access to data networks like the Internet. The 2G PDC network in Japan, although based on a different standard, provides similar features to the Group's GPRS networks.

The GPRS data service offering includes Internet and e-mail access allowing the customer to be always connected at download speeds slightly below a dial-up modem. Vodafone also offers a great variety of services on its Vodafone live! portal, such as picture and video messaging, download of ringtones, news and many other services.

3G

Vodafone's 3G networks, operating the wideband code division multiple access ("W-CDMA") standard, provide customers with mobile broadband data access, allowing data download speeds of up to 384 kilobits per second, which is up to seven times faster than a dial-up modem. Vodafone has expanded its service offering on 3G networks with high speed Internet and e-mail access, video telephony, full track music downloads, mobile TV and other data services in addition to existing voice and data services.

The Group has secured 3G licences in all jurisdictions in which it operates through its subsidiary undertakings and in which such licences have been awarded to date. Vodafone expects to participate in additional 3G licence allocation procedures in other

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jurisdictions in which it operates. No assurances can be given that the Group will be successful in obtaining any 3G licences for which it intends to apply or bid.

Rollout of the 3G network infrastructure has continued throughout the 2005 financial year, with total tangible capital expenditure amounting to approximately £5.1 billion during the financial year, including approximately £1.6 billion incremental expenditure on 3G network infrastructure. The 3G network rollout is focused to deliver high quality indoor coverage to enable the delivery of the new 3G services.

Wireless local area networks (W-LAN)

The Group's subsidiary companies in Greece, Hungary, Malta, the Netherlands and the UK introduced public access W-LAN services during 2004, bringing the total to nine subsidiaries in addition to several affiliates and Partner Networks which provide this offering. The Group is integrating public access W-LAN services into its Vodafone Mobile Connect family of data devices, software and services in a comprehensive mobile data offering. Roaming services are being introduced among several of the Group companies giving customers access to thousands of W-LAN hotspots at home and abroad.

Other initiatives

On 14 February 2005, Vodafone commenced field tests of the High Speed Downlink Packet Access (HSDPA) technology in Japan. HSDPA enables data transmission speeds of up to two megabits (Mbps) per second, although 14.4 Mbps can theoretically be achieved, which will provide customers with faster access speeds than experienced on existing 3G networks.

Global Services

One Vodafone

The One Vodafone initiatives are targeted at achieving £2.5 billion of annual pre-tax operating free cash flow improvements in the Group's controlled mobile businesses by the year ending 31 March 2008. The Group also expects mobile capital expenditure in the 2008 financial year to be 10% of mobile revenue as a result of the initiaitives. These targets, and the analysis below, have been prepared on the basis of UK GAAP.

Cost initiatives are anticipated to generate improvements of £1.4 billion, with a further £1.1 billion from revenue initiatives. Of the £1.4 billion of cost savings, £1.1 billion relates to savings in operating expenses, being payroll and other operating expenses, and tangible fixed asset additions. The remaining cost saving, of £0.3 billion, relates to handset procurement activities. The Group expects that, in the 2008 financial year, the combined mobile operating expenses and tangible fixed asset additions will be broadly similar to those for the year ended 31 March 2004, assuming no significant changes in exchange rates and after adjusting for acquisitions and disposals.

Revenue enhancement initiatives are expected to deliver benefits equivalent to at least 1% additional revenue market share for the Group's controlled mobile businesses in the 2008 financial year compared to the 2005 financial year. The Group will measure the revenue benefits in its five principal controlled markets compared to its established competitors. Incremental pre-tax operating free cash flow of £1.1 billion per annum is anticipated from these benefits, with the majority expected to be derived from enhanced handset offerings in addition to improved customer management and roaming.

The objective for the 2005 financial year has been to establish the internal structure, organisation and detailed plans for each area to deliver the One Vodafone targets. In doing this, the programme focused on the following six key initiatives:

- The Group's aim for the network and supply chain management initiative is to exploit the benefits of the Group's scale beyond the current centralised supply chain. Harmonisation of network design and planning along with standardisation of network equipment specifications across suppliers is expected to reduce maintenance costs and increase purchasing options. Sharing of best practice

across operating companies has already led to cost savings from the replacement of leased lines with owned fixed optical fibre capacity and microwave links.

- The service delivery platform initiative is aimed at consolidating European development and operations. Hosting centres in Germany and Italy are already operational and the Group's European mobile operating subsidiaries are expected to begin migrating their service delivery platforms over the next 18 months.Development activities are to be consolidated into Germany, Italy, the UK and the US.

- The Group has focused its plans for information technology delivery on the development of a roadmap towards the consolidation of billing and customer relationship management systems. This is expected to be a longer term project and is expected to deliver benefits over a number of years. A key theme is the identification of best practice and implementing this across existing systems.

- The development of an end-to-end terminals delivery process from initial design to delivery to customer, incorporating benefits from greater volumes of customised handsets, is intended to reduce time to market, through consolidation of platforms and streamlined testing programmes and to generate cost savings. These savings are expected to arise primarily from standardised handsets and accessories, through better management of volumes across Europe and efficiencies in logistics. The availability of a common portfolio of 3G handsets following the launch of Vodafone live! with 3G in November 2004 is an early example of success.

- The customer management initiative aims to implement consistent segment and value based customer management across the Group to improve customer retention and satisfaction and, therefore, reduce churn.

- Finally, providing Vodafone's customers with better value when they travel aboard, as well as generating the best value inter-operator tariffs for the Group, are the key goals of the roaming initiative. The Group also expects to centralise certain support activities for roaming. The announcement of the launch of the Vodafone Travel Promise, outlined in "Global Services – Products and services – Roaming Services", in May 2005 is a key step in delivering better value for our customers when travelling abroad.

The objective for the 2006 financial year is to begin implementation of these plans and deliver benefits in each area, although some initiatives will be more advanced than others. Significant benefits are expected in the 2007 financial year, with the full targets expected to be met in the 2008 financial year.

Products and Services

Voice Services

Revenue from voice services makes up the largest portion of the Group's turnover and the Group is undertaking a wide range of activities to encourage growth in the usage of these services. In increasingly competitive local markets where value for money is an important consideration, improving use of existing products and developing a range of new offerings for customers has helped the Group to continue to grow its total voice revenue.

Pricing is an important factor for customers choosing a mobile phone network and is also important in encouraging usage of services whilst maximising revenue and margins. Two main pricing models exist in the mobile market – contract and prepaid. Contract customers are usually governed by a written contract and credit facilities are granted to them to enable access to mobile network services. In most cases contracts have a term of 12 to 24 months with monthly payments for services and, in many of the Group's mobile operating subsidiaries, the option of purchasing a subsidised handset. A prepaid customer pays in advance in order to gain access to voice and other services. The take-up of these models in the markets in which the Group operates varies significantly, from Japan and the US, where the vast majority of customers are on contract plans, to Italy, where the market is predominantly prepaid.

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The Group has simplified tariff structures in a number of the Groups mobile operating subsidiaries. In some cases, these new price structures include large minute bundles that allow customers to talk more freely.

During the year, the Group has continued to build its business voice offerings; for example, the Vodafone Wireless Office proposition a solution reducing the need for fixed line phones has been enhanced with an increased handset range, superior call management software and availability across a broader geography.

The Group continues to invest in providing enhanced network coverage for services in response to Group-wide customer feedback. In parallel, the Group is improving network service quality to ensure that customers can use their mobile phone whenever and wherever they want.

In May 2005, the Group announced the launch of Vodafone Simply, a new service designed to provide an easy to use mobile solution for customers who want to use basic voice and text services with minimum complexity to keep in touch with family and friends.

Social Products

Work continued this year on making mobile services more accessible to people with special communication needs. This includes a product that converts text to speech, known in English speaking markets as Vodafone Speaking Phone, which is now available in six markets. This gives users who are blind or visually impaired access to all handset features, including text messaging.

Non-voice Services

Messaging Services

All of the Groups mobile operating subsidiaries offer a short message service, which allows customers to send and receive text messages using mobile handsets and various other devices. The multimedia messaging services (MMS), which offer customers the ability to send and receive multiple media, such as pictures, music, sound, video and text, to other compatible phones, are also available in all Group mobile operating subsidiaries, with the exception of Albania.

Vodafone live!

Vodafone live!, the Groups integrated communications and multimedia proposition, initially launched in October 2002, has continued to grow strongly. The proposition, targeted primarily at the young adult (young active fun) segment, has been launched in six new markets since 31 March 2004, bringing the total number of countries now offering Vodafone live! to 22. New markets added in the 2005 financial year include Malta, Austria, Belgium, Croatia and Slovenia. There were 30.9 million Vodafone live! active devices, including 12.8 million in Japan, on controlled networks at 31 March 2005, with an additional 3.2 million devices connected in the Groups associated companies.

Vodafone has continued to develop its Vodafone live! proposition by offering a new range of services, content, handsets and tariffs. The design of the Vodafone live! portal, through which customers can access a range of online services games, ringtones, news, sports and information has been enhanced and an improved search function has made it easier for customers to find and purchase content.

The important ringtones market has continued to develop with mass market adoption of real-tones where customers are able to purchase samples of real music recordings as ringtones from artists signed to labels including EMI, Sony BMG Music Entertainment, Universal Mobile and Warner Music.

Tariff structures have been updated, with a range of messaging and content based bundles now available to customers. These have delivered improved customer value, particularly when offered in conjunction with a handset purchase. In addition, browsing charges for accessing the mobile Internet have been simplified, making it more attractive for customers to browse the web using their mobile phones.

Over 23 new 2.5G phones have been added to the Vodafone live! portfolio in the 2005 financial year, with an increased emphasis on exclusive and customised devices. The

new handsets added have offered improved imaging capability across the range, better connectivity, with a significant proportion of devices now offering Bluetooth (a wireless link function), and increased memory card storage to enable customers to save content on their devices.

Throughout the 2005 financial year, Vodafone has continued to develop standards in the areas of terminals, platforms, games, digital rights management and MMS. These initiatives are expected to lead to increased speed to market and better services for customers.

Vodafone live! with 3G

In November 2004, the Group launched Vodafone live! with 3G across 13 markets with an initial portfolio of 10 devices. By 31 March 2005, there were 2.1 million devices on controlled networks capable of accessing the Vodafone live! with 3G portal.

3G has enhanced the mobile experience with up to a ten-fold increase in portal and content download speeds over GPRS, giving Vodafone live! customers access to a unique range of high quality content and communication services. Vodafone live! with 3G customers can now experience news broadcasts, sports highlights, music videos, movie trailers and a host of other video content at a quality approaching that of digital television. With the signing of an exclusive deal with Twentieth Century Fox, Vodafone customers were also the first to experience a new generation of made-for-mobile TV and film content, so called mobisodes. Several markets have already launched TV broadcast services and these will be developed further in the coming year. The wide bandwidth of 3G supports access to sophisticated 3D games and Vodafone has introduced a range of branded titles.

The 3G service also supports full track music downloads which allow customers to use their phone to listen to music, choosing from a range that currently includes over 500,000 music tracks. Vodafone has secured music from some of the world's greatest artists through agreements with Sony BMG Music Entertainment and for music from the catalogues of EMI and Warner Music. Using the 3G service, customers can also download live performance videos and stream clips direct to their mobiles through Vodafone's agreement with MTV.

Clear and simple pricing, including free/flat rate browsing, service bundles and trial promotions have also been introduced in the majority of markets offering Vodafone live! with 3G. In addition, significant focus has been given to customer service with dedicated 3G experts available in retail stores and call centres. This year has also seen the launch in several markets of video call centres where customers can learn how to use the new video telephony service.

Content Standards

Vodafone has recognised the need to provide leadership in content standards development to protect customers from inappropriate content, contact and commercialism. Specific emphasis is placed on protecting younger mobile phone users. Vodafone is also proactive on a number of content standards issues, including video and audio adult content, and continues to encourage pan-industry collaboration and self regulation for mobile operators.

In July 2004, Vodafone launched the world's first mobile age-based content control and Internet filtering solution. This is now established in the UK and will be rolled out to all other mobile operating subsidiaries.

Vodafone Mobile Connect data cards

The Vodafone Mobile Connect data card provides working mobility to customers accessing email and company applications with access speeds up to 384 kilobits per second when connected to a 3G network. The Vodafone Mobile Connect 3G/GPRS data card has now been rolled out across 17 markets, including the Group's associated undertakings in France, Belgium and South Africa and the Group's Partner Network operators in Austria, Bahrain and Finland. The product portfolio was enhanced in the financial year with the launch of a quad-band data card allowing customers to connect

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whilst travelling in the US and a data card supporting both GPRS and EDGE technology which provides high speed connectivity in a number of the Group’s Partner Networks. Vodafone Mobile Connect data cards are available in an increasing number of distribution channels and with a growing range of service and price bundles.

At 31 March 2005, there were 0.5 million registered Vodafone Mobile Connect data cards on the Group’s controlled networks, including 0.3 million 3G/GPRS data cards.

Other Business Services

Beyond the wireless enablement of laptop computers, there is an increasing demand for handheld solutions that allow real time access to email, calendar and other applications. During 2004, Vodafone launched its BlackBerry® from Vodafone proposition.

On 21 April 2005, the Group announced the roll out of Vodafone push email, a service providing real-time, secure and remote access to email, contacts and calendar direct to a range of business-focused mobile devices. New email, calendar appointment and contact details are automatically ‘pushed’ to the customer’s selected device and updates made on the device are automatically reflected on the customer’s PC. During the launch phase the service will be supported by four devices, with additional devices introduced in the coming months.

Roaming services

Accompanying the multi-market launch of 3G services in 2004, the Group delivered extensive 3G roaming services, demonstrating Vodafone’s ability to build seamless services rapidly across its international footprint. 3G roaming for the Vodafone Mobile Connect data card was rolled out during the spring and, in May 2004, roaming was launched for Vodafone live! with 3G, including the first international video telephony roaming services.

By November, roaming for Vodafone live! with 3G and the Vodafone Mobile Connect 3G/GPRS data card was available across 14 of the Group’s mobile operating subsidiaries, associated undertakings and Partner Networks in Europe and Japan, with 12 of these offering video telephony roaming services. Vodafone’s leading 3G roaming footprint is expected to continue to expand over the coming year.

In summer 2004, the Group launched a pan-European roaming promotion aimed at increasing the uptake and use of voice roaming services by consumer segment customers. Ten markets ran the promotion between July and September, supported by a common communications campaign. Many new roamers were attracted by the offer, which also increased usage and selection of Vodafone networks.

In May 2005, the Group announced the launch of the Vodafone Travel Promise, new roaming campaign, the first element of which is the Vodafone Passport voice roaming price plan. The Vodafone Passport price plan has been created following extensive customer research to offer greater price transparency and certainty to customers when using roaming services abroad.

In May 2004, Verizon Wireless and Vodafone jointly developed and launched the Global Phone roaming service to address the needs of US based frequent world travellers across their combined global footprint. The Global Phone service offers a choice of two integrated GSM/CDMA handsets that work both in the USA on Verizon’s CDMA network and on Vodafone’s and its roaming partners’ GSM networks in 120 countries worldwide. The service offers seamless features like one number, one voicemail box, international SMS and a single bill. The service, initially offered to large corporate customers, was extended to the broader mass business market in September 2004.

Other initiatives

In March 2005, Vodafone Germany launched Vodafone At Home, an alternative to a fixed line network allowing private householders and home office users to replace their existing fixed line connection. The Group also demonstrated new mobile TV technology and a number of new handsets, including two Ferrari branded handsets, jointly developed with Sharp.

Summary of Group Products and Services

The following table summarises the availability of the Group's most significant products and services:

Country						
Subsidiaries						
Germany	●	●	●	●	●	●
Italy	●	●	●	●	●	●
UK	●	●	●	●	●	●
Spain	●	●	●	●	●	●
Egypt	●		●		●	
Greece	●	●	●	●		●
Hungary	●		●	●	●	●
Ireland	●	●	●	●	●	●
Malta	●		●			
Netherlands	●	●	●	●	●	●
Portugal	●	●	●	●	●	●
Sweden	●	●	●	●	●	●

Japan	●	○		●		○
Australia	●		●		○	
New Zealand	●		●		○	●
Associates						
France	●	○	●	●	●	○
Belgium	○			○	○	
Switzerland	●	○				
South Africa	*	*		○	○	
Partner Networks						
Austria	○	○		○	○	
Bahrain			●	○		
Croatia	○		●			
Denmark			●		*	
Estonia			●			○
Finland			●	○		
Hong Kong					*	
Singapore					*	
Slovenia	○		●			
Total markets	**22**	**14**	**21**	**17**	**19**	**14**

Key:

- ● Available throughout the 2005 financial year
- ○ Launched in the 2005 financial year
- * Launched since 31 March 2005

Marketing and brand

Brand

Brand marketing focuses on consistency, differentiation and preference for the Vodafone brand. A programme has been undertaken to simplify and align the various elements of the brand in order to deliver a more consistent brand experience.

Customer Communications

Communication to drive brand preference and service usage is facilitated through various integrated advertising media including radio, television, print and outdoor sites. This is supported by strong sponsorship relationships, such as those with Ferrari and Manchester United, which have global exposure and allow for benefits to be realised at the local level. Media activity is based on customer insight, and is designed to ensure a consistent and effective brand experience across Vodafone's footprint.

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Customer Strategy and Management

During the year, Vodafone implemented a system for measuring customer delight across all the Groups customers at a local and global level. This will assist in the development of differentiated marketing propositions and programmes that drive revenue growth.

Vodafone has developed strategies to ensure that the outcome of customer interactions, whether via call centres or retail outlets, results in a level of sustainable differentiation delivering ongoing value and customer loyalty to Vodafone.

Distribution

The Group distributes its products and services through a wide variety of direct and indirect channels, with different approaches used in the consumer and business sectors.

Products and services are available directly to both consumer and business customers in the majority of markets. Nearly 1,000 stores are directly owned and managed by Vodafone, with an additional 4,600 Vodafone branded stores making Vodafone one of the largest global retailers. In addition, local websites offer products and services online and local sales forces are in place to discuss terms with business customers.

The extent of indirect distribution varies between markets, but may include using third-party service providers, independent dealers, agencies and mass marketing. Marketing to third-party service providers includes maintaining a competitive tariff structure, providing technical and other training to their staff and providing financial incentives for service providers, their dealers and sales people. It also entails providing assistance on advertising campaigns and supporting the development of both specialist retail outlets and programmes with multiple retailers.

During the year, Vodafone set up a global IT distribution channel by entering into a partnership with two leading global IT distributors. This will be an effective channel for Vodafone to access a wider number of business customers and sell mobile data products and services.

The last few years have seen the growth of MVNOs who buy access to existing networks and re-sell services to customers under a different brand name and proposition. Where such a relationship generates profitable use of network capacity and does not impact the Vodafone brand, a mobile operating subsidiary may consider entering into a partnership with an MVNO.

Multinational corporates

Vodafone currently provides products and services to over 200 of the worlds largest companies on a global basis. The first global Customer Advisory Board, which allows global customers to participate actively in driving Vodafones strategy for business, took place in February 2004, with the second meeting in September 2004.

A new Multinational Corporates business unit was established on 1 April 2005 to focus on providing end-to-end differentiated propositions and consistent, world-class service to Vodafones Multinational Corporate customers. The new business unit will aim to ensure consistent delivery across Vodafones markets for product offerings, customer service and pricing, underpinned by first-rate account management.

Research and development

The Group Research and Development (R&D) function comprises an international and multicultural team for applied research in mobile telecommunications and its applications. The majority of the Groups R&D function is undertaken through the Groups centres of excellence, located in Newbury, Maastricht, Munich, California, Milan, Tokyo and Madrid. In the 2005 financial year, the R&D function in the Groups associated undertaking in France, SFR, started working with Group R&D as an associate.

Group R&D provides technical leadership, and a programme of research support, into technology that will typically start to be used in the business in three years and beyond.

Governance is provided by the Group R&D Board which is chaired by the Group R&D Director and consists of the chief technology officers from four of the mobile operating subsidiaries, together with the heads of Future Products, Business Strategy and Technology Development.

Group R&D focuses on applied research that is positioned between the basic research undertaken by universities and commercial product development. Since the Group is primarily a user of technology, the emphasis of the Group R&D work programme is on providing technology analysis and vision that can contribute directly to business decisions, enabling new applications of mobile telecommunications, using new technology for new services, and research for improving operational efficiency and quality of the Groups networks. The work of the function is organised into three clusters: future vision and opportunity, technology research and application research. The first cluster is concerned with expanding business boundaries through advances in technology, science and business practice, providing input to the Groups strategy. The second cluster is concerned with core radio, network and service enabling technologies. It includes business modelling techniques, application of social science and analysis of disruptive technologies. The third cluster is concerned with developing new business applications of radio based technologies for commercial launch.

The work of Group R&D is delivered through a series of programmes with a substantial portion of trials and demonstrations. All work is set in a business and social context. Group R&D provides leadership for funding research into health and safety aspects of mobile telecommunications, technical leadership for the Groups spectrum strategy and technical leadership for the protection of intellectual property, including the Vodafone patent portfolio.

The main themes currently being researched are technologies that will follow the evolution of 3G. The basis of the Groups 3G radio technology is W-CDMA and this is expected to evolve to a higher speed version, usually referred to as HSDPA or HSUPA. New underlying radio technologies, beyond the current generations, are also being evaluated. Evolutions to the core network based on ubiquitous use of Internet protocols and web services complement this, and are likely to lead to a convergence of Internet and mobile technologies. Significant R&D is also being undertaken on mobile TV, including schemes for managing content rights. Applications of mobile telecommunications to health and well being are being researched in collaboration with a chair at the University of Madrid funded through the local Vodafone foundation and for more information on Vodafones work in health and well being, see the 2005 report from the Vodafone Group Foundation titled The Foundations, Investing in communities and the environment. Applications to transport management are also being researched. Key to much of the research is the need to ensure that when there is a customer proposition that demands new technology, then this can be introduced with the minimum of cost, for example by using existing investment in sites and spectrum.

Much of the work of Group R&D is done in collaboration with others, both within the Group and externally. Joint R&D facilities have been set up with three major infrastructure suppliers. Infrastructure and handset suppliers work with Group R&D on many of its projects, from providing equipment for trials, through co-authoring research reports, to being a partner in some of the R&D programmes. At the more academic end of the spectrum of applied research, Group R&D has developed relationships with a number of universities. These relationships include sponsoring research students, collaboration in European research activities, funding specialised research activities and working with academic chairs and readerships funded through the Vodafone Group Foundation.

The R&D programme provides the Group with long-term technical policy, strategy and leadership, as well as providing technical underpinning for the Groups public policies and government relations, and is shared with all subsidiaries of the Company and Group functions. They are able to influence the programme through working relationships that are designed to allow delivery of the results of the programme directly into the business units where they are needed.

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The Group spent £219 million in the 2005 financial year on R&D, compared with £171 million in the 2004 financial year and £164 million in 2003. Besides the core R&D outlined above, this expenditure was incurred principally on developing new products and services, billing systems and network development.

Regulation

The Groups operating companies are generally subject to regulation governing the operation of their business activities. Such regulation typically takes the form of industry-specific law and regulation covering telecommunications services and general competition (anti-trust) law applicable to all activities. Some regulation implements commitments made by Governments under the Basic Telecommunications Accord of the World Trade Organisation to facilitate market entry and establish regulatory frameworks. The following section describes the regulatory framework and the key regulatory developments in the European Union (EU) and selected countries in which the Group has significant interests. Many of the regulatory developments reported in the following section involve on-going proceedings or consideration of potential proceedings that have not reached a conclusion. Accordingly, the Group is unable to attach a specific level of financial risk to the Groups performance from such matters.

European Union

The Member States of the EU (Member States) were expected to implement the new EU Regulatory Framework for the communications sector (the new EU Framework), which was adopted in 2002, into national law by 24 July 2003 or prior to accession on 1 May 2004 for the ten countries that joined the EU on that date. Belgium, Greece, Luxembourg and the Czech Republic have yet to implement the new EU Framework and there are ongoing infringement proceedings against a number of Member States for late or inadequate implementation.

The new EU Framework consists of four principal Directives outlining matters such as the objectives to be pursued by national regulatory authorities (NRAs), the way in which telecommunications operators are to be licensed, measures to be taken to protect consumers and ensure universal provision of certain telecommunications services and the terms and basis upon which operators interconnect and provide access to each other.

The new EU Framework introduces a number of important changes to the previous framework. It is intended to align the techniques for defining where sector specific regulation may be applied and the threshold for when such regulation can be applied with those already employed in EU competition law. It is also intended to ensure greater consistency of approach amongst NRAs within the Member States. All NRAs are required to take utmost account of the list of markets which are specified by the European Commission (the Commission) in a Recommendation when deciding which markets to investigate. The first such Recommendation was published by the Commission in February 2003 and includes markets at a wholesale level, for voice call termination on individual mobile networks (the Call Termination Market), the wholesale national market for international roaming and the market for access and call origination on public mobile networks (together the Relevant Markets). NRAs may, with the Commissions consent, also propose markets not included in the Recommendation. The Commission will periodically review the Recommendation.

Regulation, under the new EU Framework, can only be applied to undertakings with significant market power (SMP) (either individually or collectively) in the relevant markets so identified, subject to the Commissions consent. SMP under the new EU Framework accords with the concept of dominance under existing EU competition law. This generally implies a market share of at least 40%, although other factors may also be taken into consideration. The SMP threshold under the previous framework required only a 25% share of the relevant market. The Commission published SMP Guidelines in July 2002 which set out principles for use by NRAs in the analysis of markets and effective competition to determine if undertakings have SMP under the new EU Framework.

International Roaming

In January 2000, the Competition Directorate of the Commission commenced an investigation into the market for international roaming services pursuant to the competition law of the EU. The Commission published its preliminary findings in December 2000. The Commission stated that excessive pricing and price collusion were likely concerning both the level of wholesale rates and the mark-ups applied in retail markets for international roaming services. To date, the Commission has not published the results of this review.

Officials of the Commission conducted unannounced inspections of the offices of mobile network operators in the UK and Germany, including Group subsidiaries, in July 2001. The Commission said it was seeking evidence of collusion and/or excessive prices, in relation to both retail and wholesale roaming charges, and the Commission has subsequently sought, or been provided with, additional information about roaming charges.

In July 2004, the Commission issued a statement of objections, a document detailing its proposed findings, following its investigation into the UK market for wholesale international roaming. A written response was made by Vodafone in December 2004 and an oral hearing was held in June 2005. In January 2005, the Commission issued a statement of objections following its investigation of the German market and a written response has been submitted. In both cases, the statement of objections was addressed to both the national mobile operating subsidiaries and to the Company.

The Commission's proposed findings are that Vodafone has monopoly power over its wholesale customers in both the UK and Germany. Vodafone UK and Vodafone Germany are alleged to have engaged in excessive or unfair pricing on the grounds that their wholesale roaming prices were perceived to be high, resulted in high profit margins in comparison with other services and were significantly higher than the tariffs applied to domestic wholesale access services. The Commission alleges that the abuse occurred from 1997 to at least September 2003 in the UK and from 2000 to December 2003 in Germany. If the Commission decides that there had been a breach of competition law, it would be able to impose a fine on any addressee who had committed the breach.

Separately, under the new EU Framework, which requires a forward looking analysis, the wholesale national market for international roaming is one of the Relevant Markets but no NRA has yet proposed any regulation in this market. In December 2004, the European Regulators Group (“ERG”), a body established under the new EU Framework and comprising all EU NRA's, announced that it had commenced a co-ordinated data collection exercise with a view to analysing this market. The Group's mobile operating subsidiaries in the EU have since received questionnaires to which they have responded. In June 2005, the ERG issued a draft position paper on the wholesale market for international roaming and is seeking comments by July 2005.

Germany

Germany enacted a law implementing the new EU Framework in June 2004. Vodafone Germany agreed to reduce its mobile call termination rate with Deutsche Telekom for incoming calls from Deutsche Telekom's network from 14.3 eurocents per minute to 13.2 eurocents in December 2004 and to 11.0 eurocents in December 2005. The NRA is consulting on proposals to find all mobile network operators to have SMP in the Call Termination Market.

In February 2004, the NRA decided to award licences for 450MHz spectrum for the provision of public access mobile radio services. Vodafone Germany is appealing this decision and unsuccessfully sought an injunction against the NRA's decision. The judgment in the main case is still pending. In December 2004, the NRA awarded two 450MHz licences.

Italy

Italy enacted national law implementing the new EU Framework in September 2003. In January 2005, the NRA published its proposals following a review of the Call

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Termination Market. The NRA has concluded that all mobile network operators have SMP and proposes to impose obligations on Vodafone Italy of cost-orientation, non-discrimination, accounting separation and transparency. The NRA has indicated that it expects termination charges of about 8.7 eurocents per minute to apply by 2007. In March 2005, the Italian National Competition Authority (NCA) conducted unannounced inspections of the offices of mobile network operators in Italy including Vodafone Italy seeking evidence of collusion following complaints by resellers and potential MVNOs about alleged anti-competitive conduct in the Italian mobile market. If the NCA decides that there had been a breach of competition law, it would be able to impose a fine on any operator who had committed the breach.

United Kingdom

The new Communications Act, implementing the new EU Framework and creating a new NRA for communications, was enacted in July 2003. In December 2003, the Office of Communications replaced the Office of Telecommunications as the NRA.

The NRA conducted and concluded its review of the wholesale mobile access and call origination market and found that no operator had SMP. As a result, the existing SMP obligations on Vodafone UK (including the requirement to offer indirect access) were removed. On 1 June 2004, the NRA found that all mobile network operators have SMP in the Call Termination Market and required Vodafone UK to reduce its termination charge, with effect from September 2004, from approximately 8 pence per minute to a target average charge of 5.6 pence per minute, representing a 30% reduction. In June 2005, the NRA issued proposals to maintain this price control until 31 March 2007.

The NRA has proposed that certain mobile frequencies are to be tradable from 2007. Other non-mobile frequencies become tradable from 2005. This would allow operators to transfer rights of use on commercial terms and to change the use to which frequencies are put, subject to oversight by the NRA. When spectrum becomes tradable the NRA expects to licence frequencies on broadly equivalent terms, including a move to a standard 5 year notice of revocation.

The NRA is considering whether holders of spectrum (including 2G mobile operators) will be able to use their existing spectrum to provide 3G services. The NRA is also planning a programme of spectrum release over the next 3 years.

The NRA investigated Vodafone's pricing of certain fixed-to-mobile calls to business customers and concluded that Vodafone had not infringed competition law.

Other EMEA

Spain

Legislation implementing the new EU Framework was enacted in November 2003. In October 2004, the Spanish NRA announced a 10.5% reduction in mobile termination rates, which was implemented by Vodafone Spain in November 2004.

In April 2004, the NCA requested Spanish mobile operators to provide data on SMS pricing and in September 2004 decided to open a procedure against Vodafone Spain, Telefónica Móviles and Amena for collusion regarding retail prices applied in providing SMS and MMS services. This procedure was subsequently closed without action.

Vodafone Spain successfully defended a claim before the NCA of alleged price squeezing in relation to its pricing of certain fixed-to-mobile calls to business customers.

Albania

In May 2004, the NRA designated Vodafone Albania as having SMP in the mobile market which may lead to increased regulation. Vodafone Albania has appealed this decision. In addition, the NRA has commenced regulation of mobile termination rates by approving recommended rates for 2004.

Egypt

Egypt enacted a new telecommunications law in 2003 which gave new powers to the NRA and imposed new obligations on licensees, including obligations in relation to

universal service provision. During 2004, Vodafone Egypt finalised an agreement with the NRA that covered most of these new obligations while obtaining additional spectrum in the 1800MHz range to facilitate business expansion. The nature and extent of the universal service obligations are still pending negotiation with the NRA.

Greece

Greece is expected to enact national law implementing the new EU Framework during 2005. Nevertheless, the Greek NRA has conducted a preliminary review of the Call Termination Market, has proposed that all mobile network operators have SMP, and proposed the imposition of obligations of cost-orientation, non-discrimination, accounting separation and transparency. Vodafone Greece agreed to reduce its mobile termination rate from approximately 17 eurocents to 14.5 eurocents per minute on 1 October 2004. The NRA is developing a Long Run Incremental Cost model (“LRIC Model”) to determine cost oriented mobile call termination rates.

In April 2005, the Council of State issued a judgment that base stations erected by mobile operators prior to August 2002 did not meet legal requirements. This judgment may result in a requirement for some masts to be removed. In May 2005, the Greek government proposed legislation, which amongst other things, seeks to address this issue.

Hungary

Hungary implemented the new EU Framework in January 2004 as part of its preparations for joining the EU on 1 May 2004. In its review of the Call Termination Market, the NRA has proposed that all mobile network operators have SMP and has imposed obligations of cost-orientation, non-discrimination, accounting separation and transparency. Vodafone Hungary has appealed this finding. The NRA is developing a LRIC Model to determine cost oriented mobile call termination rates. In its review of the market for wholesale mobile access and call origination, the NRA found that no mobile network operator had SMP.

The NRA has concluded a tender process for the award of 3G licences. Licences were awarded to each of the existing 2G operators, including Vodafone Hungary.

Ireland

Regulations implementing the new EU Framework were adopted in June 2003. In February 2005, the NRA found that Vodafone and O_2 have joint SMP in the wholesale access and call origination market. The NRA has imposed an obligation on both Vodafone and O_2 to negotiate wholesale access agreements on reasonable terms, with powers for the NRA to intervene if necessary. Vodafone and O_2 are appealing the NRA’s findings.

In its review of the Call Termination Market, the NRA has found that all mobile network operators have SMP. The NRA proposes the imposition of obligations of cost-orientation, non-discrimination, accounting separation and transparency. The NRA is also considering the use of price controls. In the interim, the NRA expected Vodafone Ireland and O_2 to fulfil undertakings made to reduce average mobile termination rates by 5% and 8% below inflation respectively, calculated by reference to the Irish consumer prices index. Vodafone Ireland complied with the rate reductions. Further price controls will be considered by the NRA in 2005.

Malta

Legislation implementing the new EU Framework in Malta was enacted during 2004. In the Call Termination Market, the NRA proposes to find all mobile network operators as having SMP and is expected to impose obligations on Vodafone Malta of cost orientation, non-discrimination, accounting separation and transparency.

The NRA has announced a process to offer three 3G licences in the Maltese market during 2005.

The Netherlands

The Netherlands implemented the new EU Framework during 2004. In December 2003, mobile network operators reached agreement with the NRA and the NCA to reduce mobile call termination rates between 1 January 2004 and 1 December 2005.

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Vodafone Netherlands reduced its rates from 20.6 to 15.5 eurocents per minute on 1 January 2004 and to 13 eurocents on 1 December 2004 and will reduce to 11.0 eurocents per minute on 1 December 2005. In addition, the NRA has commenced its review of the Call Termination Market and proposes to find all operators as having SMP, with remedies of cost orientation, non-discrimination and transparency.

Portugal

Portugal enacted national law implementing the new EU Framework in February 2004. The Portuguese NRA has commenced its market reviews. Following its review of the Call Termination Market, it found all three mobile network operators as having SMP and it has imposed obligations on Vodafone Portugal of cost orientation, non-discrimination, accounting separation and transparency. In February 2005, the NRA decided that Vodafone Portugal should reduce its rates from 18.5 eurocents and 18.7 eurocents for fixed to mobile and mobile to mobile calls respectively, to 11.0 eurocents for both by October 2006 while a cost orientation methodology is implemented.

Vodafone Portugal has requested the renewal of its 2G licence, which is due to expire in October 2006.

Sweden

Sweden implemented the new EU Framework in July 2003. In its review of the Call Termination Market, the NRA concluded that all mobile network operators have SMP and imposed obligations of cost-orientation, non-discrimination, accounting separation and transparency. The NRA developed a LRIC Model to determine cost oriented mobile call termination rates and proposed from July 2004, a reduction from the current rate of SEK 1.35 to SEK 0.8 and reducing to SEK 0.54 by July 2007. Vodafone Sweden has appealed various aspects of the decision, including the finding of SMP and the proposed rates and has obtained an injunction suspending the proposals.

In March 2005, the NRA awarded a licence of 450 MHz spectrum for the provision of mobile services. Vodafone Sweden challenged the proposed terms of this award.

The NRA is also reviewing the 3G coverage required to be achieved by the four 3G licensees by 31 December 2003 (such obligations were subsequently extended to 31 December 2004). Discussions between the Government, the NRA and the licensees are being held on these matters. The NRA has powers to fine operators for non-compliance.

Belgium

Belgium is expected to enact national law implementing the new EU Framework during 2005. The NRA has commenced its market reviews and has commenced a process to develop a LRIC model to assess the cost of voice call termination.

France

France implemented the new EU Framework during 2004. In its review of the Call Termination Market, the NRA concluded that all mobile network operators have SMP and imposed obligations of cost-orientation, non-discrimination, accounting separation and transparency. It has set a price cap for SFR's termination rate of 12.5 eurocents per minute from 1 January 2005 and 9.5 eurocents from 1 January 2006. The NRA will also commence work in 2005 to consider new price controls for the subsequent period.

In December 2003, a French consumers association lodged a complaint with the NCA alleging collusion amongst the three French mobile operators on SMS retail pricing. The NRA has announced that it intends to review the market for SMS termination and may notify this to the Commission as being a further relevant market susceptible to ex-ante regulation.

Following the NRA's review of the market for wholesale access and call origination on mobile networks, the NRA has found that all three mobile network operators, including SFR, have joint SMP in the market and it proposes access obligations as a remedy. The proposals were subsequently withdrawn by the NRA, which proposes instead to keep the market under review.

SFR appealed a decision by the NCA that it had abused a dominant position by price squeezing in relation to its pricing of certain fixed-to-mobile calls to business customers. The NCA proposed a fine of €2 million. The appeal court overturned the NCA's decision and the proposed fine, but the appeal court decision is subject to further appeal.

In November 2004, SFR and the other mobile operators received a statement of objections from the NCA relating to allegations that they engaged in practices which restricted competition on the retail market between 2000 and 2002. SFR has responded to the statement of objections and a hearing is expected in 2005. If the NCA decides that there had been a breach of competition law, it would be able to impose a fine on any operator who had committed the breach.

The French Government has agreed to extend SFR's 2G licence until March 2021. SFR will be required to pay an annual fee of €25 million plus 1% of 2G turnover per annum from March 2006.

Poland

Legislation implementing the new EU Framework in Poland, which joined the EU on 1 May 2004, was enacted during 2004 and the Polish NRA has commenced its market reviews.

The NRA has commenced a process to issue a new 2G licence and a new 3G licence. This process is expected to be concluded in 2005.

South Africa

In September 2004, the Minister of Communications announced a number of decisions which aim to further liberalise the telecommunications sector with effect from February 2005. These decisions include liberalising aspects of leased lines, public pay phones and value added and resale services.

A new Convergence Bill was issued for public comment in March 2005. The Bill makes significant changes to the licensing and regulatory framework for the telecommunications sector. The Bill has been approved by the Government and a consultation process is being conducted by a parliamentary committee. The Bill is expected to be finalised before the end of 2005.

An Information Communication Technologies Black Economic Empowerment Charter (the "Charter") is being developed by an industry and Government joint working group and is expected to be finalised in the second half of 2005. The Charter, in compliance with the Broad-Based Black Empowerment Act 2003, will set targets to evaluate a company's contribution to Broad-Based Black Economic Empowerment. Targets will be set in terms of equity ownership, management and control, employment, skills development, procurement, enterprise development, and corporate social investment. In May 2005, the NRA opened a proceeding on termination rates, seeking to determine if Vodacom has market power in the interconnection market. A written response from Vodacom is required by 4 July 2005. Separately, in May 2005, the NCA commenced an investigation into alleged excessive pricing of mobile termination rates.

Romania

In March 2003, the NRA determined MobiFon as having SMP in the national interconnection market under national law. From 31 December 2003 until the development of a LRIC model, MobiFon's mobile termination rates were reduced from $0.11 to $0.10 per minute. In March 2005, the NRA granted a 3G licence to MobiFon.

Switzerland

In April 2005, the Swiss NCA issued proposals to find that Swisscom Mobile has abused a dominant position in the mobile call termination market and thereby enhanced its position vis a vis its competitors. The NCA may seek to fine Swisscom Mobile. A written response from Swisscom Mobile is required by June 2005.

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Americas

The Federal Communications Commission (“FCC”), the United States’ NRA, has commenced a Notice of Inquiry into the level of termination rates charged by foreign mobile network operators to US international operators. The FCC has sought inputs on the status of foreign mobile termination rates, including actions taken to date by foreign regulators to address the issue.

Asia Pacific

Japan

The Japanese NRA has concluded the market definition stage of its effective competition review of the Japanese mobile industry, where it decided not to define a separate market for termination on individual mobile networks. It has entered the market assessment stage of the review which is expected to be concluded in 2005. The NRA has also commenced a review of the existing universal service obligation in Japan, with a view to reporting by December 2005.

The NRA is expected to award spectrum in the 1.7GHz band in 2006 under an allocation process to be determined by December 2005.

Australia

The NRA released its final decision on the regulation of mobile termination in June 2004. In its review, it proposed that all mobile network operators “have market power” with respect to mobile termination and proposed a pricing principle that requires mobile call termination rates to fall from 21 Australian cents per minute to a price that is at the upper end of the range of reasonable estimates of the cost of providing the service by 1 January 2007. It has proposed that price to be 12 Australian cents per minute. Vodafone Australia is appealing the NRA’s decision to the Federal Court of Australia and it is expected that the hearing will be in the second quarter of 2005. Vodafone Australia has lodged an “access undertaking” proposing alternative rates on which the NRA is consulting.

New Zealand

The NRA has released a draft report proposing regulation of mobile termination rates and held hearings in February 2005. A final report will be prepared by the NRA and is expected in 2005.

Non-mobile Telecommunications

The Group’s non-mobile telecommunications businesses mainly comprise interests in Arcor and Cegetel.

Arcor is the second largest fixed line telecommunications provider in Germany. With its own Germany-wide voice and data network covering more than 40,000 km, Arcor utilises its network to offer its customers a range of services for voice and data transfer, including complete ISDN/DSL connection services.

Cegetel is France’s second largest fixed line telephony operator and offers a wide range of fixed line telephone services to residential and business customers as well as special corporate services ranging from network and customer relations management to Internet-intranet hosting services. Cegetel also owns the most extensive private telecommunications network in France, with 21,000 km of fibre optic cable. On 11 May 2005, it was announced that an agreement had been reached to merge Cegetel with neuf telecom, subject to competition and regulatory authority and employee council approvals.

History and Development of the Company

The Company was incorporated under English law on 17 July 1984 as Racal Strategic Radio Limited (registered number 1833679), as a subsidiary of Racal Electronics Plc and changed its name to Racal Telecommunications Group Limited in September 1985. In September 1988, it became Racal Telecom Limited then re-registered as Racal Telecom Plc, a public limited company. In October 1988, approximately 20% of the Company's capital was offered to the public. The Company was fully demerged from Racal Electronics Plc and became an independent company in September 1991, at which time it changed its name to Vodafone Group Plc.

Between 1991 and 1999, the Group consolidated its position in the United Kingdom and enhanced its international interests through a series of transactions. At 31 March 1999, the Group had subsidiary mobile network operating companies ("mobile operating subsidiaries") in six countries (the UK, the Netherlands, Greece, Malta, Australia and New Zealand), as well as equity interests in a further seven countries, and a proportionate mobile customer base of 10.4 million.

The Group completed a number of significant business transactions between 1999 and 31 March 2002, which transformed the Company into the world's leading international mobile telecommunications company, namely:

- The merger with AirTouch Communications, Inc. ("AirTouch"), which completed on 30 June 1999. The Company changed its name to Vodafone AirTouch Plc in June 1999. The combined Group had mobile operating subsidiaries in 10 countries, (adding Sweden, Portugal, Egypt and the US) and equity interests in an additional 12 countries.

- The acquisition of Mannesmann AG ("Mannesmann"), which completed on 12 April 2000. Through this transaction the Group acquired subsidiaries in two of Europe's most important markets, Germany and Italy, and increased the Group's indirect holding in SFR, a French mobile telecommunications operator. Subsequent to the acquisition, the Group sold a number of non-core businesses acquired as part of the Mannesmann transaction. Following approval by its shareholders at the AGM, the Company reverted to its former name, Vodafone Group Plc, on 28 July 2000.

- The combination of the Group's US mobile operations with those of Bell Atlantic Corporation and GTE Corporation to form the Cellco Partnership, which operates under the name "Verizon Wireless", on 10 July 2000. The Group owns 45% of Verizon Wireless and accounts for it as an associated undertaking.

- The acquisition of Airtel Móvil S.A., a mobile network operator in Spain, which became a subsidiary of the Group in December 2000.

- The acquisition of Eircell Limited, a mobile network operator in Ireland, following a public offer for shares which closed in May 2001.

- The acquisition of the Group's operations in Japan. The Group's initial investment in Japan resulted from the AirTouch merger and between the date of the merger and October 2001, the Group increased its shareholding through a number of transactions. After an agreed tender offer for shares in Japan Telecom that completed in October 2001, the Group held, through its wholly owned subsidiary undertakings, a 39.67% stake in the Japanese mobile telecommunications company J-Phone Co. Ltd and a 66.7% stake in the fixed line operator Japan Telecom Co., Ltd. In addition, Japan Telecom Co., Ltd held 45.08% of the issued share capital in J-Phone Co. Ltd, making the Group's effective interest in J-Phone Co. Ltd 69.7%.

By 31 March 2002, the Group controlled mobile operations in 16 countries and held equity investments in mobile operations in a further 12 countries. The proportionate mobile customer base was 101.1 million at that date.

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Transactions since 31 March 2002

Acquisitions

MobiFon and Oskar

On 31 May 2005, the Company announced that its wholly-owned subsidiary, Vodafone International Holdings B.V., had completed the acquisition of approximately:

- 79% of the share capital of MobiFon S.A. (MobiFon) in Romania, increasing the Groups ownership in MobiFon to approximately 99%; and,

- 100% of the share capital of Oskar Mobil a.s. (Oskar) in the Czech Republic

from Telesystem International Wireless Inc. (TIW) for cash consideration of approximately $3.5 billion (£1.9 billion) satisfied from the Groups cash resources. In addition, the Group assumed approximately $0.9 billion of net debt.

Subsidiary undertakings

The Groups strategy is to increase its shareholding in existing operations where it believes opportunities arise to enhance value for the Companys shareholders. During the past three financial years, the Group purchased minority stakes in certain of the Groups subsidiary undertakings in order to be able to align more closely the respective businesses to the Groups business.

Japan

On 1 August 2002, Japan Telecom Co., Ltd was renamed Japan Telecom Holdings Co., Ltd, and its fixed line business was transferred to a newly established wholly owned subsidiary, Japan Telecom Co., Ltd (Japan Telecom). This created a telecommunications service group comprising two core businesses of mobile and fixed line telecommunications, namely J-Phone Co., Ltd and Japan Telecom.

During the 2004 financial year, the Group sold its interest in Japan Telecom, as described under Disposals. In addition, J-Phone Co., Ltd was renamed Vodafone K.K. on 1 October 2003 and Japan Telecom Holdings Co., Ltd. was renamed Vodafone Holdings K.K. on 10 December 2003.

On 25 May 2004, the Groups wholly owned subsidiary, Vodafone International Holdings B.V., announced offers for the shares not held by the Group in Vodafone Holdings K.K. and Vodafone K.K. As a result of these offers, the Group increased its effective shareholding in Vodafone K.K. to 98.2% and its stake in Vodafone Holdings K.K. to 96.1% for a total consideration of £2.4 billion. On 1 October 2004, the merger of Vodafone K.K. and Vodafone Holdings K.K. was completed. At 31 March 2005, the Group held a 97.7% stake in the merged company, Vodafone K.K.

The Group has applied for Vodafone K.K.s shares to be delisted from the Tokyo Stock Exchange, which is expected to occur in the 2006 financial year.

Spain

On 2 April 2002, the Company acquired a further 2.2% interest in its Spanish mobile operating subsidiary for £0.4 billion, following the exercise of a put option held by Torreal, S.A.

On 27 January 2003, the Company completed the acquisition of the remaining 6.2% interest in its Spanish mobile operating subsidiary for approximately €2.0 billion (£1.4 billion) following the exercise of a put option held by Acciona, S.A. and Tibest Cuatro, S.A. under the terms of an agreement originally made in January 2000.

Greece

On 3 December 2002, the Group completed the acquisition of a 10.85% interest in its then listed Greek operating subsidiary, Vodafone-Panafon Hellenic Telecommunications Company S.A. (Vodafone Greece), from France Telecom S.A. for £216 million in cash. The transaction increased the Groups effective holding in this company from 51.88% to 62.73%. During the 2003 financial year, the Group made market purchases of shares which increased the Groups effective interest to 64.0% at 31 March 2003.

On 1 December 2003, following the purchase of a 9.433% stake in Vodafone Greece from Intracom S.A., the Group announced a public offer for all remaining shares not held by the Group. As a result of the offer and subsequent market purchases, the Group increased its effective interest in Vodafone Greece to 99.4% at 31 March 2004. The total aggregate cash consideration paid in the 2004 financial year was £815 million.

Vodafone Greeces shares were delisted from the Athens and London Stock Exchanges on 15 July 2004 and 20 August 2004 respectively.

Between 24 January 2005 and 31 March 2005, the Group acquired a further 0.4% interest in Vodafone Greece through private transactions at a price equal to the price paid in the public offer.

The Netherlands

On 27 November 2002, the Group purchased for cash an additional 7.6% interest in Vodafone Netherlands, increasing the Groups interest from 70% to 77.6%.

As a result of a cash offer for the remaining shares of Vodafone Netherlands not held by the Group and market purchases, the Company increased its overall effective interest in Vodafone Netherlands to 97.2% at 31 March 2003. The total aggregate cash consideration paid in the 2003 financial year was £486 million, with a further £110 million paid in April 2003. As a result of private transactions, the Group increased its effective interest in Vodafone Netherlands to 99.9% at 31 March 2004. The Group has exercised its rights under Dutch law and initiated compulsory acquisition procedures in order to acquire the remaining shares. Following these procedures, Vodafone Netherlands will become a wholly owned subsidiary of the Group. Vodafone Netherlands shares have been de-listed from the Euronext Amsterdam Stock Exchange.

Sweden

During September 2002, the Group increased its effective interest in its then listed subsidiary, Vodafone Sweden, by 3.6% to 74.7% through a series of market purchases.

A recommended cash offer for all remaining shares in Vodafone Sweden not held by the Group was announced on 5 February 2003. As a result of shares bought in the offer and in the market, the Company increased its effective shareholding in Vodafone Sweden to approximately 99.1% at 25 March 2003. The total aggregate cash consideration paid was £391 million.

Under compulsory acquisition procedures, on 15 March 2004 Vodafone Holdings Sweden AB obtained advanced access to an aggregate of 2,377,774 shares in Vodafone Sweden, giving the Group ownership of and title to these shares. An arbitral tribunal in Sweden is currently determining the purchase price for the shares.

On 31 March 2004, the Group increased its effective interest in Vodafone Sweden to 100% by the purchase of 1,320,000 shares which were held in treasury by Vodafone Sweden for a total consideration of SEK62 million (£4 million).

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Portugal

During September 2002, the Group increased its effective interest in its then listed subsidiary Vodafone Portugal to 61.4% through market purchases.

On 28 February 2003, the Company announced a tender offer to acquire, for cash, all remaining shares not held by the Group. The Company's effective interest in Vodafone Portugal increased to approximately 94.4% as a result of shares purchased in the offer and in the market. The total aggregate cash consideration paid in the 2003 financial year was £184 million, with a further £336 million paid in April 2003. Having achieved an effective interest of greater than 90%, the Company implemented compulsory acquisition procedures to acquire the remaining shares, which became effective on 21 May 2003, for a further consideration of £74 million. As a result, Vodafone Portugal became a wholly owned subsidiary of the Group.

Australia

On 3 May 2002, the Group completed the purchase of the 4.5% minority interest in Vodafone Australia Limited ("Vodafone Australia"), formerly Vodafone Pacific Limited, for a cash consideration of £43 million, as a result of which Vodafone Australia became a wholly owned subsidiary.

Hungary

On 23 January 2003, the Group increased its stake in V.R.A.M. Telecommunications Limited, now called Vodafone Hungary Mobile Telecommunications Limited ("Vodafone Hungary"), to 83.8% by purchasing RWE Com GmbH & Co OHG's 15.565% interest in Vodafone Hungary for an undisclosed cash consideration. Options were granted to Antenna Hungaria RT ("Antenna") on 23 January 2003 over certain of the shares acquired from RWE on this date, representing a maximum interest of 3.89%. All of these options expired on 9 October 2003, unexercised.

On 10 June 2003, the Group increased its stake in Vodafone Hungary to 87.9% by subscribing for Antenna's share of an issue of "C" shares. Antenna's call options over 5,659,500, 5,072,700 and 7,845,855 Vodafone Hungary "C" shares, relating to equity injections in October 2001, April 2002 and June 2003 respectively, expired on 9 October 2003 unexercised.

In the first half of the 2005 financial year, the Group subscribed for HUF 89,301 million (£248 million) shares in Vodafone Hungary, increasing the Group's stake to 92.8%. On 24 September 2004, the Group entered into a sale and purchase agreement to acquire the remaining 7.2% shareholding in Vodafone Hungary from Antenna. This transaction completed on 12 January 2005 with the effect that Vodafone Hungary became a wholly owned subsidiary of the Group.

Egypt

On 16 May 2003, the Group increased its shareholding in Vodafone Egypt from 60.0% to 67.0%. Subsequently, the Group has reduced its effective interest in Vodafone Egypt to 50.1%.

Malta

On 1 August 2003, the Group announced that it had increased its shareholding in Vodafone Malta Limited ("Vodafone Malta") from 80% to 100% by purchasing Maltacom Plc's 20% interest in Vodafone Malta for cash consideration of €30 million.

UK

On 22 September 2003, the Group acquired 100% of Singlepoint (4U) Limited (Singlepoint) for a consideration of £417 million. In addition, as a result of a recommended cash offer announced on 5 August 2003, the Group acquired 98.92% of Project Telecom plc, after the offer was declared unconditional on 19 September 2003, and subsequently acquired the remaining 1.08% in November 2003, for a total consideration of £164 million. These businesses have been integrated into the Groups UK operations.

Vizzavi

On 29 August 2002, the Group acquired Vivendis 50% stake in the Vizzavi joint venture, which operated a mobile content business, for a cash consideration of €143 million (£91 million). As a result of this transaction, the Group owns 100% of Vizzavi, with the exception of Vizzavi France, which is now wholly owned by Vivendi. Vizzavi services are now provided under the Vodafone brand.

Associates

SFR and Cegetel

At 1 April 2002, the Group had a 20% direct interest in the French mobile operator SFR and an approximate 15% interest in Cegetel Groupe S.A. (Cegetel Group), the French telecommunications group and the remaining 80% shareholder in SFR, making the Groups effective interest in SFR approximately 31.9%.

On 16 October 2002, the Group announced that it had agreed to acquire BTs 26% interest in Cegetel Group and SBC Communications, Inc.s (SBCs) 15% interest in Cegetel Group for €4.0 billion cash and $2.27 billion cash, respectively. Vivendi Universal S.A. (Vivendi) had pre-emption rights in connection with the Cegetel Group shares held by SBC and BT. At the same time, the Group announced that it had made a non-binding cash offer of €6.8 billion to Vivendi for its 44% interest in Cegetel Group. On 29 October 2002, the Board of Vivendi announced it had decided not to accept the Groups offer to purchase its 44% interest in Cegetel Group and, accordingly, the offer lapsed. On 3 December 2002, Vivendi also announced its intention to exercise its pre-emption rights to acquire BTs 26% interest in Cegetel Group. On 21 January 2003, the Company announced that its subsidiary, Vodafone Holding GmbH, had completed the acquisition of SBCs 15% interest in Cegetel Group for a cash consideration of $2.27 billion (£1.4 billion), increasing the Groups effective interest in SFR to approximately 43.9%.

In December 2003, in order to optimise cash flows between Cegetel Group and its shareholders, SFR was merged into Cegetel Group and this company was renamed SFR. The fixed line businesses, Cegetel S.A. and Télécom Développement, previously controlled by SNCF, were merged to form Cegetel S.A.S. (Cegetel), a company in which SFR had a 65% stake, giving the Group an effective interest of 28.5% at that date. The Groups interest in SFR remained at approximately 43.9% as a result of this reorganisation.

On 11 May 2005, SFR announced an agreement to merge its fixed line business, Cegetel, with neuf telecom, subject to competition and regulatory authority and employee council approvals. Under the agreement, SFR will purchase SNCFs 35% minority interest in Cegetel, according to a pre-existing contract, and then contribute 100% of the capital of Cegetel to neuf telecom. In return, SFR will receive a 28% interest in the combined entity, neuf Cegetel, together with a €380 million bond to be issued by neuf Cegetel.

Vodacom

During December 2002, the Group completed the purchase of an additional 3.5% indirect equity stake in its South African associated undertaking, Vodacom Group (Pty) Limited (Vodacom), for the sterling equivalent of £78 million. The transaction increased the Groups effective interest in Vodacom to 35%.

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Safaricom

On 10 January 2003, under an agreement with Mobitelea Ventures Limited, the Group completed the purchase of a 5% indirect equity stake in the Group’s Kenyan associated undertaking, Safaricom Limited (“Safaricom”), for approximately $10 million (£6 million), increasing the Group’s effective interest in Safaricom to 35%.

Investments

China Mobile

The Company has a strategic alliance with China Mobile (Hong Kong) Limited (“China Mobile”) which sets out the principal terms for co-operation between the two parties in mobile services, technology, operations and management.

On 18 June 2002, the Group invested $750 million in China Mobile and obtained the right to appoint a non-executive director to the China Mobile board. The Group’s stake in China Mobile increased from approximately 2.18% to approximately 3.27% as a result of this transaction.

Disposals

During the three year period ended on 31 March 2005, the Group has disposed of a number of interests in companies that were outside the Company’s core business and were originally acquired as a consequence of certain acquisitions. The Group has used the proceeds from these disposals to reduce its indebtedness.

Mannesmann businesses

Arcor rail business

On 25 January 2002, the Group announced that Arcor, the Group’s German fixed line business, had agreed terms for the sale of its railway-specific business, Arcor DB Telematik GmbH (“Telematik”), to the German rail operator Deutsche Bahn, for €1.15 billion (£709 million), €1 billion of which was received on 26 March 2002. The sale completed in April 2002 following receipt of all necessary approvals and registration in the German commercial register. On completion, Arcor sold 49.9% of Telematik’s equity to Deutsche Bahn and entered into a put / call arrangement governing the remaining 50.1% equity interest, exercisable from 1 July 2002. Deutsche Bahn exercised its option to purchase the remaining 50.1% equity interest for 0.15 billion on 1 July 2002.

Holding in Ruhrgas AG

On 30 October 2001, the Group announced that it had reached agreement with E.ON AG for the sale of the Group’s 23.6% stake in Bergemann GmbH, through which it held an 8.2% stake in Ruhrgas AG. The transaction completed on 8 July 2002, realising cash proceeds of €0.9 billion.

Japan Telecom

On 14 November 2003, Vodafone Holdings K.K. completed the disposal of its 100% interest in Japan Telecom. The Group ceased consolidating the results of Japan Telecom from 1 October 2003. Receipts resulting from this transaction were ¥257.9 billion (£1.4 billion), comprising ¥178.9 billion (£1.0 billion) of cash, ¥32.5 billion (£0.2 billion) of transferable redeemable preferred equity and ¥46.5 billion (£0.2 billion) recoverable withholding tax, which was received during the 2005 financial year. In October 2004, the preferred equity was sold to the original purchaser for ¥33.9 billion (£0.2 billion).

Other disposals

During the 2004 financial year, the Group disposed of its interests in its associated undertakings in Mexico, Grupo Iusacell, and India, RPG Cellular.

On 26 January 2005 the Group completed the disposal of a 16.9% stake in Vodafone Egypt to Telecom Egypt, reducing the Group's effective interest to 50.1%.

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Cautionary Statement Regarding Forward-Looking Statements

This document contains "forward-looking statements" within the meaning of the US Private Securities Litigation Reform Act of 1995 with respect to the Group's financial condition, results of operations and businesses and certain of the Group's plans and objectives. In particular, such forward-looking statements include statements with respect to Vodafone's expectations as to launch and roll-out dates for products, services or technologies offered by Vodafone; intentions regarding the development of products and services introduced by Vodafone or by Vodafone in conjunction with initiatives with third parties; the ability to integrate our operations throughout the Group in the same format and on the same technical platform and the ability to be operationally efficient; the development and impact of new mobile technology; anticipated benefits to the Group of the One Vodafone programme; the results of Vodafone's brand awareness and brand preference campaigns; growth in customers and usage, including improvements in customer mix; future performance, including turnover, average revenue per user ("ARPU"), cash flows, costs, capital expenditures and margins, non-voice services and their revenue contribution; share purchases; the rate of dividend growth by the Group or its existing investments; expectations regarding the Group's access to adequate funding for its working capital requirements; expected effective tax rates and expected tax payments; the ability to realise synergies through cost savings, revenue generating services, benchmarking and operational experience; future acquisitions, including increases in ownership in existing investments and pending offers for investments; future disposals; contractual obligations; mobile penetration and coverage rates; the impact of regulatory and legal proceedings involving Vodafone; expectations with respect to long-term shareholder value growth; Vodafone's ability to be the mobile market leader, overall market trends and other trend projections.

Forward-looking statements are sometimes, but not always, identified by their use of a date in the future or such words as "anticipates", "aims", "could", "may", "should", "expects", "believes", "intends", "plans" or "targets". By their forward-looking statements are inherently predictive, speculative and involve risk and uncertainty because they relate to events and depend on circumstances that will occur in the future. There are a number of factors that could cause actual results and developments to differ materially from those expressed or implied by these forward-looking statements. These factors include, but are not limited to, the following:

- changes in economic or political conditions in markets served by operations of the Group that would adversely affect the level of demand for mobile services;
- greater than anticipated competitive activity requiring changes in pricing models and/or new product offerings or resulting in higher costs of acquiring new customers or providing new services;
- the impact on capital spending from investment in network capacity and the deployment of new technologies, or the rapid obsolescence of existing technology;
- slower customer growth or reduced customer retention;
- the possibility that technologies, including mobile Internet platforms, and services, including 3G services, will not perform according to expectations or that vendors' performance will not meet the Group's requirements;
- changes in the projected growth rates of the mobile telecommunications industry;
- the Group's ability to realise expected synergies and benefits associated with 3G technologies and the integration of our operations and those of acquired companies;
- future revenue contributions of both voice and non-voice services offered by the Group;
- lower than expected impact of GPRS, 3G and Vodafone live! and other new or existing products, services or technologies on the Group's future revenue, cost structure and capital expenditure outlays;
- the ability of the Group to harmonise mobile platforms and any delays, impediments or other problems associated with the roll-out and scope of 3G technology and services and Vodafone live! and other new or

existing products, services or technologies in new markets;

- the ability of the Group to offer new services and secure the timely delivery of high-quality, reliable GPRS and 3G handsets, network equipment and other key products from suppliers;
- greater than anticipated prices of new mobile handsets;
- the ability to realise benefits from entering into partnerships for developing data and Internet services and entering into service franchising and brand licensing;
- the possibility that the pursuit of new, unexpected strategic opportunities may have a negative impact on one or more of the measurements of our financial performance and may affect the level of dividends;
- any unfavourable conditions, regulatory or otherwise, imposed in connection with pending or future acquisitions or dispositions;
- changes in the regulatory framework in which the Group operates, including possible action by regulators in markets in which the Group operates or by the European Commission regulating rates the Group is permitted to charge;
- the Group's ability to develop competitive data content and services which will attract new customers and increase average usage;
- the impact of legal or other proceedings against the Group or other companies in the mobile telecommunications industry;
- the possibility that new marketing campaigns or efforts are not an effective expenditure;
- the possibility that the Group's integration efforts do not increase the speed to market for new products or improve the Group's cost position;
- changes in exchange rates, including particularly the exchange rate of pounds sterling to the euro, US dollar and the Japanese yen;
- the risk that, upon obtaining control of certain investments, the Group discovers additional information relating to the businesses of that investment leading to restructuring charges or write-offs or with other negative implications;
- changes in statutory tax rates and profit mix which would impact the weighted average tax rate;
- changes in tax legislation in the jurisdictions in which the Group operates;
- final resolution of open issues which might impact the effective tax rate;
- timing of tax payments relating to the resolution of open issues; and,
- loss of suppliers or disruption of supply chains.

Furthermore, a review of the reasons why actual results and developments may differ materially from the expectations disclosed or implied within forward-looking statements can be found under "Risk Factors and Legal Proceedings – Risk Factors". All subsequent written or oral forward-looking statements attributable to the Company or any member of the Group or any persons acting on their behalf are expressly qualified in their entirety by the factors referred to above. No assurances can be given that the forward-looking statements in this document will be realised. Neither Vodafone nor any of its affiliates intends to update these forward-looking statements.

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Risk Factors and Legal Proceedings

Risk Factors

Regulatory decisions and changes in the regulatory environment could adversely affect the Group's business.

Because the Group has ventures in a large number of geographic areas, it must comply with an extensive range of requirements that regulate and supervise the licensing, construction and operation of its telecommunications networks and services. In particular, there are agencies which regulate and supervise the allocation of frequency spectrum and which monitor and enforce regulation and competition laws which apply to the mobile telecommunications industry. Decisions by regulators regarding the granting, amendment or renewal of licences, to the Group or to third parties, could adversely affect the Group's future operations in these geographic areas. The Group cannot provide any assurances that governments in the countries in which it operates will not issue telecommunications licences to new operators whose services will compete with it. In addition, other changes in the regulatory environment concerning the use of mobile phones may lead to a reduction in the usage of mobile phones or otherwise adversely affect the Group. Additionally, decisions by regulators could further adversely affect the pricing for services the Group offers. Further details on the regulatory framework, in certain regions in which the Group operates, and on regulatory proceedings can be found in "Business Overview – Regulation".

Increased competition may reduce market share or revenue.

The Group faces intensifying competition. Competition could lead to a reduction in the rate at which the Group adds new customers and to a decrease in the size of the Group's market share as customers choose to receive mobile services, or other competing services, from other providers.

The focus of competition in many of the Company's markets continues to shift from customer acquisition to customer retention as the market for mobile telecommunications has become increasingly penetrated. Customer deactivations are measured by the Group's churn rate. There can be no assurance that the Group will not experience increases in churn rates, particularly as competition intensifies. An increase in churn rates could adversely affect profitability because the Group would experience lower revenue and additional selling costs to replace customers, although such costs would have a future revenue stream to mitigate the impact.

Increased competition has also led to declines in the prices the Group charges for its mobile services and is expected to lead to further price declines in the future. Competition could also lead to an increase in the level at which the Group must provide subsidies for handsets. Additionally, the Group could face increased competition should there be an award of additional licences in jurisdictions in which a member of the Group already has a licence, whether 2G or 3G.

Delays in the development of handsets and network compatibility and components may hinder the deployment of new technologies.

The Group's operations depend in part upon the successful deployment of continuously evolving mobile telecommunications technologies. The Group uses technologies from a number of vendors and makes significant capital expenditures in connection with the deployment of such technologies. There can be no assurance that common standards and specifications will be achieved, that there will be inter-operability across Group and other networks, that technologies will be developed according to anticipated schedules, that they will perform according to expectations or that they will achieve commercial acceptance. Commercially viable 3G handsets may not be available in the timeframe required or in the amounts needed, which may reduce the potential revenue benefits from 3G services. The introduction of software and other network components may also be delayed. The failure of vendor performance or technology performance to meet the Group's expectations or the failure of a technology to achieve commercial acceptance could result in additional capital expenditures by the Group or a reduction in profitability.

Expected benefits from the One Vodafone programme may not be realised.

The One Vodafone programme represents the Groups plan to achieve full integration of its global operations and is designed to maximise the benefits of Vodafones scale and scope. The programme is premised on six core initiatives, further details of which can be found on page 13. The Group has previously stated publicly that it expects to realise operational cash flow benefits by the financial year ending 31 March 2008. These expected benefits have been formulated by management on the assumption that all of the core initiatives which comprise the One Vodafone programme generate the results anticipated and that the Group is able to take advantage of its size and exploit the associated economies of scale to their fullest extent. Management still considers these targeted cost savings and revenue enhancements to be achievable. However, no assurance can be given that the full extent of the anticipated benefits of the One Vodafone programme will be realised.

Challenging environment in Japan.

Vodafone continues to encounter difficult market conditions in Japan due to the strength of competitor offerings, specifically in 3G customer propositions. The Group has strengthened Vodafone Japans management team and continues with the ongoing transformation plan. However, in a constantly evolving competitive environment, no assurance can be provided with respect to Vodafones ability to perform in Japan either operationally or as a management team and secure a local competitive advantage.

The Groups business would be adversely affected by the non-supply of equipment and support services by a major supplier.

Companies within the Group source their mobile network infrastructure and related support services from third party suppliers. The removal from the market of one or more of these third party suppliers would adversely affect the Groups operations and could result in additional capital expenditures by the Group.

The Companys strategic objectives may be impeded by the fact that it does not have a controlling interest in some of its ventures.

Some of the Groups interests in mobile licences are held through entities in which it is a significant but not controlling owner. Under the governing documents for some of these partnerships and corporations, certain key matters such as the approval of business plans and decisions as to the timing and amount of cash distributions require the consent of the partners. In others, these matters may be approved without the Companys consent. The Company may enter into similar arrangements as it participates in ventures formed to pursue additional opportunities. Although the Group has not been materially constrained by the nature of its mobile ownership interests, no assurance can be given that its partners will not exercise their power of veto or their controlling influence in any of the Groups ventures in a way that will hinder the Groups corporate objectives and reduce any anticipated cost savings or revenue enhancement resulting from these ventures.

Expected benefits from investment in networks, licences and new technology may not be realised.

The Group has made substantial investments in the acquisition of 3G licences and in its mobile networks, including the rollout of 3G networks. The Group expects to continue to make significant investments in its mobile networks due to increased usage and the need to offer new services and greater functionality afforded by 3G technology. Accordingly, the rate of the Groups capital expenditures in future years could remain high or exceed that which it has experienced to date.

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Risk Factors and Legal Proceedings continued

Please see Business Overview Licences and network infrastructure for more information on expenditures in connection with the acquisition of 3G licences and expected expenditure in connection with the roll-out of 3G services. There can be no assurance that the introduction of 3G services will proceed according to anticipated schedules or that the level of demand for 3G services will justify the cost of setting up and providing 3G services. Failure or a delay in the completion of networks and the launch of new services, or increases in the associated costs, could have a material adverse effect on the Groups operations.

The Group may experience a decline in revenue per customer notwithstanding its efforts to increase revenue from the introduction of new services.

As part of its strategy to increase usage of its networks, the Group will continue to offer new services to its existing customers, and seek to increase non-voice service revenue as a percentage of total service revenue. However, the Group may not be able to introduce commercially these new services, or may experience significant delays due to problems such as the availability of new mobile handsets or higher than anticipated prices of new handsets. In addition, even if these services are introduced in accordance with expected time schedules, there is no assurance that revenue from such services will increase ARPU.

The Groups business and its ability to retain customers and attract new customers may be impaired by actual or perceived health risks associated with the transmission of radiowaves from mobile telephones, transmitters and associated equipment.

Concerns have been expressed in some countries where the Group operates that the electromagnetic signals emitted by mobile telephone handsets and base stations may pose health risks at exposure levels below existing guideline levels and may interfere with the operation of electronic equipment. In addition, as described under Legal Proceedings below, several mobile industry participants, including the Company and Verizon Wireless, have had lawsuits filed against them alleging various health consequences as a result of mobile phone usage, including brain cancer. While the Company is not aware that such health risks have been substantiated, there can be no assurance that the actual, or perceived, risks associated with radiowave transmission will not impair its ability to retain customers and attract new customers, reduce mobile telecommunications usage or result in further litigation. In such event, because of the Groups strategic focus on mobile telecommunications, its business and results of operations may be more adversely affected than those of other companies in the telecommunications sector.

Legal Proceedings

The Company and its subsidiaries are currently, and may be from time to time, involved in a number of legal proceedings, including inquiries from or discussions with governmental authorities, that are incidental to their operations. However, save as disclosed below, the Company and its subsidiaries are not involved currently in any legal or arbitration proceedings (including any governmental proceedings which are pending or known to be contemplated) which are expected to have, or have had in the twelve months preceding the date of this report, a significant effect on the financial position or profitability of the Company and its subsidiaries.

The Company is a defendant in four actions in the United States alleging personal injury, including brain cancer, from mobile phone use. In each case, various other carriers and mobile phone manufacturers are also named as defendants. These actions are at an early stage and no accurate quantification on any losses which may arise out of the claims can therefore be made as at the date of this report. The Company is not aware that the health risks alleged in such personal injury claims have been substantiated and will be vigorously defending such claims.

Between 18 September and 29 November 2002, nine complaints were filed in the United States District Court for the Southern District of New York against the Company and Lord MacLaurin, the Chairman of the Company, and Sir Christopher Gent, Sir Julian Horn-Smith and Mr. Kenneth Hydon, executive officers of the Company. The actions were brought under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission. The complaints, which purport to be brought on behalf of all purchasers of ADSs of Vodafone between 7 March 2001 and 28 May 2002, alleged that Vodafone's financial statements and certain Vodafone financial disclosures were materially false and misleading. More specifically, the complaints alleged that, between 7 March 2001 and 28 May 2002, defendants made various material misrepresentations relating to Vodafone's investments in fixed-wire operations, goodwill, and prior acquisitions in an effort to inflate artificially the price of Vodafone securities. The complaints sought compensatory damages in an unspecified amount, interest, reasonable costs including attorneys' fees and experts' fees, and equitable and/or injunctive relief as permitted by law.

The plaintiffs filed a consolidated class action complaint on 6 June 2003. On 14 October 2003, the Court ordered that the complaint be dismissed, with leave for the plaintiffs to re-plead. On 20 October 2003, the plaintiffs entered into a Stipulation dismissing the complaint against Lord Ian MacLaurin without prejudice. On 10 November 2003 the plaintiffs filed a second consolidated amended class action complaint against Vodafone, Sir Christopher Gent, Sir Julian Horn-Smith and Mr. Kenneth Hydon. On 26 March 2004, the Court dismissed without prejudice the remaining individual defendants from this action. On 7 May 2004, the plaintiffs filed a third consolidated amended class action complaint naming only the Company as a defendant. Thereafter, the parties entered into substantive discussions regarding the possibility of settling the action. Those discussions led to a mediation, following which the parties reached an agreement-in-principle to settle the claims against all defendants in exchange for a settlement payment of $24.5 million to a settlement class (the "Settlement Class") comprised of all purchasers of Vodafone ADSs during the period from 7 March 2001 to 28 May 2002 (other than those class members that exclude themselves, or automatically are excluded, from the class). Following the mediation, Vodafone and its insurers paid $24.5 million into an escrow account to fund the settlement in the event that (i) the parties reached a definitive settlement agreement and (ii) that agreement received final approval by the Court after issuance of the necessary notices and the conduct of the necessary hearings. On 4 March 2005, the parties entered into definitive settlement documents and, on that date, participated in a conference and hearing before the Court, at which they submitted a motion for preliminary certification of the Settlement Class and preliminary approval of the settlement. On 15 March 2005, the Court entered an Order that, among other things, preliminarily certified the Settlement Class, preliminarily approved the settlement, set 23 May 2005 as the deadline for the submission by class members of objections to the settlement or requests for exclusion from the Settlement Class, and scheduled a Settlement Fairness Hearing for 22 June 2005.

A subsidiary of the Company, Vodafone 2, is responding to an enquiry by the UK Inland Revenue with regard to the UK tax treatment of its Luxembourg holding company, Vodafone Investments Luxembourg SARL ("VIL"), under the Controlled Foreign Companies section of the UK's Income and Corporation Taxes Act 1988 ("the CFC Regime"). The enquiry by the UK Inland Revenue relates to the tax treatment of profits earned by the holding company for the accounting period ended 31 March 2001. The CFC Regime serves to subject a UK resident company to corporation tax in the UK in respect of the profits of a controlled foreign company in certain circumstances.

Vodafone 2's position is that it is not liable to corporation tax in the UK under the CFC Regime in respect of VIL on the basis that the CFC Regime is contrary to EU law. An application for closure of the enquiry (inter alia) was made by Vodafone 2 to the Special Commissioners of the UK Inland Revenue on 1 October 2004 on the basis that the enquiry could not reasonably be continued as it is premised on UK legislation (the CFC

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Regime) which is contrary to EU law and thus invalid. In summary, it is argued that imposition of corporation tax under the CFC Regime amounts to unlawful discrimination or an unlawful restriction on the exercise of fundamental freedoms under the EU Treaty (particularly Articles 43 and 56).

On 3 May 2005 the Special Commissioners referred the matter to the European Court of Justice (the ECJ) requesting that a number of questions in relation to the invalidity argument be determined as a preliminary matter. Pending resolution of such questions, Vodafone 2s application for closure of the enquiry (and, effectively, the enquiry itself) has been stayed. It is not expected that the ECJ will deliver a judgment in this matter until, at the earliest, mid 2006. The ECJ does not have jurisdiction to determine the outcome of Vodafone 2s application rather the Special Commissioners will apply the ECJs judgment to the particular facts of Vodafone 2s application.

If the ECJ decides that the CFC Regime in its entirety is invalid under EU law, then no charge to UK corporation tax can arise to Vodafone 2 with respect to VIL under the CFC Regime and the Special Commissioners will order that the Inland Revenues enquiry be closed. If the CFC Regime is held by the ECJ to be valid, either in part or as a whole, then it will be a matter for the Special Commissioners to apply the ECJs reasoning to the particular circumstances of Vodafone 2s case. Although it is not possible to address all possible outcomes under such a scenario, it should be noted that even if the CFC Regime is held by the ECJ to be entirely lawful, Vodafone 2 would continue to resist the imposition of corporation tax liability on other grounds.

The Company has taken provisions, which at 31 March 2005 amounted to £1,757 million, for the potential UK corporation tax liability and related interest expense that may arise if the Company is not successful in its challenge of the CFC Regime. The provisions relate to the accounting period which is the subject of the proceedings and accounting periods after 31 March 2001 to date. Please see note 8 to the Companys Consolidated Financial Statements. The Company considers these provisions are sufficient to settle any assessments that may arise from the enquiry. However, the amount ultimately paid by the Company (if any) upon resolution of the enquiry may differ materially from the amount accrued and, therefore, could have a significant effect on the profitability or cash flows of the Group in future periods. In the absence of any material unexpected developments, the Company expects to reassess the amount of this provision when the views of the ECJ become known, which is expected to be during 2006.

A number of Vodafone subsidiaries acquired 3G licences through auctions in 2000 and 2001. An appeal was filed by Vodafone UK, along with other UK mobile network operators which were granted a 3G licence, with the VAT and Duties Tribunal on 18 October 2003 for recovery of VAT on the basis that the amount of the licence fee was inclusive of VAT. The amount of this claim is approximately £888 million. In August 2004, these claims were referred, jointly, to the ECJ although no hearing date has yet been listed. A decision from the ECJ is not expected before 2006. The Group has not recognised any amounts in respect of this matter to date. In addition, the Group has made a claim for recovery of VAT in relation to 3G licence fees in Portugal and may pursue similar claims in certain other European jurisdictions.

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Operating and Financial Review and Prospects

Contents

Introduction

The following discussion is based on the Consolidated Financial Statements included elsewhere in this Annual Report. Such Consolidated Financial Statements are prepared in accordance with Generally Accepted Accounting Principles in the United Kingdom, or UK GAAP, which differ in certain significant respects from US GAAP. Reconciliations of the material differences in the UK GAAP Consolidated Financial Statements to US GAAP are disclosed in note 36 to the Consolidated Financial Statements, US GAAP information.

On 19 July 2002, the European Parliament adopted Regulation No. 1606/2002 requiring listed companies in the Member States of the European Union to prepare their consolidated financial statements in accordance with International Financial Reporting Standards (IFRS) from 2005. IFRS will apply for the first time in the Groups Annual Report for the year ending 31 March 2006. Consequently, the Groups interim results for the six-month period ending 30 September 2005 will be presented under IFRS together with restated information for the six months ended 30 September 2004 and the year ended 31 March 2005. Further information on the effects of the adoption of IFRS can be found in Information on International Financial Reporting Standards on pages 138 to 140.

Vodafone Group Plc is the worlds leading mobile telecommunications company, with equity interests in 26 countries across Europe, the United States and Asia Pacific at 31 March 2005. The Group had 154.8 million registered proportionate mobile customers based on ownership interests at 31 March 2005. Partner Network arrangements extend the Group’s footprint by a further 14 countries. As the world’s mobile telecommunications leader, the Group’s vision is to be the world’s mobile communications leader enriching our customers’ lives through the unique power of mobile communications. See “Business Overview – Business strategy”.

The Group currently provides a range of voice and data communication services, including SMS, MMS and other data services. Services are provided to both consumers and corporate customers, through a variety of both prepaid and contract tariff arrangements.

In the majority of the Group’s controlled networks, services are offered over a GSM network, on which a GPRS service is also provided. Where licences have been issued, the Group has also secured 3G licences in all jurisdictions in which it operates through its subsidiary undertakings and continues to rollout mobile 3G network infrastructure. See “Business Overview – Licences and network infrastructure”.

The Group faces a number of significant risks that may impact on its future performance and activities. Please see “Risk Factors and Legal Proceedings”.

Presentation of Information

In the discussion of the Group’s reported financial position and results, information in addition to that contained within the Consolidated Financial Statements is presented, including the following:

Customers

Mobile customer

A mobile customer is defined as a subscriber identity module (“SIM”) or, in territories where SIMs do not exist, a unique mobile telephone number which has access to the network for any purpose (including data only usage) except telemetric applications. Telemetric applications include, but are not limited to, asset and equipment tracking and mobile payment / billing functionality (for example, vending machines and meter readings) and include voice enabled customers whose usage is limited to a central service operation (for example, emergency response applications in vehicles).

Proportionate customers

The proportionate customer number represents the number of mobile customers in ventures which the Group either controls or invests, based on the Group’s ownership in such ventures.

Activity level

Active customers are defined as customers who have made or received a chargeable event in the last three months.

The active customers are expressed as a percentage of the closing customer base. Contract and prepaid activity is reported separately.

Vodafone live! active device

A handset or device equipped with the Vodafone live! portal which has made or received a chargeable event in the last month.

3G device

A handset or device capable of accessing 3G data services.

ARPU

ARPU is calculated as service revenue divided by the weighted average number of customers in the period.

Average monthly ARPU represents total ARPU in an accounting period divided by the number of months in the period.

This performance indicator is commonly used in the mobile telecommunications industry and by Vodafone management to compare service revenue to prior periods and internal forecasts. Management believes that this measure provides useful information for investors regarding trends in customer revenue derived from mobile telecommunications services and the extent to which customers change their use of mobile services and the network from period to period.

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Churn

Churn is calculated as total gross customer disconnections divided by average total customers in the period. Stated churn figures are twelve month average figures.

Organic growth

The percentage movements in organic growth are presented to reflect operating performance on a comparable basis. Where a subsidiary or associated undertaking was newly acquired or disposed of in the current or prior year, the Group adjusts, under organic growth calculations, the results for the current and prior year to remove the amount the Group earned in both periods as a result of the acquisition or disposal of subsidiary or associated undertakings. Where the Group increases, or decreases, its ownership interest in an associated undertaking in the current or prior year, the Group's share of results for the prior year is restated at the current year's ownership level. A further adjustment in organic calculations excludes the effect of exchange rate movements by restating the prior period's results as if they had been generated at the current period's exchange rates. Management believes that these measures provide useful information to assist investors in assessing the Group's operating performance from period to period.

Trading results

The following metrics are used in the discussion of trading results.

Service revenue

Service revenue comprises all revenue related to the provision of ongoing services including, but not limited to, monthly access charges, airtime usage, roaming, incoming and outgoing network usage by non-Vodafone customers and interconnect charges for incoming calls.

—

(496
)

—

(3,892
)

—

—

(3,892
)
Equity based compensation expense

—

—

—

—

3,300

—

—

3,300

Accrued dividends attributable to stock-based awards

—

—

—

—

225

—

—

225

Dividends declared on common stock

—

—

—

—

—

(153,855
)

—

(153,855
)
Dividends declared on preferred stock

—

—

—

—

—

(7,500
)

—

(7,500
)
Dividends attributable to dividend equivalents

—

—

—

—

—

(481
)

—

(481
)
Change in unrealized gains on MBS, net

—

—

—

—

—

—

47,820

47,820

Derivative hedging instruments fair value changes, net

—

—

—

—

—

—

10,880

10,880

Balance at June 30, 2017

8,000

$
80

396,311

$
3,963

$
3,214,701

$
(576,482
)

$

632,382

$
3,274,644

(1) For the six months ended June 30, 2018 and 2017, includes approximately $2.0 million (250,946 shares) and $3.9 million (496,325 shares), respectively surrendered for tax purposes related to equity-based compensation awards.

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MFA FINANCIAL, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

(In Thousands)	Six Months Ended June 30, 2018	2017
Cash Flows From Operating Activities:		
Net income	$153,790	$157,995
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sales of MBS, CRT securities and U.S. Treasury securities	(16,246)	(15,597)
Gain on sales of real estate owned	(4,673)	(2,039)
Gain on liquidation of residential whole loans	(12,742)	(2,059)
Other-than-temporary impairment charges	—	1,032
Accretion of purchase discounts on MBS and CRT securities, residential whole loans and MSR related assets	(40,948)	(46,179)
Amortization of purchase premiums on MBS and CRT securities	12,508	16,002
Depreciation and amortization on real estate, fixed assets and other assets	805	439
Equity-based compensation expense	2,809	3,459
Unrealized gain on residential whole loans at fair value	(18,346)	(7,209)
(Increase)/decrease in other assets and other	(23,061)	3,101
Decrease in other liabilities	(10,091)	(10,660)
Net cash provided by operating activities	$43,805	$98,285
Cash Flows From Investing Activities:		
Principal payments on MBS, CRT securities and MSR related assets	$1,107,871	$2,461,731
Proceeds from sales of MBS, CRT securities and U.S. Treasury securities	198,392	177,625
Purchases of MBS, CRT securities, MSR related assets and U.S. Treasury securities	(323,309)	(888,736)
Purchases of residential whole loans and capitalized advances	(943,433)	(9,408)
Principal payments on residential whole loans	174,713	69,615
Proceeds from sales of real estate owned	58,230	30,459
Purchases of real estate owned and capital improvements	(5,282)	(1,882)
Redemption of Federal Home Loan Bank stock	—	10,422
Additions to leasehold improvements, furniture and fixtures	(551)	(333)
Net cash provided by investing activities	$266,631	$1,849,493
Cash Flows From Financing Activities:		
Principal payments on repurchase agreements and other advances	$(32,054,576)	$(39,588,099)
Proceeds from borrowings under repurchase agreements	31,331,949	37,941,405
Proceeds from issuance of securitized debt	183,970	147,847
Principal payments on securitized debt	(28,639)	(2,652)
Payments made for securitization related costs	(956)	(1,008)
Payments made for settlements on interest rate swap agreements (“Swaps”)	(33,316)	(35,840)
Proceeds from settlements on Swaps	51,711	—
Proceeds from issuances of common stock	1,711	186,250
Dividends paid on preferred stock	(7,500)	(7,500)
Dividends paid on common stock and dividend equivalents	(159,676)	(149,433)
Net cash used in financing activities	$(715,322)	$(1,509,030)
Net (decrease)/increase in cash, cash equivalents and restricted cash	$(404,886)	$438,748
Cash, cash equivalents and restricted cash at beginning of period	$463,064	$318,575

Cash, cash equivalents and restricted cash at end of period	$58,178	$757,323
Non-cash Investing and Financing Activities:		
Net decrease in securities obtained as collateral/obligation to return securities obtained as collateral	$(248,550)	$(2,782)
Transfer from residential whole loans to real estate owned	$103,521	$58,444
Dividends and dividend equivalents declared and unpaid	$79,948	$79,559

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

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MFA FINANCIAL, INC.
NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2018

1. Organization

MFA Financial, Inc. (the “Company”) was incorporated in Maryland on July 24, 1997 and began operations on April 10, 1998. The Company has elected to be treated as a real estate investment trust (“REIT”) for U.S. federal income tax purposes. In order to maintain its qualification as a REIT, the Company must comply with a number of requirements under federal tax law, including that it must distribute at least 90% of its annual REIT taxable income to its stockholders. The Company has elected to treat certain of its subsidiaries as a taxable REIT subsidiary (“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. (See Note 2(o))

2. Summary of Significant Accounting Policies

(a) Basis of Presentation and Consolidation

The interim unaudited consolidated financial statements of the Company have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (the “SEC”). Certain information and note disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) have been condensed or omitted according to these SEC rules and regulations. Management believes that the disclosures included in these interim unaudited consolidated financial statements are adequate to make the information presented not misleading. The accompanying unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017. In the opinion of management, all normal and recurring adjustments necessary to present fairly the financial condition of the Company at June 30, 2018 and results of operations for all periods presented have been made. The results of operations for the three and six months ended June 30, 2018 should not be construed as indicative of the results to be expected for the full year.

The accompanying consolidated financial statements of the Company have been prepared on the accrual basis of accounting in accordance with GAAP. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although the Company’s estimates contemplate current conditions and how it expects them to change in the future, it is reasonably possible that actual conditions could differ from those estimates, which could materially impact the Company’s results of operations and its financial condition. Management has made significant estimates in several areas, including other-than-temporary impairment (“OTTI”) on MBS (See Note 3), valuation of MBS, CRT securities and MSR related assets (See Notes 3 and 14), income recognition and valuation of residential whole loans (See Notes 4 and 14), valuation of derivative instruments (See Notes 5(c) and 14) and income recognition on certain Non-Agency MBS (defined below) purchased at a discount. (See Note 3) In addition, estimates are used in the determination of taxable income used in the assessment of REIT compliance and contingent liabilities for related taxes, penalties and interest. (See Note 2(o)) Actual results could differ from those estimates.

The Company has one reportable segment as it manages its business and analyzes and reports its results of operations on the basis of one operating segment; investing, on a leveraged basis, in residential mortgage assets.

The consolidated financial statements of the Company include the accounts of all subsidiaries; all intercompany accounts and transactions have been eliminated. In addition, the Company consolidates entities established to facilitate transactions related to the acquisition and securitization of residential whole loans as well as MBS resecuritization transactions completed in prior years. Certain prior period amounts have been reclassified to conform to the current period presentation.

(b) MBS and CRT Securities

The Company has investments in residential MBS that are issued or guaranteed as to principal and/or interest by a federally chartered corporation, such as the Federal National Mortgage Association ("Fannie Mae") or the Federal Home Loan Mortgage Corporation ("Freddie Mac"), or an agency of the U.S. Government, such as the Government National Mortgage Association ("Ginnie Mae") (collectively, "Agency MBS"), and residential MBS that are not guaranteed by any agency of the U.S. Government or any federally chartered corporation ("Non-Agency MBS"). In addition, the Company has investments in CRT securities that are issued by Fannie Mae and Freddie Mac. The coupon payments on CRT securities are paid by Fannie Mae and Freddie Mac and the principal payments received are based on the performance of loans in a reference pool of previously securitized MBS. As the loans in the underlying reference pool are paid, the principal balance of the CRT securities is paid. As an investor in a CRT security, the Company may incur a loss if certain defined credit events occur, including, for certain CRT securities, if the loans in the reference pool experience delinquencies exceeding specified thresholds.

Designation

The Company generally intends to hold its MBS until maturity; however, from time to time, it may sell any of its securities as part of the overall management of its business. As a result, all of the Company's MBS are designated as "available-for-sale" ("AFS") and, accordingly, are carried at their fair value with unrealized gains and losses excluded from earnings (except when an OTTI is recognized, as discussed below) and reported in Accumulated other comprehensive income/(loss) ("AOCI"), a component of Stockholders' Equity.

Upon the sale of an AFS security, any unrealized gain or loss is reclassified out of AOCI to earnings as a realized gain or loss using the specific identification method.

The Company has elected the fair value option for certain of its CRT securities as it considers this method of accounting to more appropriately reflect the risk sharing structure of these securities. Such securities are carried at their fair value with changes in fair value included in earnings for the period and reported in Other Income, net on the Company's consolidated statements of operations.

Revenue Recognition, Premium Amortization and Discount Accretion

Interest income on securities is accrued based on the outstanding principal balance and their contractual terms. Premiums and discounts associated with Agency MBS and Non-Agency MBS assessed as high credit quality at the time of purchase are amortized into interest income over the life of such securities using the effective yield method. Adjustments to premium amortization are made for actual prepayment activity.

Interest income on the Non-Agency MBS that were purchased at a discount to par value and/or are considered to be of less than high credit quality is recognized based on the security's effective interest rate which is the security's internal rate of return ("IRR"). The IRR is determined using management's estimate of the projected cash flows for each security, which are based on the Company's observation of current information and events and include assumptions related to fluctuations in interest rates, prepayment speeds and the timing and amount of credit losses. On at least a quarterly basis, the Company reviews and, if appropriate, makes adjustments to its cash flow projections based on input and analysis received from external sources, internal models, and its judgment about interest rates, prepayment rates, the timing and amount of credit losses, and other factors. Changes in cash flows from those originally projected, or from those estimated at the last evaluation, may result in a prospective change in the IRR/ interest income recognized on these securities or in the recognition of OTTIs. (See Note 3)

Based on the projected cash flows from the Company's Non-Agency MBS purchased at a discount to par value, a portion of the purchase discount may be designated as non-accretable purchase discount ("Credit Reserve"), which effectively mitigates the Company's risk of loss on the mortgages collateralizing such MBS and is not expected to be accreted into interest income. The amount designated as Credit Reserve may be adjusted over time, based on the actual performance of the security, its underlying collateral, actual and projected cash flow from such collateral, economic conditions and other factors. If the performance of a security with a Credit Reserve is more favorable than forecasted, a portion of the amount designated as Credit Reserve may be reallocated to accretable discount and recognized into interest income over time. Conversely, if the performance of a security with a Credit Reserve is less favorable than forecasted, the amount designated as Credit Reserve may be increased, or impairment charges and write-downs of such securities to a new cost basis could result.

Determination of Fair Value for MBS and CRT Securities

In determining the fair value of the Company's MBS and CRT securities, management considers a number of observable market data points, including prices obtained from pricing services, brokers and repurchase agreement counterparties, dialogue with market participants, as well as management's observations of market activity. (See Note 14)

Impairments/OTTI

When the fair value of an AFS security is less than its amortized cost at the balance sheet date, the security is considered impaired. The Company assesses its impaired securities on at least a quarterly basis and designates such impairments as either "temporary" or "other-than-temporary." If the Company intends to sell an impaired security, or it is more likely than not that it will be required to sell the impaired security before its anticipated recovery, then the Company must recognize an OTTI through charges to earnings equal to the entire difference between the investment's amortized cost and its fair value at the balance sheet date. If the Company does not expect to sell an other-than-temporarily impaired security, only the portion of the OTTI related to credit losses is recognized through charges to earnings with the remainder recognized through AOCI on the consolidated balance sheets. Impairments recognized through other comprehensive income/(loss) ("OCI") do not impact earnings. Following the recognition of an OTTI through earnings, a new cost basis is established for the security and may not be adjusted for subsequent recoveries in fair value through earnings. However, OTTIs recognized through charges to earnings may be accreted back to the amortized cost basis of the security on a prospective basis through interest income. The determination as to whether an OTTI exists and, if so, the amount of credit impairment recognized in earnings is subjective, as such determinations are based on factual information available at the time of assessment as well as the Company's estimates of the future performance and cash flow projections. As a result, the timing and amount of OTTIs constitute material estimates that are susceptible to significant change. (See Note 3)

Non-Agency MBS that are assessed to be of less than high credit quality and on which impairments are recognized have experienced, or are expected to experience, credit-related adverse cash flow changes. The Company's estimate of cash flows for its Non-Agency MBS is based on its review of the underlying mortgage loans securing the MBS. The Company considers information available about the past and expected future performance of underlying mortgage loans, including timing of expected future cash flows, prepayment rates, default rates, loss severities, delinquency rates, percentage of non-performing loans, year of origination, loan-to-value ratios ("LTVs"), geographic concentrations and dialogue with market participants. As a result, significant judgment is used in the Company's analysis to determine the expected cash flows for its Non-Agency MBS. In determining the OTTI related to credit losses for securities that were purchased at significant discounts to par and/or are considered to be of less than high credit quality, the Company compares the present value of the remaining cash flows expected to be collected at the purchase date (or last date previously revised) against the present value of the cash flows expected to be collected at the current financial reporting date. The discount rate used to calculate the present value of expected future cash flows is the current yield used for income recognition purposes. Impairment assessment for Non-Agency MBS and CRT securities that were purchased at prices close to par and/or are otherwise considered to be of high credit quality involves comparing the present value of the remaining cash flows expected to be collected against the amortized cost of the security at the assessment date. The discount rate used to calculate the present value of the expected future cash flows is based on the instrument's IRR.

Balance Sheet Presentation

The Company's MBS and CRT Securities pledged as collateral against repurchase agreements and Swaps are included on the consolidated balance sheets with the fair value of the securities pledged disclosed parenthetically. Purchases and sales of securities are recorded on the trade date.

(c) MSR Related Assets

The Company has investments in financial instruments whose cash flows are considered to be largely dependent on underlying MSRs that either directly or indirectly act as collateral for the investment. These financial instruments, which are referred to as MSR related assets, are discussed in more detail below. The Company's MSR related assets pledged as collateral against repurchase agreements are included in the consolidated balance sheets with the amounts pledged disclosed parenthetically. Purchases and sales of MSR related assets are recorded on the trade date. (See Notes 3, 6, 7 and 14)

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MFA FINANCIAL, INC.
NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2018

Term Notes Backed by MSR Related Collateral

The Company has invested in term notes that are issued by special purpose vehicles ("SPV") that have acquired rights to receive cash flows representing the servicing fees and/or excess servicing spread associated with certain MSRs. The Company considers payment of principal and interest on these term notes to be largely dependent on the cash flows generated by the underlying MSRs as this impacts the cash flows available to the SPV that issued the term notes. Credit risk borne by the holders of the term notes is also mitigated by structural credit support in the form of over-collateralization. Credit support is also provided by a corporate guarantee from the ultimate parent or sponsor of the SPV that is intended to provide for payment of interest and principal to the holders of the term notes should cash flows generated by the underlying MSRs be insufficient.

The Company's term notes backed by MSR related collateral are reported at fair value on the Company's consolidated balance sheets with unrealized gains and losses excluded from earnings and reported in AOCI. Interest income is recognized on an accrual basis on the Company's consolidated statements of operations. The Company's valuation process for such notes considers a number of factors, including a comparable bond analysis performed by a third-party pricing service which involves determining a pricing spread at issuance of the term note. The pricing spread is used at each subsequent valuation date to determine an implied yield to maturity of the term note, which is then used to derive an indicative market value for the security. This indicative market value is further reviewed by the Company and may be adjusted to ensure it reflects a realistic exit price at the valuation date given the structural features of these securities. Other factors taken into consideration include indicative values provided by repurchase agreement counterparties, estimated changes in fair value of the related underlying MSR collateral and the financial performance of the ultimate parent or sponsoring entity of the issuer, which has provided a guarantee that is intended to provide for payment of interest and principal to the holders of the term notes should cash flows generated by the related underlying MSR collateral be insufficient.

Corporate Loan

In December 2016, the Company entered into a loan agreement with an entity that originates loans and owns the related MSRs. Under the terms of the loan agreement, the Company committed to lend $130.0 million of which approximately $124.2 million was drawn at March 31, 2018, and which was paid in full as of June 30, 2018. The loan was secured by certain U.S. Government, Agency and private-label MSRs, as well as other unencumbered assets owned by the borrower. The term loan was recorded on the Company's consolidated balance sheets at the drawn amount, on which interest income was recognized on an accrual basis on the Company's consolidated statements of operations. Commitment fees received on the undrawn amount were deferred and recognized as interest income over the remaining loan term at the time of draw. Upon repayment of the loan during the three months ended June 30, 2018, the remaining deferred commitment fees were recorded as Other Income on the Company's consolidated statements of operations.

(d) Residential Whole Loans (including Residential Whole Loans transferred to consolidated VIEs)

Residential whole loans included in the Company's consolidated balance sheets are primarily comprised of pools of fixed and adjustable rate residential mortgage loans acquired through consolidated trusts in secondary market transactions, with the majority at discounted purchase prices. The accounting model utilized by the Company is determined at the time each loan package is initially acquired and is generally based on the delinquency status of the majority of the underlying borrowers in the package at acquisition. The accounting model described below for purchased credit impaired loans that are held at carrying value is typically utilized by the Company for purchased credit impaired loans where the underlying borrower has a delinquency status of less than 60 days at the acquisition date. The Company may also purchase newly or recently originated loans that are performing as of the purchase date. Such loans are typically held at carrying value, but the accounting methods for income recognition and determination and measurement of any required loan loss reserves differ to those used for purchased credit impaired loans held at carrying value. The accounting model described below for residential whole loans held at fair value is typically utilized by the Company for loans where the underlying borrower has a delinquency status of 60 days or more at the acquisition date. The accounting model initially applied is not subsequently changed.

The Company's residential whole loans pledged as collateral against repurchase agreements are included in the consolidated balance sheets with amounts pledged disclosed parenthetically. Purchases and sales of residential whole loans are recorded on the trade date, with amounts recorded reflecting management's current estimate of assets that will be acquired or disposed at the closing of the transaction. This estimate is subject to revision at the closing of the transaction, pending the outcome of due diligence performed prior to closing. Recorded amounts of residential whole loans for which the closing of the purchase transaction is yet

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to occur are not eligible to be pledged as collateral against any repurchase agreement financing until the closing of the purchase transaction. (See Notes 4, 6, 7, 14 and 15)

Residential Whole Loans at Carrying Value

Purchased Credit Impaired Loans

The Company has elected to account for these loans as credit impaired as they were acquired at discounted prices that reflect, in part, the impaired credit history of the borrower. Substantially all of these loans have previously experienced payment delinquencies and the amount owed may exceed the value of the property pledged as collateral. Consequently, these loans generally have a higher likelihood of default than newly originated mortgage loans with LTVs of 80% or less to creditworthy borrowers. The Company believes that amounts paid to acquire these loans represent fair market value at the date of acquisition. Loans considered credit impaired are initially recorded at the purchase price with no allowance for loan losses. Subsequent to acquisition, the recorded amount for these loans reflects the original investment amount, plus accretion of interest income, less principal and interest cash flows received. These loans are presented on the Company’s consolidated balance sheets at carrying value, which reflects the recorded amount reduced by any allowance for loan losses established subsequent to acquisition.

Under the application of the accounting model for purchased credit impaired loans, the Company may aggregate into pools loans acquired in the same fiscal quarter that are assessed as having similar risk characteristics. For each pool established, or on an individual loans basis for loans not aggregated into pools, the Company estimates at acquisition, and periodically on at least a quarterly basis, the principal and interest cash flows expected to be collected. The difference between the cash flows expected to be collected and the carrying amount of the loans is referred to as the “accretable yield.” This amount is accreted as interest income over the life of the loans using an effective interest rate (level yield) methodology. Interest income recorded each period reflects the amount of accretable yield recognized and not the coupon interest payments received on the underlying loans. The difference between contractually required principal and interest payments and the cash flows expected to be collected is referred to as the “non-accretable difference,” and includes estimates of both the effect of prepayments and expected credit losses over the life of the underlying loans.

A decrease in expected cash flows in subsequent periods may indicate impairment at the pool and/or individual loan level, thus requiring the establishment of an allowance for loan losses by a charge to the provision for loan losses. The allowance for loan losses generally represents the present value of cash flows expected at acquisition, adjusted for any increases due to changes in estimated cash flows, that are subsequently no longer expected to be received at the relevant measurement date. Under the accounting model applied to credit impaired loans, a significant increase in expected cash flows in subsequent periods first reduces any previously recognized allowance for loan losses and then will result in a recalculation in the amount of accretable yield. The adjustment of accretable yield due to a significant increase in expected cash flows is accounted for prospectively as a change in estimate and results in reclassification from nonaccretable difference to accretable yield.

Other Loans at Carrying Value

The Company also has investments in loans that are not considered to be credit impaired at purchase. To date such loans have included newly or previously originated performing loans that are primarily comprised of: (i) loans to finance (or refinance) one-to-four family residential properties and are not considered to meet the definition of a “Qualified Mortgage” in accordance with guidelines adopted by the Consumer Financial Protection Bureau (“Non-QM loans”), (ii) short-term business purpose loans collateralized by residential properties made to non-occupant borrowers who intend to rehabilitate and sell the property for a profit (“Rehabilitation loans” or “Fix and Flip loans”), (iii) loans to finance (or refinance) non-owner occupied one-to-four family residential properties that are rented to one or more tenants (“Single-family rental loans”), and (iv) previously originated loans secured by residential real estate that is generally owner occupied (“Seasoned performing loans”), (collectively “Other Loans at Carrying Value”). The Company’s Other Loans at Carrying Value are initially recorded at their purchase price. Interest income on Other Loans at Carrying Value purchased at par is accrued based on each loan’s current interest bearing balance and current interest rate, net of related servicing costs. Interest income on such loans purchased at a premium/discount to par is recorded each period based on the contractual coupon net of any premium or discount and related servicing costs, and adjusted for actual prepayment activity.

An allowance for loan losses is recorded when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the existing contractual terms of the loan agreement. Any required loan loss allowance would typically be measured based on fair value of the collateral securing the loan and would reduce the carrying value

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of the loan with a corresponding charge to earnings. Significant judgments are required in determining any allowance for loan loss, including assumptions regarding the loan cash flows expected to be collected, the value of the underlying collateral and the ability of the Company to collect on any other forms of security, such as a personal guaranty provided either by the borrower or an affiliate of the borrower. Income recognition is suspended for loans at the earlier of the date at which payments become 90 days past due or when, in the opinion of management, a full recovery of income and principal becomes doubtful. When the ultimate collectability of the principal of an impaired loan is in doubt, all payments are applied to principal under the cost recovery method. When the ultimate collectability of the principal of an impaired loan is not in doubt, contractual interest is recorded as interest income when received, under the cash basis method until an accrual is resumed when the loan becomes contractually current and performance is demonstrated to be resumed. A loan is written off when it is no longer realizable and/or it is legally discharged.

Residential Whole Loans at Fair Value

Certain of the Company’s residential whole loans are presented at fair value on its consolidated balance sheets as a result of a fair value election made at time of acquisition. For the majority of these loans, there is significant uncertainty associated with estimating the timing of and amount of cash flows that will be collected. Further, the cash flows ultimately collected may be dependent on the value of the property securing the loan. Consequently, the Company considers that accounting for these loans at fair value should result in a better reflection over time of the economic returns for the majority of these loans. The Company determines the fair value of its residential whole loans held at fair value after considering portfolio valuations obtained from a third-party who specializes in providing valuations of residential mortgage loans and trading activity observed in the market place. Subsequent changes in fair value are reported in current period earnings and presented in Net gain on residential whole loans held at fair value on the Company’s consolidated statements of operations.

Cash received reflecting coupon payments on residential whole loans held at fair value is not included in Interest Income, but rather is presented in Net gain on residential whole loans held at fair value on the Company’s consolidated statements of operations. Cash outflows associated with loan-related advances made by the Company on behalf of the borrower are included in the basis of the loan and are reflected in Net gain on residential whole loans held at fair value.

(e) Cash and Cash Equivalents

Cash and cash equivalents include cash on deposit with financial institutions and investments in money market funds, all of which have original maturities of three months or less. Cash and cash equivalents may also include cash pledged as collateral to the Company by its repurchase agreement counterparties as a result of reverse margin calls (i.e., margin calls made by the Company). At June 30, 2018 and December 31, 2017, the Company had cash and cash equivalents of $54.9 million and $449.8 million, respectively. The Company’s investments in overnight money market funds, which are not bank deposits and are not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency, were $33.7 million and $354.0 million at June 30, 2018 and December 31, 2017, respectively. (See Notes 7 and 14)

(f) Restricted Cash

Restricted cash represents the Company’s cash held by its counterparties in connection with certain of the Company’s repurchase agreements that is not available to the Company for general corporate purposes. Restricted cash may be applied against amounts due to repurchase agreement counterparties, or may be returned to the Company when the related collateral requirements are exceeded or at the maturity of the repurchase agreement. The Company had aggregate restricted cash held as collateral or otherwise in connection with its repurchase agreements of $3.3 million and $13.3 million at June 30, 2018 and December 31, 2017, respectively. (See Notes 5(c), 6, 7 and 14)

(g) Goodwill

At June 30, 2018 and December 31, 2017, the Company had goodwill of $7.2 million, which represents the unamortized portion of the excess of the fair value of its common stock issued over the fair value of net assets acquired in connection with its formation in 1998. Goodwill is tested for impairment at least annually, or more frequently under certain circumstances, at the entity level. Through June 30, 2018, the Company had not recognized any impairment against its goodwill. Goodwill is included in Other assets on the Company's consolidated balance sheets.

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(h) Real Estate Owned ("REO")

REO represents real estate acquired by the Company, including through foreclosure, deed in lieu of foreclosure, or purchased in connection with the acquisition of residential whole loans. REO acquired through foreclosure or deed in lieu of foreclosure is initially recorded at fair value less estimated selling costs. REO acquired in connection with the acquisition of residential whole loans is initially recorded at its purchase price. Subsequent to acquisition, REO is reported, at each reporting date, at the lower of the current carrying amount or fair value less estimated selling costs and for presentation purposes is included in Other assets on the Company's consolidated balance sheets. Changes in fair value that result in an adjustment to the reported amount of an REO property that has a fair value at or below its carrying amount are reported in Other Income, net on the Company's consolidated statements of operations. (See Note 5(b))

(i) Depreciation

Leasehold Improvements and Other Depreciable Assets

Depreciation is computed on the straight-line method over the estimated useful life of the related assets or, in the case of leasehold improvements, over the shorter of the useful life or the lease term. Furniture, fixtures, computers and related hardware have estimated useful lives ranging from five to eight years at the time of purchase.

(j) Loan Securitization and Other Debt Issuance Costs

Loan securitization related costs are costs associated with the issuance of beneficial interests by consolidated VIEs and incurred by the Company in connection with various financing transactions completed by the Company. Other debt issuance and related costs include costs incurred by the Company in connection with issuing 8% Senior Notes due 2042 ("Senior Notes") and certain other repurchase agreement financings. These costs may include underwriting, rating agency, legal, accounting and other fees. Such costs, which reflect deferred charges, are included on the Company's consolidated balance sheets as a direct deduction from the corresponding debt liability. These deferred charges are amortized as an adjustment to interest expense using the effective interest method. For Senior Notes and other repurchase agreement financings, such costs are amortized over the shorter of the period to the expected or stated legal maturity of the debt instruments. The Company periodically reviews the recoverability of these deferred costs and in the event an impairment charge is required, such amount will be included in Operating and Other Expense on the Company's consolidated statements of operations.

(k) Repurchase Agreements

The Company finances the holdings of a significant portion of its residential mortgage assets with repurchase agreements. Under repurchase agreements, the Company sells securities to a lender and agrees to repurchase the same securities in the future for a price that is higher than the original sale price. The difference between the sale price that the Company receives and the repurchase price that the Company pays represents interest paid to the lender. Although legally structured as sale and repurchase transactions, the Company accounts for repurchase agreements as secured borrowings. Under its repurchase agreements, the Company pledges its securities as collateral to secure the borrowing, which is equal in value to a specified percentage of the fair value of the pledged collateral, while the Company retains beneficial ownership of the pledged collateral. At the maturity of a repurchase financing, unless the repurchase financing is renewed with the same counterparty, the Company is required to repay the loan including any accrued interest and concurrently receives back its pledged collateral from the lender. With the consent of the lender, the Company may renew a repurchase financing at the then prevailing financing terms. Margin calls, whereby a lender requires that the Company pledge additional securities or cash as collateral to secure borrowings under its repurchase financing with such lender, are routinely experienced by the Company when the value of the MBS pledged as collateral declines as a result of principal amortization and prepayments or due to changes in market interest rates, spreads or other market conditions. The Company also may make margin calls on counterparties when collateral values increase.

The Company’s repurchase financings typically have terms ranging from one month to six months at inception, but may also have longer or shorter terms. Should a counterparty decide not to renew a repurchase financing at maturity, the Company must either refinance elsewhere or be in a position to satisfy the obligation. If, during the term of a repurchase financing, a lender should default on its obligation, the Company might experience difficulty recovering its pledged assets which could result in an unsecured claim against the lender for the difference between the amount loaned to the Company plus interest due to the counterparty and the fair value of the collateral pledged by the Company to such lender, including accrued interest receivable or such collateral. (See Notes 6, 7 and 14)

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In addition to the repurchase agreement financing arrangements discussed above, as part of its financing strategy for Non-Agency MBS, the Company has entered into contemporaneous repurchase and reverse repurchase agreements with a single counterparty. Under a typical reverse repurchase agreement, the Company buys securities from a borrower for cash and agrees to sell the same securities in the future for a price that is higher than the original purchase price. The difference between the purchase price the Company originally paid and the sale price represents interest received from the borrower. In contrast, the contemporaneous repurchase and reverse repurchase transactions effectively resulted in the Company pledging Non-Agency MBS as collateral to the counterparty in connection with the repurchase agreement financing and obtaining U.S. Treasury securities as collateral from the same counterparty in connection with the reverse repurchase agreement. No net cash was exchanged between the Company and counterparty at the inception of the transactions. Securities obtained and pledged as collateral are recorded in Other assets on the Company's consolidated balance sheets. Interest income is recorded on the reverse repurchase agreement and interest expense is recorded on the repurchase agreement on an accrual basis. Both the Company and the counterparty have the right to make daily margin calls based on changes in the value of the collateral obtained and/or pledged. The Company's liability to the counterparty in connection with this financing arrangement is recorded in Other liabilities on the Company's consolidated balance sheets and disclosed as "Obligation to return securities obtained as collateral, at fair value." (See Note 5(a))

(l) Equity-Based Compensation

Compensation expense for equity-based awards that are subject to vesting conditions, is recognized ratably over the vesting period of such awards, based upon the fair value of such awards at the grant date. For certain awards granted prior to January 1, 2017, compensation expense recognized included the impact of estimated forfeitures, with any changes in estimated forfeiture rates accounted for as a change in estimate. Upon adoption of new accounting guidance that was effective for the Company on January 1, 2017, the Company made a policy election to account for forfeitures as they occur.

From 2011 through 2013, the Company granted certain restricted stock units ("RSUs") that vested annually over a one or three-year period, provided that certain criteria were met, which were based on a formula tied to the Company's achievement of average total stockholder return during that three-year period. Starting in 2014, the Company has made annual grants of RSUs certain of which cliff vest after a three-year period and others of which cliff vest after a three-year period, subject to the achievement of certain performance criteria based on a formula tied to the Company's achievement of average total stockholder return during that three-year period. The features in these awards related to the attainment of total stockholder return over a specified period constitute a "market condition" which impacts the amount of compensation expense recognized for these awards. Specifically, the uncertainty regarding the achievement of the market condition was reflected in the grant date fair valuation of the RSUs, which is recognized as compensation expense over the relevant vesting period. The amount of compensation expense recognized is not dependent on whether the market condition was or will be achieved.

The Company makes dividend equivalent payments in connection with certain of its equity-based awards. A dividend equivalent is a right to receive a distribution equal to the dividend distributions that would be paid on a share of the Company's common stock. Dividend equivalents may be granted as a separate instrument or may be a right associated with the grant of another award (e.g., an RSU) under the Company's Equity Compensation Plan (the "Equity Plan"), and they are paid in cash or other consideration at such times and in accordance with such rules, terms and conditions, as the Compensation Committee of the Company's Board of Directors (the "Compensation Committee") may determine in its discretion. Payments pursuant to dividend equivalents are generally charged to Stockholders' Equity to the extent that the attached equity awards are expected to vest. Compensation expense is recognized for payments made for dividend equivalents to the extent that the attached equity awards do not or are not expected to vest and grantees are not required to return payments of dividends or dividend equivalents to the Company. (See Notes 2(m) and 13)

(m) Earnings per Common Share ("EPS")

Basic EPS is computed using the two-class method, which includes the weighted-average number of shares of common stock outstanding during the period and an estimate of other securities that participate in dividends, such as the Company's unvested restricted stock and RSUs that have non-forfeitable rights to dividends and dividend equivalents attached to/associated with RSUs and vested stock options to arrive at total common equivalent shares. In applying the two-class method, earnings are allocated to both shares of common stock and estimated securities that participate in dividends based on their respective weighted-average shares outstanding for the period. For the diluted EPS calculation, common equivalent shares are further adjusted for the effect of dilutive unexercised stock options and RSUs outstanding that are unvested and have dividends that are subject to forfeiture using the treasury stock method. Under the treasury stock method, common equivalent shares are calculated assuming that all dilutive common stock equivalents are exercised and the proceeds, along with future compensation expenses associated with such instruments, are used to repurchase shares of the Company’s outstanding common stock at the average market price during the reported period. (See Note 12)

(n) Comprehensive Income/(Loss)

The Company’s comprehensive income/(loss) available to common stock and participating securities includes net income, the change in net unrealized gains/(losses) on its AFS securities and derivative hedging instruments, (to the extent that such changes are not recorded in earnings), adjusted by realized net gains/(losses) reclassified out of AOCI for sold AFS securities and is reduced by dividends declared on the Company’s preferred stock and issuance costs of redeemed preferred stock.

(o) U.S. Federal Income Taxes

The Company has elected to be taxed as a REIT under the provisions of the Internal Revenue Code of 1986, as amended, (the “Code”) and the corresponding provisions of state law. The Company expects to operate in a manner that will enable it to satisfy the various requirements to maintain its status as a REIT for federal income tax purposes. In order to maintain its status as a REIT, the Company must, among other things, distribute at least 90% of its REIT taxable income (excluding net long-term capital gains) to stockholders in the timeframe permitted by the Code. As long as the Company maintains its status as a REIT, the Company will not be subject to regular federal income tax to the extent that it distributes 100% of its REIT taxable income (including net long-term capital gains) to its stockholders within the permitted timeframe. Should this not occur, the Company would be subject to federal taxes at prevailing corporate tax rates on the difference between its REIT taxable income and the amounts deemed to be distributed for that tax year. As the Company’s objective is to distribute 100% of its REIT taxable income to its stockholders within the permitted timeframe, no provision for current or deferred income taxes has been made in the accompanying consolidated financial statements. Should the Company incur a liability for corporate income tax, such amounts would be recorded as REIT income tax expense on the Company’s consolidated statements of operations. Furthermore, if the Company fails to distribute during each calendar year, or by the end of January following the calendar year in the case of distributions with declaration and record dates falling in the last three months of the calendar year, at least the sum of (i) 85% its REIT ordinary income for such year, (ii) 95% of its REIT capital gain income for such year, and (iii) any undistributed taxable income from prior periods, the Company would be subject to a 4% nondeductible excise tax on the excess of the required distribution over the amounts actually distributed. To the extent that the Company incurs interest, penalties or related excise taxes in connection with its tax obligations, including as a result of its assessment of uncertain tax positions, such amounts will be included in Operating and Other Expense on the Company’s consolidated statements of operations.

In addition, the Company has elected to treat certain of its subsidiaries as a 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. Generally, a domestic TRS is subject to U.S. federal, state and local corporate income taxes. Since a portion of the Company’s business may be conducted through one or more TRS, its income earned by TRS may be subject to corporate income taxation. To maintain the Company’s REIT election, no more than 20% of the value of a REIT’s assets at the end of each calendar quarter may consist of stock or securities in TRS. For purposes of the determination of U.S. federal and state income taxes, the Company’s subsidiaries that elected to be treated as a TRS record current or deferred income taxes based on differences (both permanent and timing) between the determination of their taxable income and net income under GAAP. No deferred tax benefit was recorded by the Company for the six months ended June 30, 2018 and 2017, as a valuation allowance for the full amount of the associated deferred tax asset was recognized as its recovery is not considered more likely than not.

Based on its analysis of any potential uncertain tax positions, the Company concluded that it does not have any material uncertain tax positions that meet the relevant recognition or measurement criteria as of June 30, 2018, December 31, 2017, or June 30, 2017. The Company filed its 2016 tax return prior to October 16, 2017. The Company’s tax returns for tax years 2014 through 2016 are open to examination.

(p) Derivative Financial Instruments

The Company may use a variety of derivative instruments to economically hedge a portion of its exposure to market risks, including interest rate risk and prepayment risk. The objective of the Company’s risk management strategy is to reduce fluctuations in net book value over a range of interest rate scenarios. In particular, the Company attempts to mitigate the risk of the cost of its variable rate liabilities increasing during a period of rising interest rates. The Company’s derivative instruments are currently comprised of Swaps, which are designated as cash flow hedges against the interest rate risk associated with its borrowings.

Swaps

The Company documents its risk-management policies, including objectives and strategies, as they relate to its hedging activities and the relationship between the hedging instrument and the hedged liability for all Swaps designated as hedging transactions. The Company assesses, both at inception of a hedge and on a quarterly basis thereafter, whether or not the hedge is "highly effective."

Swaps are carried on the Company's consolidated balance sheets at fair value, in Other assets, if their fair value is positive, or in Other liabilities, if their fair value is negative. Beginning in January 2017, variation margin payments on the Company's Swaps that have been novated to a clearing house are treated as a legal settlement of the exposure under the Swap contract. Previously such payments were treated as collateral pledged against the exposure under the Swap contract. The effect of this change is to reduce what would have otherwise been reported as fair value of the Swap. All of the Company's Swaps have been novated to a central clearing house. Changes in the fair value of the Company's Swaps designated in hedging transactions are recorded in OCI provided that the hedge remains effective. Changes in fair value for any ineffective amount of a Swap are recognized in earnings. The Company has not recognized any change in the value of its existing Swaps designated as hedges through earnings as a result of hedge ineffectiveness.

The Company discontinues hedge accounting on a prospective basis and recognizes changes in fair value through earnings when: (i) it is determined that the derivative is no longer effective in offsetting cash flows of a hedged item (including forecasted transactions); (ii) it is no longer probable that the forecasted transaction will occur; or (iii) it is determined that designating the derivative as a hedge is no longer appropriate. (See Notes 5(c), 7 and 14)

Changes in the fair value of the Company's Swaps not designated in hedging transactions (if any) are recorded in Other income, net on the Company's consolidated statement of operations.

(q) Fair Value Measurements and the Fair Value Option for Financial Assets and Financial Liabilities

The Company's presentation of fair value for its financial assets and liabilities is determined within a framework that stipulates that the fair value of a financial asset or liability is an exchange price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability. The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. This definition of fair value focuses on exit price and prioritizes the use of market-based inputs over entity-specific inputs when determining fair value. In addition, the framework for measuring fair value establishes a three-level hierarchy for fair value measurements based upon the observability of inputs to the valuation of an asset or liability as of the measurement date.

In addition to the financial instruments that it is required to report at fair value, the Company has elected the fair value option for certain of its residential whole loans and CRT securities at time of acquisition. Subsequent changes in the fair value of these loans and CRT securities are reported in Net gain on residential whole loans held at fair value and Other income, net respectively on the Company's consolidated statements of operations. A decision to elect the fair value option for an eligible financial instrument, which may be made on an instrument by instrument basis, is irrevocable. (See Notes 2(d), 4 and 14)

(r) Variable Interest Entities

An entity is referred to as a VIE if it meets at least one of the following criteria: (i) the entity has equity that is insufficient to permit the entity to finance its activities without additional subordinated financial support of other parties; or (ii) as a group, the holders of the equity investment at risk lack (a) the power to direct the activities of an entity that most significantly impact the entity's economic performance; (b) the obligation to absorb the expected losses; or (c) the right to receive the expected residual returns; or (iii) have disproportional voting rights and the entity's activities are conducted on behalf of the investor that has disproportionately few voting rights.

The Company consolidates a VIE when it has both the power to direct the activities that most significantly impact the economic performance of the VIE and a right to receive benefits or absorb losses of the entity that could be potentially significant to the VIE.

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The Company is required to reconsider its evaluation of whether to consolidate a VIE each reporting period, based upon changes in the facts and circumstances pertaining to the VIE.

The Company has entered into several financing transactions which resulted in the Company consolidating the VIEs that were created to facilitate these transactions. In determining the accounting treatment to be applied to these transactions, the Company concluded that the entities used to facilitate these transactions were VIEs and that they should be consolidated. If the Company had determined that consolidation was not required, it would have then assessed whether the transfers of the underlying assets would qualify as sale or should be accounted for as secured financings under GAAP. (See Note 15)

The Company also includes on its consolidated balance sheets certain financial assets and liabilities that are acquired/issued by trusts and/or other special purpose entities that have been evaluated as being required to be consolidated by the Company under the applicable accounting guidance.

(s) Offering Costs Related to Issuance and Redemption of Preferred Stock

Offering costs related to issuance of preferred stock are recorded as a reduction in Additional paid-in capital, a component of Stockholders' Equity, at the time such preferred stock is issued. On redemption of preferred stock, any excess of the fair value of the consideration transferred to the holders of the preferred stock over the carrying amount of the preferred stock in the Company's consolidated balance sheets is included in the determination of Net Income Available to Common Stock and Participating Securities in the calculation of EPS.

(t) New Accounting Standards and Interpretations

Accounting Standards Adopted in 2018

Compensation - Stock Compensation - Scope of Modification Accounting

In May 2017, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2017-09, Scope of Modification Accounting ("ASU 2017-09"). The amendments in ASU 2017-09 provide guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting. Pursuant to this ASU, an entity should account for the effects of a modification unless all of the following are met: (1) the fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) of the modified award is the same as the fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) of the original award immediately before the original award is modified; (2) the vesting conditions of the modified award are the same as the vesting conditions of the original award immediately before the original award is modified; and (3) the classification of the modified award as an equity instrument or a liability instrument is the same as the classification of the original award immediately before the original award date is modified. The Company adopted ASU 2017-09 on January 1, 2018 and its adoption did not have an impact on its financial position or financial statement disclosures.

Statement of Cash Flows - Restricted Cash

In November 2016, the FASB issued ASU 2016-18, Restricted Cash ("ASU 2016-18"). ASU 2016-18 clarifies how entities should present restricted cash and restricted cash equivalents in the statement of cash flows with the objective of reducing the existing diversity in practice. The amendments in ASU 2016-18 require restricted cash and restricted cash equivalents to be included with cash and cash equivalents when reconciling the beginning-of-period and end-of period total amounts shown on the statement of cash flows. The Company adopted ASU 2016-18 on January 1, 2018 and its adoption did not have a significant impact on its financial position or financial statement disclosures.

Statement of Cash Flows - Classification of Certain Cash Receipts and Cash Payments

In August 2016, the FASB issued ASU 2016-15, Classification of Certain Cash Receipts and Cash Payments (“ASU 2016-15”). The amendments in ASU 2016-15 provide guidance for eight specific cash flow classification issues, certain cash receipts and cash payments on the statement of cash flows with the objective of reducing the existing diversity in practice. The Company adopted ASU 2016-15 on January 1, 2018 and its adoption did not have a significant impact on its financial position or financial statement disclosures.

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Financial Instruments - Overall - Recognition and Measurement of Financial Assets and Financial Liabilities

In January 2016, the FASB issued ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities (“ASU 2016-01”). The amendments in this ASU affect all entities that hold financial assets or owe financial liabilities, and address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. The classification and measurement guidance of investments in debt securities and loans are not affected by the amendments in this ASU. ASU 2016-01 was effective for the Company for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. The Company’s adoption of this ASU on January 1, 2018 did not have a significant impact on the Company’s financial position or financial statement disclosures as the classification and measurement of its investments in debt securities and loans were not affected by the amendments in this ASU.

Revenue from Contracts with Customers

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (“ASU 2014-09”). The ASU requires an entity to recognize revenue in an amount that reflects the consideration to which it expects to be entitled for the transfer of promised goods or services to customers. ASU 2014-09 replaced most existing revenue recognition guidance in GAAP when it became effective. The Company adopted this ASU on January 1, 2018 and its adoption did not have a material impact on the Company’s financial position or financial statement disclosures as the majority of the Company’s revenues are generated by financial instruments that are explicitly scoped out of this ASU. On adoption of the new standard on January 1, 2018, the Company recorded a transition adjustment, under the modified retrospective approach, of approximately $295,000 to the opening balance of retained earnings in order to reflect the recognition of a gain on sale of REO that was previously deferred under the prior accounting guidance.

3. MBS, CRT Securities and MSR Related Assets

Agency and Non-Agency MBS

The Company's MBS are comprised of Agency MBS and Non-Agency MBS which include MBS issued prior to 2008 ("Legacy Non-Agency MBS"). These MBS are secured by: (i) hybrid mortgages ("Hybrids"), which have interest rates that are fixed for a specified period of time and, thereafter, generally adjust annually to an increment over a specified interest rate index; (ii) adjustable-rate mortgages ("ARMs"), which have interest rates that reset annually or more frequently (collectively, "ARM-MBS"); and (iii) 15 and 30 year fixed-rate mortgages for Agency MBS and, for Non-Agency MBS, 30-year and longer-term fixed rate mortgages. In addition, the Company's MBS are also comprised of MBS backed by securitized re-performing/non-performing loans ("RPL/NPL MBS"), where the cash flows of the bond may not reflect the contractual cash flows of the underlying collateral. The Company's RPL/NPL MBS are generally structured with a contractual coupon step-up feature where the coupon increases up to 300 basis points at 36 months from issuance or sooner. The Company pledges a significant portion of its MBS as collateral against its borrowings under repurchase agreements and Swaps. (See Note 7)

Agency MBS: Agency MBS are guaranteed as to principal and/or interest by a federally chartered corporation, such as Fannie Mae or Freddie Mac, or an agency of the U.S. Government, such as Ginnie Mae. The payment of principal and/or interest on Ginnie Mae MBS is explicitly backed by the full faith and credit of the U.S. Government. Since the third quarter of 2008, Fannie Mae and Freddie Mac have been under the conservatorship of the Federal Housing Finance Agency, which significantly strengthened the backing for these government-sponsored entities.

Non-Agency MBS: The Company's Non-Agency MBS are primarily secured by pools of residential mortgages, which are not guaranteed by an agency of the U.S. Government or any federally chartered corporation. Credit risk associated with Non-Agency MBS is regularly assessed as new information regarding the underlying collateral becomes available and based on updated estimates of cash flows generated by the underlying collateral.

CRT Securities

CRT securities are debt obligations issued by Fannie Mae and Freddie Mac. The payments of principal and interest on the CRT securities are paid by Fannie Mae or Freddie Mac, as the case may be, on a monthly basis, and are dependent on the performance of loans in a reference pool of Agency MBS securitized by the issuing entity. As an investor in a CRT security, the Company may incur a loss if losses on the mortgage loans in the reference pool exceed the credit enhancement on the underlying CRT security owned by the Company. The Company assesses the credit risk associated with CRT securities by assessing the current and expected future performance of the associated reference pool. The Company pledges a portion of its CRT securities as collateral against its borrowings under repurchase agreements. (See Note 7)

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The following tables present certain information about the Company's MBS and CRT securities at June 30, 2018 and December 31, 2017:

June 30, 2018

(In Thousands)	Principal/ Current Face	Purchase Premiums	Accretable Purchase Discounts	Discount Designated as Credit Reserve and OTTI (1)	Amortized Cost (2)	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Net Unrealized Gain/(Loss)
Agency MBS:									
Fannie Mae	$1,874,754	$71,870	$(34)	$—	$1,946,590	$1,928,719	$17,695	$(35,566)	$(17,871)
Freddie Mac	428,102	17,080	—	—	446,360	428,465	1,100	(18,995)	(17,895)
Ginnie Mae	5,557	101	—	—	5,658	5,713	56	(1)	55
Total Agency MBS	2,308,413	89,051	(34)	—	2,398,608	2,362,897	18,851	(54,562)	(35,711)
Non-Agency MBS:									
Expected to Recover Par (3)(4)	1,122,973	43	(27,359)	—	1,095,657	1,123,299	28,736	(1,094)	27,642
Expected to Recover Less than Par (3)	2,298,626	—	(174,889)	(553,596)	1,570,141	2,119,668	549,719	(192)	549,527
Total Non-Agency MBS (5)	3,421,599	43	(202,248)	(553,596)	2,665,798	3,242,967	578,455	(1,286)	577,169
Total MBS	5,730,012	89,094	(202,282)	(553,596)	5,064,406	5,605,864	597,306	(55,848)	541,458
CRT securities (6)	520,688	9,825	(1,830)	—	528,683	571,955	43,365	(93)	43,272
Total MBS and CRT securities	$6,250,700	$98,919	$(204,112)	$(553,596)	$5,593,089	$6,177,819	$640,671	$(55,941)	$584,730

December 31, 2017

(In Thousands)	Principal/ Current Face	Purchase Premiums	Accretable Purchase Discounts	Discount Designated as Credit Reserve and OTTI (1)	Amortized Cost (2)	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Net Unrealized Gain/(Loss)
Agency MBS:									
Fannie Mae	$2,170,974	$82,271	$(40)	$—	$2,253,205	$2,246,600	$21,736	$(28,341)	$(6,605)
Freddie Mac	561,346	21,683	—	—	584,920	571,748	1,624	(14,796)	(13,172)
Ginnie Mae	6,142	112	—	—	6,254	6,333	79	—	79
Total Agency MBS	2,738,462	104,066	(40)	—	2,844,379	2,824,681	23,439	(43,137)	(19,698)

Non-Agency MBS:									
Expected to Recover Par (3)(4)	1,128,808	50	(22,737)	—	1,106,121	1,132,205	26,518	(434)	26,084
Expected to Recover Less than Par (3)	2,589,935	—	(192,588)	(593,227)	1,804,120	2,401,761	597,660	(19)	597,641
Total Non-Agency MBS (5)	3,718,743	50	(215,325)	(593,227)	2,910,241	3,533,966	624,178	(453)	623,725
Total MBS	6,457,205	104,116	(215,365)	(593,227)	5,754,620	6,358,647	647,617	(43,590)	604,027
CRT securities (6)	602,799	8,887	(3,550)	—	608,136	664,403	56,290	(23)	56,267
Total MBS and CRT securities	$7,060,004	$113,003	$(218,915)	$(593,227)	$6,362,756	$7,023,050	$703,907	$(43,613)	$660,294

(1) Discount designated as Credit Reserve and amounts related to OTTI are generally not expected to be accreted into interest income. Amounts disclosed at June 30, 2018 reflect Credit Reserve of $540.7 million and OTTI of $12.9 million. Amounts disclosed at December 31, 2017 reflect Credit Reserve of $579.0 million and OTTI of $14.2 million.

(2) Includes principal payments receivable of $1.2 million and $1.9 million at June 30, 2018 and December 31, 2017, respectively, which are not included in the Principal/Current Face.

(3) Based on management's current estimates of future principal cash flows expected to be received.

(4) Includes RPL/NPL MBS, which at June 30, 2018 had a $909.3 million Principal/Current face, $907.5 million amortized cost and $907.9 million fair value. At December 31, 2017, RPL/NPL MBS had a $922.0 million Principal/Current face, $920.1 million amortized cost and $923.1 million fair value.

(5) At both June 30, 2018 and December 31, 2017, the Company expected to recover approximately 84% of the then-current face amount of Non-Agency MBS, respectively.

(6) Amounts disclosed at June 30, 2018 includes CRT securities with a fair value of $522.1 million for which the fair value option has been elected. Such securities had gross unrealized gains of approximately $37.3 million and gross unrealized losses of approximately $92,500 at June 30, 2018. Amounts disclosed at December 31, 2017 includes CRT securities with a fair value of $528.9 million for which the fair value option has been elected. Such securities had gross unrealized gains of approximately $40.5 million and gross unrealized losses of approximately $23,000 at December 31, 2017.

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Sales of MBS and CRT Securities

During the three and six months ended June 30, 2018, the Company sold certain Agency MBS for $75.3 million realizing gross losses of $3.8 million. The Company also sold certain CRT securities during the three and six months ended June 30, 2018 for $104.0 million, realizing gross gains of $11.2 million. In addition, during the six months ended June 30, 2018, the Company sold certain Non-Agency MBS for $19.4 million, realizing gross gains of $8.8 million. During the three and six months ended June 30, 2017, the Company sold certain Non-Agency MBS for $16.9 million and $38.5 million, realizing gross gains of $5.9 million and $15.6 million, respectively. The Company has no continuing involvement with any of the sold MBS.

Unrealized Losses on MBS and CRT Securities

The following table presents information about the Company's MBS and CRT securities that were in an unrealized loss position at June 30, 2018:

Unrealized Loss Position For:								
	Less than 12 Months			12 Months or more			Total	
(Dollars in Thousands)	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses
Agency MBS:								
Fannie Mae	$304,882	$ 3,195	97	$888,232	$ 32,371	237	$1,193,114	$ 35,566
Freddie Mac	88,740	1,232	40	300,183	17,763	96	388,923	18,995
Ginnie Mae	672	1	3	—	—	—	672	1
Total Agency MBS	394,294	4,428	140	1,188,415	50,134	333	1,582,709	54,562
Non-Agency MBS:								
Expected to Recover Par (1)	278,307	971	14	8,174	123	8	286,481	1,094
Expected to Recover Less than Par (1)	15,728	192	4	—	—	—	15,728	192
Total Non-Agency MBS	294,035	1,163	18	8,174	123	8	302,209	1,286
Total MBS	688,329	5,591	158	1,196,589	50,257	341	1,884,918	55,848
CRT securities (2)	18,064	93	5	—	—	—	18,064	93
Total MBS and CRT securities	$706,393	$ 5,684	163	$1,196,589	$ 50,257	341	$1,902,982	$ 55,941

(1) Based on management's current estimates of future principal cash flows expected to be received.
(2) Amounts disclosed at June 30, 2018 represent CRT securities on which the fair value option has been elected.

At June 30, 2018, the Company did not intend to sell any of its investments that were in an unrealized loss position, and it is "more likely than not" that the Company will not be required to sell these securities before recovery of their amortized cost basis, which may be at their maturity.

Gross unrealized losses on the Company's Agency MBS were $54.6 million at June 30, 2018. Agency MBS are issued by Government Sponsored Entities ("GSEs") and enjoy either the implicit or explicit backing of the full faith and credit of the U.S. Government. While the Company's Agency MBS are not rated by any rating agency, they are currently perceived by market participants to be of high credit quality, with risk of default limited to the unlikely event that the U.S. Government would not continue to support the GSEs. Given the credit quality inherent in Agency MBS, the

Company does not consider any of the current impairments on its Agency MBS to be credit related. In assessing whether it is more likely than not that it will be required to sell any impaired security before its anticipated recovery, which may be at its maturity, the Company considers for each impaired security, the significance of each investment, the amount of impairment, the projected future performance of such impaired securities, as well as the Company’s current and anticipated leverage capacity and liquidity position. Based on these analyses, the Company determined that at June 30, 2018 any unrealized losses on its Agency MBS were temporary.

Gross unrealized losses on the Company’s Non-Agency MBS were $1.3 million at June 30, 2018. Based upon the most recent evaluation, the Company does not consider these unrealized losses to be indicative of OTTI and does not believe that these unrealized losses are credit related, but are rather a reflection of current market yields and/or marketplace bid-ask spreads. The Company has reviewed its Non-Agency MBS that are in an unrealized loss position to identify those securities with losses that

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are other-than-temporary based on an assessment of changes in expected cash flows for such securities, which considers recent bond performance and, where possible, expected future performance of the underlying collateral.

The Company did not recognize any credit-related OTTI losses through earnings related to its Non-Agency MBS during the three and six months ended June 30, 2018. The Company recognized credit-related OTTI losses through earnings related to its Non-Agency MBS of $618,000 and $1.0 million during the three and six months ended June 30, 2017.

Non-Agency MBS on which OTTI is recognized have experienced, or are expected to experience, credit-related adverse cash flow changes. The Company’s estimate of cash flows for these Non-Agency MBS is based on its review of the underlying mortgage loans securing these MBS. The Company considers information available about the structure of the securitization, including structural credit enhancement, if any, and the past and expected future performance of underlying mortgage loans, including timing of expected future cash flows, prepayment rates, default rates, loss severities, delinquency rates, percentage of non-performing loans, year of origination, LTVs, geographic concentrations, as well as Rating Agency reports, general market assessments, and dialogue with market participants. Changes in the Company’s evaluation of each of these factors impacts the cash flows expected to be collected at the OTTI assessment date. For Non-Agency MBS purchased at a discount to par that were assessed for and had no OTTI recorded this period, such cash flow estimates indicated that the amount of expected losses decreased compared to the previous OTTI assessment date. These positive cash flow changes are primarily driven by recent improvements in LTVs due to loan amortization and home price appreciation, which, in turn, positively impacts the Company’s estimates of default rates and loss severities for the underlying collateral. In addition, voluntary prepayments (i.e., loans that prepay in full with no loss) have generally trended higher relative to the Company’s assumptions for these MBS which also positively impacts the Company’s estimate of expected loss. Overall, the combination of higher voluntary prepayments and lower LTVs supports the Company’s assessment that such MBS are not other-than-temporarily impaired.

The following table presents the composition of OTTI charges recorded by the Company for the three and six months ended June 30, 2018 and 2017:

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2018	2017	2018	2017
Total OTTI losses	$—	$—	$—	$(63)
OTTI reclassified from OCI	—	(618)	—	(969)
OTTI recognized in earnings	$—	$(618)	$—	$(1,032)

The following table presents a roll-forward of the credit loss component of OTTI on the Company’s Non-Agency MBS for which a non-credit component of OTTI was previously recognized in OCI. Changes in the credit loss component of OTTI are presented based upon whether the current period is the first time OTTI was recorded on a security or a subsequent OTTI charge was recorded.

	Three Months Ended	Six Months Ended

(In Thousands)	June 30, 2018	June 30, 2018
Credit loss component of OTTI at beginning of period	$38,337	$38,337
Additions for credit related OTTI not previously recognized	—	—
Subsequent additional credit related OTTI recorded	—	—
Credit loss component of OTTI at end of period	$38,337	$38,337

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Purchase Discounts on Non-Agency MBS

The following tables present the changes in the components of the Company's purchase discount on its Non-Agency MBS between purchase discount designated as Credit Reserve and OTTI and accretable purchase discount for the three and six months ended June 30, 2018 and 2017:

(In Thousands)	Three Months Ended June 30, 2018 Discount Designated as Credit Reserve and OTTI	Three Months Ended June 30, 2018 Accretable Discount (1)	Three Months Ended June 30, 2017 Discount Designated as Credit Reserve and OTTI	Three Months Ended June 30, 2017 Accretable Discount (1)
Balance at beginning of period	$(572,580)	$(199,659)	$(653,337)	$(269,724)
Impact of RMBS Issuer Settlement (2)	—	(12,089)	—	—
Accretion of discount	—	17,530	—	20,223
Realized credit losses	10,954	—	13,139	—
Purchases	—	—	(484)	(1,520)
Sales	—	—	5,037	2,819
Net impairment losses recognized in earnings	—	—	(618)	—
Transfers/release of credit reserve	8,030	(8,030)	9,765	(9,765)
Balance at end of period	$(553,596)	$(202,248)	$(626,498)	$(257,967)

(In Thousands)	Six Months Ended June 30, 2018 Discount Designated as Credit Reserve and OTTI	Six Months Ended June 30, 2018 Accretable Discount (1)	Six Months Ended June 30, 2017 Discount Designated as Credit Reserve and OTTI	Six Months Ended June 30, 2017 Accretable Discount (1)
Balance at beginning of period	$(593,227)	$(215,325)	$(694,241)	$(278,191)
Impact of RMBS Issuer Settlement (2)	—	(12,089)	—	—
Accretion of discount	—	34,746	—	41,840
Realized credit losses	19,401	—	25,463	—
Purchases	(535)	488	(484)	(1,520)
Sales	5,592	5,105	24,778	(1,078)
Net impairment losses recognized in earnings	—	—	(1,032)	—
Transfers/release of credit reserve	15,173	(15,173)	19,018	(19,018)
Balance at end of period	$(553,596)	$(202,248)	$(626,498)	$(257,967)

(1) Together with coupon interest, accretable purchase discount is recognized as interest income over the life of the security.
(2) Includes the impact of approximately $12.1 million of cash proceeds (a one-time payment) received by the Company during the three months ended June 30, 2018 in connection with the settlement of litigation related to

certain residential mortgage backed securitization trusts that were sponsored by JP Morgan Chase & Co. and affiliated entities.

MSR Related Assets

(a) Term Notes Backed by MSR Related Collateral

At June 30, 2018 and December 31, 2017, the Company had $381.4 million and $381.8 million, respectively, of term notes issued by SPVs that have acquired rights to receive cash flows representing the servicing fees and/or excess servicing spread associated with certain MSRs. Payment of principal and interest on these term notes is considered to be largely dependent on cash flows generated by the underlying MSRs, as this impacts the cash flows available to the SPV that issued the term notes.

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At June 30, 2018, these term notes had an amortized cost of $380.4 million, gross unrealized gains of $1.0 million, a weighted average yield of 5.56% and a weighted average term to maturity of 4.1 years. At December 31, 2017, the term notes had an amortized cost of $381.0 million, gross unrealized gains of $804,000, a weighted average yield of 5.80% and a weighted average term to maturity of 3.4 years.

(b) Corporate Loan

In December 2016, the Company entered into a loan agreement with an entity that originates loans and owns the related MSRs. The loan was secured by certain U.S. Government, Agency and private-label MSRs, as well as other unencumbered assets owned by the borrower. Under the terms of the loan agreement, the Company committed to lend $130.0 million of which approximately $124.2 million was drawn at March 31, 2018, and which was paid in full as of June 30, 2018. For the three and six months ended June 30, 2018, the Company recognized interest income of $1.2 million and $3.7 million including discount accretion and commitment fee income of $1.1 million and $1.2 million, respectively. In addition, the Company recorded $136,000 of Other Income consisting of deferred commitment fees recognized upon repayment of the loan during the three months ended June 30, 2018. For the three and six months ended June 30, 2017, the Company recognized interest income of approximately $2.0 million and $3.7 million including discount accretion and commitment fee income of approximately $73,000 and $135,000, respectively.

Impact of AFS Securities on AOCI

The following table presents the impact of the Company's AFS securities on its AOCI for the three and six months ended June 30, 2018 and 2017:

(In Thousands)	Three Months Ended June 30, 2018	2017	Six Months Ended June 30, 2018	2017
AOCI from AFS securities:				
Unrealized gain on AFS securities at beginning of period	$574,485	$629,487	$620,648	$620,403
Unrealized loss on Agency MBS, net	(9,641)	(11,157)	(18,331)	(19,209)
Unrealized (loss)/gain on Non-Agency MBS, net	(11,115)	56,167	(38,308)	83,663
Reclassification adjustment for MBS sales included in net income	(5,178)	(5,656)	(15,458)	(15,602)
Reclassification adjustment for OTTI included in net income	—	(618)	—	(1,032)
Change in AOCI from AFS securities	(25,934)	38,736	(72,097)	47,820
Balance at end of period	$548,551	$668,223	$548,551	$668,223

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Interest Income on MBS, CRT Securities and MSR Related Assets

The following table presents the components of interest income on the Company's MBS, CRT securities and MSR related assets for the three and six months ended June 30, 2018 and 2017:

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2018	2017	2018	2017
Agency MBS				
Coupon interest	$20,040	$24,904	$40,997	$51,117
Effective yield adjustment (1)	(6,870)	(8,317)	(12,534)	(16,636)
Interest income	$13,170	$16,587	$28,463	$34,481
Legacy Non-Agency MBS				
Coupon interest	$27,931	$32,444	$56,765	$67,108
Effective yield adjustment (2)	17,462	19,586	34,664	41,028
Interest income	$45,393	$52,030	$91,429	$108,136
RPL/NPL MBS				
Coupon interest	$9,588	$17,601	$19,641	$40,529
Effective yield adjustment (1)	62	638	75	812
Interest income	$9,650	$18,239	$19,716	$41,341
CRT securities				
Coupon interest	$7,854	$6,586	$16,227	$11,843
Effective yield adjustment (2)	841	1,260	1,964	2,379
Interest income	$8,695	$7,846	$18,191	$14,222
MSR related assets				
Coupon interest	$5,081	$5,832	$12,598	$10,505
Effective yield adjustment (1)	1,138	73	1,244	134
Interest income	$6,219	$5,905	$13,842	$10,639

(1) Includes amortization of premium paid net of accretion of purchase discount. For Agency MBS, RPL/NPL MBS and the corporate loan secured by MSRs, interest income is recorded at an effective yield, which reflects net premium amortization/accretion based on actual prepayment activity.
(2) The effective yield adjustment is the difference between the net income calculated using the net yield, which is based on management's estimates of the amount and timing of future cash flows, less the current coupon yield.

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4. Residential Whole Loans

Included on the Company's consolidated balance sheets at June 30, 2018 and December 31, 2017 are approximately \$3.4 billion and \$2.2 billion, respectively, of residential whole loans arising from the Company's interests in certain trusts established to acquire the loans and certain entities established in connection with its loan securitization transactions. The Company has assessed that these entities are required to be consolidated for financial reporting purposes.

Residential Whole Loans, at Carrying Value

The following table presents the components of the Company's Residential whole loans, at carrying value at June 30, 2018 and December 31, 2017:

(Dollars In Thousands)	June 30, 2018	December 31, 2017
Purchased credit impaired loans	$804,848	$790,879
Other loans at carrying value:		
Non-QM loans	626,927	55,612
Rehabilitation loans	162,741	56,706
Single-family rental loans	55,571	5,319
Seasoned performing loans	256,155	—
Total other loans at carrying value	$1,101,394	$117,637
Total Residential whole loans, at carrying value	$1,906,242	$908,516
Number of loans	8,300	4,800

Purchased Credit Impaired Loans

As of June 30, 2018, the Company had established an allowance for loan losses of approximately \$297,000 on its purchased credit impaired loans held at carrying value. For the three and six months ended June 30, 2018, a net reversal of provision for loan losses of approximately \$83,000 and \$33,000 was recorded, respectively, which is included in Operating and Other expense on the Company's consolidated statements of operations. For the three and six months ended June 30, 2017, a net reversal of provision for loan losses of approximately \$394,000 and \$615,000 was recorded, respectively.

The following table presents the activity in the Company's allowance for loan losses on its purchased credit impaired loans held at carrying value for the three and six months ended June 30, 2018 and 2017:

(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Balance at the beginning of period	$380	$769	$330	$990
Reversal of provisions for loan losses	(83)	(394)	(33)	(615)
Balance at the end of period	$297	$375	$297	$375

Information regarding estimates of the contractually required payments, the cash flows expected to be collected, and the estimated fair value of the $57.6 million and $101.4 million of purchased credit impaired loans held at carrying value acquired by the Company during the three and six months ended June 30, 2018 and 2017 is not presented as the closing of the purchase transactions had not occurred as of June 30, 2018 and 2017, respectively.

The following table presents accretable yield activity for the Company's purchased credit impaired loans held at carrying value for the three and six months ended June 30, 2018 and 2017:

(In Thousands)	Three Months Ended June 30, (1)		Six Months Ended June 30, (1)	
	2018	2017	2018	2017
Balance at beginning of period	$413,404	$325,551	$421,872	$334,379
Accretion	(10,910)	(8,503)	(21,941)	(17,193)
Liquidations and other	(12,840)	—	(15,010)	—
Reclassifications (to)/from non-accretable difference, net	11,421	1,077	16,154	939
Balance at end of period	$401,075	$318,125	$401,075	$318,125

(1) Excluded from the table above are approximately $57.6 million and $101.4 million of purchased credit impaired loans held at carrying value for which the closing of the purchase transaction had not occurred as of June 30, 2018 and 2017, respectively.

Accretable yield for purchased credit impaired residential whole loans is the excess of loan cash flows expected to be collected over the purchase price. The cash flows expected to be collected represent the Company's estimate of the amount and timing of undiscounted principal and interest cash flows. Additions include accretable yield estimates for purchases made during the period and reclassification to accretable yield from non-accretable yield. Accretable yield is reduced by accretion during the period. The reclassifications between accretable and non-accretable yield and the accretion of interest income are based on changes in estimates regarding loan performance and the value of the underlying real estate securing the loans. In future periods, as the Company updates estimates of cash flows expected to be collected from the loans and the underlying collateral, the accretable yield may change. Therefore, the amount of accretable income recorded during the three and six months ended June 30, 2018 is not necessarily indicative of future results.

Other Loans at Carrying Value

As of June 30, 2018, there were six loans held at carrying value, that have been placed on non-accrual status as they are more than 90 days delinquent and had not yet become current with respect to the contractually required payments under the loan. Such loans have an unpaid balance of approximately $2.1 million. These non-performing loans represent approximately 0.2% of the total outstanding principal balance of all of the Company's Other Loans at Carrying Value. Management have assessed the recoverability of these loans and based on estimates of the value of the underlying collateral, no allowance for loan loss reserves has been recorded as of June 30, 2018.

In connection with purchased Rehabilitation loans, the Company has unfunded commitments of $29.7 million.

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Residential Whole Loans, at Fair Value

Certain of the Company’s residential whole loans are presented at fair value on its consolidated balance sheets as a result of a fair value election made at time of acquisition. Subsequent changes in fair value are reported in current period earnings and presented in Net gain on residential whole loans held at fair value on the Company’s consolidated statements of operations.

The following table presents information regarding the Company’s residential whole loans held at fair value at June 30, 2018 and December 31, 2017:

(Dollars in Thousands)	June 30, 2018 (1)	December 31, 2017
Less than 60 Days Past Due:		
Outstanding principal balance	$563,446	$488,600
Aggregate fair value	$522,687	$446,616
Number of loans	2,718	2,323
60 Days to 89 Days Past Due:		
Outstanding principal balance	$71,880	$45,955
Aggregate fair value	$61,112	$37,927
Number of loans	292	207
90 Days or More Past Due:		
Outstanding principal balance	$1,025,432	$1,027,818
Aggregate fair value	$884,741	$840,572
Number of loans	3,615	3,984
Total Residential whole loans, at fair value	$1,468,540	$1,325,115

(1) Excluded from the table above are approximately $34.4 million of residential whole loans held at fair value for which the closing of the purchase transaction had not occurred as of June 30, 2018.

The following table presents the components of Net gain on residential whole loans held at fair value for the three and six months ended June 30, 2018 and 2017:

(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Coupon payments and other income received	$19,002	$9,974	$34,400	$18,148
Net unrealized gains	4,599	4,262	18,346	7,209
Net gain on payoff/liquidation of loans	4,044	752	6,952	1,619
Net gain on transfers to REO	4,798	1,220	11,243	3,005
Total	$32,443	$16,208	$70,941	$29,981

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5. Other Assets

The following table presents the components of the Company’s Other assets at June 30, 2018 and December 31, 2017:

(In Thousands)	June 30, 2018	December 31, 2017
Securities obtained and pledged as collateral, at fair value	$253,721	$ 504,062
REO	192,162	152,356
Interest receivable	31,139	27,415
Swaps, at fair value	11,183	679
Goodwill	7,189	7,189
Prepaid and other assets	122,754	51,208
Total Other Assets	$618,148	$ 742,909

(a) Securities Obtained and Pledged as Collateral/Obligation to Return Securities Obtained as Collateral

The Company has obtained securities as collateral under collateralized financing arrangements in connection with its financing strategy for Non-Agency MBS. Securities obtained as collateral in connection with these transactions are recorded at fair value, with a liability, representing the obligation to return the collateral obtained, recorded in Other liabilities. While beneficial ownership of securities obtained remains with the counterparty, the Company has the right to transfer the collateral obtained or to pledge it as part of a subsequent collateralized financing transaction.

(b) Real Estate Owned

At June 30, 2018, the Company had 884 REO properties with an aggregate carrying value of $192.2 million. At December 31, 2017, the Company had 709 REO properties with an aggregate carrying value of $152.4 million.

During the three and six months ended June 30, 2018, the Company reclassified 251 and 555 mortgage loans to REO at an aggregate estimated fair value less estimated selling costs of $48.7 million and $103.5 million, respectively, at the time of transfer. During the three and six months ended June 30, 2017, the Company reclassified 168 and 347 mortgage loans to REO at an aggregate estimated fair value less estimated selling cost of $27.3 million and $58.4 million, respectively, at the time of transfer. Such transfers occur when the Company takes possession of the property by foreclosing on the borrower or completes a “deed-in-lieu of foreclosure” transaction. From time to time, the Company also acquires REO in connection with transactions to acquire residential whole loans.

At June 30, 2018, $183.8 million of residential real estate property was held by the Company that was acquired either through a completed foreclosure proceeding or from completion of a deed-in-lieu of foreclosure or similar legal agreement. In addition, formal foreclosure proceedings were in process with respect to $46.4 million of residential whole loans held at carrying value and $780.6 million of residential whole loans held at fair value at June 30, 2018.

During the three and six months ended June 30, 2018, the Company sold 212 and 380 REO properties for consideration of $40.6 million and $66.1 million, realizing net gains of approximately $2.7 million and $4.7 million, respectively. During the three and six months ended June 30, 2017, the Company sold 145 and 229 REO properties for consideration of $21.8 million and $34.5 million, realizing net gain of approximately $1.2 million and $2.0 million, respectively. These amounts are included in Other, net on the Company's consolidated statements of operations. In addition, following an updated assessment of liquidation amounts expected to be realized that was performed on all REO held at the end of the second quarters of 2018 and 2017, downward adjustments of approximately $4.1 million and $2.4 million were recorded to reflect certain REO properties at the lower of cost or estimated fair value as of June 30, 2018 and 2017, respectively.

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The following table presents the activity in the Company's REO for the three and six months ended June 30, 2018 and 2017:

(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Balance at beginning of period	$182,940	$98,708	$152,356	$80,503
Adjustments to record at lower of cost or fair value	(4,121)	(2,354)	(7,536)	(4,177)
Transfer from residential whole loans (1)	48,699	27,345	103,521	58,444
Purchases and capital improvements	2,604	1,109	5,282	1,882
Disposals	(37,960)	(20,365)	(61,461)	(32,209)
Balance at end of period	$192,162	$104,443	$192,162	$104,443

(1) Includes net gain recorded on transfer of approximately $5.3 million and $1.1 million, for the three months ended June 30, 2018 and 2017, respectively; and approximately $11.7 million and $2.5 million for the six months ended June 30, 2018 and 2017, respectively.

(c) Derivative Instruments

The Company's derivative instruments are currently comprised of Swaps, which are designated as cash flow hedges against the interest rate risk associated with its borrowings. The following table presents the fair value of the Company's derivative instruments and their balance sheet location at June 30, 2018 and December 31, 2017:

			June 30, 2018		December 31, 2017	
Derivative Instrument	Designation	Balance Sheet Location	Notional Amount	Fair Value	Notional Amount	Fair Value
(In Thousands)						
Cleared Swaps (1)	Hedging	Assets	$2,500,000	$11,183	$750,000	$ 679
Cleared Swaps (1)	Hedging	Liabilities	$100,000	$—	$1,800,000	$ —

(1) Cleared Swaps represent Swaps executed bilaterally with a counterparty in the over-the-counter market but then novated to a central clearing house, whereby the central clearing house becomes the counterparty to both of the original counterparties.

Swaps

The following table presents the assets pledged as collateral against the Company's Swap contracts at June 30, 2018 and December 31, 2017:

(In Thousands)	June 30, 2018	December 31, 2017
Agency MBS, at fair value	$3,097	$ 21,756
Restricted cash	—	6,405
Total assets pledged against Swaps	$3,097	$ 28,161

The Company's derivative hedging instruments, or a portion thereof, could become ineffective in the future if the associated repurchase agreements that such derivatives hedge fail to exist or fail to have terms that match those of the derivatives that hedge such borrowings. At June 30, 2018, all of the Company's derivatives were deemed effective for hedging purposes.

The Company's Swaps designated as hedging transactions have the effect of modifying the repricing characteristics of the Company's repurchase agreements and cash flows for such liabilities. To date, no cost has been incurred at the inception of a Swap (except for certain transaction fees related to entering into Swaps cleared though a central clearing house), pursuant to which the Company agrees to pay a fixed rate of interest and receive a variable interest rate, generally based on one-month or three-month London Interbank Offered Rate ("LIBOR"), on the notional amount of the Swap. The Company did not recognize any change in the value of its existing Swaps designated as hedges through earnings as a result of hedge ineffectiveness during the three and six months ended June 30, 2018 and 2017.

At June 30, 2018, the Company had Swaps (all of which were designated in hedging relationships) with an aggregate notional amount of $2.6 billion and extended 22 months on average with a maximum term of approximately 62 months.

The following table presents information about the Company's Swaps at June 30, 2018 and December 31, 2017:

	June 30, 2018			December 31, 2017		
Maturity (1)	Notional Amount	Weighted Average Fixed-Pay Interest Rate	Weighted Average Variable Interest Rate (2)	Notional Amount	Weighted Average Fixed-Pay Interest Rate	Weighted Average Variable Interest Rate (2)
(Dollars in Thousands)						
Within 30 days	$500,000	1.50 %	2.06 %	$—	— %	— %
Over 30 days to 3 months	—	—	—	—	—	—
Over 3 months to 6 months	—	—	—	50,000	1.45	1.56
Over 6 months to 12 months	200,000	1.71	2.09	500,000	1.50	1.46
Over 12 months to 24 months	200,000	2.05	2.10	200,000	1.71	1.54
Over 24 months to 36 months	1,600,000	2.25	2.09	1,500,000	2.22	1.51
Over 36 months to 48 months	—	—	—	200,000	2.20	1.53
Over 48 months to 60 months	—	—	—	—	—	—
Over 60 months to 72 months (3)	100,000	2.75	2.09	100,000	2.75	1.50
Total Swaps	$2,600,000	2.07 %	2.08 %	$2,550,000	2.04 %	1.50 %

(1) Each maturity category reflects contractual amortization and/or maturity of notional amounts.
(2) Reflects the benchmark variable rate due from the counterparty at the date presented, which rate adjusts monthly or quarterly based on one-month or three-month LIBOR, respectively.
(3) Reflects one Swap with a maturity date of July 2023.

The following table presents the net impact of the Company's derivative hedging instruments on its interest expense and the weighted average interest rate paid and received for such Swaps for the three and six months ended June 30, 2018 and 2017:

	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in Thousands)	2018	2017	2018	2017
Interest expense attributable to Swaps	$808	$6,488	$3,640	$14,297
Weighted average Swap rate paid	2.05 %	1.98 %	2.04 %	1.93 %
Weighted average Swap rate received	1.92 %	1.01 %	1.76 %	0.90 %

Impact of Derivative Hedging Instruments on AOCI

The following table presents the impact of the Company's derivative hedging instruments on its AOCI for the three and six months ended June 30, 2018 and 2017:

(In Thousands)	Three Months Ended June 30, 2018	Three Months Ended June 30, 2017	Six Months Ended June 30, 2018	Six Months Ended June 30, 2017
AOCI from derivative hedging instruments:				
Balance at beginning of period	$8,245	$(34,824)	$(11,424)	$(46,721)
Net gain/(loss) on Swaps	7,915	(1,017)	27,584	10,880
Balance at end of period	$16,160	$(35,841)	$16,160	$(35,841)

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6. Repurchase Agreements

The Company's repurchase agreements are accounted for as secured borrowings and bear interest that is generally LIBOR-based. (See Notes 2(k) and 7) At June 30, 2018, the Company's borrowings under repurchase agreements had a weighted average remaining term-to-interest rate reset of 14 days and an effective repricing period of 9 months, including the impact of related Swaps. At December 31, 2017, the Company's borrowings under repurchase agreements had a weighted average remaining term-to-interest rate reset of 16 days and an effective repricing period of 11 months, including the impact of related Swaps.

The following table presents information with respect to the Company's borrowings under repurchase agreements and associated assets pledged as collateral at June 30, 2018 and December 31, 2017:

(Dollars in Thousands)	June 30, 2018	December 31, 2017
Repurchase agreement borrowings secured by Agency MBS	$2,111,547	$2,501,340
Fair value of Agency MBS pledged as collateral under repurchase agreements	$2,283,312	$2,705,754
Weighted average haircut on Agency MBS (1)	4.52 %	4.65 %
Repurchase agreement borrowings secured by Legacy Non-Agency MBS	$1,364,458	$1,256,033
Fair value of Legacy Non-Agency MBS pledged as collateral under repurchase agreements	$1,813,359	$1,652,983
Weighted average haircut on Legacy Non-Agency MBS (1)	21.24 %	21.87 %
Repurchase agreement borrowings secured by RPL/NPL MBS	$499,294	$567,140
Fair value of RPL/NPL MBS pledged as collateral under repurchase agreements	$634,073	$726,540
Weighted average haircut on RPL/NPL MBS (1)	22.01 %	22.05 %
Repurchase agreements secured by U.S. Treasuries	$220,931	$470,334
Fair value of U.S. Treasuries pledged as collateral under repurchase agreements	$220,731	$472,095
Weighted average haircut on U.S. Treasuries (1)	1.00 %	1.47 %
Repurchase agreements secured by CRT securities	$410,157	$459,058
Fair value of CRT securities pledged as collateral under repurchase agreements	$516,486	$595,900
Weighted average haircut on CRT securities (1)	20.43 %	22.16 %
Repurchase agreements secured by MSR related assets	$297,063	$317,255
Fair value of MSR related assets pledged as collateral under repurchase agreements	$381,390	$482,158
Weighted average haircut on MSR related assets (1)	21.70 %	33.19 %
Repurchase agreements secured by residential whole loans (2)	$988,831	$1,043,747
Fair value of residential whole loans pledged as collateral under repurchase agreements	$1,382,068	$1,474,704
Weighted average haircut on residential whole loans (1)	25.55 %	26.10 %

(1) Haircut represents the percentage amount by which the collateral value is contractually required to exceed the loan amount.
(2) Excludes $53,000 and $206,000 of unamortized debt issuance costs at June 30, 2018 and December 31, 2017, respectively.

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The following table presents repricing information about the Company's borrowings under repurchase agreements, which does not reflect the impact of associated derivative hedging instruments, at June 30, 2018 and December 31, 2017:

Time Until Interest Rate Reset	June 30, 2018 Balance	Weighted Average Interest Rate		December 31, 2017 Balance	Weighted Average Interest Rate	
(Dollars in Thousands)						
Within 30 days	$5,682,864	2.92	%	$6,161,008	2.39	%
Over 30 days to 3 months	209,417	3.24		453,899	2.76	
Total repurchase agreements	5,892,281	2.93	%	6,614,907	2.42	%
Less debt issuance costs	53			206		
Total repurchase agreements less debt issuance costs	$5,892,228			$6,614,701		

The following table presents contractual maturity information about the Company's borrowings under repurchase agreements, all of which are accounted for as secured borrowings, at June 30, 2018, and does not reflect the impact of derivative contracts that hedge such repurchase agreements:

Contractual Maturity	June 30, 2018 Overnight	Within 30 Days	Over 30 Days to 3 Months	Over 3 Months to 12 Months	Over 12 months	Total
(Dollars in Thousands)						
Agency MBS	$—	$2,111,547	$—	$—	$ —	$2,111,547
Legacy Non-Agency MBS	—	1,268,585	95,873	—	—	1,364,458
RPL/NPL MBS	—	439,865	59,429	—	—	499,294
U.S. Treasuries	—	220,931	—	—	—	220,931
CRT securities	—	404,042	6,115	—	—	410,157
MSR related assets	—	249,063	48,000	—	—	297,063
Residential whole loans	—	—	234,665	754,166	—	988,831
Total (1)	$—	$4,694,033	$444,082	$754,166	$ —	$5,892,281
Weighted Average Interest Rate	—%	2.65 %	3.65 %	4.28 %	— %	2.93 %

Gross amount of recognized liabilities for repurchase agreements in Note 8	$5,892,281
Amounts related to repurchase agreements not included in offsetting disclosure in Note 8	$—

(1) Excludes $53,000 of unamortized debt issuance costs at June 30, 2018.

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The Company had repurchase agreement borrowings with 26 and 31 counterparties at June 30, 2018 and December 31, 2017. The following table presents information with respect to each counterparty under repurchase agreements for which the Company had greater than 5% of stockholders' equity at risk in the aggregate at June 30, 2018:

	June 30, 2018				
Counterparty	Counterparty Rating (1)	Amount at Risk (2)	Weighted Average Months to Maturity for Repurchase Agreements	Percent of Stockholders' Equity	
(Dollars in Thousands)					
Goldman Sachs (3)	BBB+/A3/A	$228,240	1	7.1	%
Wells Fargo (4)	A+/Aa2/AA-	215,022	5	6.7	

(1) As rated at June 30, 2018 by S&P, Moody's and Fitch, Inc., respectively. The counterparty rating presented is the lowest published for these entities.
(2) The amount at risk reflects the difference between (a) the amount loaned to the Company through repurchase agreements, including interest payable, and (b) the cash and the fair value of the securities pledged by the Company as collateral, including accrued interest receivable on such securities.
(3) Includes $110.1 million at risk with Goldman Sachs Lending Partners and $118.2 million at risk with Goldman Sachs Bank USA.
(4) Includes $207.8 million at risk with Wells Fargo Bank, NA and $7.2 million at risk with Wells Fargo Securities LLC.

7. Collateral Positions

The Company pledges securities or cash as collateral to its counterparties pursuant to its borrowings under repurchase agreements and for initial margin payments on centrally cleared Swaps. In addition, the Company receives securities or cash as collateral pursuant to financing provided under reverse repurchase agreements. The Company exchanges collateral with its counterparties based on changes in the fair value, notional amount and term of the associated repurchase agreements and Swap contracts, as applicable. In connection with these margining practices, either the Company or its counterparty may be required to pledge cash or securities as collateral. When the Company's pledged collateral exceeds the required margin, the Company may initiate a reverse margin call, at which time the counterparty may either return the excess collateral or provide collateral to the Company in the form of cash or equivalent securities.

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The following table summarizes the fair value of the Company's collateral positions, which includes collateral pledged and collateral held, with respect to its borrowings under repurchase agreements, reverse repurchase agreements and derivative hedging instruments at June 30, 2018 and December 31, 2017:

	June 30, 2018		December 31, 2017	
(In Thousands)	Assets Pledged	Collateral Held	Assets Pledged	Collateral Held
Derivative Hedging Instruments:				
Agency MBS	$3,097	$ —	$21,756	$ —
Cash (1)	—	—	6,405	—
	3,097	—	28,161	—
Repurchase Agreement Borrowings:				
Agency MBS	2,283,312	—	2,705,754	—
Legacy Non-Agency MBS (2)	1,813,359	—	1,652,983	—
RPL/NPL MBS	634,073	—	726,540	—
U.S. Treasury securities	220,731	—	472,095	—
CRT securities	516,486	—	595,900	—
MSR related assets	381,390	—	482,158	—
Residential whole loans	1,382,068	—	1,474,704	—
Cash (1)	3,298	—	6,902	—
	7,234,717	—	8,117,036	—
Reverse Repurchase Agreements:				
U.S. Treasury securities	—	253,721	—	504,062
	—	253,721	—	504,062
Total	$7,237,814	$ 253,721	$8,145,197	$ 504,062

(1) Cash pledged as collateral is reported as "Restricted cash" on the Company's consolidated balance sheets.
(2) In addition, at June 30, 2018 and December 31, 2017, $320.3 million and $688.1 million of Legacy Non-Agency MBS, respectively, are pledged as collateral in connection with contemporaneous repurchase and reverse repurchase agreements entered into with a single counterparty.

The following table presents detailed information about the Company's assets pledged as collateral pursuant to its borrowings under repurchase agreements and derivative hedging instruments at June 30, 2018:

	June 30, 2018						
	Assets Pledged Under Repurchase Agreements			Assets Pledged Against Derivative Hedging Instruments			Total Fair Value of Assets Pledged and Accrued Interest
(In Thousands)	Fair Value	Amortized Cost	Accrued Interest on Pledged Assets	Fair Value/ Carrying Value	Amortized Cost	Accrued Interest on Pledged Assets	
Agency MBS	$2,283,312	$2,318,975	$ 6,281	$ 3,097	$ 3,242	$ 8	$2,292,698
Legacy Non-Agency MBS (1)	1,813,359	1,377,319	7,119	—	—	—	1,820,478
RPL/NPL MBS	634,073	633,223	502	—	—	—	634,575
U.S. Treasuries	220,731	—	—	—	—	—	220,731
CRT securities	516,486	475,568	451	—	—	—	516,937

MSR related assets	381,390	380,350	428	—	—	—	381,818
Residential whole loans (2)	1,382,068	1,349,191	4,898	—	—	—	1,386,966
Cash (3)	3,298	3,298	—	—	—	—	3,298
Total	$7,234,717	$6,537,924	$ 19,679	$ 3,097	$ 3,242	$ 8	$7,257,501

(1) In addition, at June 30, 2018, $320.3 million of Legacy Non-Agency MBS are pledged as collateral in connection with contemporaneous repurchase and reverse repurchase agreements entered into with a single counterparty.

(2) Includes residential whole loans held at carrying value with an aggregate fair value of $429.7 million and aggregate amortized cost of $396.9 million and residential whole loans held at fair value with an aggregate fair value and amortized cost of $952.3 million.

(3) Cash pledged as collateral is reported as “Restricted cash” on the Company’s consolidated balance sheets.

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8. Offsetting Assets and Liabilities

The following tables present information about certain assets and liabilities that are subject to master netting arrangements (or similar agreements) and may potentially be offset on the Company's consolidated balance sheets at June 30, 2018 and December 31, 2017:

Offsetting of Financial Assets and Derivative Assets

(In Thousands)	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	Gross Amounts Not Offset in the Consolidated Balance Sheets: Cash Collateral Received	Net Amount
June 30, 2018						
Swaps, at fair value	$ 11,183	$ —	$ 11,183	$ (11,183)	$ —	$ —
Total	$ 11,183	$ —	$ 11,183	$ (11,183)	$ —	$ —
December 31, 2017						
Swaps, at fair value	$ 679	$ —	$ 679	$ (679)	$ —	$ —
Total	$ 679	$ —	$ 679	$ (679)	$ —	$ —

Offsetting of Financial Liabilities and Derivative Liabilities

(In Thousands)	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Consolidated Balance Sheets	Net Amounts of Liabilities Presented in the Consolidated Balance Sheets	Gross Amounts Not Offset in the Consolidated Balance Sheets: Financial Instruments (1)	Gross Amounts Not Offset in the Consolidated Balance Sheets: Cash Collateral Pledged (1)	Net Amount
June 30, 2018						
Swaps, at fair value (2)	$ —	$ —	$ —	$ —	$ —	$ —
Repurchase agreements (3)(4)	5,892,281	—	5,892,281	(5,888,983)	(3,298)	—
Total	$ 5,892,281	$ —	$ 5,892,281	$ (5,888,983)	$ (3,298)	$ —
December 31, 2017						
Swaps, at fair value (2)	$ —	$ —	$ —	$ —	$ —	$ —
Repurchase agreements (3)(4)	6,614,907	—	6,614,907	(6,608,005)	(6,902)	—
Total	$ 6,614,907	$ —	$ 6,614,907	$ (6,608,005)	$ (6,902)	$ —

(1) Amounts disclosed in the Financial Instruments column of the above table represent collateral pledged that is available to be offset against liability balances associated with repurchase agreements. Amounts disclosed in the Cash Collateral Pledged column of the above table represent amounts pledged as collateral against repurchase agreements.
(2) The fair value of securities pledged against the Company's Swaps was $3.1 million and $21.8 million at June 30, 2018 and December 31, 2017, respectively. Beginning in January 2017, variation margin payments on the Company's cleared Swaps are treated as a legal settlement of the exposure under the Swap contract. Previously such payments were treated as collateral pledged against the exposure under the Swap contract. The effect of this change is to reduce

what would have otherwise been reported as fair value of the Swap.
(3) The fair value of financial instruments pledged against the Company's repurchase agreements was $7.2 billion and $8.1 billion at June 30, 2018 and December 31, 2017, respectively.
(4) Excludes $53,000 and $206,000 of unamortized debt issuance costs at June 30, 2018 and December 31, 2017, respectively.

Nature of Setoff Rights

In the Company's consolidated balance sheets, all balances associated with repurchase agreements 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 agreements provide for an unconditional right of setoff.

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9. Other Liabilities

The following table presents the components of the Company's Other liabilities at June 30, 2018 and December 31, 2017:

(In Thousands)	June 30, 2018	December 31, 2017
Securitized debt (1)	$518,655	$ 363,944
Obligation to return securities held as collateral, at fair value	253,721	504,062
Senior Notes	96,794	96,773
Dividends and dividend equivalents payable	79,948	79,771
Accrued interest payable	11,018	12,263
Accrued expenses and other liabilities	17,871	21,584
Total Other Liabilities	$978,007	$ 1,078,397

(1) Securitized debt represents third-party liabilities of consolidated VIEs and excludes liabilities of the VIEs acquired by the Company that are eliminated in consolidation. The third-party beneficial interest holders in the VIEs have no recourse to the general credit of the Company. (See Notes 10 and 15 for further discussion.)

Senior Notes

On April 11, 2012, the Company issued $100.0 million in aggregate principal amount of its Senior Notes in an underwritten public offering. The total net proceeds to the Company from the offering of the Senior Notes were approximately $96.6 million, after deducting offering expenses and the underwriting discount. The Senior Notes bear interest at a fixed rate of 8.00% per year, paid quarterly in arrears on January 15, April 15, July 15 and October 15 of each year and will mature on April 15, 2042. The Senior Notes have an effective interest rate, including the impact of amortization to interest expense of debt issuance costs, of 8.31%. The Company may redeem the Senior Notes, in whole or in part, at any time on or after April 15, 2017, at a redemption price equal to 100% of the principal amount redeemed plus accrued and unpaid interest to, but not excluding, the redemption date.

The Senior Notes are the Company's senior unsecured obligations and are subordinate to all of the Company's secured indebtedness, which includes the Company's repurchase agreements, obligation to return securities obtained as collateral and other financing arrangements, to the extent of the value of the collateral securing such indebtedness.

10. Commitments and Contingencies

(a) Lease Commitments

The Company pays monthly rent pursuant to two operating leases. The lease term for the Company's headquarters in New York, New York extends through June 30, 2020. The lease provides for aggregate cash payments ranging over time of approximately $2.6 million per year, paid on a monthly basis, exclusive of escalation charges. In addition, as part of this lease agreement, the Company has provided the landlord a $785,000 irrevocable standby letter of credit fully collateralized by cash. The letter of credit may be drawn upon by the landlord in the event that the Company defaults under certain terms of the lease. In addition, the Company has a lease through December 31, 2021 for its off-site back-up facility located in Rockville Centre, New York, which provides for, among other things, lease payments totaling $32,000 annually.

(b) Representations and Warranties in Connection with Loan Securitization Transactions

In connection with the loan securitization transactions entered into by the Company, the Company has the obligation under certain circumstances to repurchase assets previously transferred to securitization vehicles upon breach of certain representations and warranties. As of June 30, 2018, the Company had no reserve established for repurchases of loans and was not aware of any material unsettled repurchase claims that would require the establishment of such a reserve. (See Note 15)

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(c) MBS Purchase Commitment

At June 30, 2018, the Company had a commitment to purchase Non-Agency MBS at an estimated price of $61.0 million. The expected settlement amount is included in the Non-Agency MBS balances presented at fair value on the Company’s consolidated balance sheets, with a corresponding liability in Payable for unsettled MBS and residential whole loan purchases.

(d) Residential Whole Loan Purchase Commitments

At June 30, 2018, the Company has agreed, subject to the completion of due diligence and customary closing conditions, to purchase residential whole loans at an aggregate estimated purchase price of $506.9 million, including $57.6 million of purchased credit impaired loans held at carrying value, $414.9 million of other loans held at carrying value and $34.4 million of residential whole loans held at fair value. The expected settlement amounts are included in the Company’s consolidated balance sheets in Residential whole loans, at carrying value and Residential whole loans, at fair value, respectively, with a corresponding liability included in Payable for unsettled MBS and residential whole loan purchases.

11. Stockholders’ Equity

(a) Preferred Stock

On April 15, 2013, the Company completed the issuance of 8.0 million shares of its 7.50% Series B Cumulative Redeemable Preferred Stock (“Series B Preferred Stock”) with a par value of $0.01 per share, and a liquidation preference of $25.00 per share plus accrued and unpaid dividends, in an underwritten public offering. The Company’s Series B Preferred Stock is entitled to receive a dividend at a rate of 7.50% per year on the $25.00 liquidation preference before the Company’s common stock is paid any dividends and is senior to the Company’s common stock with respect to distributions upon liquidation, dissolution or winding up. Dividends on the Series B Preferred Stock are payable quarterly in arrears on or about March 31, June 30, September 30 and December 31 of each year. The Series B Preferred Stock is redeemable at $25.00 per share plus accrued and unpaid dividends (whether or not authorized or declared) exclusively at the Company’s option commencing on April 15, 2018 (subject to the Company’s right, under limited circumstances, to redeem the Series B Preferred Stock prior to that date in order to preserve its qualification as a REIT) and upon certain specified change in control transactions in which the Company’s common stock and the acquiring or surviving entity common securities would not be listed on the New York Stock Exchange (the “NYSE”), the NYSE American or NASDAQ, or any successor exchange.
The Series B Preferred Stock generally does not have any voting rights, subject to an exception in the event the Company fails to pay dividends on such stock for six or more quarterly periods (whether or not consecutive). Under such circumstances, the Series B Preferred Stock will be entitled to vote to elect two additional directors to the Company’s Board of Directors (the “Board”), until all unpaid dividends have been paid or declared and set apart for payment. In addition, certain material and adverse changes to the terms of the Series B Preferred Stock cannot be made without the affirmative vote of holders of at least 66 2/3% of the outstanding shares of Series B Preferred Stock.

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The following table presents cash dividends declared by the Company on its Series B Preferred Stock from January 1, 2018 through June 30, 2018:

Declaration Date	Record Date	Payment Date	Dividend Per Share
May 17, 2018	June 4, 2018	June 29, 2018	$ 0.46875
February 20, 2018	March 2, 2018	March 30, 2018	0.46875

(b) Dividends on Common Stock

The following table presents cash dividends declared by the Company on its common stock from January 1, 2018 through June 30, 2018:

Declaration Date (1)	Record Date	Payment Date	Dividend Per Share	
June 7, 2018	June 29, 2018	July 31, 2018	$ 0.20	(1)
March 7, 2018	March 29, 2018	April 30, 2018	0.20	

(1) At June 30, 2018, the Company had accrued dividends and dividend equivalents payable of $79.9 million related to the common stock dividend declared on June 7, 2018.

(c) Public Offering of Common Stock

The Company did not issue any common stock through public offerings during the six months ended June 30, 2018. The table below presents information with respect to shares of the Company's common stock issued through public offerings during the year ended December 31, 2017.

Share Issue Date	Shares Issued	Gross Proceeds Per Share	Gross Proceeds
(In Thousands, Except Per Share Amounts)			
May 10, 2017	23,000	$ 7.85	$ 180,550 (1)

(1) The Company incurred approximately $415,000 of underwriting discounts and related expenses in connection with this equity offering.

(d) Discount Waiver, Direct Stock Purchase and Dividend Reinvestment Plan ("DRSPP")

On September 16, 2016, the Company filed a shelf registration statement on Form S-3 with the SEC under the Securities Act of 1933, as amended (the "1933 Act"), for the purpose of registering additional common stock for sale through its DRSPP. Pursuant to Rule 462(e) of the 1933 Act, this shelf registration statement became effective automatically upon filing with the SEC and, when combined with the unused portion of the Company's previous DRSPP shelf registration statements, registered an aggregate of 15 million shares of common stock. The Company's DRSPP is designed to provide existing stockholders and new investors with a convenient and economical way to purchase shares of common stock through the automatic reinvestment of dividends and/or optional cash investments. At June 30, 2018, 12.0 million shares of common stock remained available for issuance pursuant to the DRSPP shelf registration statement.

During the three and six months ended June 30, 2018, the Company issued 63,555 and 237,533 shares of common stock through the DRSPP, raising net proceeds of approximately $480,000 and $1.7 million, respectively. From the inception of the DRSPP in September 2003 through June 30, 2018, the Company issued 33,913,510 shares pursuant to the DRSPP, raising net proceeds of $283.1 million.

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(e) Stock Repurchase Program

As previously disclosed, in August 2005, the Company's Board authorized a stock repurchase program (the "Repurchase Program") to repurchase up to 4.0 million shares of its outstanding common stock. The Board reaffirmed such authorization in May 2010. In December 2013, the Board increased the number of shares authorized under the Repurchase Program to an aggregate of 10.0 million. Such authorization does not have an expiration date and, at present, there is no intention to modify or otherwise rescind such authorization. Subject to applicable securities laws, repurchases of common stock under the Repurchase Program are made at times and in amounts as the Company deems appropriate, (including, in our discretion, through the use of one or more plans adopted under Rule 10b5-1 promulgated under the Securities Exchange Act of 1934, as amended (the "1934 Act")) using available cash resources. Shares of common stock repurchased by the Company under the Repurchase Program are cancelled and, until reissued by the Company, are deemed to be authorized but unissued shares of the Company's common stock. The Repurchase Program may be suspended or discontinued by the Company at any time and without prior notice. The Company did not repurchase any shares of its common stock during the six months ended June 30, 2018. At June 30, 2018, 6,616,355 shares remained authorized for repurchase under the Repurchase Program.

(f) Accumulated Other Comprehensive Income/(Loss)

The following table presents changes in the balances of each component of the Company's AOCI for the three and six months ended June 30, 2018:

(In Thousands)	Three Months Ended June 30, 2018 Net Unrealized Gain/(Loss) on AFS Securities	Net (Loss)/Gain on Swaps	Total AOCI	Six Months Ended June 30, 2018 Net Unrealized Gain/(Loss) on AFS Securities	Net (Loss)/Gain on Swaps	Total AOCI
Balance at beginning of period	$574,485	$ 8,245	$582,730	$620,648	$(11,424)	$609,224
OCI before reclassifications	(20,756)	7,915	(12,841)	(56,639)	27,584	(29,055)
Amounts reclassified from AOCI (1)	(5,178)	—	(5,178)	(15,458)	—	(15,458)
Net OCI during the period (2)	(25,934)	7,915	(18,019)	(72,097)	27,584	(44,513)
Balance at end of period	$548,551	$ 16,160	$564,711	$548,551	$ 16,160	$564,711

(1) See separate table below for details about these reclassifications.
(2) For further information regarding changes in OCI, see the Company's consolidated statements of comprehensive income/(loss).

The following table presents changes in the balances of each component of the Company's AOCI for the three and six months ended June 30, 2017:

(In Thousands)	Three Months Ended June 30, 2017 Net Unrealized Gain/(Loss) on	Net (Loss)/Gain on Swaps	Total AOCI	Six Months Ended June 30, 2017 Net Unrealized Gain/(Loss) on	Net (Loss)/Gain on Swaps	Total AOCI

	AFS Securities			AFS Securities		
Balance at beginning of period	$629,487	$(34,824)	$594,663	$620,403	$(46,721)	$573,682
OCI before reclassifications	45,010	(1,017)	43,993	64,454	10,880	75,334
Amounts reclassified from AOCI (1)	(6,274)	—	(6,274)	(16,634)	—	(16,634)
Net OCI during the period (2)	38,736	(1,017)	37,719	47,820	10,880	58,700
Balance at end of period	$668,223	$(35,841)	$632,382	$668,223	$(35,841)	$632,382

(1) See separate table below for details about these reclassifications.
(2) For further information regarding changes in OCI, see the Company's consolidated statements of comprehensive income/(loss).

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The following table presents information about the significant amounts reclassified out of the Company's AOCI for the three and six months ended June 30, 2018:

Details about AOCI Components	Three Months Ended June 30, 2018	Six Months Ended June 30, 2018	Affected Line Item in the Statement Where Net Income is Presented
	Amounts Reclassified from AOCI		
(In Thousands)			
AFS Securities:			
Realized gain on sale of securities	$(5,178)	$(15,458)	Net gain on sales of investment securities
Total AFS Securities	$(5,178)	$(15,458)	
Total reclassifications for period	$(5,178)	$(15,458)	

The following table presents information about the significant amounts reclassified out of the Company's AOCI for the three and six months ended June 30, 2017:

Details about AOCI Components	Three Months Ended June 30, 2017	Six Months Ended June 30, 2017	Affected Line Item in the Statement Where Net Income is Presented
	Amounts Reclassified from AOCI		
(In Thousands)			
AFS Securities:			
Realized gain on sale of securities	$(5,656)	$(15,602)	Net gain on sales of investment securities
OTTI recognized in earnings	(618)	(1,032)	Net impairment losses recognized in earnings
Total AFS Securities	$(6,274)	$(16,634)	
Total reclassifications for period	$(6,274)	$(16,634)	

On securities for which OTTI had been recognized in prior periods, the Company did not have any unrealized losses recorded in AOCI at June 30, 2018 and December 31, 2017.

12. EPS Calculation

The following table presents a reconciliation of the earnings and shares used in calculating basic and diluted EPS for the three and six months ended June 30, 2018 and 2017:

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands, Except Per Share Amounts)	2018	2017	2018	2017
Numerator:				
Net income	$70,395	$79,935	$153,790	$157,995
Dividends declared on preferred stock	(3,750)	(3,750)	(7,500)	(7,500)
Dividends, dividend equivalents and undistributed earnings allocated to participating securities	(472)	(459)	(921)	(890)
Net income to common stockholders - basic and diluted	$66,173	$75,726	$145,369	$149,605
Denominator:				
Weighted average common shares for basic and diluted earnings per share (1)	398,478	386,303	398,398	379,479
Basic and diluted earnings per share	$0.17	$0.20	$0.36	$0.39

(1) At June 30, 2018, the Company had approximately 2.3 million equity instruments outstanding that were not included in the calculation of diluted EPS for the three and six months ended June 30, 2018, as their inclusion would have been anti-dilutive. These equity instruments reflect RSUs (based on current estimate of expected share settlement amount) with a weighted average grant date fair value of $6.74. These equity instruments may have a dilutive impact on future EPS.

13. Equity Compensation, Employment Agreements and Other Benefit Plans

(a) Equity Compensation Plan

In accordance with the terms of the Company's Equity Plan, which was adopted by the Company's stockholders on May 21, 2015 (and which amended and restated the Company's 2010 Equity Compensation Plan), directors, officers and employees of the Company and any of its subsidiaries and other persons expected to provide significant services for the Company and any of its subsidiaries are eligible to receive grants of stock options ("Options"), restricted stock, RSUs, dividend equivalent rights and other stock-based awards under the Equity Plan.

Subject to certain exceptions, stock-based awards relating to a maximum of 12.0 million shares of common stock may be granted under the Equity Plan; forfeitures and/or awards that expire unexercised do not count towards this limit. At June 30, 2018, approximately 5.7 million shares of common stock remained available for grant in connection with stock-based awards under the Equity Plan. A participant may generally not receive stock-based awards in excess of 1.5 million shares of common stock in any one year and no award may be granted to any person who, assuming exercise of all Options and payment of all awards held by such person, would own or be deemed to own more than 9.8% of the outstanding shares of the Company's common stock. Unless previously terminated by the Board, awards may be granted under the Equity Plan until May 20, 2025.

Restricted Stock Units

Under the terms of the Equity Plan, RSUs are instruments that provide the holder with the right to receive, subject to the satisfaction of conditions set by the Compensation Committee at the time of grant, a payment of a specified value, which may be a share of the Company’s common stock, the fair market value of a share of the Company’s common stock, or such fair market value to the extent in excess of an established base value, on the applicable settlement date. Although the Equity Plan permits the Company to issue RSUs that can settle in cash, all of the Company’s outstanding RSUs as of June 30, 2018 are designated to be settled in shares of the Company’s common stock. The Company granted 151,302 and 843,802 and RSUs during the three and six months ended June 30, 2018, respectively, and granted 140,195 and 898,945 RSUs during the three and six months ended June 30, 2017, respectively. There were 20,000 RSUs forfeited during the six months ended June 30, 2018. There were no RSUs forfeited during the six months ended June 30, 2017. All RSUs outstanding at June 30, 2018 may be entitled to receive dividend

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equivalent payments depending on the terms and conditions of the award either in cash at the time dividends are paid by the Company, or for certain performance-based RSU awards, as a grant of stock at the time such awards are settled. At June 30, 2018 and December 31, 2017, the Company had unrecognized compensation expense of $7.3 million and $4.1 million, respectively, related to RSUs. The unrecognized compensation expense at June 30, 2018 is expected to be recognized over a weighted average period of 2.0 years.

Restricted Stock

The Company did not award any shares of restricted common stock during the six months ended June 30, 2018 and 2017. At June 30, 2018, the Company did not have any unvested shares of restricted common stock outstanding.

Dividend Equivalents

A dividend equivalent is a right to receive a distribution equal to the dividend distributions that would be paid on a share of the Company's common stock. Dividend equivalents may be granted as a separate instrument or may be a right associated with the grant of another award (e.g., an RSU) under the Equity Plan, and they are paid in cash or other consideration at such times and in accordance with such rules, terms and conditions, as the Compensation Committee may determine in its discretion.

Expense Recognized for Equity-Based Compensation Instruments

The following table presents the Company's expenses related to its equity-based compensation instruments for the three and six months ended June 30, 2018 and 2017:

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2018	2017	2018	2017
RSUs	$2,256	$2,302	$2,809	$3,358
Restricted shares of common stock	—	51	—	101
Total	$2,256	$2,353	$2,809	$3,459

(b) Employment Agreements

At June 30, 2018, the Company had employment agreements with four of its officers, with varying terms that provide for, among other things, base salary, bonus and change-in-control payments upon the occurrence of certain triggering events.

(c) Deferred Compensation Plans

The Company administers deferred compensation plans for its senior officers and non-employee directors (collectively, the "Deferred Plans"), pursuant to which participants may elect to defer up to 100% of certain cash compensation. The Deferred Plans are designed to align participants' interests with those of the Company's stockholders.

Amounts deferred under the Deferred Plans are considered to be converted into "stock units" of the Company. Stock units do not represent stock of the Company, but rather are a liability of the Company that changes in value as would equivalent shares of the Company's common stock. Deferred compensation liabilities are settled in cash at the termination of the deferral period, based on the value of the stock units at that time. The Deferred Plans are non-qualified plans under the Employee Retirement Income Security Act of 1974 and, as such, are not funded. Prior to the time that the deferred accounts are settled, participants are unsecured creditors of the Company.

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The Company's liability for stock units in the Deferred Plans is based on the market price of the Company's common stock at the measurement date. The following table presents the Company's expenses related to its Deferred Plans for the three and six months ended June 30, 2018 and 2017:

(In Thousands)	Three Months Ended June 30, 2018	2017	Six Months Ended June 30, 2018	2017
Non-employee directors	$71	$100	$22	$214
Total	$71	$100	$22	$214

The following table presents the aggregate amount of income deferred by participants of the Deferred Plans through June 30, 2018 and December 31, 2017 that had not been distributed and the Company's associated liability for such deferrals at June 30, 2018 and December 31, 2017:

(In Thousands)	June 30, 2018 Undistributed Income Deferred (1)	June 30, 2018 Liability Under Deferred Plans	December 31, 2017 Undistributed Income Deferred (1)	December 31, 2017 Liability Under Deferred Plans
Non-employee directors	$2,100	$ 2,441	$1,688	$ 2,056
Total	$2,100	$ 2,441	$1,688	$ 2,056

(1) Represents the cumulative amounts that were deferred by participants through June 30, 2018 and December 31, 2017, which had not been distributed through such respective date.

(d) Savings Plan

The Company sponsors a tax-qualified employee savings plan (the "Savings Plan") in accordance with Section 401(k) of the Code. Subject to certain restrictions, all of the Company's employees are eligible to make tax-deferred contributions to the Savings Plan subject to limitations under applicable law. Participant's accounts are self-directed and the Company bears the costs of administering the Savings Plan. The Company matches 100% of the first 3% of eligible compensation deferred by employees and 50% of the next 2%, subject to a maximum as provided by the Code. The Company has elected to operate the Savings Plan under the applicable safe harbor provisions of the Code, whereby among other things, the Company must make contributions for all participating employees and all matches contributed by the Company immediately vest 100%. For the three months ended June 30, 2018 and 2017, the Company recognized expenses for matching contributions of $89,500 and $87,500, respectively, $193,000 and $175,000 for the six months ended June 30, 2018 and 2017, respectively.

14. Fair Value of Financial Instruments

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The three levels of valuation hierarchy are defined as follows:

Level 1 — Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 — Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 — Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The following describes the valuation methodologies used for the Company's financial instruments measured at fair value on a recurring basis, as well as the general classification of such instruments pursuant to the valuation hierarchy.

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Securities Obtained and Pledged as Collateral/Obligation to Return Securities Obtained as Collateral

The fair value of U.S. Treasury securities obtained as collateral and the associated obligation to return securities obtained as collateral are based upon prices obtained from a third-party pricing service, which are indicative of market activity. Securities obtained as collateral are classified as Level 1 in the fair value hierarchy.

MBS and CRT Securities

The Company determines the fair value of its Agency MBS based upon prices obtained from third-party pricing services, which are indicative of market activity, and repurchase agreement counterparties.

For Agency MBS, the valuation methodology of the Company’s third-party pricing services incorporate commonly used market pricing methods, trading activity observed in the marketplace and other data inputs. The methodology also considers the underlying characteristics of each security, which are also observable inputs, including: collateral vintage, coupon, maturity date, loan age, reset date, collateral type, periodic and life cap, geography, and prepayment speeds. Management analyzes pricing data received from third-party pricing services and compares it to other indications of fair value including data received from repurchase agreement counterparties and its own observations of trading activity observed in the marketplace.

In determining the fair value of the Company’s Non-Agency MBS and CRT securities, management considers a number of observable market data points, including prices obtained from pricing services and brokers as well as dialogue with market participants. In valuing Non-Agency MBS, the Company understands that pricing services use observable inputs that include, in addition to trading activity observed in the marketplace, loan delinquency data, credit enhancement levels and vintage, which are taken into account to assign pricing factors such as spread and prepayment assumptions. For tranches of Legacy Non-Agency MBS that are cross-collateralized, performance of all collateral groups involved in the tranche are considered. The Company collects and considers current market intelligence on all major markets, including benchmark security evaluations and bid-lists from various sources, when available.

The Company’s Legacy Non-Agency MBS, RPL/NPL MBS and CRT securities are valued using various market data points as described above, which management considers directly or indirectly observable parameters. Accordingly, these securities are classified as Level 2 in the fair value hierarchy.

Term Notes Backed by MSR Related Collateral

The Company’s valuation process for term notes backed by MSR related collateral considers a number of factors, including a comparable bond analysis performed by a third-party pricing service which involves determining a pricing spread at issuance of the term note. The pricing spread is used at each subsequent valuation date to determine an implied yield to maturity of the term note, which is used to derive an indicative market value for the security. This indicative market value is further reviewed by the Company and may be adjusted to ensure it reflects a realistic exit price at the valuation date given the structural features of these securities. At June 30, 2018, the indicative implied yields used in the valuation of these securities ranged from 5.6% to 6.8%. The weighted average indicative yield to maturity was 5.96%. Other factors taken into consideration include indicative values provided by repurchase agreement counterparties, estimated changes in fair value of the related underlying MSR collateral and the financial performance of the ultimate parent or sponsoring entity of the issuer, which has provided a guarantee that is intended to provide for payment of interest and principal to the holders of the term notes should cash flows generated by the related underlying MSR collateral be insufficient. As this process includes significant unobservable inputs, these securities are classified as Level 3 in the fair value hierarchy.

Residential Whole Loans, at Fair Value

The Company determines the fair value of its residential whole loans held at fair value after considering valuations obtained from a third-party that specializes in providing valuations of residential mortgage loans trading activity observed in the marketplace. The Company’s residential whole loans held at fair value are classified as Level 3 in the fair value hierarchy.

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Swaps

All of the Company's Swaps are cleared by a central clearing house. Valuations provided by the clearing house are used for purposes of determining the fair value of the Company's Swaps. Such valuations obtained are tested with internally developed models that apply readily observable market parameters. As the Company's Swaps are subject to the clearing house's margin requirements, no credit valuation adjustment was considered necessary in determining the fair value of such instruments. Beginning in January 2017, variation margin payments on the Company's cleared Swaps are treated as a legal settlement of the exposure under the Swap contract. Previously such payments were treated as collateral pledged against the exposure under the Swap contract. The effect of this change is to reduce what would have otherwise been reported as fair value of the Swap. Swaps are classified as Level 2 in the fair value hierarchy.

Changes to the valuation methodologies used with respect to the Company's financial instruments are reviewed by management to ensure any such changes result in appropriate exit price valuations. The Company will refine its valuation methodologies as markets and products develop and pricing methodologies evolve. The methods described above may produce fair value estimates that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Company believes its valuation methods are appropriate and consistent with those used by market participants, the use of different methodologies, or assumptions, to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. The Company uses inputs that are current as of the measurement date, which may include periods of market dislocation, during which price transparency may be reduced. The Company reviews the classification of its financial instruments within the fair value hierarchy on a quarterly basis, and management may conclude that its financial instruments should be reclassified to a different level in the future.

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The following tables present the Company’s financial instruments carried at fair value on a recurring basis as of June 30, 2018 and December 31, 2017, on the consolidated balance sheets by the valuation hierarchy, as previously described:

Fair Value at June 30, 2018

(In Thousands)	Level 1	Level 2	Level 3	Total
Assets:				
Agency MBS	$—	$2,362,897	$—	$2,362,897
Non-Agency MBS	—	3,242,967	—	3,242,967
CRT securities	—	571,955	—	571,955
Term notes backed by MSR related collateral	—	—	381,390	381,390
Residential whole loans, at fair value	—	—	1,502,986	1,502,986
Securities obtained and pledged as collateral	253,721	—	—	253,721
Swaps	—	11,183	—	11,183
Total assets carried at fair value	$253,721	$6,189,002	$1,884,376	$8,327,099
Liabilities:				
Obligation to return securities obtained as collateral	$253,721	$—	$—	$253,721
Total liabilities carried at fair value	$253,721	$—	$—	$253,721

Fair Value at December 31, 2017

(In Thousands)	Level 1	Level 2	Level 3	Total
Assets:				
Agency MBS	$—	$2,824,681	$—	$2,824,681
Non-Agency MBS	—	3,533,966	—	3,533,966
CRT securities	—	664,403	—	664,403
Term notes backed by MSR related collateral	—	—	381,804	381,804
Residential whole loans, at fair value	—	—	1,325,115	1,325,115
Securities obtained and pledged as collateral	504,062	—	—	504,062
Swaps	—	679	—	679
Total assets carried at fair value	$504,062	$7,023,729	$1,706,919	$9,234,710
Liabilities:				
Obligation to return securities obtained as collateral	$504,062	$—	$—	$504,062
Total liabilities carried at fair value	$504,062	$—	$—	$504,062

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Changes in Level 3 Assets Measured at Fair Value on a Recurring Basis

The following table presents additional information for the three and six months ended June 30, 2018 and 2017 about the Company's Residential whole loans, at fair value, which are classified as Level 3 and measured at fair value on a recurring basis:

	Residential Whole Loans, at Fair Value (1)			
	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2018	2017	2018	2017
Balance at beginning of period	$1,555,619	$775,152	$1,325,115	$814,682
Purchases and capitalized advances	6,175	4,831	317,300	10,164
Changes in fair value recorded in Net gain on residential whole loans held at fair value	4,599	4,262	18,346	7,209
Collection of principal, net of liquidation gains/losses	(54,184)	(15,652)	(100,868)	(35,695)
Repurchases	(867)	(450)	(1,061)	(756)
Transfer to REO	(42,802)	(24,071)	(90,292)	(51,532)
Balance at end of period	$1,468,540	$744,072	$1,468,540	$744,072

(1) Excludes approximately $34.4 million and $239.2 million of residential whole loans held at fair value for which the closing of the purchase transaction had not occurred as of June 30, 2018 and 2017, respectively.

The following table presents additional information for the three and six months ended June 30, 2018 and 2017 about the Company's investments in term notes backed by MSR related collateral held at fair value, which are classified as Level 3 and measured at fair value on a recurring basis:

	Term Notes Backed by MSR Related Collateral			
	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2018	2017	2018	2017 (1)
Balance at beginning of period	$332,040	$282,332	$381,804	$—
Purchases	49,350	—	149,350	150,000
Collection of principal	—	(8,371)	(150,000)	(17,019)
Changes in unrealized gain/losses	—	—	236	—
Transfers from Level 2 to Level 3 (1)	—	—	—	140,980
Balance at end of period	$381,390	$273,961	$381,390	$273,961

(1) Investments in term notes backed by MSR related collateral were transferred from Level 2 to Level 3 during the six months ended June 30, 2017 as there had been very limited secondary market trading in these securities since issuance. Transfers between levels are deemed to take place on the first day of the reporting period in which the transfer has taken place.

The Company did not transfer any assets or liabilities from one level to another during the three and six months ended June 30, 2018 and the three months ended June 30, 2017.

Fair Value Methodology for Level 3 Financial Instruments

Residential Whole Loans, at Fair Value

The following tables present a summary of quantitative information about the significant unobservable inputs used in the fair value measurement of the Company's residential whole loans held at fair value for which it has utilized Level 3 inputs to determine fair value as of June 30, 2018 and December 31, 2017:

(Dollars in Thousands)	June 30, 2018 Fair Value (1)	Valuation Technique	Unobservable Input	Weighted Average (2)		Range
Residential whole loans, at fair value	$ 673,765	Discounted cash flow	Discount rate	5.5	%	4.5-8.2%
			Prepayment rate	3.9	%	0.9-13.5%
			Default rate	2.5	%	0.0-20.8%
			Loss severity	13.0	%	0.0-100.0%
	$ 794,715	Liquidation model	Discount rate	8.2	%	6.1-50.0%
			Annual change in home prices	3.1	%	(0.6)-11.2%
			Liquidation timeline (in years)	1.8		0.1-4.5
			Current value of underlying properties (3)	$ 829		$1-$12,400
Total	$ 1,468,480					

(Dollars in Thousands)	December 31, 2017 Fair Value (1)	Valuation Technique	Unobservable Input	Weighted Average (2)		Range
Residential whole loans, at fair value	$358,871	Discounted cash flow	Discount rate	5.5	%	4.5-13.0%
			Prepayment rate	4.1	%	1.15-15.1%
			Default rate	2.9	%	0.0-6.5%
			Loss severity	13.8	%	0.0-100.0%
	$592,940	Liquidation model	Discount rate	8.0	%	6.1-50.0%
			Annual change in home prices	2.5	%	(8.0)-8.8%
			Liquidation timeline (in years)	1.6		0.1-4.5
				$ 772		$0-$9,900

		Current value of underlying properties (3)
Total	$951,811	

(1) Excludes approximately $34.5 million and $373.3 million of loans for which management considers the purchase price continues to reflect the fair value of such loans at June 30, 2018 and December 31, 2017, respectively.
(2) Amounts are weighted based on the fair value of the underlying loan.
(3) The simple average value of the properties underlying residential whole loans held at fair value valued via a liquidation model was approximately$384,000 and $336,000 as of June 30, 2018 and December 31, 2017, respectively.

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The following table presents the carrying values and estimated fair values of the Company’s financial instruments at June 30, 2018 and December 31, 2017:

(In Thousands)	June 30, 2018 Carrying Value	June 30, 2018 Estimated Fair Value	December 31, 2017 Carrying Value	December 31, 2017 Estimated Fair Value
Financial Assets:				
Agency MBS	$2,362,897	$2,362,897	$2,824,681	$2,824,681
Non-Agency MBS	3,242,967	3,242,967	3,533,966	3,533,966
CRT securities	571,955	571,955	664,403	664,403
MSR related assets	381,390	381,390	492,080	493,026
Residential whole loans, at carrying value	1,906,242	1,987,218	908,516	988,688
Residential whole loans, at fair value	1,502,986	1,502,986	1,325,115	1,325,115
Securities obtained and pledged as collateral	253,721	253,721	504,062	504,062
Cash and cash equivalents	54,880	54,880	449,757	449,757
Restricted cash	3,298	3,298	13,307	13,307
Swaps	11,183	11,183	679	679
Financial Liabilities (1):				
Repurchase agreements	5,892,228	5,900,049	6,614,701	6,623,255
Securitized debt	518,655	518,659	363,944	366,109
Obligation to return securities obtained as collateral	253,721	253,721	504,062	504,062
Senior Notes	96,794	102,231	96,773	103,729

(1) Carrying value of securitized debt, Senior Notes and certain repurchase agreements is net of associated debt issuance costs.

In addition to the methodologies used to determine the fair value of the Company’s financial assets and liabilities reported at fair value on a recurring basis discussed on pages 43-48, the following methods and assumptions were used by the Company in arriving at the fair value of the Company’s other financial instruments presented in the above table that are not reported at fair value on a recurring basis:

Residential Whole Loans, at Carrying Value: The Company generally determines the fair value of its residential whole loans held at carrying value after considering portfolio valuations obtained from a third-party who specializes in providing valuations of residential mortgage loans and trading activity observed in the market place. Given the short duration of the Company’s Rehabilitation loans, these investments are determined to have a carrying value which approximates fair value. The Company’s residential whole loans held at carrying value are classified as Level 3 in the fair value hierarchy.

Cash and Cash Equivalents and Restricted Cash: Cash and cash equivalents and restricted cash are comprised of cash held in overnight money market investments and demand deposit accounts. At June 30, 2018 and December 31, 2017, the Company’s money market funds were invested in securities issued by the U.S. Government or its agencies, instrumentalities, and sponsored entities, and repurchase agreements involving the securities described above. Given the overnight term and assessed credit risk, the Company’s investments in money market funds are determined to have a fair value equal to their carrying value.

Corporate Loan: The Corporate loan was repaid during the three months ended June 30, 2018. The Company had determined the fair value of this loan at December 31, 2017 after considering recent past and expected future loan performance, recent financial performance of the borrower and estimates of the current value of the underlying collateral which included certain MSRs and other assets of the borrower that had been pledged to secure the borrowing. The Company's investment in this term loan was classified as Level 3 in the fair value hierarchy.

Repurchase Agreements: The fair value of repurchase agreements reflects the present value of the contractual cash flows discounted at market interest rates at the valuation date for repurchase agreements with a term equivalent to the remaining term

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to interest rate repricing, which may be at maturity. Such interest rates are estimated based on LIBOR rates observed in the market. The Company's repurchase agreements are classified as Level 2 in the fair value hierarchy.

Securitized Debt: In determining the fair value of securitized debt, management considers a number of observable market data points, including prices obtained from pricing services and brokers as well as dialogue with market participants. Accordingly, the Company's securitized debt is classified as Level 2 in the fair value hierarchy.

Senior Notes: The fair value of the Senior Notes is determined using the end of day market price quoted on the NYSE at the reporting date. The Company's Senior Notes are classified as Level 1 in the fair value hierarchy.

The Company holds REO at the lower of the current carrying amount or fair value less estimated selling costs. At June 30, 2018 and December 31, 2017, the Company's REO had an aggregate carrying value of $192.2 million and $152.4 million, and an aggregate estimated fair value of $214.8 million and $175.8 million, respectively. The Company classifies fair value measurements of REO as Level 3 in the fair value hierarchy.

15. Use of Special Purpose Entities and Variable Interest Entities

A Special Purpose Entity ("SPE") is an entity designed to fulfill a specific limited need of the company that organized it. SPEs are often used to facilitate transactions that involve securitizing financial assets or resecuritizing previously securitized financial assets. The objective of such transactions may include obtaining non-recourse financing, obtaining liquidity or refinancing the underlying financial assets on improved terms. Securitization involves transferring assets to a SPE to convert all or a portion of those assets into cash before they would have been realized in the normal course of business, through the SPE's issuance of debt or equity instruments. Investors in an SPE usually have recourse only to the assets in the SPE and, depending on the overall structure of the transaction, may benefit from various forms of credit enhancement such as over-collateralization in the form of excess assets in the SPE, priority with respect to receipt of cash flows relative to holders of other debt or equity instruments issued by the SPE, or a line of credit or other form of liquidity agreement that is designed with the objective of ensuring that investors receive principal and/or interest cash flow on the investment in accordance with the terms of their investment agreement.

The Company has entered into several financing transactions that resulted in the Company consolidating as VIEs the SPEs that were created to facilitate these transactions. See Note 2(r) for a discussion of the accounting policies applied to the consolidation of VIEs and transfers of financial assets in connection with financing transactions.

The Company has engaged in loan securitizations and in prior years, MBS resecuritization transactions, primarily for the purpose of obtaining improved overall financing terms as well as non-recourse financing on a portion of its residential whole loan and Non-Agency MBS portfolios. Notwithstanding the Company's participation in these transactions, the risks facing the Company are largely unchanged as the Company remains economically exposed to the first loss position on the underlying assets transferred to the VIEs.

Loan Securitization Transactions

In May 2018, as part of a loan securitization transaction, the Company sold residential whole loans with an aggregate unpaid principal balance of $319.1 million to an entity that the Company consolidates as a VIE. In connection with the transaction, third-party investors purchased $184.0 million face amount of senior bonds ("Senior Bonds") with a coupon rate of 3.875%. As a result of this transaction, the Company acquired $46.4 million face amount of non-rated certificates issued by the securitization vehicle, and received $184.0 million in cash, excluding expenses, accrued interest, and underwriting fees.

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The following table summarizes the key details of the loan securitization transactions the Company has been involved in to date:

(Dollars in Thousands)	June 30, 2018		December 31, 2017	
Aggregate unpaid principal balance of residential whole loans sold	$942,285		$620,924	
Face amount of Senior Bonds issued by the VIE and purchased by third-party investors	$566,817		$382,847	
Outstanding amount of Senior Bonds	$518,655	(1)	$363,944	(1)
Weighted average fixed rate for Senior Bonds issued	3.40	%(2)	3.14	%(2)
Face amount of Senior Support Certificates received by the Company (3)	$173,431		$127,001	
Cash received	$566,815		$382,845	

(1) Net of $2.9 million and $2.3 million of deferred financing costs at June 30, 2018 and December 31, 2017, respectively.

(2) At June 30, 2018 and December 31, 2017, $399.6 million and $233.7 million, respectively, of Senior Bonds sold in securitization transactions contained a contractual coupon step-up feature whereby the coupon increases by 300 basis points at 36 months from issuance if the bond is not redeemed before such date.

(3) Provides credit support to the Senior Bonds sold to third-party investors in the securitization transactions.

As of June 30, 2018 and December 31, 2017, as a result of the transactions described above, securitized loans with a carrying value of approximately $199.8 million and $183.2 million are included in “Residential whole loans, at carrying value,” securitized loans with a fair value of approximately $476.2 million and $289.3 million are included in “Residential whole loans, at fair value,” and REO with a carrying value approximately $33.4 million and $5.5 million are included in “Other assets” on the Company’s consolidated balance sheets, respectively. As of June 30, 2018 and December 31, 2017, the aggregate carrying value of Senior Bonds issued by consolidated VIEs was $518.7 million and $363.9 million, respectively. These Senior Bonds are disclosed as “Securitized debt” and are included in Other liabilities on the Company’s consolidated balance sheets. The holders of the securitized debt have no recourse to the general credit of the Company, but the Company does have the obligation, under certain circumstances to repurchase assets from the VIE upon the breach of certain representations and warranties with respect to the residential whole loans sold to the VIE. In the absence of such a breach, the Company has no obligation to provide any other explicit or implicit support to any VIE.

The Company concluded that the entities created to facilitate the loan securitization transactions are VIEs. The Company then completed an analysis of whether each VIE created to facilitate the securitization transactions should be consolidated by the Company, based on consideration of its involvement in each VIE, including the design and purpose of the SPE, and whether its involvement reflected a controlling financial interest that resulted in the Company being deemed the primary beneficiary of each VIE. In determining whether the Company would be considered the primary beneficiary, the following factors were assessed:

- whether the Company has both the power to direct the activities that most significantly impact the economic performance of the VIE; and
- whether the Company has a right to receive benefits or absorb losses of the entity that could be potentially significant to the VIE.

Based on its evaluation of the factors discussed above, including its involvement in the purpose and design of the entity, the Company determined that it was required to consolidate each VIE created to facilitate the loan securitization transactions.

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Residential Whole Loans and REO (including Residential Whole Loans and REO transferred to consolidated VIEs)

Included on the Company's consolidated balance sheets as of June 30, 2018 and December 31, 2017 are a total of $3.4 billion and $2.2 billion of residential whole loans, of which approximately $1.9 billion and $908.5 million are reported at carrying value and $1.5 billion and $1.3 billion are reported at fair value, respectively. In addition, at June 30, 2018 and December 31, 2017, the Company had REO with an aggregate carrying value of $192.2 million and $152.4 million, and an aggregate estimated fair value of $214.8 million and $175.8 million, respectively. The inclusion of these assets arises from the Company's interests in certain trusts established to acquire the loans and entities established in connection with its loan securitization transactions. The Company has assessed that these entities are required to be consolidated. During the three and six months ended June 30, 2018, the Company recognized interest income from residential whole loans reported at carrying value of approximately $17.9 million and $32.3 million, respectively. During the three and six months ended June 30, 2017, the Company recognized interest income from residential whole loans reported at carrying value of approximately $8.5 million and $17.2 million, respectively. These amounts are included in Interest Income on the Company's consolidated statements of operations. In addition, the Company recognized net gains on residential whole loans held at fair value during the three and six months ended June 30, 2018 of approximately $32.4 million and $70.9 million, respectively. During the three and six months ended June 30, 2017, the Company recognized net gains on residential whole loans held at fair value $16.2 million and $30.0 million, respectively. These amounts are included in Other Income, net on the Company's consolidated statements of operations. (See Note 4)

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

In this Quarterly Report on Form 10-Q, we refer to MFA Financial, Inc. and its subsidiaries as "the Company," "MFA," "we," "us," or "our," unless we specifically state otherwise or the context otherwise indicates.

The following discussion should be read in conjunction with our financial statements and accompanying notes included in Item 1 of this Quarterly Report on Form 10-Q as well as our Annual Report on Form 10-K for the year ended December 31, 2017.

Forward Looking Statements

When used in this Quarterly Report on Form 10-Q, in future filings with the SEC or in press releases or other written or oral communications, statements which are not historical in nature, including those containing words such as "will," "believe," "expect," "anticipate," "estimate," "plan," "continue," "intend," "should," "could," "would," "may" the negative of t similar expressions, are intended to identify "forward-looking statements" within the meaning of Section 27A of the 1933 Act and Section 21E of the 1934 Act and, as such, may involve known and unknown risks, uncertainties and assumptions.

These forward-looking statements include information about possible or assumed future results with respect to our business, financial condition, liquidity, results of operations, plans and objectives. Statements regarding the following subjects, among others, may be forward-looking: changes in interest rates and the market (i.e., fair) value of our MBS, residential whole loans, CRT securities and other assets; changes in the prepayment rates on the mortgage loans securing our MBS, an increase of which could result in a reduction of the yield on MBS in our portfolio and an increase of which could require us to reinvest the proceeds received by us as a result of such prepayments in MBS with lower coupons; credit risks underlying our assets, including changes in the default rates and management's assumptions regarding default rates on the mortgage loans securing our Non-Agency MBS and relating to our residential whole loan portfolio; our ability to borrow to finance our assets and the terms, including the cost, maturity and other terms, of any such borrowings; implementation of or changes in government regulations or programs affecting our business; our estimates regarding taxable income the actual amount of which is dependent on a number of factors, including, but not limited to, changes in the amount of interest income and financing costs, the method elected by us to accrete the market discount on Non-Agency MBS and residential whole loans and the extent of prepayments, realized losses and changes in the composition of our Agency MBS, Non-Agency MBS and residential whole loan portfolios that may occur during the applicable tax period, including gain or loss on any MBS disposals and whole loan modification foreclosure and liquidation; the timing and amount of distributions to stockholders, which are declared and paid at the discretion of our Board and will depend on, among other things, our taxable income, our financial results and overall financial condition and liquidity, maintenance of our REIT qualification and such other factors as the Board deems relevant; our ability to maintain our qualification as a REIT for federal income tax purposes; our ability to maintain our exemption from registration under the Investment Company Act of 1940, as amended (or the Investment Company Act), including statements regarding the concept release issued by the SEC relating to interpretive issues under the Investment Company Act with respect to the status under the Investment Company Act of certain companies that are engaged in the business of acquiring mortgages and mortgage-related interests; our ability to successfully implement our strategy to grow our residential whole loan portfolio, which is dependent on, among other things, the supply of loans offered for sale in the market; expected returns on our investments in nonperforming loans (or NPLs), which are affected by, among other things, the length of time required to foreclose upon, sell, liquidate or otherwise reach a resolution of the property underlying the NPL, home price values, amounts advanced to carry the asset (e.g., taxes, insurance, maintenance expenses, etc. on the underlying property) and the amount ultimately realized upon resolution of the asset; risks associated with our investments in MSR related assets, including servicing, regulatory and economic risks, and risks associated with investing in real estate assets, including changes in business conditions and the general economy. These and other risks, uncertainties and factors, including those described in the annual, quarterly and current reports that we file with the SEC, could cause our actual results to differ materially from those projected in any forward-looking statements we make. All forward-looking statements are based on beliefs, assumptions and expectations of our future performance, taking into account all information currently available. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date on which they are made. New risks and uncertainties arise over time and it is not possible to predict those events or how they may affect us. Except as required by law, we are not obligated to, and do not intend to, update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

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Business/General

We are a REIT primarily engaged in the business of investing, on a leveraged basis, in residential mortgage assets, including Agency MBS, Non-Agency MBS, residential whole loans, CRT securities and MSR related assets. Our principal business objective is to deliver shareholder value through the generation of distributable income and through asset performance linked to residential mortgage credit fundamentals. We selectively invest in residential mortgage assets with a focus on credit analysis, projected prepayment rates, interest rate sensitivity and expected return.

At June 30, 2018, we had total assets of approximately $10.6 billion, of which $5.6 billion, or 52.7%, represented our MBS portfolio. At such date, our MBS portfolio was comprised of $2.4 billion of Agency MBS and $3.2 billion of Non-Agency MBS, which includes $2.3 billion of Legacy Non-Agency MBS and $907.9 million of RPL/NPL MBS that are primarily structured with a contractual coupon step-up feature where the coupon increases up to 300 basis points at 36 months from issuance or sooner. These RPL/NPL MBS are primarily backed by securitized re-performing and non-performing loans. In addition, at June 30, 2018, we had approximately $3.4 billion in residential whole loans acquired through interests in certain trusts established to acquire the loans, which represented approximately 32.0% of our total assets. During the second quarter of 2018 we again experienced the most growth in residential whole loans. In addition to re-performing and non-performing loans, during 2018 we have purchased or committed to purchase loans that are not considered credit impaired. To date such loans, which as of June 30, 2018 comprise approximately one-third of our residential whole loans, have included newly or previously originated performing loans that are primarily comprised of: (i) loans to finance (or refinance) one-to-four family residential properties and are not considered to meet the definition of a "Qualified Mortgage" in accordance with guidelines adopted by the Consumer Financial Protection Bureau (or Non-QM loans), (ii) short-term business purpose loans collateralized by residential properties made to non-occupant borrowers who intend to rehabilitate and sell the property for a profit (or Rehabilitation loans or Fix and Flip loans), (iii) loans to finance (or refinance) non-owner occupied one-to-four family residential properties that are rented to one or more tenants (or Single-family rental loans), and (iv) previously originated loans secured by residential real estate that is generally owner occupied (or Seasoned performing loans). Our remaining investment-related assets were primarily comprised of CRT securities, MSR related assets, collateral obtained in connection with reverse repurchase agreements, cash and cash equivalents (including restricted cash), REO and MBS and loan-related receivables.

The results of our business operations are affected by a number of factors, many of which are beyond our control, and primarily depend on, among other things, the level of our net interest income, the market value of our assets, which is driven by numerous factors, including the supply and demand for residential mortgage assets in the marketplace, the terms and availability of adequate financing, general economic and real estate conditions (both on a national and local level), the impact of government actions in the real estate and mortgage sector, and the credit performance of our credit sensitive residential mortgage assets. In recent periods, the impact on our results from changes in market values of certain assets for which we have elected the fair value option, such as certain residential whole loans and CRT securities, has increased. Our net interest income varies primarily as a result of changes in interest rates, the slope of the yield curve (i.e., the differential between long-term and short-term interest rates), borrowing costs (i.e., our interest expense) and prepayment speeds on our MBS, the behavior of which involves various risks and uncertainties. Interest rates and conditional prepayment rates (or CPRs) (which measure the amount of unscheduled principal prepayment on a bond as a percentage of the bond balance), 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.

With respect to our business operations, increases in interest rates, in general, may over time cause: (i) the interest expense associated with our borrowings to increase; (ii) the value of our residential mortgage assets and, correspondingly, our stockholders' equity to decline; (iii) coupons on our adjustable rate assets to reset, on a delayed basis, to higher interest rates; (iv) prepayments on our assets to decline, thereby slowing the amortization of purchase premiums and the accretion of our purchase discounts; and (v) the value of our derivative hedging instruments and, correspondingly, our stockholders' equity to increase. Conversely, decreases in interest rates, in general, may over time cause: (i) the interest expense associated with our borrowings to decrease; (ii) the value of our residential mortgage assets and, correspondingly, our stockholders' equity to increase; (iii) coupons on our adjustable rate assets to reset, on a delayed basis, to lower interest rates; (iv) prepayments on assets to increase, thereby accelerating the amortization of purchase premiums and the accretion of our purchase discounts; and (v) the value of our derivative hedging instruments and, correspondingly, our stockholders' equity to decrease. In addition, our borrowing costs and credit lines are further affected by the type of collateral we pledge and general conditions in the credit market.

Our investments in residential mortgage assets expose us to credit risk, generally meaning that we are subject to credit losses due to the risk of delinquency, default and foreclosure on the underlying real estate collateral. We believe the discounted purchase prices paid on certain of these investments mitigate our risk of loss in the event that, as we expect on most such investments, we receive less than 100% of the par value of these investments. Our investment process for credit sensitive assets focuses primarily on quantifying and pricing credit risk.

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Premiums arise when we acquire an MBS or loan at a price in excess of the aggregate principal balance of the mortgages securing the MBS (i.e., par value) or when we acquire residential whole loans at a price in excess of their aggregate principal balance. Conversely, discounts arise when we acquire an MBS or loan at a price below the aggregate principal balance of the mortgages securing the MBS or when we acquire residential whole loans at a price below their aggregate principal balance. Premiums paid are amortized against interest income and accretable purchase discounts on these investments are accreted to interest income. Purchase premiums, which are primarily carried on our Agency MBS, certain CRT securities and Non-QM loans, are amortized against interest income over the life of the investment using the effective yield method, adjusted for actual prepayment activity. An increase in the prepayment rate, as measured by the CPR, will typically accelerate the amortization of purchase premiums, thereby reducing the interest income earned on these assets.

CPR levels are impacted by, among other things, conditions in the housing market, new regulations, government and private sector initiatives, interest rates, availability of credit to home borrowers, underwriting standards and the economy in general. In particular, CPR reflects the conditional repayment rate (or CRR), which measures voluntary prepayments of mortgages collateralizing a particular MBS, and the conditional default rate (or CDR), which measures involuntary prepayments resulting from defaults. CPRs on Agency MBS and Legacy Non-Agency MBS may differ significantly. For the three months ended June 30, 2018, our Agency MBS portfolio experienced a weighted average CPR of 16.2%, and our Legacy Non-Agency MBS portfolio experienced a weighted average CPR of 15.8%. Over the last consecutive eight quarters, ending with June 30, 2018, the monthly weighted average CPR on our Agency and Legacy Non-Agency MBS portfolios ranged from a high of 18.4% experienced during the month ended July 31, 2017 to a low of 13.5%, experienced during the month ended March 31, 2018, with an average CPR over such quarters of 16.1%.

Our method of accounting for Non-Agency MBS purchased at significant discounts to par value requires us to make assumptions with respect to each security. These assumptions include, but are not limited to, future interest rates, voluntary prepayment rates, default rates, mortgage modifications and loss severities. As part of our Non-Agency MBS surveillance process, we track and compare each security’s actual performance over time to the performance expected at the time of purchase or, if we have modified our original purchase assumptions, to our revised performance expectations. To the extent that actual performance or our expectation of future performance of our Non-Agency MBS deviates materially from our expected performance parameters, we may revise our performance expectations, such that the amount of purchase discount designated as credit discount may be increased or decreased over time. Nevertheless, credit losses greater than those anticipated or in excess of the recorded purchase discount could occur, which could materially adversely impact our operating results.

It is our business strategy to hold our residential mortgage assets as long-term investments. On at least a quarterly basis, excluding investments for which the fair value option has been elected or for which specialized loan accounting is otherwise applied, we assess our ability and intent to continue to hold each asset and, as part of this process, we monitor our MBS, CRT securities and MSR related assets that are designated as AFS for OTTI. A change in our ability and/or intent to continue to hold any of these securities that are in an unrealized loss position, or a deterioration in the underlying characteristics of these securities, could result in our recognizing future impairment charges or a loss upon the sale of any such security. At June 30, 2018, we had net unrealized gains on our Non-Agency MBS of $577.2 million, comprised of gross unrealized gains of $578.5 million and gross unrealized losses of $1.3 million, and net unrealized losses of $35.7 million on our Agency MBS, comprised of gross unrealized losses of $54.6 million and gross unrealized gains of $18.9 million. At June 30, 2018, we did not intend to sell any securities in our portfolio that are designated as AFS and that were in an unrealized loss position, and we believe it is more likely than not that we will not be required to sell those securities before recovery of their amortized cost basis, which may be at their maturity.

We rely primarily on borrowings under repurchase agreements to finance our residential mortgage assets. Our residential mortgage investments have longer-term contractual maturities than our borrowings under repurchase agreements. Even though the majority of our investments have interest rates that adjust over time based on short-term changes in corresponding interest rate indices (typically following an initial fixed-rate period for our Hybrids), the interest rates we pay on our borrowings will typically change at a faster pace than the interest rates we earn on our investments. In order to reduce this interest rate risk exposure, we may enter into derivative instruments, which at June 30, 2018 were comprised of Swaps.

Our Swap derivative instruments are designated as cash-flow hedges against a portion of our current and forecasted LIBOR-based repurchase agreements. Our Swaps do not extend the maturities of our repurchase agreements; they do, however, lock in a fixed rate of interest over their term for the notional amount of the Swap corresponding to the hedged item.

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Recent Market Conditions and Our Strategy

At June 30, 2018, our residential mortgage asset portfolio, which includes MBS, residential whole loans and REO, CRT securities and MSR related assets was approximately $10.2 billion compared to $10.0 billion at March 31, 2018. We will continue to seek investments in residential mortgage assets during 2018, with our investment focus primarily on residential whole loans, as well as RPL/NPL MBS and MSR related assets as market opportunities arise.

The following table presents the activity for our residential mortgage asset portfolio for the three months ended June 30, 2018:

(In Millions)	March 31, 2018	Runoff (1)	Acquisitions	Other (2)	June 30, 2018	Change
Residential whole loans and REO	$ 2,838	$(155)	$ 898	$20	$3,601	$ 763
RPL/NPL MBS	935	(166)	141	(1)	909	(26)
MSR related assets	455	(124)	49	1	381	(74)
CRT securities	679	(4)	—	(104)	571	(108)
Legacy Non-Agency MBS	2,463	(135)	—	7	2,335	(128)
Agency MBS	2,647	(193)	—	(91)	2,363	(284)
Totals	$ 10,017	$(777)	$ 1,088	$(168)	$10,160	$ 143

(1) Primarily includes principal repayments, cash collections on purchased credit impaired loans and sales of REO.

(2) Primarily includes sales, changes in fair value, net premium amortization/discount accretion and adjustments to record lower of cost or estimated fair value adjustments on REO. During the three months ended June 30, 2018, we sold certain Agency MBS for $75.3 million, realizing gross losses of $3.8 million and sold certain CRT securities for $104.0 million, realizing gross gains of $11.2 million.

At June 30, 2018, our total recorded investment in residential whole loans and REO was $3.6 billion, or 35.4% of our residential mortgage asset portfolio. Of this amount, (i) $1.9 billion is presented as Residential whole loans, at carrying value, (of which $804.8 million were purchased credit impaired loans and $1.1 billion were other loans held at carrying value), and (ii) $1.5 billion as Residential whole loans, at fair value, in our consolidated balance sheets. For the three months ended June 30, 2018, we recognized approximately $17.9 million of income on residential whole loans held at carrying value in Interest Income on our consolidated statements of operations, representing an effective yield of 5.84% (excluding servicing costs). In addition, we recorded a net gain on residential whole loans held at fair value of $32.4 million in Other Income, net in our consolidated statements of operations for the three months ended June 30, 2018. At June 30, 2018 and March 31, 2018, we had REO with an aggregate carrying value of $192.2 million and $182.9 million, respectively, which is included in Other assets on our consolidated balance sheets.

At the end of the second quarter of 2018, the average coupon on mortgages underlying our Agency MBS was higher compared to the end of the second quarter of 2017, due to upward resets on securities within the portfolio and the impact of the removal from the portfolio of Agency MBS sold during the quarter. As a result, the coupon yield on our Agency MBS portfolio increased to 3.09% for the three months ended June 30, 2018, from 2.94% for the three months ended June 30, 2017, and the net Agency MBS yield increased to 2.03% for the three months ended June 30, 2018 from 1.96% for the three months ended June 30, 2017. The net yield for our Legacy Non-Agency MBS portfolio was 9.89% for the three months ended June 30, 2018 compared to 8.85% for the three months ended June 30, 2017. The increase in the net yield on our Legacy Non-Agency MBS portfolio reflects the improved performance of loans underlying the Legacy Non-Agency MBS portfolio, which has resulted in credit reserve releases and changes in interest rates since the second quarter of the prior year and the impact of the cash proceeds received during the second quarter of 2018 in connection with the settlement of litigation related to certain residential mortgage backed securitization trusts that were sponsored by JP Morgan Chase & Co. and affiliated entities. The net yield for our RPL/NPL MBS portfolio was 4.52% for the three months ended June 30, 2018 compared to 4.18% for the three months ended June 30, 2017. The increase in the net yield reflects an increase in the average coupon yield to 4.49% for the three months ended June 30, 2018 from 4.03% for the three months ended June 30, 2017.

We believe that our $553.6 million Credit Reserve and OTTI appropriately factors in remaining uncertainties regarding underlying mortgage performance and the potential impact on future cash flows for our existing Legacy Non-Agency MBS portfolio. In addition, while the majority of our Legacy Non-Agency MBS will not return their full face value due to loan defaults, we believe that they will deliver attractive loss adjusted yields due to our discounted amortized cost of 70% of face value at June 30, 2018. Home price appreciation and underlying mortgage loan amortization have decreased the LTV for many of the mortgages underlying our Legacy Non-Agency portfolio. Home price appreciation during the past few years has generally been driven by a combination of limited housing supply due partly to low levels of new home construction, low mortgage rates and demographic-driven U.S. household formation. Lower LTVs lessen the likelihood of defaults and simultaneously decrease loss severities. Further,

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during 2017 and the six months ended June 30, 2018, we have also observed faster voluntary prepayment (i.e., prepayment of loans in full with no loss) speeds than originally projected. The yields on our Legacy Non-Agency MBS that were purchased at a discount are generally positively impacted if prepayment rates on these securities exceed our prepayment assumptions. Based on these current conditions, we have reduced estimated future losses within our Legacy Non-Agency portfolio. As a result, during the three months ended June 30, 2018, $8.0 million was transferred from Credit Reserve to accretable discount. This increase in accretable discount is expected to increase the interest income realized over the remaining life of our Legacy Non-Agency MBS. We believe that the majority of the impact on interest income from the reduction in Credit Reserve will occur over the next ten years.

Our book value per common share was $7.54 as of June 30, 2018, a decline from book value per common share of $7.62 as of March 31, 2018. This decrease was primarily due to the impact of dividend distributions which exceeded net income for the quarter and the impact of fair value changes of Legacy Non-Agency MBS and Agency MBS, which was partially offset by an increase in the fair value of Swaps.

Repurchase agreement funding for our residential mortgage investments continued to be available to us from multiple counterparties during the second quarter of 2018. Typically, repurchase agreement funding involving credit-sensitive investments is available at terms requiring higher collateralization and higher interest rates than for repurchase agreement funding involving Agency MBS. At June 30, 2018, our debt consisted of borrowings under repurchase agreements with 26 counterparties, securitized debt, Senior Notes outstanding, an obligation to return securities obtained as collateral and payable for unsettled purchases, resulting in a debt-to-equity multiple of 2.3 times. (See table on page 74 under Results of Operations that presents our quarterly leverage multiples since June 30, 2017.)

In May 2018, as part of a loan securitization transaction, we sold residential whole loans with an aggregate unpaid principal balance of $319.1 million to an entity that we consolidate as a VIE. In connection with the transaction, third-party investors purchased $184.0 million face amount of senior bonds with a coupon rate of 3.875%. As a result of this transaction, we acquired $46.4 million face amount of non-rated certificates issued by the securitization vehicle, and received $184.0 million in cash, excluding expenses, accrued interest, and underwriting fees.

At June 30, 2018, we have access to various sources of liquidity which we estimate to be in excess of $606.4 million. This amount includes (i) $54.9 million of cash and cash equivalents; (ii) $172.0 million in estimated financing available from unpledged Agency MBS and U.S. Treasury securities and from other Agency MBS collateral that is currently pledged in excess of contractual requirements; and (iii) $379.5 million in estimated financing available from unpledged Non-Agency MBS and from other Non-Agency MBS and CRT collateral that is currently pledged in excess of contractual requirements. Our sources of liquidity do not include restricted cash. In addition, we have $877.1 million of unencumbered residential whole loans. We are evaluating potential opportunities to finance these assets including loan securitization. With access to multiple sources of liquidity and potential financing opportunities for unencumbered residential whole loans, we believe that we are positioned to continue to take advantage of investment opportunities within the residential mortgage marketplace.

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Information About Our Assets

The table below presents certain information about our asset allocation at June 30, 2018:

ASSET ALLOCATION

	Agency MBS	Legacy Non-Agency MBS	RPL/NPL MBS (1)	Credit Risk Transfer Securities	MSR Related Assets	Residential Whole Loans, at Carrying Value (2)	Residential Whole Loans, at Fair Value	Other, net (3)	Total
(Dollars in Millions)									
Fair Value/Carrying Value	$2,363	$ 2,335	$ 908	$ 572	$ 381	$ 1,906	$ 1,503	$ 315	$ 10,283
Less Payable for Unsettled Purchases	—	—	(61)	—	—	(473)	(34)	—	(568)
Less Repurchase Agreements	(2,112)	(1,585)	(499)	(410)	(297)	(318)	(671)	—	(5,892)
Less Securitized Debt	—	—	—	—	—	(167)	(352)	—	(519)
Less Senior Notes	—	—	—	—	—	—	—	(97)	(97)
Net Equity Allocated	$ 251	$ 750	$ 348	$ 162	$ 84	$ 948	$ 446	$ 218	$ 3,207
Debt/Net Equity Ratio (4)	8.4 x	2.1 x	1.6 x	2.5 x	3.5 x	1.0 x	2.4 x		2.3 x

(1) RPL/NPL MBS are backed primarily by securitized re-performing and non-performing loans. The securities are structured such that the coupon increases up to 300 basis points at 36 months from issuance or sooner. Included with the balance of Non-Agency MBS reported on our consolidated balance sheets.

(2) Includes $804.8 million of purchased credit impaired loans, $626.9 million of Non-QM loans, $162.7 million of Rehabilitation loans, $55.6 million of Single-family rental loans and $256.2 million of Seasoned performing loans. At June 30, 2018, the total fair value of these loans is estimated to be approximately $2.0 billion.

(3) Includes cash and cash equivalents and restricted cash, other assets and other liabilities.

(4) Represents the sum of borrowings under repurchase agreements, securitized debt and payable for unsettled purchases as a multiple of net equity allocated. The numerator of our Total Debt/Net Equity Ratio also includes the obligation to return securities obtained as collateral of $253.7 million and Senior Notes.

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Agency MBS

The following table presents certain information regarding the composition of our Agency MBS portfolio as of June 30, 2018 and December 31, 2017:

June 30, 2018

(Dollars in Thousands)	Current Face	Weighted Average Purchase Price	Weighted Average Market Price	Fair Value (1)	Weighted Average Loan Age (Months) (2)	Weighted Average Coupon (2)	3 Month Average CPR
15-Year Fixed Rate:							
Low Loan Balance (3)	$777,502	104.4 %	99.8 %	$775,950	74	2.98 %	10.6 %
HARP (4)	80,054	104.8	99.8	79,886	72	2.95	9.0
Other (Post June 2009) (5)	70,992	104.0	102.8	72,974	93	4.14	9.4
Other (Pre June 2009) (6)	277	104.9	102.8	284	109	4.50	2.3
Total 15-Year Fixed Rate	$928,825	104.4 %	100.0 %	$929,094	75	3.07 %	10.4 %
Hybrid:							
Other (Post June 2009) (5)	$893,055	104.4 %	103.4 %	$923,058	84	3.30 %	20.4 %
Other (Pre June 2009) (6)	418,436	101.7	105.0	439,537	139	3.68	20.4
Total Hybrid	$1,311,491	103.5 %	103.9 %	$1,362,595	102	3.42 %	20.4 %
CMO/Other	$68,097	102.5 %	102.8 %	$70,030	204	3.55 %	17.7 %
Total Portfolio	$2,308,413	103.9 %	102.3 %	$2,361,719	94	3.28 %	16.2 %

December 31, 2017

(Dollars in Thousands)	Current Face	Weighted Average Purchase Price	Weighted Average Market Price	Fair Value (1)	Weighted Average Loan Age (Months) (2)	Weighted Average Coupon (2)	3 Month Average CPR
15-Year Fixed Rate:							
Low Loan Balance (3)	$948,225	104.3 %	101.7 %	$964,373	67	2.95 %	10.3 %
HARP (4)	91,131	104.7	101.8	92,800	66	2.95	8.2
Other (Post June 2009) (5)	81,428	104.0	104.5	85,094	87	4.14	10.7
Other (Pre June 2009) (6)	303	104.9	104.4	316	103	4.50	2.0
Total 15-Year Fixed Rate	$1,121,087	104.3 %	101.9 %	$1,142,583	68	3.04 %	10.2 %
Hybrid:							
Other (Post June 2009) (5)	$1,028,630	104.4 %	103.6 %	$1,065,312	78	3.17 %	17.7 %
Other (Pre June 2009) (6)	511,801	101.7	104.7	535,795	132	3.44	16.0
Total Hybrid	$1,540,431	103.5 %	103.9 %	$1,601,107	96	3.26 %	17.1 %
CMO/Other	$76,944	102.5 %	102.8 %	$79,100	198	3.16 %	9.9 %
Total Portfolio	$2,738,462	103.8 %	103.1 %	$2,822,790	88	3.16 %	14.1 %

(1) Does not include principal payments receivable of $1.2 million and $1.9 million at June 30, 2018 and December 31, 2017, respectively.
(2) Weighted average is based on MBS current face at June 30, 2018 and December 31, 2017, respectively.
(3) Low loan balance represents MBS collateralized by mortgages with an original loan balance of less than or equal to $175,000.

(4) Home Affordable Refinance Program (or HARP) MBS are backed by refinanced loans with LTVs greater than or equal to 80% at origination.

(5) MBS issued in June 2009 or later. Majority of underlying loans are ineligible to refinance through the HARP program.

(6) MBS issued before June 2009.

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The following table presents certain information regarding our 15-year fixed-rate Agency MBS as of June 30, 2018 and December 31, 2017:

June 30, 2018

Coupon	Current Face	Weighted Average Purchase Price	Weighted Average Market Price	Fair Value (1)	Weighted Average Loan Age (Months) (2)	Weighted Average Loan Rate	Low Loan Balance and/or HARP (3)	3 Month Average CPR
(Dollars in Thousands)								
15-Year Fixed Rate:								
2.5%	$449,162	104.1 %	98.3 %	$441,567	67	3.02 %	100 %	9.7 %
3.0%	208,550	105.9	100.2	208,979	71	3.49	100	10.0
3.5%	4,401	103.5	101.6	4,470	92	4.17	100	21.7
4.0%	230,088	103.5	102.7	236,253	91	4.40	80	12.8
4.5%	36,624	105.2	103.3	37,825	95	4.89	33	14.5
Total 15-Year Fixed Rate	$928,825	104.4 %	100.0 %	$929,094	75	3.54 %	92 %	10.4 %

December 31, 2017

Coupon	Current Face	Weighted Average Purchase Price	Weighted Average Market Price	Fair Value (1)	Weighted Average Loan Age (Months) (2)	Weighted Average Loan Rate	Low Loan Balance and/or HARP (3)	3 Month Average CPR
(Dollars in Thousands)								
15-Year Fixed Rate:								
2.5%	$579,003	104.0 %	100.5 %	$581,866	60	3.04 %	100 %	9.3 %
3.0%	231,325	105.9	102.2	236,316	66	3.49	100	9.5
3.5%	5,402	103.5	103.4	5,587	86	4.18	100	23.0
4.0%	263,447	103.5	104.3	274,783	85	4.40	80	12.4
4.5%	41,910	105.2	105.1	44,031	89	4.88	34	10.2
Total 15-Year Fixed Rate	$1,121,087	104.3 %	101.9 %	$1,142,583	68	3.52 %	93 %	10.2 %

(1) Does not include principal payments receivable of $1.2 million and $1.9 million at June 30, 2018 and December 31, 2017, respectively.
(2) Weighted average is based on MBS current face at June 30, 2018 and December 31, 2017, respectively.
(3) Low Loan Balance represents MBS collateralized by mortgages with an original loan balance less than or equal to $175,000. HARP MBS are backed by refinanced loans with LTVs greater than or equal to 80% at origination.

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The following table presents certain information regarding our Hybrid Agency MBS as of June 30, 2018 and December 31, 2017:

June 30, 2018

(Dollars in Thousands)	Current Face	Weighted Average Purchase Price	Weighted Average Market Price	Fair Value (1)	Weighted Average Coupon (2)	Weighted Average Loan Age (Months) (2)	Weighted Average Months to Reset (3)	Interest Only (4)	3 Month Average CPR
Hybrid Post June 2009:									
Agency 5/1	$348,596	104.3 %	104.6 %	$364,593	3.72 %	95	6	22 %	20.3 %
Agency 7/1	386,730	104.4	103.4	399,960	3.02	79	9	26	23.6
Agency 10/1	157,729	104.6	100.5	158,505	3.06	74	45	65	12.8
Total Hybrids Post June 2009	$893,055	104.4 %	103.4 %	$923,058	3.30 %	84	14	31 %	20.4 %
Hybrid Pre June 2009:									
Coupon < 4.5% (5)	$417,633	101.7 %	105.0 %	$438,688	3.67 %	139	5	— %	20.4 %
Coupon >= 4.5% (6)	803	100.8	105.7	849	4.62	133	10	—	0.2
Total Hybrids Pre June 2009	$418,436	101.7 %	105.0 %	$439,537	3.68 %	139	5	— %	20.4 %
Total Hybrids	$1,311,491	103.5 %	103.9 %	$1,362,595	3.42 %	102	11	21 %	20.4 %

December 31, 2017

(Dollars in Thousands)	Current Face	Weighted Average Purchase Price	Weighted Average Market Price	Fair Value (1)	Weighted Average Coupon (2)	Weighted Average Loan Age (Months) (2)	Weighted Average Months to Reset (3)	Interest Only (4)	3 Month Average CPR
Hybrid Post June 2009:									
Agency 5/1	$398,801	104.3 %	104.6 %	$416,978	3.47 %	89	5	27 %	16.7 %
Agency 7/1	456,295	104.4	103.3	471,142	2.94	73	13	25	20.8
Agency 10/1	173,534	104.6	102.1	177,192	3.08	68	51	64	11.8
Total Hybrids Post June 2009	$1,028,630	104.4 %	103.6 %	$1,065,312	3.17 %	78	16	32 %	17.7 %
Hybrid Pre June 2009:									
Coupon < 4.5% (5)	$509,290	101.6 %	104.7 %	$533,183	3.43 %	132	6	19 %	16.1 %
Coupon >= 4.5% (6)	2,511	103.2	104.0	2,612	5.13	119	2	42	1.0
Total Hybrids Pre June 2009	$511,801	101.7 %	104.7 %	$535,795	3.44 %	132	5	19 %	16.0 %
Total Hybrids	$1,540,431	103.5 %	103.9 %	$1,601,107	3.26 %	96	13	28 %	17.1 %

(1) Does not include principal payments receivable of $1.2 million and $1.9 million at June 30, 2018 and December 31, 2017, respectively.

(2) Weighted average is based on MBS current face at June 30, 2018 and December 31, 2017, respectively.

(3) Weighted average months to reset is the number of months remaining before the coupon interest rate resets. At reset, the MBS coupon will adjust based upon the underlying benchmark interest rate index, margin and periodic or lifetime caps. The months to reset do not reflect scheduled amortization or prepayments.

(4)

Interest only represents MBS backed by mortgages currently in their interest-only period. Percentage is based on MBS current face at June 30, 2018 and December 31, 2017, respectively.

(5) Agency 3/1, 5/1, 7/1 and 10/1 Hybrid ARM-MBS with coupon less than 4.5%.

(6) Agency 3/1, 5/1, 7/1 and 10/1 Hybrid ARM-MBS with coupon greater than or equal to 4.5%.

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Non-Agency MBS

The following table presents information with respect to our Non-Agency MBS at June 30, 2018 and December 31, 2017:

(In Thousands)	June 30, 2018	December 31, 2017
Non-Agency MBS		
Face/Par	$3,421,599	$3,718,743
Fair Value	3,242,967	3,533,966
Amortized Cost	2,665,798	2,910,241
Purchase Discount Designated as Credit Reserve and OTTI	(553,596) (1)	(593,227) (2)
Purchase Discount Designated as Accretable	(202,248)	(215,325)
Purchase Premiums	43	50

(1) Includes discount designated as Credit Reserve of $540.7 million and OTTI of $12.9 million.
(2) Includes discount designated as Credit Reserve of $579.0 million and OTTI of $14.2 million.

Purchase Discounts on Non-Agency MBS

The following table presents the changes in the components of purchase discount on Non-Agency MBS with respect to purchase discount designated as Credit Reserve and OTTI, and accretable purchase discount, for the three and six months ended June 30, 2018 and 2017:

	Three Months Ended June 30, 2018		Three Months Ended June 30, 2017	
(In Thousands)	Discount Designated as Credit Reserve and OTTI	Accretable Discount (1)	Discount Designated as Credit Reserve and OTTI	Accretable Discount (1)
Balance at beginning of period	$(572,580)	$(199,659)	$(653,337)	$(269,724)
Impact of RMBS Issuer Settlement (2)	—	(12,089)	—	—
Accretion of discount	—	17,530	—	20,223
Realized credit losses	10,954	—	13,139	—
Purchases	—	—	(484)	(1,520)
Sales	—	—	5,037	2,819
Net impairment losses recognized in earnings	—	—	(618)	—
Transfers/release of credit reserve	8,030	(8,030)	9,765	(9,765)
Balance at end of period	$(553,596)	$(202,248)	$(626,498)	$(257,967)

	Six Months Ended June 30, 2018		Six Months Ended June 30, 2017	
(In Thousands)	Discount Designated as Credit Reserve and OTTI	Accretable Discount (1)	Discount Designated as Credit Reserve and OTTI	Accretable Discount (1)
Balance at beginning of period	$(593,227)	$(215,325)	$(694,241)	$(278,191)
Impact of RMBS Issuer Settlement (2)	—	(12,089)	—	—

Accretion of discount	—	34,746	—	41,840
Realized credit losses	19,401	—	25,463	—
Purchases	(535)	488	(484)	(1,520)
Sales	5,592	5,105	24,778	(1,078)
Net impairment losses recognized in earnings	—	—	(1,032)	—
Transfers/release of credit reserve	15,173	(15,173)	19,018	(19,018)
Balance at end of period	$(553,596)	$(202,248)	$(626,498)	$(257,967)

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

(2) Includes the impact of approximately $12.1 million of cash proceeds (a one-time payment) received by the Company during the three months ended June 30, 2018 in connection with the settlement of litigation related to certain residential mortgage backed securitization trusts that were sponsored by JP Morgan Chase & Co. and affiliated entities.

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The following table presents information with respect to the yield components of our Non-Agency MBS for the three months ended June 30, 2018 and 2017:

	Three Months Ended June 30, 2018		Three Months Ended June 30, 2017	
	Legacy Non-Agency MBS	RPL/NPL MBS	Legacy Non-Agency MBS	RPL/NPL MBS
Non-Agency MBS				
Coupon Yield (1)	6.09%	4.49 %	5.52%	4.03 %
Effective Yield Adjustment (2)	3.80	0.03	3.33	0.15
Net Yield	9.89%	4.52 %	8.85%	4.18 %

(1) Reflects the annualized coupon interest income divided by the average amortized cost. The discounted purchase price on Legacy Non-Agency MBS causes the coupon yield to be higher than the pass-through coupon interest rate.

(2) The effective yield adjustment is the difference between the net yield, calculated utilizing management's estimates of timing and amount of future cash flows for Legacy Non-Agency MBS and RPL/NPL MBS, less the current coupon yield.

Actual maturities of MBS are generally shorter than stated contractual maturities because actual maturities of MBS are affected by the contractual lives of the underlying mortgage loans, periodic payments of principal and prepayments of principal. The following table presents certain information regarding the amortized costs, weighted average yields and contractual maturities of our MBS at June 30, 2018 and does not reflect the effect of prepayments or scheduled principal amortization on our MBS:

	Within One Year		One to Five Years		Five to Ten Years		Over Ten Years		Total MBS		
(Dollars in Thousands)	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Total Amortized Cost	Total Fair Value	Weighted Average Yield
Agency MBS:											
Fannie Mae	$—	—%	$52	2.16%	$564,832	2.04%	$1,381,706	2.00%	$1,946,590	$1,928,719	2.01%
Freddie Mac	—	—	—	—	405,668	1.87	40,692	3.05	446,360	428,465	1.98
Ginnie Mae	—	—	—	—	93	3.32	5,565	2.72	5,658	5,713	2.73
Total Agency MBS	$—	—%	$52	2.16%	$970,593	1.97%	$1,427,963	2.03%	$2,398,608	$2,362,897	2.01%
Non-Agency MBS	$—	—%	$234,479	4.23%	$2,642	3.95%	$2,428,677	8.67%	$2,665,798	$3,242,967	8.27%
Total MBS	$—	—%	$234,531	4.23%	$973,235	1.98%	$3,856,640	6.21%	$5,064,406	$5,605,864	5.30%

CRT Securities

At June 30, 2018, our total investment in CRT securities was $572.0 million, with a net unrealized gain of $43.3 million, a weighted average yield of 6.35% and a weighted average time to maturity of 9.2 years. At December 31, 2017, our total investment in CRT securities was $664.4 million, with a net unrealized gain of $56.3 million, a weighted average yield of 6.02% and weighted average time to maturity of 9.2 years.

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Residential Whole Loans

The following table presents the contractual maturities of our residential whole loans held by consolidated trusts and certain entities established in connection with our loan securitization transactions at June 30, 2018 and does not reflect estimates of prepayments or scheduled amortization. For purchased credit impaired loans held at carrying value, amounts presented are estimated based on the underlying loan contractual amounts.

(In Thousands)	Purchased Credit Impaired Loans, at Carrying Value (1)	Other Loans, at Carrying Value (1)	Residential Whole Loans, at Fair Value (1)
Amount due:			
Within one year	$1,117	$126,218	$9,933
After one year:			
Over one to five years	4,507	36,522	9,602
Over five years	741,611	523,798	1,449,005
Total due after one year	$746,118	$560,320	$1,458,607
Total residential whole loans	$747,235	$686,538	$1,468,540

(1) Excludes approximately $57.6 million of purchased credit impaired loans held at carrying value, $414.9 million of other loans held at carrying value and $34.4 million of residential whole loans held at fair value for which the closing of the purchase transaction had not occurred as of June 30, 2018.

The following table presents, at June 30, 2018, the dollar amount of certain of our residential whole loans contractually maturing after one year, and indicates whether the loans have fixed interest rates or adjustable interest rates:

(In Thousands)	Other Loans, at Carrying Value (1)(2)	Residential Whole Loans, at Fair Value (1)(2)
Interest rates:		
Fixed	$117,410	$822,319
Adjustable	442,910	636,288
Total	$560,320	$1,458,607

(1) Includes loans on which borrowers have defaulted and are not making payments of principal and/or interest as of June 30, 2018.
(2) Excludes approximately $414.9 million of other loans held at carrying value and $34.4 million of residential whole loans held at fair value for which the closing of the purchase transaction had not occurred as of June 30, 2018.

Information is not presented for purchased credit impaired loans held at carrying value as income is recognized based on pools of assets with similar risk characteristics using an estimated yield based on cash flows expected to be collected over the lives of the loans in such pools rather than on the contractual coupons of the underlying loans.

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Exposure to Financial Counterparties

We finance a significant portion of our residential mortgage assets with repurchase agreements and other advances. In connection with these financing arrangements, we pledge our assets as collateral to secure the borrowing. The amount of collateral pledged will typically exceed the amount of the financing with the extent of over-collateralization ranging from 1% to 5% of the amount borrowed for U.S. Treasury and Agency MBS collateral, up to 35% for Non-Agency MBS and residential whole loan collateral, and up to 30% for MSR related asset collateral. Consequently, while repurchase agreement financing results in our recording a liability to the counterparty in our consolidated balance sheets, we are exposed to the counterparty, if during the term of the repurchase agreement financing, a lender should default on its obligation and we are not able to recover our pledged assets. The amount of this exposure is the difference between the amount loaned to us plus interest due to the counterparty and the fair value of the collateral pledged by us to the lender including accrued interest receivable on such collateral.

The table below summarizes our exposure to our counterparties at June 30, 2018, by country:

Country	Number of Counterparties	Repurchase Agreement Financing	Exposure (1)	Exposure as a Percentage of MFA Total Assets	
(Dollars in Thousands)					
European Countries: (2)					
Switzerland (3)	3	$659,064	$238,448	2.24	%
France	2	569,770	129,870	1.22	
United Kingdom	2	473,688	130,040	1.22	
Holland	1	103,978	6,197	0.06	
Total European	8	1,806,500	504,555	4.74	%
Other Countries:					
United States	11	$2,927,215	$690,166	6.48	%
Canada (4)	2	598,191	174,055	1.64	
Japan (5)	3	334,535	27,465	0.26	
China (5)	1	308,754	13,012	0.12	
South Korea	1	167,086	11,899	0.11	
Total Other	18	4,335,781	916,597	8.61	%
Total	26	$6,142,281 (6)	$1,421,152	13.35	%

(1) Represents for each counterparty the amount of cash and/or securities pledged as collateral less the aggregate of repurchase agreement financing and net interest receivable/payable on all such instruments.
(2) Includes European-based counterparties as well as U.S.-domiciled subsidiaries of the European parent entity.
(3) Includes London branch of one counterparty and Cayman Islands branch of the other counterparty.
(4) Includes Canada-based counterparties as well as U.S.-domiciled subsidiaries of Canadian parent entities. In the case of one counterparty, also includes exposure of $167.3 million to a Barbados-based affiliate of the Canadian parent entity.
(5) Exposure is to U.S.-domiciled subsidiary of the Japanese or Chinese parent entity, as the case may be.
(6) Includes $250.0 million of repurchase agreements entered into in connection with contemporaneous repurchase and reverse repurchase agreements with a single counterparty.

At June 30, 2018, we did not use credit default swaps or other forms of credit protection to hedge the exposures summarized in the table above.

Uncertainty in the global financial market and weak economic conditions in Europe, including as a result of the United Kingdom's recent vote to leave the European Union (commonly known as "Brexit"), could potentially impact our major European financial counterparties, with the possibility that this would also impact the operations of their U.S. domiciled subsidiaries. This could adversely affect our financing and operations as well as those of the entire mortgage sector in general. Management monitors our exposure to our repurchase agreement counterparties on a regular basis, using various methods, including review of recent rating agency actions or other developments and by monitoring the amount of cash and securities collateral pledged and the associated loan amount under repurchase agreements with our counterparties. We intend to make reverse margin calls on our counterparties to recover excess collateral as permitted by the agreements governing our financing arrangements, or take other necessary actions to reduce the amount of our exposure to a counterparty when such actions are considered necessary.

Tax Considerations

Current period estimated taxable income

We estimate that for the six months ended June 30, 2018, our taxable income was approximately $157.9 million. Based on dividends paid or declared during the six months ended June 30, 2018, we have undistributed taxable income of approximately $45.4 million, or $0.11 per share. We have until the filing of our 2018 tax return (due not later than October 15, 2019) to declare the distribution of any 2018 REIT taxable income not previously distributed.

Key differences between GAAP net income and REIT Taxable Income for Non-Agency MBS and Residential Whole Loans

Our total Non-Agency MBS portfolio for tax differs from our portfolio reported for GAAP primarily due to the fact that for tax purposes: (i) certain of the MBS contributed to the VIEs used to facilitate MBS resecuritization transactions were deemed to be sold; and (ii) the tax basis of underlying MBS considered to be reacquired in connection with the unwind of such transactions becomes the fair value of such securities at the time of the unwind. For GAAP reporting purposes the underlying MBS that were included in these MBS resecuritization transactions were not considered to be sold. Similarly, for tax purposes the residential whole loans contributed to the VIE used to facilitate our second quarter 2017 loan securitization transaction were deemed to be sold for tax purposes, but not for GAAP reporting purposes. In addition, for our Non-Agency MBS and residential whole loan tax portfolios, potential timing differences arise with respect to the accretion of market discount into income and recognition of realized losses for tax purposes as compared to GAAP. Consequently, our REIT taxable income calculated in a given period may differ significantly from our GAAP net income.

The determination of taxable income attributable to Non-Agency MBS and residential whole loans is dependent on a number of factors, including principal payments, defaults, loss mitigation efforts and loss severities. In estimating taxable income for Non-Agency MBS and residential whole loans during the year, management considers estimates of the amount of discount expected to be accreted. Such estimates require significant judgment and actual results may differ from these estimates. Moreover, the deductibility of realized losses from Non-Agency MBS and residential whole loans and their effect on market discount accretion are analyzed on an asset-by-asset basis and, while they will result in a reduction of taxable income, this reduction tends to occur gradually and primarily for Non-Agency MBS in periods after the realized losses are reported. In addition, for MBS resecuritization transactions that were treated as a sale of the underlying MBS for tax purposes, taxable gain or loss, if any, resulting from the unwind of such transactions is not recognized in GAAP net income.

Securitization transactions result in differences between GAAP net income and REIT Taxable Income

For tax purposes, depending on the transaction structure, a securitization and/or resecuritization transaction may be treated either as a sale or a financing of the underlying collateral. Income recognized from securitization and resecuritization transactions will differ for tax and GAAP purposes. For tax purposes, we own and may in the future acquire interests in securitization and/or resecuritization trusts, in which several of the classes of securities are or will be issued with original issue discount (or OID). As the holder of the retained interests in the trust, we generally will be required to include OID in our current gross interest income over the term of the applicable securities as the OID accrues. The rate at which the OID is recognized into taxable income is calculated using a constant rate of yield to maturity, with realized losses impacting the amount of OID recognized in REIT taxable income once they are actually incurred. Under the Tax Cuts and Jobs Act (or TCJA), the timing of REIT taxable income may be affected by when we include such income for financial accounting purposes. For tax purposes, REIT taxable income may be recognized in excess of economic income (i.e., OID) or in advance of the corresponding cash flow from these assets, thereby affecting our dividend distribution requirement to stockholders. In addition, for securitization and/or resecuritization transactions that were treated as a sale of the underlying collateral for tax purposes, the unwind of any such transaction will likely result in a taxable gain or loss that is likely not recognized in GAAP net income since securitization and resecuritization transactions are typically accounted for as financing transactions for GAAP purposes. The tax basis of underlying residential whole loans or MBS re-acquired in connection with the unwind of such transactions becomes the fair market value of such assets at the time of the unwind.

Regulatory Developments

The U.S. Congress, Board of Governors of the Federal Reserve System, U.S. Treasury, Federal Deposit Insurance Corporation, SEC and other governmental and regulatory bodies have taken and continue to consider additional actions in response to the 2007-2008 financial crisis. In particular, the Dodd-Frank Wall Street Reform and Consumer Protection Act (or the Dodd-Frank Act) created a new regulator, an independent bureau housed within the Federal Reserve System, and known as the Consumer Financial Protection Bureau (or the CFPB). The CFPB has broad authority over a wide range of consumer financial products and services, including mortgage lending and servicing. One portion of the Dodd-Frank Act, the Mortgage Reform and Anti-Predatory

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Lending Act (or Mortgage Reform Act), contains underwriting and servicing standards for the mortgage industry, restrictions on compensation for mortgage loan originators, and various other requirements related to mortgage origination. In addition, the Dodd-Frank Act grants enforcement authority and broad discretionary regulatory authority to the CFPB to prohibit or condition terms, acts or practices relating to residential mortgage loans that the CFPB finds abusive, unfair, deceptive or predatory, as well as to take other actions that the CFPB finds are necessary or proper to ensure responsible affordable mortgage credit remains available to consumers. The Dodd-Frank Act also affects the securitization of mortgages (and other assets) with requirements for risk retention by securitizers and requirements for regulating rating agencies.

The Dodd-Frank Act requires that numerous regulations be issued, many of which (including those mentioned above regarding servicing, underwriting and mortgage loan originator compensation) have only recently been implemented and operationalized. As a result, we are unable to fully predict at this time how the Dodd-Frank Act, as well as other laws or regulations that may be adopted in the future, will affect our business, results of operations and financial condition, or the environment for repurchase financing and other forms of borrowing, the investing environment for Agency MBS, Non-Agency MBS and/or residential mortgage loans, the securitization industry, Swaps and other derivatives. However, at a minimum, we believe that the Dodd-Frank Act and the regulations promulgated thereunder are likely to continue to increase the economic and compliance costs for participants in the mortgage and securitization industries, including us.

In addition to the regulatory actions being implemented under the Dodd-Frank Act, on August 31, 2011, the SEC issued a concept release under which it is reviewing interpretive issues related to Section 3(c)(5)(C) of the Investment Company Act. Section 3(c)(5)(C) excludes from the definition of “investment company” entities that are primarily engaged in, among other things, “purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.” Many companies that engage in the business of acquiring mortgages and mortgage-related instruments seek to rely on existing interpretations of the SEC Staff with respect to Section 3(c)(5)(C) so as not to be deemed an investment company for the purpose of regulation under the Investment Company Act. In connection with the concept release, the SEC requested comments on, among other things, whether it should reconsider its existing interpretation of Section 3(c)(5)(C). To date the SEC has not taken or otherwise announced any further action in connection with the concept release.

The FHFA and both houses of Congress have discussed and considered separate measures intended to restructure the U.S. housing finance system and the operations of Fannie Mae and Freddie Mac. Congress may continue to consider legislation that would significantly reform the country’s mortgage finance system, including, among other things, eliminating Freddie Mac and Fannie Mae and replacing them with a single new MBS insurance agency. Many details remain unsettled, including the scope and costs of the agencies’ guarantee and their affordable housing mission, some of which could be addressed even in the absence of large-scale reform. While the likelihood of enactment of major mortgage finance system reform in the short term remains uncertain, it is possible that the adoption of any such reforms could adversely affect the types of assets we can buy, the costs of these assets and our business operations. As the FHFA and both houses of Congress continue to consider various measures intended to dramatically restructure the U.S. housing finance system and the operations of Fannie Mae and Freddie Mac, we expect debate and discussion on the topic to continue throughout 2018. In June 2018, the Trump Administration proposed a plan that would end the conservatorship of Fannie Mae and Freddie Mac and privatize the GSEs. However, we cannot be certain if any housing and/or mortgage-related legislation will emerge from committee, or be approved by Congress, and if so, what the effect would be on our business.

Additional Material U.S. Federal Income Tax Considerations

The following is a summary of certain additional material federal income tax considerations with respect to the ownership of our stock. This summary supplements and should be read together with “Material U.S. Federal Income

Tax Considerations” in the prospectus dated November 16, 2016 and filed as part of our registration statement on Form S-3 (No. 333-214659).

Taxation of Foreign Owners

Foreign Owners that are “qualified shareholders” or “qualified foreign pension funds” may be eligible for additional exemptions from Foreign Investment in Real Property Tax Act of 1980 (or FIRPTA) withholding. REIT distributions that are exempt from FIRPTA withholding may still be subject to regular U.S. withholding tax.

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Results of Operations

Quarter Ended June 30, 2018 Compared to the Quarter Ended June 30, 2017

General

For the second quarter of 2018, we had net income available to our common stock and participating securities of $66.6 million, or $0.17 per basic and diluted common share, compared to net income available to common stock and participating securities of $76.2 million, or $0.20 per basic and diluted common share, for the second quarter of 2017. The decrease in net income available to common stock and participating securities and the decrease of this item on a per share basis primarily reflects a decrease in our net interest income on our MBS portfolio, lower unrealized gains on CRT securities accounted for at fair value partially offset by an increase in net interest income on our residential whole loans held at carrying value and higher net gains realized on residential whole loans held at fair value.

Net Interest Income

Net interest income represents the difference between income on interest-earning assets and expense on interest-bearing liabilities. Net interest income depends primarily upon the volume of interest-earning assets and interest-bearing liabilities and the corresponding interest rates earned or paid. Our net interest income varies primarily as a result of changes in interest rates, the slope of the yield curve (i.e., the differential between long-term and short-term interest rates), borrowing costs (i.e., our interest expense) and prepayment speeds on our MBS. Interest rates and CPRs (which measure the amount of unscheduled principal prepayment on a bond as a percentage of the bond balance) vary according to the type of investment, conditions in the financial markets, and other factors, none of which can be predicted with any certainty.

The changes in average interest-earning assets and average interest-bearing liabilities and their related yields and costs are discussed in greater detail below under “Interest Income” and “Interest Expense.”

For the second quarter of 2018, our net interest spread and margin were 2.30% and 2.66%, respectively, compared to a net interest spread and margin of 2.10% and 2.58%, respectively, for the second quarter of 2017. Our net interest income decreased by $11.2 million, or 18.3%, to $49.9 million for the second quarter of 2018, from $61.1 million for the second quarter of 2017. Current quarter net interest income from Agency MBS and Non-Agency MBS declined compared to the second quarter of 2017 by approximately $12.3 million, primarily due to lower average amounts invested in these securities and higher funding costs, partially offset by higher yields earned on these securities. These decreases were partially offset by higher net interest income on residential whole loans at carrying value of approximately $7.4 million compared to the second quarter of 2017, primarily due to the higher average balance invested in these assets. In addition, net interest income also includes $10.5 million of interest expense associated with residential whole loans at fair value, reflecting a $6.1 million increase in borrowing costs related to these investments compared to the second quarter of 2017. Coupon interest income received from residential whole loans at fair value is presented as a component of the total income earned on these investments and therefore is included in Other Income, net rather than net interest income.

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Analysis of Net Interest Income

The following table sets forth certain information about the average balances of our assets and liabilities and their related yields and costs for the three months ended June 30, 2018 and 2017. Average yields are derived by dividing annualized interest income by the average amortized cost of the related assets, and average costs are derived by dividing annualized interest expense by the daily average balance of the related liabilities, for the periods shown. The yields and costs include premium amortization and purchase discount accretion which are considered adjustments to interest rates.

	Three Months Ended June 30,							
	2018				2017			
(Dollars in Thousands)	Average Balance	Interest	Average Yield/Cost		Average Balance	Interest	Average Yield/Cost	
Assets:								
Interest-earning assets:								
Agency MBS (1)	$2,596,721	$13,170	2.03	%	$3,384,724	$16,587	1.96	%
Legacy Non-Agency MBS (1)	1,836,651	45,393	9.89		2,351,663	52,030	8.85	
RPL/NPL MBS (1)	853,950	9,650	4.52		1,745,794	18,239	4.18	
Total MBS	5,287,322	68,213	5.16		7,482,181	86,856	4.64	
CRT securities (1)	548,373	8,695	6.34		525,164	7,846	5.98	
MSR related assets (1)	361,829	6,219	6.88		377,164	5,905	6.26	
Residential whole loans, at carrying value (2)	1,228,129	17,935	5.84		568,080	8,503	5.99	
Cash and cash equivalents (3)	182,772	685	1.50		609,353	1,047	0.69	
Total interest-earning assets	7,608,425	101,747	5.35		9,561,942	110,157	4.61	
Total non-interest-earning assets (2)	2,723,523				2,021,401			
Total assets	$10,331,948				$11,583,343			
Liabilities and stockholders’ equity:								
Interest-bearing liabilities:								
Total repurchase agreements (4)	$6,189,916	$46,234	2.95	%	$7,612,393	$46,802	2.43	%
Securitized debt	432,283	3,565	3.26		30,414	211	2.74	
Senior Notes	96,787	2,011	8.31		96,746	2,009	8.31	
Total interest-bearing liabilities	6,718,986	51,810	3.05		7,739,553	49,022	2.51	
Total non-interest-bearing liabilities	390,708				648,231			
Total liabilities	7,109,694				8,387,784			
Stockholders’ equity	3,222,254				3,195,559			
Total liabilities and stockholders’ equity	$10,331,948				$11,583,343			
Net interest income/net interest rate spread (5)		$49,937	2.30	%		$61,135	2.10	%
Net interest-earning assets/net interest margin (6)	$889,439		2.66	%	$1,822,389		2.58	%
Ratio of interest-earning assets to interest-bearing liabilities	1.13 x				1.24 x			

(1) Yields presented throughout this Quarterly Report on Form 10-Q are calculated using average amortized cost data for securities which excludes unrealized gains and losses and includes principal payments receivable on securities. For GAAP reporting purposes, purchases and sales are reported on the trade date. Average amortized cost data used to determine yields is calculated based on the settlement date of the associated purchase or sale as interest

income is not earned on purchased assets and continues to be earned on sold assets until settlement date.

(2) Excludes residential whole loans held at fair value that are reported as a component of total non-interest-earning assets.

(3) Includes average interest-earning cash, cash equivalents and restricted cash.

(4) Average cost of repurchase agreements includes the cost of Swaps allocated based on the proportionate share of the overall estimated weighted average portfolio duration.

(5) Net interest rate spread reflects the difference between the yield on average interest-earning assets and average cost of funds.

(6) Net interest margin reflects annualized net interest income divided by average interest-earning assets.

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Rate/Volume Analysis

The following table presents the extent to which changes in interest rates (yield/cost) and changes in the volume (average balance) of interest-earning assets and interest-bearing liabilities have affected our interest income and interest expense during the periods indicated. Information is provided in each category with respect to: (i) the changes attributable to changes in volume (changes in average balance multiplied by prior rate); (ii) the changes attributable to changes in rate (changes in rate multiplied by prior average balance); and (iii) the net change. The changes attributable to the combined impact of volume and rate have been allocated proportionately, based on absolute values, to the changes due to rate and volume.

	Three Months Ended June 30, 2018 Compared to Three Months Ended June 30, 2017		
	Increase/(Decrease) due to		Total Net Change in Interest Income/Expense
(In Thousands)	Volume	Rate	
Interest-earning assets:			
Agency MBS	$(3,988)	$571	$ (3,417)
Legacy Non-Agency MBS	(12,278)	5,641	(6,637)
RPL/NPL MBS	(9,973)	1,384	(8,589)
CRT securities	356	493	849
MSR related assets	(247)	561	314
Residential whole loans, at carrying value (1)	9,644	(212)	9,432
Cash and cash equivalents	(1,055)	693	(362)
Total net change in income from interest-earning assets	$(17,541)	$9,131	$ (8,410)
Interest-bearing liabilities:			
Agency repurchase agreements	$(3,328)	$3,070	$ (258)
Legacy Non-Agency repurchase agreements	(1,984)	101	(1,883)
RPL/NPL MBS repurchase agreements	(6,261)	2,016	(4,245)
CRT securities repurchase agreements	264	600	864
MSR related assets repurchase agreements	189	40	229
Residential whole loans at carrying value repurchase agreements	321	655	976
Residential whole loans at fair value repurchase agreements	2,960	789	3,749
Securitized debt	3,307	47	3,354
Senior Notes	2	—	2
Total net change in expense of interest-bearing liabilities	$(4,530)	$7,318	$ 2,788
Net change in net interest income	$(13,011)	$1,813	$ (11,198)

(1) Excludes residential whole loans held at fair value which are reported as a component of non-interest-earning assets.

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The following table presents certain quarterly information regarding our net interest spread and net interest margin for the quarterly periods presented:

	Total Interest-Earning Assets and Interest-Bearing Liabilities	
Quarter Ended	Net Interest Spread (1)	Net Interest Margin (2)
June 30, 2018	2.30 %	2.66 %
March 31, 2018	2.25	2.64
December 31, 2017	2.08	2.54
September 30, 2017	2.02	2.54
June 30, 2017	2.10	2.58

(1) Reflects the difference between the yield on average interest-earning assets and average cost of funds.
(2) Reflects annualized net interest income divided by average interest-earning assets.

The following table presents the components of the net interest spread earned on our Agency MBS, Legacy Non-Agency MBS and RPL/NPL MBS for the quarterly periods presented:

	Agency MBS			Legacy Non-Agency MBS			RPL/NPL MBS			Total MBS		
Quarter Ended	Net Yield (1)	Cost of Funding (2)	Net Interest Rate Spread (3)	Net Yield (1)	Cost of Funding (2)	Net Interest Rate Spread (3)	Net Yield (1)	Cost of Funding (2)	Net Interest Rate Spread (3)	Net Yield (1)	Cost of Funding (2)	Net Interest Rate Spread (3)
June 30, 2018	2.03 %	2.04 %	(0.01)%	9.89 %	3.30 %	6.59 %	4.52 %	3.19 %	1.33 %	5.16 %	2.64 %	2.52 %
March 31, 2018	2.21	1.91	0.30	9.44	3.29	6.15	4.36	2.94	1.42	5.06	2.53	2.53
December 31, 2017	2.08	1.79	0.29	9.12	3.29	5.83	4.27	2.72	1.55	4.85	2.44	2.41
September 30, 2017	1.97	1.75	0.22	8.93	3.26	5.67	4.43	2.69	1.74	4.74	2.41	2.33
June 30, 2017	1.96	1.57	0.39	8.85	3.28	5.57	4.18	2.46	1.72	4.64	2.27	2.37

(1) Reflects annualized interest income on MBS divided by average amortized cost of MBS.
(2) Reflects annualized interest expense divided by average balance of repurchase agreements, including the cost of Swaps allocated based on the proportionate share of the overall estimated weighted average portfolio duration and securitized debt. Agency MBS cost of funding includes 28, 26, 43, 44 and 49 basis points and Legacy Non-Agency MBS cost of funding includes 31, 30, 45, 45, and 58 basis points associated with Swaps to hedge interest rate sensitivity on these assets for the quarters ended June 30, 2018, March 31, 2018, December 31, 2017, September 30, 2017 and June 30, 2017, respectively.
(3) Reflects the difference between the net yield on average MBS and average cost of funds on MBS.

Interest Income

Interest income on our Agency MBS for the second quarter of 2018 decreased by $3.4 million, or 20.6%, to $13.2 million from $16.6 million for the second quarter of 2017. This decrease primarily reflects a $788.0 million decrease in the average amortized cost of our Agency MBS portfolio to $2.6 billion for the second quarter of 2018 from $3.4 billion for the second quarter of 2017 partially offset by an increase in the net yield on our Agency MBS to 2.03% for the second quarter of 2018 from 1.96% for the second quarter of 2017. At the end of the second quarter of 2018, the average coupon on mortgages underlying our Agency MBS was higher compared to the end of the second quarter of 2017, due to upward resets on securities within the portfolio and the impact of the removal from the portfolio of Agency MBS sold during the quarter. In addition, for the second quarter of 2018, our Agency MBS portfolio experienced a 16.2% CPR and we recognized $6.9 million of net premium amortization compared to a CPR of 16.3% and $8.3 million of net premium amortization for the second quarter of 2017. At June 30, 2018, we had net purchase premiums on our Agency MBS of $89.0 million, or 3.9% of current par value, compared to net purchase premiums of $104.0 million, or 3.8% of par value, at December 31, 2017.

Interest income on our Non-Agency MBS decreased $15.2 million, or 21.7%, for the second quarter of 2018 to $55.0 million compared to $70.3 million for the second quarter of 2017. This decrease is primarily due to the decrease in the average amortized cost of our Non-Agency MBS portfolio of $1.4 billion, or 34.3%, to $2.7 billion for the second quarter of 2018 from $4.1 billion for the second quarter of 2017. This decrease more than offset the impact of the higher yields generated on our Legacy Non-

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Agency MBS portfolio, which were 9.89% for the second quarter of 2018 compared to 8.85% for the second quarter of 2017. The increase in the net yield on our Legacy Non-Agency MBS portfolio reflects the improved performance of loans underlying the Legacy Non-Agency MBS portfolio, which has resulted in credit reserve releases and changes in interest rates since the second quarter of the prior year and the impact of the cash proceeds received during the second quarter of 2018 in connection with the settlement of litigation related to certain residential mortgage backed securitization trusts that were sponsored by JP Morgan Chase & Co. and affiliated entities. Our RPL/NPL MBS portfolio yielded 4.52% for the second quarter of 2018 compared to 4.18% for the second quarter of 2017. The increase in the net yield reflects an increase in the average coupon yield to 4.49% for the second quarter of 2018 from 4.03% for the second quarter of 2017.

During the second quarter of 2018, we recognized net purchase discount accretion of $17.5 million on our Non-Agency MBS, compared to $20.2 million for the second quarter of 2017. At June 30, 2018, we had net purchase discounts of $754.0 million, including Credit Reserve and previously recognized OTTI of $553.6 million, on our Legacy Non-Agency MBS, or 30.0% of par value. During the second quarter of 2018 we reallocated $8.0 million of purchase discount designated as Credit Reserve to accretable purchase discount.

The following table presents the coupon yield and net yields earned on our Agency MBS, Legacy Non-Agency MBS and RPL/NPL MBS and weighted average CPRs experienced for such MBS for the quarterly periods presented:

	Agency MBS			Legacy Non-Agency MBS			RPL/NPL MBS		
Quarter Ended	Coupon Yield (1)	Net Yield (2)	3 Month Average CPR (3)	Coupon Yield (1)	Net Yield (2)	3 Month Average CPR (3)	Coupon Yield (1)	Net Yield (2)	3 Month Average Bond CPR (4)
June 30, 2018	3.09%	2.03 %	16.2 %	6.09%	9.89 %	15.8 %	4.49%	4.52 %	20.4 %
March 31, 2018	3.02	2.21	12.7	5.91	9.44	14.9	4.35	4.36	14.0
December 31, 2017	3.00	2.08	14.1	5.82	9.12	16.3	4.24	4.27	20.1
September 30, 2017	2.98	1.97	16.2	5.63	8.93	18.7	4.24	4.43	26.2
June 30, 2017	2.94	1.96	16.3	5.52	8.85	18.2	4.03	4.18	36.2

(1) Reflects the annualized coupon interest income divided by the average amortized cost. The discounted purchase price on Legacy Non-Agency MBS causes the coupon yield to be higher than the pass-through coupon interest rate.
(2) Reflects annualized interest income on MBS divided by average amortized cost of MBS.
(3) 3 month average CPR weighted by positions as of the beginning of each month in the quarter.
(4) All principal payments are considered to be prepayments for CPR purposes.

Interest income on our residential whole loans held at carrying value increased by $9.4 million, or 110.9%, for the second quarter of 2018, to $17.9 million compared to $8.5 million for the second quarter of 2017. This increase primarily reflects a $660.0 million increase in the average balance of this portfolio to $1.2 billion for the second quarter of 2018 from $568.1 million for the second quarter of 2017 partially offset by a decrease in the yield (net of servicing costs) to 5.84% for the second quarter of 2018 from 5.99% for the second quarter of 2017.

Interest Expense

Our interest expense for the second quarter of 2018 increased by $2.8 million to $51.8 million from $49.0 million for the second quarter of 2017. This increase primarily reflects an increase in financing rates on our repurchase agreement financings, and an increase in our average borrowings and securitized debt to finance residential whole loans, CRT securities and MSR related assets, which was partially offset by a decrease in our average repurchase agreement borrowings to finance our MBS portfolio. The effective interest rate paid on our borrowings increased to

3.05% for the quarter ended June 30, 2018 from 2.51% for the quarter ended June 30, 2017.

At June 30, 2018, we had repurchase agreement borrowings of $5.9 billion, of which $2.6 billion was hedged with Swaps. At June 30, 2018, our Swaps designated in hedging relationships had a weighted average fixed-pay rate of 2.07% and extended 22 months on average with a maximum remaining term of approximately 62 months.

Payments made and/or received on our Swaps are a component of our borrowing costs and accounted for interest expense of $808,000, or 28 basis points, for the second quarter of 2018, as compared to interest expense of $6.5 million, or 33 basis points, for the second quarter of 2017. The weighted average fixed-pay rate on our Swaps designated as hedges increased to 2.05% for the quarter ended June 30, 2018 from 1.98% for the quarter ended and June 30, 2017. The weighted average variable interest rate

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received on our Swaps designated as hedges increased to 1.92% for the quarter ended June 30, 2018 from 1.01% for the quarter ended June 30, 2017.

We expect that our interest expense and funding costs for the remainder of 2018 will be impacted by market interest rates, the amount of our borrowings and incremental hedging activity, existing and future interest rates on our hedging instruments and the extent to which we execute additional longer-term structured financing transactions. As a result of these variables, our borrowing costs cannot be predicted with any certainty. (See Notes 5(c), 6 and 14 to the accompanying consolidated financial statements, included under Item 1 of this Quarterly Report on Form 10-Q.)

OTTI

We did not recognize any OTTI charges through earnings during the second quarter of 2018. During the second quarter of 2017, we recognized OTTI charges through earnings against certain of our Non-Agency MBS of $618,000. These impairment charges reflected changes in our estimated cash flows for such securities based on an updated assessment of the estimated future performance of the underlying collateral, including the expected principal loss over the term of the securities and changes in the expected timing of receipt of cash flows. At June 30, 2018, we had 473 Agency MBS with a gross unrealized loss of $54.6 million and 26 Non-Agency MBS with a gross unrealized loss of $1.3 million. Impairments on Agency MBS in an unrealized loss position at June 30, 2018 are considered temporary and not credit related. Unrealized losses on Non-Agency MBS for which no OTTI was recorded during the quarter are considered temporary based on an assessment of changes in the expected cash flows for such securities, which considers recent bond performance and expected future performance of the underlying collateral. Significant judgment is used both in our analysis of expected cash flows for our Legacy Non-Agency MBS and any determination of the credit component of OTTI.

Other Income, net

For the second quarter of 2018, Other Income, net increased by $4.1 million, or 11.0%, to $41.0 million compared to $36.9 million for the second quarter of 2017. Other Income, net for the second quarter of 2018 primarily reflects a $32.4 million net gain recorded on residential whole loans held at fair value and $7.4 million of net gains realized on the sale of $179.3 million of investment securities. In addition, Other Income, net for the second quarter of 2018 reflects $1.4 million of net losses on REO, $2.4 million of unrealized losses on CRT securities accounted for at fair value partially offset by $4.3 million of gains on liquidations of purchased credit impaired loans and other loan income. Other Income, net for the second quarter of 2017 primarily reflects a $16.2 million net gain recorded on residential whole loans held at fair value, $13.8 million of unrealized gains on CRT securities accounted for at fair value and $5.9 million of net gains realized on the sale of $16.9 million of Non-Agency MBS and U.S. Treasury securities.

Operating and Other Expense

For the second quarter of 2018, we had compensation and benefits and other general and administrative expenses of $12.6 million, or 1.57% of average equity, compared to $13.3 million, or 1.67% of average equity, for the second quarter of 2017. Compensation and benefits expense decreased by approximately $535,000 to $7.0 million for the second quarter of 2018, compared to $7.6 million for the second quarter of 2017, which primarily reflects lower incentive compensation accruals. Our other general and administrative expenses decreased by $172,000 to $5.6 million for the quarter ended June 30, 2018 compared to $5.8 million for the quarter ended June 30, 2017.

Operating and Other Expense for the second quarter of 2018 also includes $7.9 million of loan servicing and other related operating expenses related to our residential whole loan activities. These expenses increased compared to the prior year period by approximately $3.7 million, or 88.8%, primarily due to higher non-recoverable advances on REO, loan servicing and modification fees and loan acquisition related expenses.

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Selected Financial Ratios

The following table presents information regarding certain of our financial ratios at or for the dates presented:

At or for the Quarter Ended	Return on Average Total Assets (1)	Return on Average Total Stockholders' Equity (2)	Total Average Stockholders' Equity to Total Average Assets (3)	Dividend Payout Ratio (4)	Leverage Multiple (5)	Book Value per Share of Common Stock (6)
June 30, 2018	2.58 %	8.74 %	31.19 %	1.18	2.3	$ 7.54
March 31, 2018	2.93	10.27	29.91	1.00	2.2	7.62
December 31, 2017	3.47	12.29	29.33	0.83	2.3	7.70
September 30, 2017	2.10	7.78	28.60	1.33	2.4	7.70
June 30, 2017	2.63	10.01	27.59	1.00	2.5	7.76

(1) Reflects annualized net income available to common stock and participating securities divided by average total assets.
(2) Reflects annualized net income divided by average total stockholders' equity.
(3) Reflects total average stockholders' equity divided by total average assets.
(4) Reflects dividends declared per share of common stock divided by earnings per share.
(5) Represents the sum of borrowings under repurchase agreements, securitized debt, payable for unsettled purchases, and obligations to return securities obtained as collateral and Senior Notes divided by stockholders' equity.
(6) Reflects total stockholders' equity less the preferred stock liquidation preference divided by total shares of common stock outstanding.

Six Month Period Ended June 30, 2018 Compared to the Six Month Period Ended June 30, 2017

General

For the six months ended June 30, 2018, we had net income available to common stock and participating securities of $146.3 million, or $0.36 per basic and diluted common share, compared to net income available to common stock and participating securities of $150.5 million, or $0.39 per basic and diluted common share, for the six months ended June 30, 2017. The decrease in net income available to common stock and participating securities, and the decrease of this item on a per share basis primarily reflects a decrease in our net interest income on our MBS portfolio, lower unrealized gains on CRT securities accounted for at fair value partially offset by an increase in net interest income on our residential whole loans held at carrying value and higher net gains realized on residential whole loans held at fair value.

Net Interest Income

For the six months ended June 30, 2018, our net interest spread and margin were 2.28% and 2.65%, respectively, compared to a net interest spread and margin of 2.19% and 2.61%, respectively, for the six months ended June 30, 2017. Our net interest income decreased by $24.9 million, or 19.5%, to $103.1 million for the six months ended June 30, 2018, from $128.0 million for the six months ended June 30, 2017. For the six months ended June 30, 2018, net interest income from Agency MBS and Non-Agency MBS declined compared to the six months ended June 30, 2017, by approximately $29.3 million, primarily due to lower average amounts invested in these securities and higher funding costs, partially offset by higher yields earned on these securities. These decreases were partially offset by higher net interest income on residential whole loans at carrying value, MSR related assets and CRT securities of approximately $14.8 million compared to the six months ended June 30, 2017, primarily due to higher average balances invested in these assets. In addition, net interest income for the six months ended June 30, 2018 also includes $19.2 million of interest expense associated with residential whole loans at fair value, reflecting a $10.6 million increase in borrowing costs related to these investments compared to the six months ended June 30, 2017. Coupon interest income received from residential whole loans at fair value is presented as a component of the total income earned on these investments and therefore is included in Other Income, net rather than net interest income.

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Analysis of Net Interest Income

The following table sets forth certain information about the average balances of our assets and liabilities and their related yields and costs for the six months ended June 30, 2018 and 2017. Average yields are derived by dividing annualized interest income by the average amortized cost of the related assets, and average costs are derived by dividing annualized interest expense by the daily average balance of the related liabilities, for the periods shown. The yields and costs include premium amortization and purchase discount accretion which are considered adjustments to interest rates.

	Six Months Ended June 30,							
	2018				2017			
(Dollars in Thousands)	Average Balance	Interest	Average Yield/Cost		Average Balance	Interest	Average Yield/Cost	
Assets:								
Interest-earning assets:								
Agency MBS (1)	$2,684,929	$28,463	2.12	%	$3,499,903	$34,481	1.97	%
Legacy Non-Agency MBS (1)	1,893,093	91,429	9.66		2,436,786	108,136	8.88	
RPL/NPL MBS (1)	888,626	19,716	4.44		2,066,593	41,341	4.00	
Total MBS	5,466,648	139,608	5.11		8,003,282	183,958	4.60	
CRT securities (1)	584,526	18,191	6.22		478,022	14,222	5.95	
MSR related assets (1)	420,078	13,842	6.59		337,397	10,639	6.31	
Residential whole loans, at carrying value (2)	1,108,272	32,264	5.82		576,315	17,193	5.97	
Cash and cash equivalents (3)	253,832	1,594	1.26		467,876	1,402	0.60	
Total interest-earning assets	7,833,356	205,499	5.25		9,862,892	227,414	4.61	
Total non-interest-earning assets (2)	2,759,854				2,065,613			
Total assets	$10,593,210				$11,928,505			
Liabilities and stockholders' equity:								
Interest-bearing liabilities:								
Total repurchase agreements and other advances (4)	6,353,742	91,951	2.88		8,051,184	95,141	2.35	
Securitized debt	395,256	6,392	3.22		15,291	211	2.74	
Senior Notes	96,782	4,021	8.31		96,741	4,019	8.31	
Total interest-bearing liabilities	6,845,780	102,364	2.97		8,163,216	99,371	2.42	
Total non-interest-bearing liabilities	512,881				635,729			
Total liabilities	7,358,661				8,798,945			
Stockholders' equity	3,234,549				3,129,560			
Total liabilities and stockholders' equity	$10,593,210				$11,928,505			
Net interest income/ net interest rate spread (5)		$103,135	2.28	%		$128,043	2.19	%
Net interest-earning assets/ net interest margin (6)	$987,576		2.65	%	$1,699,676		2.61	%
Ratio of interest-earning assets to interest-bearing liabilities	1.14	x			1.21	x		

(1) Yields presented throughout this Quarterly Report on Form 10-Q are calculated using average amortized cost data for securities which excludes unrealized gains and losses and includes principal payments receivable on securities.

For GAAP reporting purposes, purchases and sales are reported on the trade date. Average amortized cost data used to determine yields is calculated based on the settlement date of the associated purchase or sale as interest income is not earned on purchased assets and continues to be earned on sold assets until settlement date.

(2) Excludes residential whole loans held at fair value that are reported as a component of total non-interest-earning assets.

(3) Includes average interest-earning cash, cash equivalents and restricted cash.

(4) Average cost of repurchase agreements includes the cost of Swaps allocated based on the proportionate share of the overall estimated weighted average portfolio duration.

(5) Net interest rate spread reflects the difference between the yield on average interest-earning assets and average cost of funds.

(6) Net interest margin reflects annualized net interest income divided by average interest-earning assets.

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Rate/Volume Analysis

The following table presents the extent to which changes in interest rates (yield/cost) and changes in the volume (average balance) of interest-earning assets and interest-bearing liabilities have affected our interest income and interest expense during the periods indicated. Information is provided in each category with respect to: (i) the changes attributable to changes in volume (changes in average balance multiplied by prior rate); (ii) the changes attributable to changes in rate (changes in rate multiplied by prior average balance); and (iii) the net change. The changes attributable to the combined impact of volume and rate have been allocated proportionately, based on absolute values, to the changes due to rate and volume.

	Six Months Ended June 30, 2018 Compared to Six Months Ended June 30, 2017 Increase/(Decrease) due to		
(In Thousands)	Volume	Rate	Total Net Change in Interest Income/Expense
Interest-earning assets:			
Agency MBS	$(8,487)	$2,469	$ (6,018)
Legacy Non-Agency MBS	(25,660)	8,953	(16,707)
RPL/NPL MBS	(25,743)	4,118	(21,625)
CRT securities	3,290	679	3,969
MSR related assets	2,706	497	3,203
Residential whole loans, at carrying value (1)	15,496	(425)	15,071
Cash and cash equivalents	(848)	1,040	192
Total net change in income from interest-earning assets	$(39,246)	$17,331	$ (21,915)
Interest-bearing liabilities:			
Agency repurchase agreements and other advances	$(6,602)	$6,001	$ (601)
Legacy Non-Agency repurchase agreements	(5,145)	1,319	(3,826)
RPL/NPL MBS repurchase agreements	(15,226)	4,574	(10,652)
CRT securities repurchase agreements	1,239	1,052	2,291
MSR related assets repurchase agreements	1,150	183	1,333
Residential whole loan at carrying value repurchase agreements	447	1,199	1,646
Residential whole loan at fair value repurchase agreements	4,880	1,739	6,619
Securitized debt	6,139	42	6,181
Senior Notes	2	—	2
Total net change in expense of interest-bearing liabilities	$(13,116)	$16,109	$ 2,993
Net change in net interest income	$(26,130)	$1,222	$ (24,908)

(1) Excludes residential whole loans held at fair value which are reported as a component of non-interest-earning assets.

The following table presents the components of the net interest spread earned on our Agency MBS, Legacy Non-Agency MBS and RPL/NPL MBS for the periods presented:

	Agency MBS			Legacy Non-Agency MBS			RPL/NPL MBS			Total MBS		
Six Months Ended	Net Yield	Cost of Funding	Net Interest	Net Yield	Cost of Funding	Net Interest	Net Yield	Cost of Funding	Net Interest	Net Yield	Cost of Funding	Net Interest

	(1)	(2)	Spread (3)	(1)	(2)	Spread (3)	(1)	(2)	Spread (3)	(1)	(2)	Spread (3)
June 30, 2018	2.12%	1.97 %	0.15 %	9.66%	3.29 %	6.37 %	4.44%	3.06 %	1.38 %	5.11%	2.58 %	2.53 %
June 30, 2017	1.97%	1.53 %	0.44 %	8.88%	3.16 %	5.72 %	4.00%	2.35 %	1.65 %	4.60%	2.20 %	2.40 %

(1) Reflects annualized interest income on MBS divided by average amortized cost of MBS.
(2) Reflects annualized interest expense divided by average balance of repurchase agreements and other advances, including the cost of Swaps allocated based on the proportionate share of the overall estimated weighted average portfolio duration, and securitized debt. Agency MBS cost of funding includes 18 and 51 basis points and Legacy Non-Agency MBS cost of funding includes 19 and 54 basis points associated with Swaps to hedge interest rate sensitivity on these assets for the six months ended June 30, 2018 and 2017, respectively.
(3) Reflects the difference between the net yield on average MBS and average cost of funds on MBS.

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Interest Income

Interest income on our Agency MBS for the six months ended June 30, 2018 decreased by $6.0 million, or 17.5%, to $28.5 million from $34.5 million for the six months ended June 30, 2017. This change primarily reflects a $815.0 million decrease in the average amortized cost of our Agency MBS portfolio to $2.7 billion for the six months ended June 30, 2018 from $3.5 billion for the six months ended June 30, 2017 partially offset by an increase in the net yield on our Agency MBS to 2.12% for the six months ended June 30, 2018 from 1.97% for the six months ended June 30, 2017. At the end of the second quarter of 2018, the average coupon on mortgages underlying our Agency MBS was higher compared to the end of the second quarter of 2017. In addition, during the six months ended June 30, 2018, our Agency MBS portfolio experienced a 14.4% CPR and we recognized $12.5 million of net premium amortization compared to a CPR of 13.6% and $16.6 million of net premium amortization for the six months ended June 30, 2017. At June 30, 2018, we had net purchase premiums on our Agency MBS of $89.0 million, or 3.9% of current par value, compared to net purchase premiums of $104.0 million, or 3.8% of par value at December 31, 2017.

Interest income on our Non-Agency MBS decreased by $38.3 million, or 25.6%, for the six months ended June 30, 2018 to $111.1 million compared to $149.5 million for the six months ended June 30, 2017. This decrease is primarily due to the decrease in the average amortized cost of our Non-Agency MBS portfolio of $1.7 billion or 38.2%, to $2.8 billion from $4.5 billion for the six months ended June 30, 2017. This decrease more than offset the impact of the higher yields generated on our Legacy Non-Agency MBS portfolio, which were 9.66% for the six months ended June 30, 2018 compared to 8.88% for the six months ended June 30, 2017. The increase in the net yield on our Legacy Non-Agency MBS portfolio reflects the improved performance of loans underlying the Legacy Non-Agency MBS portfolio, which has resulted in credit reserve releases and changes in interest rates since the second quarter of the prior year and the impact of the cash proceeds received during the six months ended June 30, 2018 in connection with the settlement of litigation related to certain residential mortgage backed securitization trusts that were sponsored by JP Morgan Chase & Co. and affiliated entities. Our RPL/NPL MBS portfolio yielded 4.44% for the six months ended June 30, 2018 compared to 4.00% for the six months ended June 30, 2017. The increase in the net yield reflects an increase in the average coupon yield to 4.42% for the six months ended June 30, 2018 from 3.92% for the six months ended June 30, 2017.

During the six months ended June 30, 2018, we recognized net purchase discount accretion of $34.7 million on our Non-Agency MBS, compared to $41.8 million for the six months ended June 30, 2017. At June 30, 2018, we had net purchase discounts of $754.0 million, including Credit Reserve and previously recognized OTTI of $553.6 million, on our Legacy Non-Agency MBS, or 30.0% of par value. During the six months ended June 30, 2018 we reallocated $15.2 million of purchase discount designated as Credit Reserve to accretable purchase discount.

The following table presents the coupon yield and net yields earned on our Agency MBS, Legacy Non-Agency MBS and RPL/NPL MBS and weighted average CPRs experienced for such MBS for the periods presented:

	Agency MBS			Legacy Non-Agency MBS			RPL/NPL MBS		
Six Months Ended	Coupon Yield (1)	Net Yield (2)	6 Month Average CPR (3)	Coupon Yield (1)	Net Yield (2)	6 Month Average CPR (3)	Coupon Yield (1)	Net Yield (2)	6 Month Average Bond CPR (4)
June 30, 2018	3.05%	2.12 %	14.4 %	6.00%	9.66 %	15.3 %	4.42%	4.44 %	17.2 %
June 30, 2017	2.92	1.97	13.6	5.51	8.88	15.2	3.92	4.00	31.5

(1) Reflects the annualized coupon interest income divided by the average amortized cost. The discounted purchase price on Legacy Non-Agency MBS causes the coupon yield to be higher than the pass-through coupon interest rate.

(2) Reflects annualized interest income on MBS divided by average amortized cost of MBS.
(3) 6 month average CPR weighted by positions as of the beginning of each month in the quarter.
(4) All principal payments are considered to be prepayments for CPR purposes.

Interest income on our residential whole loans held at carrying value increased by $15.1 million, or 87.7%, for the six months ended June 30, 2018 to $32.3 million compared to $17.2 million for the six months ended June 30, 2017. This increase primarily reflects a $532.0 million increase in the average balance of this portfolio to $1.1 billion for the six months ended June 30, 2018 from $576.3 million for the six months ended June 30, 2017 partially offset by a decrease in the yield (net of servicing costs) to 5.82% for the six months ended June 30, 2018 from 5.97% for the six months ended June 30, 2017.

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Interest Expense

Our interest expense for the six months ended June 30, 2018 increased by $3.0 million, or 3.0%, to $102.4 million, from $99.4 million for the six months ended June 30, 2017. This increase primarily reflects an increase in financing rates on our repurchase agreement financings, an increase in our average borrowings and securitized debt to finance residential whole loans, CRT securities and MSR related assets, which was partially offset by a decrease in our average repurchase agreement borrowings and other advances to finance our MBS portfolio. The effective interest rate paid on our borrowings increased to 2.97% for the six months ended June 30, 2018, from 2.42% for the six months ended June 30, 2017.

Payments made and/or received on our Swaps are a component of our borrowing costs and accounted for interest expense of $3.6 million, or 11 basis points, for the six months ended June 30, 2018, compared to interest expense of $14.3 million, or 35 basis points, for the six months ended June 30, 2017. The weighted average fixed-pay rate on our Swaps designated as hedges increased to 2.04% for the six months ended June 30, 2018 from 1.93% for the six months ended June 30, 2017. The weighted average variable interest rate received on our Swaps designated as hedges increased to 1.76% for the six months ended June 30, 2018 from 0.90% for the six months ended June 30, 2017.

We expect that our interest expense and funding costs for the remainder of 2018 will be impacted by market interest rates, the amount of our borrowings and incremental hedging activity, existing and future interest rates on our hedging instruments and the extent to which we execute additional longer-term structured financing transactions. As a result of these variables, our borrowing costs cannot be predicted with any certainty. (See Notes 5(b), 6 and 14 to the accompanying consolidated financial statements, included under Item 1 of this Quarterly Report on Form 10-Q.)

OTTI

We did not recognize any OTTI charges through earnings during the six months ended June 30, 2018. During the six months ended June 30, 2017, we recognized OTTI charges through earnings against certain of our Non-Agency MBS of $1.0 million. These impairment charges reflected changes in our estimated cash flows for such securities based on an updated assessment of the estimated future performance of the underlying collateral, including the expected principal loss over the term of the securities and changes in the expected timing of receipt of cash flows.

Other Income, net

For the six months ended June 30, 2018, Other Income, net increased by $23.7 million, or 36.5%, to $88.7 million compared to $64.9 million for the six months ended June 30, 2017. Other Income, net for the six months ended June 30, 2018 primarily reflects a $70.9 million net gain recorded on residential whole loans held at fair value and $16.2 million of net gains realized on the sale of $198.7 million of investment securities. In addition, Other Income, net for the six months ended June 30, 2018 reflects $2.8 million of net losses on REO, $3.2 million of unrealized losses on CRT securities accounted for at fair value partially offset by $6.8 million of other loan income. Other Income, net for the six months ended June 30, 2017 primarily reflects a net gain of $30.0 million on residential whole loans held at fair value, $19.4 million of unrealized gains on CRT securities accounted for at fair value and $15.6 million of gains realized on the sale of $177.6 million of Non-Agency MBS and U.S. Treasury securities.

Operating and Other Expense

During the six months ended June 30, 2018, we had compensation and benefits and other general and administrative expenses of $23.2 million, or 1.43% of average equity, compared to $25.3 million, or 1.62% of average equity, for the six months ended June 30, 2017. Compensation and benefits expense decreased $1.6 million to $13.8 million for the six months ended June 30, 2018, compared to $15.4 million for the six months ended June 30, 2017, which primarily reflects lower incentive compensation accruals and lower expense recognized in connection with long-term incentive awards. Our other general and administrative expenses decreased by $565,000 to $9.4 million for the six months ended June 30, 2018 compared to $10.0 million for the six months ended June 30, 2017, primarily due to costs associated with loan securitization transaction completed during the prior year period, lower deferred compensation costs to Directors, which were impacted during the current six month period by changes in the Company's stock price, partially offset by an increase in professional services related costs.

Operating and Other Expense during the six months ended June 30, 2018 also includes $14.8 million of loan servicing and other related operating expenses related to our residential whole loan activities. These expenses increased compared to the prior year period by approximately $6.2 million, primarily due to increased loan servicing and modification fees, higher loan acquisition related expenses and increases in non-recoverable advances on REO.

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Selected Financial Ratios

The following table presents information regarding certain of our financial ratios at or for the dates presented:

At or for the Six Months Ended	Return on Average Total Assets (1)	Return on Average Total Stockholders' Equity (2)	Total Average Stockholders' Equity to Total Average Assets (3)	Dividend Payout Ratio (4)	Leverage Multiple (5)	Book Value per Share of Common Stock (6)
June 30, 2018	2.76 %	9.51 %	30.53 %	1.11	2.3	$ 7.54
June 30, 2017	2.52	10.10	26.24	1.03	2.5	7.76

(1) Reflects annualized net income available to common stock and participating securities divided by average total assets.
(2) Reflects annualized net income divided by average total stockholders' equity.
(3) Reflects total average stockholders' equity divided by total average assets.
(4) Reflects dividends declared per share of common stock divided by earnings per share.
(5) Represents the sum of borrowings under repurchase agreements, securitized debt, payable for unsettled purchases, and obligations to return securities obtained as collateral and Senior Notes divided by stockholders' equity.
(6) Reflects total stockholders' equity less the preferred stock liquidation preference divided by total shares of common stock outstanding.

Recent Accounting Standards to Be Adopted in Future Periods

Compensation - Stock Compensation - Improvements to Nonemployee Share-Based Payment Accounting

In June 2018, the FASB issued ASU 2018-07, Improvements to Nonemployee Share-Based Payment Accounting (or ASU 2018-07). The amendments in this ASU simplify the accounting for share-based payments to nonemployees by aligning it with the accounting for share-based payments to employees, with certain exceptions. The amendments in ASU 2018-07 do not change existing guidance on accounting for share-based payment transactions for employees. ASU 2018-07 is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, but no earlier than an entity's adoption of FASB Accounting Standards Codification Topic 606, Revenue from Contracts with Customers. An entity should apply the amendments of this ASU to all new awards granted after the date of adoption. In addition, entities will apply the new guidance to equity-classified nonemployee awards for which a measurement date has not been established and liability-classified nonemployee awards that have not been settled as of date of adoption by recognizing a cumulative-effect adjustment to retained earnings as of the beginning of the annual period of adoption. We are currently evaluating our adoption timing and the effect that ASU 2018-07 will have on our consolidated financial statements and related disclosures, but do not anticipate that adoption of the new standard would have a significant impact.

Derivatives and Hedging - Targeted Improvements to Accounting for Hedging Activities

In August 2017, the FASB issued ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities (or ASU 2017-12). The amendments in this ASU expand an entity's ability to hedge non-financial and financial risk components and reduce complexity in fair value hedges of interest rate risk. The new guidance eliminates the requirement to separately measure and report hedge ineffectiveness and requires the entire change in the fair value of a hedging instrument to be presented in the same income statement line as the hedged item. ASU 2017-12 also simplifies certain documentation and assessment requirements and modifies the accounting for components excluded from the assessment of hedge effectiveness. ASU 2017-12 is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early application is permitted in any interim period or fiscal year before the effective date. An entity should apply the amendments of this ASU to cash flow and net investment hedge relationships that exist on the date of adoption using a modified retrospective approach. The presentation and disclosure requirements of ASU 2017-12 should be applied prospectively. In addition, certain transition elections may be made by an entity upon adoption to allow for existing hedging relationships to transition to the newly allowable alternatives within this ASU. We are currently evaluating our adoption timing and the effect that ASU 2017-12 will have on our consolidated financial statements and related disclosures, but do not anticipate that adoption of the new standard would have a significant impact.

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Financial Instruments - Credit Losses - Measurement of Credit Losses on Financial Instruments

In June 2016, the FASB issued ASU 2016-13, Measurements of Credit Losses on Financial Instruments (or ASU 2016-13). The amendments in ASU 2016-13 require entities to measure all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions and reasonable and supportable forecasts. Entities will now use forward-looking information to better inform their credit loss estimates. ASU 2016-13 also requires enhanced financial statement disclosures to help financial statement users better understand significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an entity's portfolio. Under ASU 2016-13, credit losses for available-for-sale debt securities should be measured in a manner similar to current GAAP. However, the amendments in this ASU require that credit losses be recorded through an allowance for credit losses, which will allow subsequent reversals in credit loss estimates to be recognized in current income. In addition, the allowance on available-for-sale debt securities will be limited to the extent that the fair value is less than the amortized cost.

ASU 2016-13 is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early adoption is permitted for all entities for annual periods beginning after December 15, 2018, and interim periods therein. The amendments in this ASU are required to be applied by recording a cumulative-effect adjustment to equity as of the beginning of the first reporting period in which the guidance is effective. A prospective transition approach is required for debt securities for which an OTTI had been recognized before the effective date. Based on our initial evaluation of the amendments in this ASU, we anticipate being required to make changes to the way we account for credit impairment losses on our available-for-sale debt securities. Under our current accounting, credit impairment losses are generally required to be recorded as OTTI, which directly reduce the carrying amount of impaired securities, and are recorded in earnings and are not reversed if expected cash flows subsequently recover. Under the new guidance, credit impairments on such securities will be recorded as an allowance for credit losses that are also recorded in earnings, but the allowance can be reversed through earnings in a subsequent period if expected cash flows subsequently recover. In addition, we expect that the new guidance will also result in changes to the accounting and presentation of our residential whole loans held at carrying value. We currently anticipate that, upon adoption, the guidance will result in an increase in the gross carrying amount of our residential whole loans at carrying value by the amount of the allowance for loan losses calculated under the new guidance. Thereafter, changes in the expected cash flows of such assets are expected to result in the recognition (or reversal) of an allowance for loan losses that will impact earnings. We will continue to monitor and evaluate the potential effects that ASU 2016-13 will have on our consolidated financial statements and related disclosures.

Leases

In February 2016, the FASB issued ASU 2016-02, Leases (or ASU 2016-02). The amendments in this ASU establish a right-of-use model that requires a lessee to record a right-of-use asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. ASU 2016-02 is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. Our significant lease contracts are discussed in Note 10(a) of the accompanying consolidated financial statements. While we continue to evaluate the potential impact that adoption of ASU 2016-02 will have on our financial reporting, given the relatively limited nature and extent of lease financing transactions that we have entered into, we do not expect that the adoption of ASU 2016-02 will have a significant impact on our financial position or financial statement disclosures.

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Liquidity and Capital Resources

General

Our principal sources of cash generally consist of borrowings under repurchase agreements and other collateralized financings, payments of principal and interest we receive on our investment portfolio, cash generated from our operating results and, to the extent such transactions are entered into, proceeds from capital market and structured financing transactions. Our most significant uses of cash are generally to pay principal and interest on our financing transactions, to purchase residential mortgage assets, to make dividend payments on our capital stock, to fund our operations and to make other investments that we consider appropriate.

We seek to employ a diverse capital raising strategy under which we may issue capital stock and other types of securities. To the extent we raise additional funds through capital market transactions, we currently anticipate using the net proceeds from such transactions to acquire additional residential mortgage-related assets, consistent with our investment policy, and for working capital, which may include, among other things, the repayment of our financing transactions. There can be no assurance, however, that we will be able to access the capital markets at any particular time or on any particular terms. We have available for issuance an unlimited amount (subject to the terms and limitations of our charter) of common stock, preferred stock, depositary shares representing preferred stock, warrants, debt securities, rights and/or units pursuant to our automatic shelf registration statement and, at June 30, 2018, we had 12.0 million shares of common stock available for issuance pursuant to our DRSPP shelf registration statement. During the six months ended June 30, 2018, we issued 237,533 shares of common stock through our DRSPP, raising net proceeds of approximately $1.7 million. On May 10, 2017, we closed on the sale of 23,000,000 shares of common stock, including 3,000,000 shares purchased pursuant to the exercise of the underwriters' option to purchase additional shares, for gross proceeds of approximately $178.7 million before deducting estimated offering expenses.

Our borrowings under repurchase agreements are uncommitted and renewable at the discretion of our lenders and, as such, our lenders could determine to reduce or terminate our access to future borrowings at virtually any time. The terms of the repurchase transaction borrowings under our master repurchase agreements, as such terms relate to repayment, margin requirements and the segregation of all securities that are the subject of repurchase transactions, generally conform to the terms contained in the standard master repurchase agreement published by the Securities Industry and Financial Markets Association (or SIFMA) or the global master repurchase agreement published by SIFMA and the International Capital Market Association. In addition, each lender typically requires that we include supplemental terms and conditions to the standard master repurchase agreement. Typical supplemental terms and conditions, which differ by lender, may include changes to the margin maintenance requirements, required haircuts (as defined below), purchase price maintenance requirements, requirements that all controversies related to the repurchase agreement be litigated in a particular jurisdiction and cross default and setoff provisions.

With respect to margin maintenance requirements for repurchase agreements secured by harder to value assets, such as Non-Agency MBS, residential whole loans and MSR related assets, margin calls are typically determined by our counterparties based on their assessment of changes in the fair value of the underlying collateral and in accordance with the agreed upon haircuts specified in the transaction confirmation with the counterparty. We address margin call requests in accordance with the required terms specified in the applicable repurchase agreement and such requests are typically satisfied by posting additional cash or collateral on the same business day. We review margin calls made by counterparties and assess them for reasonableness by comparing the counterparty valuation against our valuation determination. When we believe that a margin call is unnecessary because our assessment of collateral value differs from the counterparty valuation, we typically hold discussions with the counterparty and are able to resolve the matter. In the unlikely event that resolution cannot be reached, we will look to resolve the dispute based on the remedies available to us under the terms of the repurchase agreement, which in some instances may include the engagement of a third-party to review collateral valuations. For other agreements that do not include such provisions, we could resolve the matter by substituting collateral as permitted in accordance with the agreement or otherwise request the counterparty to return the collateral in exchange for cash to unwind the financing.

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The following table presents information regarding the margin requirements, or the percentage amount by which the collateral value is contractually required to exceed the loan amount (this difference is referred to as the "haircut"), on our repurchase agreements at June 30, 2018 and December 31, 2017:

At June 30, 2018	Weighted Average Haircut	Low	High
Repurchase agreement borrowings secured by:			
Agency MBS	4.52 %	3.00 %	5.00 %
Legacy Non-Agency MBS	21.24	15.00	35.00
RPL/NPL MBS	22.01	15.00	30.00
U.S. Treasury securities	1.00	1.00	1.00
CRT securities	20.43	15.00	25.00
MSR related assets	21.70	20.00	30.00
Residential whole loans	25.55	20.00	34.00

At December 31, 2017	Weighted Average Haircut	Low	High
Repurchase agreement borrowings secured by:			
Agency MBS	4.65 %	3.00 %	8.00 %
Legacy Non-Agency MBS	21.87	15.00	35.00
RPL/NPL MBS	22.05	20.00	27.50
U.S. Treasury securities	1.47	1.00	2.00
CRT securities	22.16	15.00	25.00
MSR related assets	33.19	30.00	50.00
Residential whole loans	26.10	20.00	35.00

During the first six months of 2018, the weighted average haircut requirements for the respective underlying collateral types for our repurchase agreements have remained fairly consistent compared to the end of 2017. Weighted average haircuts have decreased on MSR related assets and CRT securities.

Repurchase agreement funding for our residential mortgage investments has been available to us at generally attractive market terms from multiple counterparties. Typically, due to the risks inherent in credit sensitive residential mortgage investments, repurchase agreement funding involving such investments is available at terms requiring higher collateralization and higher interest rates than repurchase agreement funding secured by Agency MBS and U.S. Treasury securities. Therefore, we generally expect to be able to finance our acquisitions of Agency MBS on more favorable terms than financing for credit sensitive investments.

We maintain cash and cash equivalents, unpledged Agency and Non-Agency MBS and collateral in excess of margin requirements held by our counterparties (or collectively, "cash and other unpledged collateral") to meet routine margin calls and protect against unforeseen reductions in our borrowing capabilities. Our ability to meet future margin calls will be impacted by our ability to use cash or obtain financing from unpledged collateral, which can vary based on the market value of such collateral, our cash position and margin requirements. Our cash position fluctuates based on the timing of our operating, investing and financing activities and is managed based on our anticipated cash needs. (See our Consolidated Statements of Cash Flows, included under Item 1 of this Quarterly Report on Form 10-Q and "Interest Rate Risk" included under Item 3 of this Quarterly Report on Form 10-Q.)

At June 30, 2018, we had a total of $7.2 billion of MBS, U.S. Treasury securities, CRT securities, residential whole loans and MSR related assets and $3.3 million of restricted cash pledged against our repurchase agreements. At June 30, 2018, we have access to various sources of liquidity which we estimate exceeds $606.4 million. This includes (i) $54.9 million of cash and cash equivalents; (ii) $172.0 million in estimated financing available from unpledged Agency MBS and U.S. Treasury securities and other Agency MBS collateral that is currently pledged in excess of contractual requirements; and (iii) $379.5 million in estimated financing available from unpledged Non-Agency MBS and from other Non-Agency MBS and CRT collateral that is currently pledged in excess of contractual requirements. Our sources of liquidity do not include restricted cash. In addition, we have $877.1

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million of unencumbered residential whole loans. We are evaluating potential opportunities to finance these assets including loan securitization.

The table below presents certain information about our borrowings under repurchase agreements and securitized debt:

	Repurchase Agreements			Securitized Debt		
Quarter Ended (1)	Quarterly Average Balance	End of Period Balance	Maximum Balance at Any Month-End	Quarterly Average Balance	End of Period Balance	Maximum Balance at Any Month-End
(In Thousands)						
June 30, 2018	$6,189,916	$ 5,892,228	$ 6,319,178	$432,283	$ 518,655	$ 523,490
March 31, 2018	6,519,390	6,558,860	6,558,860	357,819	351,278	361,002
December 31, 2017	6,661,020	6,614,701	6,760,360	212,445	363,944	363,944
September 30, 2017	7,022,913	6,871,443	7,023,702	139,276	137,327	141,088
June 30, 2017	7,612,393	7,040,844	7,763,860	30,414	143,698	143,698

(1) The information presented in the table above excludes Senior Notes issued in April 2012. The outstanding balance of Senior Notes has been unchanged at $100.0 million since issuance.

Cash Flows and Liquidity for the Six Months Ended June 30, 2018

Our cash, cash equivalents and restricted cash decreased by $404.9 million during the six months ended June 30, 2018, reflecting: $715.3 million used in our financing activities; $266.6 million provided by our investing activities; and $43.8 million provided by our operating activities.

At both June 30, 2018 and December 31, 2017, our debt-to-equity multiple was 2.3 times. At June 30, 2018, we had borrowings under repurchase agreements of $5.9 billion with 26 counterparties, of which $2.1 billion were secured by Agency MBS, $1.4 billion were secured by Legacy Non-Agency MBS, $499.3 million were secured by RPL/NPL MBS, $220.9 million were secured by U.S. Treasuries, $410.2 million were secured by CRT securities, $297.1 million were secured by MSR related assets and $988.8 million were secured by residential whole loans. We continue to have available capacity under our repurchase agreement credit lines. In addition, at June 30, 2018, we had securitized debt of $518.7 million in connection with our loan securitization transactions. At December 31, 2017, we had borrowings under repurchase agreements of $6.6 billion with 31 counterparties, of which $2.5 billion were secured by Agency MBS, $1.3 billion were secured by Legacy Non-Agency MBS, $567.1 million were secured by RPL/NPL MBS, $470.3 million were secured by U.S. Treasuries, $459.1 million were secured by CRT securities, $317.3 million were secured by MSR related assets and $1.0 billion were secured by residential whole loans. In addition, at December 31, 2017, we had securitized debt of $363.9 million in connection with our loan securitization transactions.

During the six months ended June 30, 2018, $266.6 million was provided by our investing activities. We paid $943.4 million for purchases of residential whole loans and capitalized advances, and purchased $162.4 million of MSR related assets, $140.4 million of Non-Agency MBS, and $20.6 million of CRT securities funded with cash and repurchase agreement borrowings. In addition, during the six months ended June 30, 2018, we received cash of $1.1 billion from prepayments and scheduled amortization on our MBS, CRT securities and MSR related assets, of which $354.4 million was attributable to Agency MBS, $470.0 million was from Non-Agency MBS, $9.2 million was from CRT securities and $274.2 million was attributable to MSR related assets, and we sold certain of our investment securities for $198.4 million, realizing net gains of $16.2 million. While we generally intend to hold our MBS and CRT securities as long-term investments, we may sell certain of our securities in order to manage our interest rate risk and liquidity needs, meet other operating objectives and adapt to market conditions. During the six months ended June 30, 2018 we received $174.7 million of principal payments on residential whole loans and $58.2 million of proceeds on sales of REO.

In connection with our repurchase agreement borrowings and Swaps, we routinely receive margin calls/reverse margin calls from our counterparties and make margin calls to our counterparties. Margin calls and reverse margin calls, which requirements vary over time, may occur daily between us and any of our counterparties when the value of collateral pledged changes from the amount contractually required. The value of securities pledged as collateral fluctuates reflecting changes in: (i) the face (or par) value of our MBS; (ii) market interest rates and/or other market conditions; and (iii) the market value of our Swaps. Margin calls/reverse margin calls are satisfied when we pledge/receive additional collateral in the form of additional securities and/or cash.

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The table below summarizes our margin activity with respect to our repurchase agreement financings for the quarterly periods presented:

	Collateral Pledged to Meet Margin Calls				
For the Quarter Ended (1)	Fair Value of Securities Pledged	Cash Pledged	Aggregate Assets Pledged For Margin Calls	Cash and Securities Received for Reverse Margin Calls	Net Assets Received/(Pledged) for Margin Activity
(In Thousands)					
June 30, 2018	$ 44,278	$ —	$ 44,278	$ 20,001	$ (24,277)
March 31, 2018	40,831	—	40,831	18,835	(21,996)
December 31, 2017	87,960	—	87,960	80,105	(7,855)
September 30, 2017	83,513	—	83,513	53,499	(30,014)
June 30, 2017	106,432	500	106,932	75,996	(30,936)

(1) Excludes variation margin payments on the Company's cleared Swaps which are treated as a legal settlement of the exposure under the Swap contract.

We are subject to various financial covenants under our repurchase agreements and derivative contracts, which include minimum net worth and/or profitability requirements, maximum debt-to-equity ratios and minimum market capitalization requirements. We have maintained compliance with all of our financial covenants through June 30, 2018.

During the six months ended June 30, 2018, we paid $159.7 million for cash dividends on our common stock and dividend equivalents and paid cash dividends of $7.5 million on our preferred stock. On June 7, 2018, we declared our second quarter 2018 dividend on our common stock of $0.20 per share; on July 31, 2018, we paid this dividend, which totaled approximately $79.9 million, including dividend equivalents of approximately $241,000.

We believe that we have adequate financial resources to meet our current obligations, including margin calls, as they come due, to fund dividends we declare and to actively pursue our investment strategies. However, should the value of our MBS suddenly decrease, significant margin calls on our repurchase agreement borrowings could result and our liquidity position could be materially and adversely affected. Further, should market liquidity tighten, our repurchase agreement counterparties may increase our margin requirements on new financings, reducing our ability to use leverage. Access to financing may also be negatively impacted by the ongoing volatility in the world financial markets, potentially adversely impacting our current or potential lenders' ability or willingness to provide us with financing. In addition, there is no assurance that favorable market conditions will continue to permit us to consummate additional securitization transactions if we determine to seek that form of financing.

Off-Balance Sheet Arrangements

We have not participated in transactions that create relationships with unconsolidated entities or financial partnerships which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

Inflation

Substantially all of our assets and liabilities are financial in nature. As a result, changes in interest rates and other factors impact our performance far more than does inflation. Our results of operations and reported assets, liabilities and equity are measured with reference to historical cost or fair value without considering inflation.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk.

We seek to manage our risks related to interest rates, liquidity, prepayment speeds, market value and the credit quality of our assets while, at the same time, seeking to provide an opportunity to stockholders to realize attractive total returns through ownership of our capital stock. While we do not seek to avoid risk, we seek, consistent with our investment policies, to: assume risk that can be quantified based on management's judgment and experience and actively manage such risk; earn sufficient returns to justify the taking of such risks; and maintain capital levels consistent with the risks that we undertake.

Interest Rate Risk

We generally acquire interest-rate sensitive assets and fund them with interest-rate sensitive liabilities, a portion of which are hedged with Swaps. We are exposed to interest rate risk on our residential mortgage assets, as well as on our liabilities. Changes in interest rates can affect our net interest income and the fair value of our assets and liabilities.

We finance the majority of our investments in residential mortgage assets with short-term repurchase agreements. In general, when interest rates change, the borrowing costs of our repurchase agreements (net of the impact of Swaps) change more quickly than the yield on our assets. In a rising interest rate environment, the borrowing costs of our repurchase agreements may increase faster than the interest income on our assets, thereby reducing our net income. In order to mitigate compression in net income based on such interest rate movements, we use Swaps to lock in a portion of the net interest spread between assets and liabilities.

When interest rates change, the fair value of our residential mortgage assets could change at a different rate than the fair value of our liabilities. We measure the sensitivity of our portfolio to changes in interest rates by estimating the duration of our assets and liabilities. Duration is the approximate percentage change in fair value for a 100 basis point parallel shift in the yield curve. In general, our assets have higher duration than our liabilities and in order to reduce this exposure we use Swaps to reduce the gap in duration between our assets and liabilities.

In calculating the duration of our Agency MBS we take into account the characteristics of the underlying mortgage loans including whether the underlying loans are fixed rate, adjustable or hybrid; coupon, expected prepayment rates and lifetime and periodic caps. We use third-party financial models, combined with management's assumptions and observed empirical data when estimating the duration of our Agency MBS.

In analyzing the interest rate sensitivity of our Legacy Non-Agency MBS we take into account the characteristics of the underlying mortgage loans, including credit quality and whether the underlying loans are fixed-rate, adjustable or hybrid. We estimate the duration of our Legacy Non-Agency MBS using management's assumptions.

The majority of our RPL/NPL MBS deal structures contain a contractual coupon step-up feature where the coupon increases up to 300 basis points at 36 months from issuance or sooner. Therefore, we believe their fair value exhibits little sensitivity to changes in interest rates. We estimate the duration of these securities using management's assumptions.

The fair value of our re-performing residential whole loans is dependent on the value of the underlying real estate collateral, past and expected delinquency status of the borrower as well as the level of interest rates. Because the borrower is not delinquent on their mortgage payments but is less likely to prepay the loan due to weak credit history and/or high LTV, we believe our re-performing residential whole loans exhibit positive duration. We estimate the duration of our re-performing residential whole loans using management's assumptions.

The fair value of our Non-QM loans and Single family rental loans are dependent on the value of the underlying real estate collateral, as well as the level of interest rates. Because these loans are primarily newly or recently originated performing loans, we believe these investments exhibit positive duration. Given the short duration of the Company’s Rehabilitation loans, we believe the fair value of these loans exhibits little sensitivity to changes in interest rates. We estimate the duration of these other loans held at carrying value using management’s assumptions.

The fair value of our non-performing residential whole loans is primarily dependent on the value of the underlying real estate collateral and the time required for collateral liquidation. Since neither the value of the collateral nor the liquidation timeline is generally sensitive to interest rates, we believe their fair value exhibits little sensitivity to interest rates. We estimate the duration of our non-performing residential whole loans using management’s assumptions.

We use Swaps as part of our overall interest rate risk management strategy. Such derivative financial instruments are intended to act as a hedge against future interest rate increases on our repurchase agreement financings, which rates are typically highly

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correlated with LIBOR. While our derivatives do not extend the maturities of our borrowings under repurchase agreements, they do, in effect, lock in a fixed rate of interest over their term for a corresponding amount of our repurchase agreement financings that are hedged.

At June 30, 2018, MFA's $4.7 billion of Agency MBS and Legacy Non-Agency MBS were backed by Hybrid, adjustable and fixed-rate mortgages. Additional information about these MBS, including average months to reset and three-month average CPR, is presented below:

	Agency MBS			Legacy Non-Agency MBS (1)			Total (1)		
Time to Reset	Fair Value (2)	Average Months to Reset (3)	3 Month Average CPR (4)	Fair Value	Average Months to Reset (3)	3 Month Average CPR (4)	Fair Value (2)	Average Months to Reset (3)	3 Month Average CPR (4)
(Dollars in Thousands)									
< 2 years (5)	$1,275,911	6	21.2 %	$1,538,689	5	16.2 %	$2,814,600	5	18.4 %
2-5 years	146,586	45	13.2	—	—	—	146,586	45	13.2
> 5 years	10,128	84	11.5	—	—	—	10,128	84	11.5
ARM-MBS Total	$1,432,625	11	20.3 %	$1,538,689	5	16.2 %	$2,971,314	8	18.1 %
15-year fixed (6)	$929,094		10.4 %	$2,370		4.0 %	$931,464		10.3 %
30-year fixed (6)	—		—	757,623		15.2	757,623		15.2
40-year fixed (6)	—		—	36,408		14.2	36,408		14.2
Fixed-Rate Total	$929,094		10.4 %	$796,401		15.1 %	$1,725,495		12.6 %
MBS Total	$2,361,719		16.2 %	$2,335,090		15.8 %	$4,696,809		16.0 %

(1) Excludes $907.9 million of RPL/NPL MBS. Refer to table below for further information.
(2) Does not include principal payments receivable of $1.2 million.
(3) Months to reset is the number of months remaining before the coupon interest rate resets. At reset, the MBS coupon will adjust based upon the underlying benchmark interest rate index, margin and periodic and/or lifetime caps. The months to reset do not reflect scheduled amortization or prepayments.
(4) 3 month average CPR weighted by positions as of the beginning of each month in the quarter.
(5) Includes floating-rate MBS that may be collateralized by fixed-rate mortgages.
(6) Information presented based on data available at time of loan origination.

The following table presents certain information about our RPL/NPL MBS portfolio at June 30, 2018:

	Fair Value	Net Coupon	Months to Step-Up (1)	3 Month Average Bond CPR (2)
(Dollars in Thousands)				
Re-Performing loans	$7,945	3.88 %	26	86.1 %
Non-Performing loans	899,932	4.54	20	18.1
Total RPL/NPL MBS	$907,877	4.53 %	20	20.4 %

(1) Months to step-up is the weighted average number of months remaining before the coupon interest rate increases pursuant to the first coupon reset. We anticipate that the securities will be redeemed prior to the step-up date.
(2) All principal payments are considered to be prepayments for CPR purposes.

At June 30, 2018, our CRT securities and MSR related assets had a fair value of $572.0 million and $381.4 million, respectively, and their coupons reset monthly based on one-month LIBOR.

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Shock Table

The information presented in the following “Shock Table” projects the potential impact of sudden parallel changes in interest rates on our net interest income and portfolio value, including the impact of Swaps, over the next 12 months based on the assets in our investment portfolio at June 30, 2018. All changes in income and value are measured as the percentage change from the projected net interest income and portfolio value under the base interest rate scenario at June 30, 2018.

Change in Interest Rates	Estimated Value of Assets (1)	Estimated Value of Swaps	Estimated Value of Financial Instruments	Change in Estimated Value	Percentage Change in Net Interest Income	Percentage Change in Portfolio Value
(Dollars in Thousands)						
+100 Basis Point Increase	$10,130,059	$59,761	$10,189,820	$(124,151)	(3.80)%	(1.20)%
+ 50 Basis Point Increase	$10,214,525	$37,960	$10,252,485	$(61,486)	(1.78)%	(0.60)%
Actual at June 30, 2018	$10,297,811	$16,160	$10,313,971	$—	—	—
- 50 Basis Point Decrease	$10,379,916	$(5,641)	$10,374,275	$60,304	(0.24)%	0.58%
-100 Basis Point Decrease	$10,460,840	$(27,441)	$10,433,399	$119,428	(0.70)%	1.16%

(1) Such assets include MBS and CRT securities, residential whole loans and REO, MSR related assets, cash and cash equivalents and restricted cash.

Certain assumptions have been made in connection with the calculation of the information set forth in the Shock Table and, as such, there can be no assurance that assumed events will occur or that other events will not occur that would affect the outcomes. The base interest rate scenario assumes interest rates at June 30, 2018. The analysis presented utilizes assumptions and estimates based on management’s judgment and experience. Furthermore, while we generally expect to retain the majority of our assets and the associated interest rate risk to maturity, future purchases and sales of assets could materially change our interest rate risk profile. It should be specifically noted that the information set forth in the above table and all related disclosure constitute forward-looking statements within the meaning of Section 27A of the 1933 Act and Section 21E of the 1934 Act. Actual results could differ significantly from those estimated in the Shock Table above.

The Shock Table quantifies the potential changes in net interest income and portfolio value, which includes the value of our Swaps (which are carried at fair value), should interest rates immediately change (i.e., are shocked). The Shock Table presents the estimated impact of interest rates instantaneously rising 50 and 100 basis points, and falling 50 and 100 basis points. The cash flows associated with our portfolio of MBS for each rate shock are calculated based on assumptions, including, but not limited to, prepayment speeds, yield on replacement assets, the slope of the yield curve and composition of our portfolio. Assumptions made with respect to the interest rate sensitive liabilities include anticipated interest rates, collateral requirements as a percent of repurchase agreement financings, and the amounts and terms of borrowing. At June 30, 2018, we applied a floor of 0% for all anticipated interest rates included in our assumptions. Due to this floor, it is anticipated that any hypothetical interest rate shock decrease would have a limited positive impact on our funding costs; however, because prepayments speeds are unaffected by this floor, it is expected that any increase in our prepayment speeds (occurring as a result of any interest rate shock decrease or otherwise) could result in an acceleration of premium amortization on our Agency MBS and discount accretion on our Non-Agency MBS and in the reinvestment of principal repayments in lower yielding assets. As a result, because the presence of this floor limits the positive impact of interest rate decrease on our funding costs, hypothetical interest rate shock decreases could cause a decline in the fair value of our financial instruments and our net interest income.

At June 30, 2018, the impact on portfolio value was approximated using estimated effective duration (i.e., the price sensitivity to changes in interest rates), including the effect of Swaps, of 1.19 which is the weighted average of 1.75 for our Agency MBS, 0.88 for our Non-Agency investments, 2.50 for our Residential whole loans, (1.67) for our Swaps, and 0.19 for our Other assets and cash and cash equivalents. Estimated convexity (i.e., the approximate change in duration relative to the change in interest rates) of the portfolio was (0.05), which is the weighted average of (0.20) for our Agency MBS, zero for our Swaps, zero for our Non-Agency MBS, zero for our Residential whole loans and zero for our Other assets and cash and cash equivalents. The impact on our net interest income is driven mainly by the difference between portfolio yield and cost of funding of our repurchase agreements, which includes the cost and/or benefit from Swaps. Our asset/liability structure is generally such that an increase in interest rates would be expected to result in a decrease in net interest income, as our borrowings are generally shorter in term than our interest-earning assets. When interest rates are shocked, prepayment assumptions are adjusted based on management's expectations along with the results from the prepayment model.

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Credit Risk

Although we do not believe that we are exposed to credit risk in our Agency MBS portfolio, we are exposed to credit risk through our credit-sensitive residential mortgage investments, in particular Legacy Non-Agency MBS and residential whole loans and to a lesser extent our investments in RPL/NPL MBS, CRT securities and MSR related assets. Our exposure to credit risk from our credit sensitive investments is discussed in more detail below:

Legacy Non-Agency MBS

Our investment process for Legacy Non-Agency MBS involves analysis focused primarily on quantifying and pricing credit risk. When we purchase Legacy Non-Agency MBS, we assign certain assumptions to each of the MBS, including but not limited to, future interest rates, voluntary prepayment rates, mortgage modifications, default rates and loss severities, and generally allocate a portion of the purchase discount as a Credit Reserve which provides credit protection for such securities. As part of our surveillance process, we review our Legacy Non-Agency MBS by tracking their actual performance compared to the securities' expected performance at purchase or, if we have modified our original purchase assumptions, compared to our revised performance expectations. To the extent that actual performance of a Legacy Non-Agency MBS is less favorable than its expected performance, we may revise our performance expectations. As a result, we could reduce the accretable discount on the security and/or recognize an other-than-temporary impairment through earnings, either of which could have a material adverse impact on our operating results.

In evaluating our asset/liability management and Legacy Non-Agency MBS credit performance, we consider the credit characteristics of the mortgage loans underlying our Legacy Non-Agency MBS. The following table presents certain information about our Legacy Non-Agency MBS portfolio at June 30, 2018. Information presented with respect to the weighted average Fair Isaac Corporation (or FICO) scores and other information aggregated based on information reported at the time of mortgage origination are historical and, as such, do not reflect the impact of the general changes in home prices or changes in borrowers' credit scores or the current use of the mortgaged properties.

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The information in the table below is presented as of June 30, 2018:

	Securities with Average Loan FICO of 715 or Higher (1)			Securities with Average Loan FICO Below 715 (1)			
Year of Securitization (2)	2007	2006	2005 and Prior	2007	2006	2005 and Prior	Total
(Dollars in Thousands)							
Number of securities	84	61	82	32	57	65	381
MBS current face (3)	$696,816	$411,701	$436,047	$157,071	$399,145	$408,669	$2,509,449
Total purchase discounts, net (3)	$(213,994)	$(123,724)	$(90,883)	$(52,707)	$(156,082)	$(116,578)	$(753,968)
Purchase discount designated as Credit Reserve and OTTI (3)(4)	$(150,333)	$(62,509)	$(54,302)	$(42,516)	$(152,420)	$(91,517)	$(553,597)
Purchase discount designated as Credit Reserve and OTTI as percentage of current face	21.6%	15.2%	12.5%	27.1%	38.2%	22.4%	22.1%
MBS amortized cost (3)	$482,822	$287,977	$345,164	$104,364	$243,063	$292,091	$1,755,481
MBS fair value (3)	$649,085	$386,782	$418,519	$144,315	$348,120	$385,438	$2,332,259
Weighted average fair value to current face	93.2%	93.9%	96.0%	91.9%	87.2%	94.3%	92.9%
Weighted average coupon (5)	4.34%	3.73%	4.06%	5.07%	5.10%	4.82%	4.44%
Weighted average loan age (months) (5)(6)	134	143	158	139	145	158	146
Weighted average current loan size (5)(6)	$494	$485	$292	$330	$244	$233	$365
Percentage amortizing (7)	100%	99%	100%	99%	99%	100%	100%
Weighted average FICO score at origination (5)(8)	729	728	726	705	702	703	718
Owner-occupied loans	91.1%	91.6%	86.6%	85.2%	86.6%	85.3%	88.4%
Rate-term refinancings	30.8%	22.3%	14.4%	22.6%	15.4%	14.7%	20.9%
Cash-out refinancings	35.1%	35.7%	27.9%	44.2%	45.8%	39.6%	36.9%
3 Month CPR (6)	16.5%	17.2%	18.0%	14.9%	15.3%	14.3%	16.2%
3 Month CRR (6)(9)	13.2%	13.3%	16.1%	11.0%	11.9%	12.0%	13.2%
3 Month CDR (6)(9)	4.1%	4.6%	2.4%	4.4%	4.2%	2.9%	3.7%
3 Month loss severity	45.3%	54.2%	43.5%	61.2%	64.5%	62.2%	53.7%
60+ days delinquent (8)	12.0%	10.5%	9.3%	14.5%	13.2%	11.6%	11.6%

Percentage of always current borrowers (Lifetime) (10)	28.5	%	29.0	%	37.1	%	25.5	%	21.6	%	26.7	%	28.5	%
Percentage of always current borrowers (12M) (11)	73.7	%	76.5	%	78.8	%	70.2	%	70.4	%	72.9	%	74.2	%

(1) FICO score is used by major credit bureaus to indicate a borrower's creditworthiness at time of loan origination.

(2) Information presented based on the initial year of securitization of the underlying collateral. Certain of our Non-Agency MBS have been resecuritized. The historical information presented in the table is based on the initial securitization date and data available at the time of original securitization (and not the date of resecuritization). No information has been updated with respect to any MBS that have been resecuritized.

(3) Excludes Non-Agency MBS issued since 2012 in which the underlying collateral consists of RPL/NPL MBS. These Non-Agency MBS have a current face of $909.3 million, amortized cost of $907.5 million, fair value of $907.9 million and purchase discounts of $1.8 million at June 30, 2018.

(4) Purchase discounts designated as Credit Reserve and OTTI are not expected to be accreted into interest income.

(5) Weighted average is based on MBS current face at June 30, 2018.

(6) Information provided is based on loans for individual groups owned by us.

(7) Percentage of face amount for which the original mortgage note contractually calls for principal amortization in the current period.

(8) Information provided is based on loans for all groups that provide credit enhancement for MBS with credit enhancement.

(9) CRR represents voluntary prepayments and CDR represents involuntary prepayments.

(10) Percentage of face amount of loans for which the borrower has not been delinquent since origination.

(11) Percentage of face amount of loans for which the borrower has not been delinquent in the last twelve months.

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The mortgages securing our Legacy Non-Agency MBS are located in many geographic regions across the United States. The following table presents the five largest geographic concentrations by state of the mortgages collateralizing our Legacy Non-Agency MBS at June 30, 2018:

Property Location	Percent of Unpaid Principal Balance
California	42.2 %
Florida	8.0 %
New York	7.1 %
New Jersey	4.0 %
Maryland	4.0 %

RPL/NPL MBS

These securities are backed by re-performing and non-performing loans, were purchased primarily at prices around par and represent the senior and mezzanine tranches of the related securitizations. The majority of these securities are structured with significant credit enhancement (typically approximately 50%) and the subordinate tranches absorb all credit losses (until those tranches are extinguished) and typically receive no cash flow (interest or principal) until the senior tranche is paid off. Prior to purchase, we analyze the deal structure in order to assess the associated credit risk. Subsequent to purchase, the ongoing credit risk associated with the deal is evaluated by analyzing the extent to which actual credit losses occur that result in a reduction in the amount of subordination enjoyed by our bond.

CRT Securities

We are exposed to potential credit losses from our investments in CRT securities issued by Fannie Mae and Freddie Mac. While CRT securities are debt obligations of these GSEs, payment of principal on these securities is not guaranteed. As an investor in a CRT security, we may incur a loss if losses on the mortgage loans in the reference pool exceed the credit enhancement on the underlying CRT security owned by us. We assess the credit risk associated with our investments in CRT securities by assessing the current and expected future performance of the associated reference pool.

MSR Related Assets

Term Notes

We have invested in certain term notes that are issued by SPVs that have acquired rights to receive cash flows representing the servicing fees and/or excess servicing spread associated with certain MSRs. Payment of principal and interest on these term notes is considered by us to be largely dependent on the cash flows generated by the underlying MSRs as this impacts the cash flows available to the SPV that issued the term notes. Credit risk borne by the holders of the term notes is also mitigated by structural credit support in the form of over-collateralization. In addition, credit support is also provided by a corporate guarantee from the ultimate parent or sponsor of the SPV that is intended to provide for payment of interest and principal to the holders of the term notes should cash flows generated by the underlying MSRs be insufficient.

Residential Whole Loans

We are also exposed to credit risk from our investments in residential whole loans. Our investment process for residential whole loans is generally similar to that used for Legacy Non-Agency MBS and is likewise focused on quantifying and pricing credit risk. Consequently, the majority of these loans are acquired at purchase prices that are generally discounted (particularly for purchased credit impaired loans) to the contractual loan balances based on a number of factors, including the impaired credit history of the borrower and the value of the collateral securing the loan. In addition, as we generally own the master-servicing rights associated with loans in our portfolio, our process is also focused on selecting a sub-servicer with the appropriate expertise to mitigate losses and maximize our overall return. This involves, among other things, performing due diligence on the sub-servicer prior to their engagement as well as ongoing oversight and surveillance. To the extent that loan delinquencies and defaults are higher than our expectation at the time the loans were purchased, the discounted purchase price at which the asset is acquired is intended to provide a level of protection against financial loss.

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The following table presents the five largest geographic concentrations by state of our residential whole loan portfolio at June 30, 2018:

Property Location	Percent of Interest-Bearing Unpaid Principal Balance (1)	
California	27.4	%
New York	12.3	%
Florida	9.6	%
New Jersey	7.1	%
Maryland	4.3	%

(1) Excludes approximately $506.9 million of residential whole loans for which the closing of the purchase transaction had not occurred as of June 30, 2018.

Liquidity Risk

The primary liquidity risk we face arises from financing long-maturity assets with shorter-term borrowings primarily in the form of repurchase agreement financings. We pledge residential mortgage assets and cash to secure our repurchase agreements and Swaps. At June 30, 2018, we had access to various sources of liquidity which we estimate to be in excess of $606.4 million, an amount which includes: (i) $54.9 million of cash and cash equivalents, (ii) $172.0 million in estimated financing available from unpledged Agency MBS and U.S. Treasury securities and other Agency MBS collateral that are currently pledged in excess of contractual requirements, and (iii) $379.5 million in estimated financing available from currently unpledged Non-Agency MBS and from other Non-Agency MBS and CRT collateral that is currently pledged in excess of contractual requirements. Our sources of liquidity do not include restricted cash. In addition, we have $877.1 million of unencumbered residential whole loans. We are evaluating potential opportunities to finance these assets including loan securitization. Should the value of our residential mortgage assets pledged as collateral suddenly decrease, margin calls under our repurchase agreements would likely increase, causing an adverse change in our liquidity position. Additionally, if one or more of our financing counterparties chose not to provide ongoing funding, our ability to finance our long-maturity assets would decline or be available on possibly less advantageous terms. As such, we cannot assure you that we will always be able to roll over our repurchase agreement financings. Further, should market liquidity tighten, our repurchase agreement counterparties may increase our margin requirements on new financings, including repurchase agreement borrowings that we roll with the same counterparty, reducing our ability to use leverage.

Prepayment Risk

Premiums arise when we acquire an MBS or loan at a price in excess of the aggregate principal balance of the mortgages securing the MBS (i.e., par value) or when we acquire residential whole loans at a price in excess of their aggregate principal balance. Conversely, discounts arise when we acquire an MBS or loan at a price below the aggregate principal balance of the mortgages securing the MBS or when we acquire residential whole loans at a price below their aggregate principal balance. Premiums paid are amortized against interest income and accretable purchase discounts on these investments are accreted to interest income. Purchase premiums, which are primarily carried on our Agency MBS, certain CRT securities and Non-QM loans, are amortized against interest income over the life of the investment using the effective yield method, adjusted for actual prepayment activity. An increase in the prepayment rate, as measured by the CPR, will typically accelerate the amortization of purchase premiums, thereby reducing the interest income earned on these assets. Generally, if prepayments on Non-Agency MBS and residential whole loans purchased at significant discounts and not accounted for at fair value are less than anticipated, we expect that the income recognized on these assets will be reduced and impairments and/or loan loss reserves may result.

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Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

Management, under the direction of its Chief Executive Officer and Chief Financial Officer, is responsible for maintaining disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the 1934 Act) that are designed to ensure that information required to be disclosed in reports filed or submitted under the 1934 Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms and that such information is accumulated and communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosures.

In connection with the preparation of this Quarterly Report on Form 10-Q, management reviewed and evaluated the Company's disclosure controls and procedures. The evaluation was performed under the direction of the Company's Chief Executive Officer and Chief Financial Officer to determine the effectiveness, as of June 30, 2018, of the design and operation of the Company's disclosure controls and procedures. Based on that review and evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that the Company's current disclosure controls and procedures, as designed and implemented, were effective as of June 30, 2018. Notwithstanding the foregoing, a control system, no matter how well designed, implemented and operated, can provide only reasonable, not absolute, assurance that it will detect or uncover failures within the Company to disclose material information otherwise required to be set forth in the Company's current periodic reports.

(b) Changes in Internal Control over Financial Reporting

There have been no changes in the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2018 that materially affected, or are reasonably likely to materially affect, its internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

There are no material pending legal proceedings to which we are a party or any of our assets are subject.

Item 1A. Risk Factors

For a discussion of the Company's risk factors, see Part 1, Item 1A. "Risk Factors" of the Company's Annual Report on Form 10-K for the year ended December 31, 2017. There are no material changes from the risk factors set forth in such Annual Report on Form 10-K. However, the risks and uncertainties that the Company faces are not limited to those set forth in the Company's Annual Report on Form 10-K for the year ended December 31, 2017. Additional risks and uncertainties not currently known to the Company (or that it currently believes to be immaterial) may also adversely affect the Company's business and the trading price of our securities.

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

Purchases of Equity Securities

As previously disclosed, in August 2005, the Company's Board authorized a Repurchase Program, to repurchase up to 4.0 million shares of the Company's outstanding common stock under the Repurchase Program. The Board reaffirmed such authorization in May 2010. In December, 2013, the Company's Board increased the number of shares authorized for repurchase to an aggregate of 10.0 million shares (under which approximately 6.6 million shares remain available for repurchase). Such authorization does not have an expiration date and, at present, there is no intention to modify or otherwise rescind such authorization. Subject to applicable securities laws, repurchases of common stock under the Repurchase Program are made at times and in amounts as we deem appropriate (including, in our discretion, through the use of one or more plans adopted under Rule 10b-5-1 promulgated under the 1934 Act), using available cash resources. Shares of common stock repurchased by the Company under the Repurchase Program are cancelled and, until reissued by the Company, are deemed to be authorized but unissued shares of the Company's common stock. The Repurchase Program may be suspended or discontinued by the Company at any time and without prior notice.

The Company engaged in no share repurchase activity during the second quarter of 2018 pursuant to the Repurchase Program nor did it withhold any restricted shares (under the terms of grants under our Equity Plan) to offset tax withholding obligations that occur upon the vesting and release of restricted stock awards and/or RSUs.

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Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

Item 6. Exhibits

The list of exhibits required to be filed as exhibits to this report are listed on page E-1 hereof, under “Exhibit Index,” which is incorporated herein by reference.

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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.

Date: August 2, 2018 MFA FINANCIAL, INC.
(Registrant)

By: /s/ Stephen D. Yarad
Stephen D. Yarad
Chief Financial Officer
(Principal Financial Officer)

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EXHIBIT INDEX

The following exhibits are filed as part of this Quarterly Report:

Exhibit	Description
10.1	Amendment No. 1, dated March 28, 2018, to Employment Agreement, entered into as of November 4, 2016, by and between the Company and Craig L. Knutson (incorporated herein by reference to Exhibit 10.2 to the Company's Form 8-K, filed April 2, 2018 (Commission File No. 1-13991)).
10.2	Employment Agreement, entered into as of March 28, 2018, by and between the Company and Gudmundur Kristjansson (incorporated herein by reference to Exhibit 10.2 to the Company's Form 8-K, filed April 2, 2018 (Commission File No. 1-13991)).
10.3	Employment Agreement entered into as of March 28, 2018, by and between the Company and Bryan Wulfsohn (incorporated herein by reference to Exhibit 10.3 to the Company's Form 8-K, filed April 2, 2018 (Commission File No. 1-13991)).
31.1	Certification of the Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of the Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of the Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema Document
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document

*These interactive data files are furnished and deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.